

Why Canada Needs a Flexible Exchange Rate

Working Paper

By John Murray

International Department

Bank of Canada

July 1999

A Little History

- Great Depression convinced economists flexible exchange system inherently unstable.
- After World War Two, Bretton Woods System adopted.
- Countries obliged to declare a parity of value for each currency in terms of gold and U.S. dollars, with narrow band either side of parity.
- Bretton Woods system delivered “worst of both worlds”, was neither flexible nor strong (difficult to negotiate).

- Early 70's, Bretton Woods system collapsed.
- Since, Canada has operated under a flexible exchange system, for all but 10 of last 50 years.
- This is rare, of 181 countries in IMF, fewer than 20 can be said to operate under a true flexible exchange system (e.g. low level of international open market operations).
- Begg's question: why pursue flexible exchange rate policy?

Advantages of Flexible Exchange Rate System

- Monetary Policy Independence (impossible to have both fixed exchange rate and independent monetary policy).
- Automatic buffer or cushion against economic shocks.
- Helps stabilize economy by overcoming assumed nominal price and wage “stickiness”
- Allows real prices and wages to re-equilibrate.
- This can mitigate fluctuations in employment and output.
- Can more easily incorporate seigniorage.

How does flexible exchange offset sticky prices?

- (AD ↓ REAL GDP ↓ MD ↓ P ↓ R ↓ x-rate ↓)
- If prices are stuck firms will decrease output and layoff workers. Interest rates will drop anyway as banks want to lend, dollar will depreciate, exports will increase, price pressure will re-equilibriate

Disadvantages of Flexible Exchange Rate System

- Higher transaction costs associated with converting and hedging currencies.
- Higher uncertainty, which may impact decisions, like investment.
- Less efficient economic decision making on the part of entrepreneurs.
- Fixed exchange can improve operation of price system.
- Fixed exchange can enhance usefulness of money-medium of exchange/unit of account/store of value.

- Flexible exchange more volatile.
- Any movement in exchange up/down usually has political repercussions.
- Cannot easily mimic policies of country with history of superior economic performance.

Which system is better?

- Different countries have different political environments, different economic histories and different responses to economic “shocks”.
- There is no “better system”.
- This paper demonstrates why flexible exchange is better for Canada.

Refuting Criticism: Why flexible Exchange is Better for Canada

- Canada and U.S. Have similar institutional and structural environments. Why not peg Looney to Greenback, set adjustable peg, set up currency board or share one currency?

- Policy objectives may be different (Fed doesn't set explicit inflation target or define mandate to pursue growth/employment and price stability).
- Structures of economies are actually different.
- Currency union may result in “colonial” relationship, as Canadians would have very little say over the conduct of monetary policy under a union with the U.S.

Differences between Canada and U.S. Economic structures

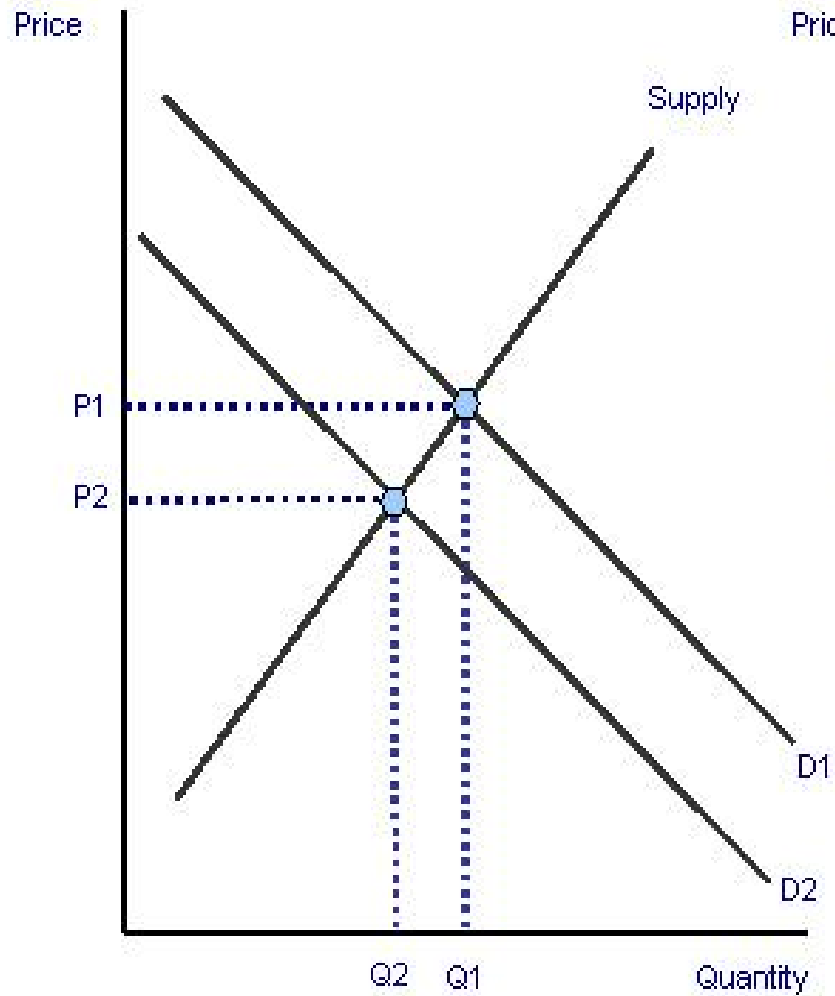
- Canada is more exposed to external shocks than the U.S.
- Canada sees terms of trade improve to sudden increases in commodity prices.
- U.S., sees terms of trade decline (and not just U.S., many of G10)

Evidence of Structural Differences

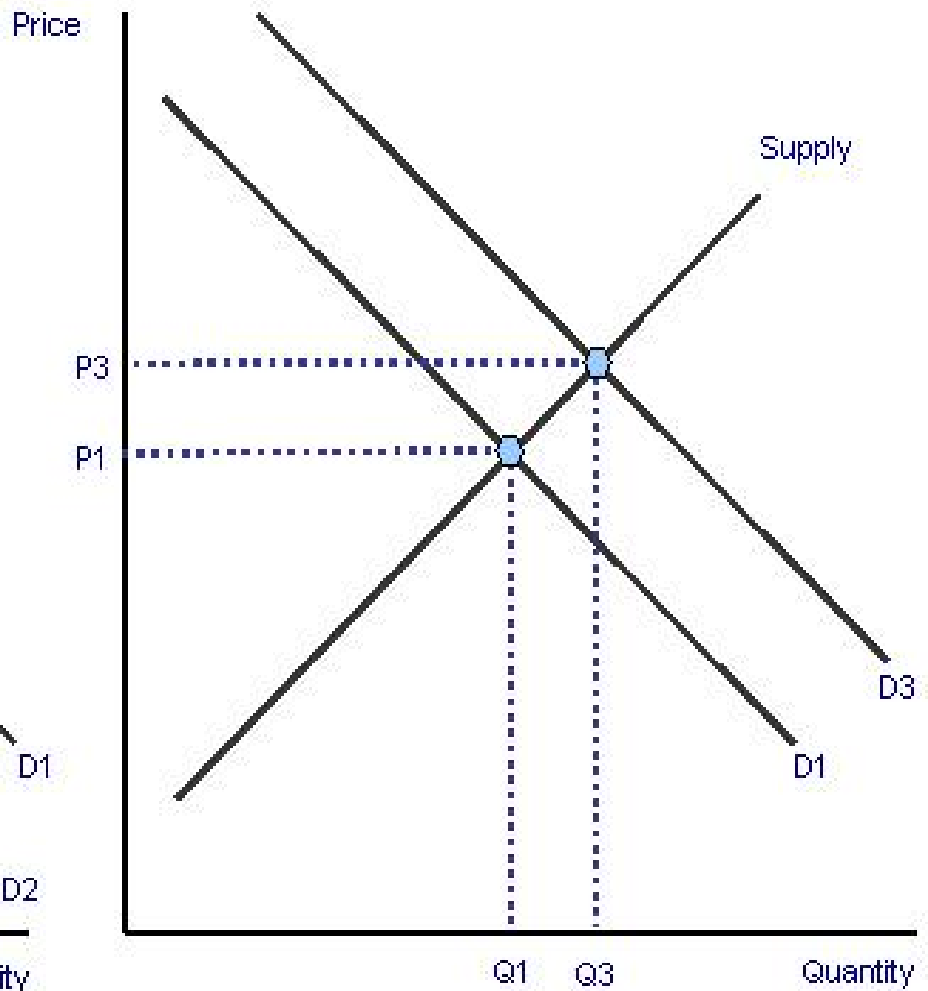
- Economists DeSerres and Lalonde, 1994, use Structural Vector Autoregressions (Vars).
- Results show U.S./Canada are subject to significant asymmetric shock.
- Are unlikely to form optimum currency area.
- If anything, optimal currency regions would run north to south dividing east and west.

- Asymmetric shock occurs when an event affects one economy or part of an economy more than another.
- (see “A Theory of Optimal Currency Areas” Robert A. Mundell)
- So, as Canada and U.S., are affected differently from economic shocks, monetary authorities in each country need to respond differently to internal and external shocks.

An Inward Shift in Demand



An Outward Shift in Demand



Another Criticism: Do Flexible Exchange Rates Hurt Productivity?

- If flexible exchange rates automatically adjust to preserve international competitiveness so CDN firms have less incentive to reinvest (and reinvest less), then yes.
- But more likely is U.S. Firms perform better due to their own achievements. So no.
- That is to say, any declines in standard of living (CDN) relative to U.S., are not caused by exchange rate depreciations.

Interesting to Note:

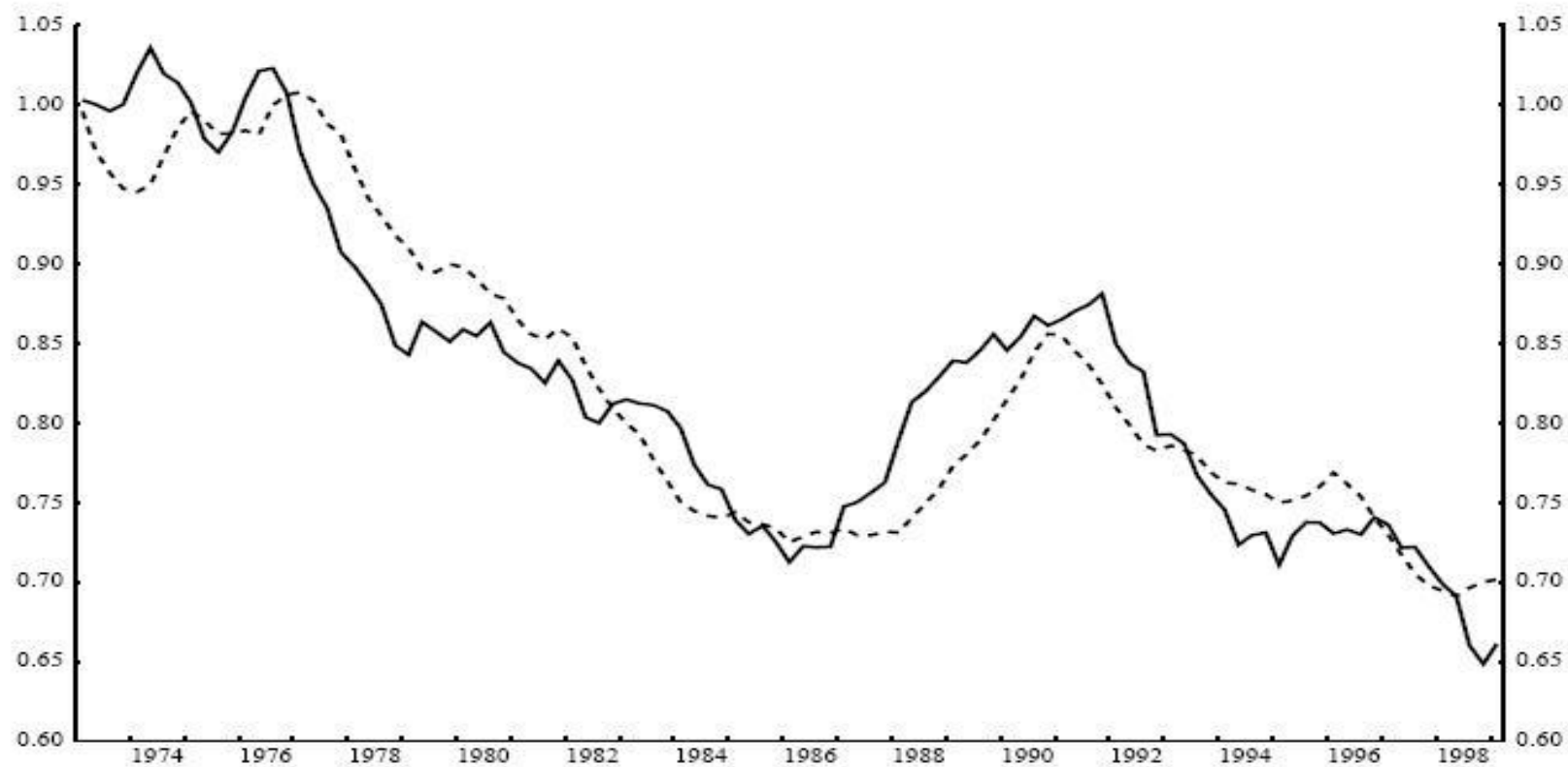
- Economists Robert Amano and Simon van Norden (1993) suggest that speculation is not as responsible for major movements in U.S./CDN exchange rate. Instead movements are due to:
 - Inflation differential
 - Relative Price of Energy
 - Relative price of non-energy commodities

Conclusion

- Flexible exchange does not appear to have misbehaved or subverted Canada's economic performance
- Concerns raised about the behaviour of the current flexible exchange rate system are mostly exaggerated or unsubstantiated
- Flexible exchange continues to offer important advantages for Canada, given the significant differences between Canadian/U.S. Economies and Canada's desire for policy independence

U.S. - Canada Exchange Rate

— Actual
- - - Predicted



Questions:

- What is an Asymmetric shock?
- Why aren't Canada and U.S. Optimal currency area?
- What three variables most affect Can/U.S. Exchange rate?
- Is China's recent rise in GDP due to its rolling or pegged exchange rate or to other causes?

