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Getting Talk Back on Target: The Exchange Rate and the Inflation Rate

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- Recent efforts by the Bank of Canada to "talk down" the dollar in its public statements have led to public perceptions that the Bank is considering action to weaken it.
- In permitting this response to gather momentum, the Bank has stepped onto a slippery slope, because if talk seems to be failing, people might reasonably expect direct intervention in the exchange market to follow.

Is the Canadian dollar too strong, and is the Bank of Canada considering action to weaken it? Although a careful parsing of the Bank's recent statements reveals a more nuanced message, too many people have extracted simple answers from them: "yes" and "yes."

The Bank needs to take more care than it has recently about encouraging such expectations. Its announcements, no less than its actions, should first and foremost stress the control of inflation. It is the job of markets to find the exchange rate compatible with the timely restoration of CPI inflation to 2 percent. The changes in international economic circumstances that have been driving the currency's recent appreciation are not things the Bank of Canada can control.

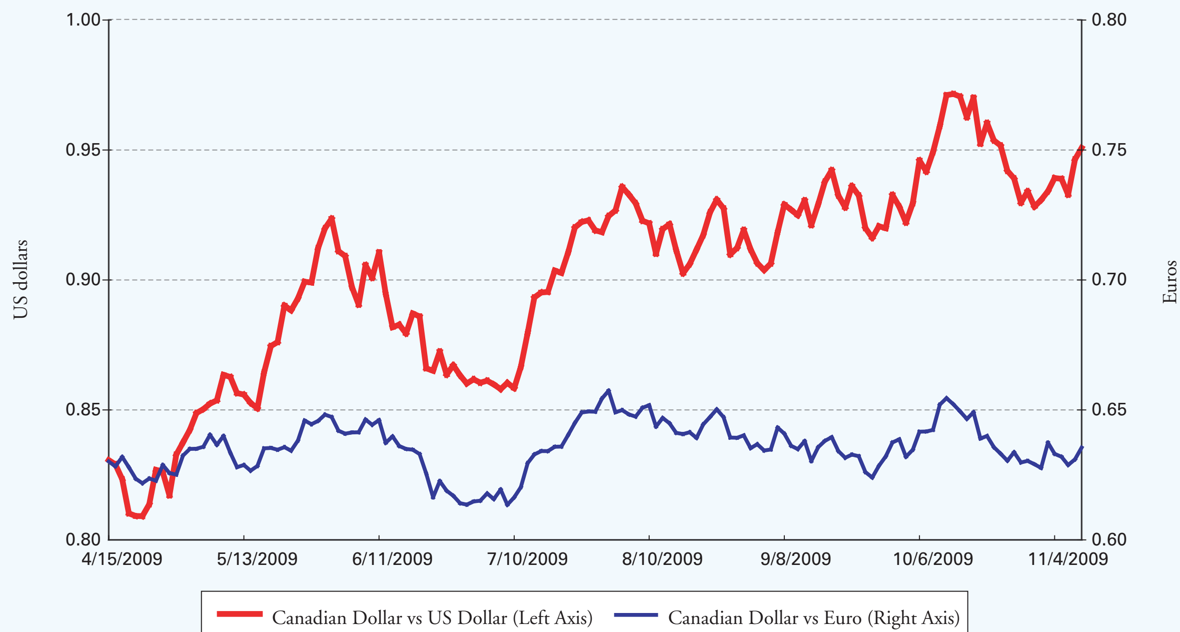
Governor Carney recently remarked that though markets sometimes lose their focus, the Bank of Canada does not. While he meant that the Bank always keeps its goal of 2 percent inflation squarely in front of it – and the Bank's recent prepared texts have consistently connected its concerns about the exchange rate to the medium-term prospects for inflation – the frequency and insistence of its public references to the dollar's recent appreciation and its likely effects on the pace of economic recovery in the next few months have distracted attention from this more distant goal.

What the public is hearing is that the Bank has been surprised by the dollar's appreciation from the US87-cent range that it "assumed" in its July *Monetary Policy Report,* and that the currency's "heightened volatility and persistent strength . . . are working to slow growth," and that the dollar's "current strength… is expected, over time, to more than fully offset the favourable developments since July."[1] And for most of that public, the Bank's recent efforts to "talk the dollar down," are welcome not because they might move CPI inflation back to 2 percent in mid-2011, rather than to the 1.9 percent rate that is currently forecast, but because they might improve the competitiveness of Canadian exports in the US market right now.

In permitting this response to gather momentum, the Bank has stepped onto a slippery slope, because if talk seems to be failing, people might reasonably expect direct intervention in the exchange market to follow.

1 The phrases in quotation marks are taken from p. 1 of the Bank's October *Monetary Policy Report.*

Figure 1 - The Canadian Dollar vis-à-vis the US Dollar and the Euro



Source: Bank of Canada.

Already, one prominent bank economist has urged the Bank to consider intervening, a proposal that received prompt and prominent editorial support.[2]

But intervention has its pitfalls. It always requires the Bank of Canada to create enough new Canadian dollars to decisively alter the balance of supply and demand for the currency. If it does this when their supply is already compatible with getting and then keeping inflation on target in the face of other developments at home and abroad, it risks an inflation overshoot, which in due course would force it to choose between reversing its exchange-rate policies to get inflation back on track, or letting that target slip. This is how a policy regime ostensibly aimed at stable inflation can veer toward one aimed at the exchange rate, and have its credibility among the public at large eroded too, as the incompatibility of these two goals is revealed.

Granted, this does not have to happen. Talk can be helpful and intervention can be benign under some circumstances. The Bank's recent reminder about some of the differences between Canada and Australia was surely useful to those traders who were buying the Canadian dollar because the Reserve Bank of Australia had raised its interest rate. More generally, a central bank that knows more about domestic developments relevant to the exchange rate than do traders – a clear possibility in the case of a smaller economy with a currency lightly used internationally – can make the occasional harmless profit by trading on that knowledge.

But in Canada in recent weeks, it has been the dollar's overall appreciation since the July *Monetary Policy Report* was prepared that has attracted comments from the Bank and has prompted calls for it to abandon its decade-plus policy of letting the exchange rate float completely freely.

This appreciation has had nothing to do with badly informed traders, or with domestic events that have been misunderstood or overlooked abroad. It has had much more to do with a broadly based depreciation of the US dollar. The Canadian-US dollar exchange rate has indeed appreciated since May 2009, when the Bank began drafting its July Report, but the C$-Euro exchange rate has seen no significant change over the same period (Figure 1).

2 See Avery Shenfield "Is No Policy the Right Policy?" *CIBC Economic Insights,* October 27th 2009, and "When to Intervene" *The Globe and Mail* October 28th, 2009.

The Bank of Canada is well aware of the US dollar's recent weakening, attributing it to "portfolio movements," as though these were divorced from economic fundamentals. But is this really the case? Last year, as we all know, a US consumption boom, financed by something akin to an international Ponzi scheme with securitized mortgages at its heart, collapsed. Now, an already weak US fiscal situation is deteriorating rapidly, and though there currently seems to be no political will to do anything about it, any replacement of consumer by government spending must necessarily come to an end eventually.

Restoration of demand for US output to a sustainable full-employment level will therefore require a substantial and, as far as one can see, permanent increase in US net exports. Perhaps it is this economic fundamental, which requires a depreciation of the US real exchange rate, that underlies the US dollar's continuing weakness.

The idea that the Bank of Canada can or should insulate the Canadian economy from such deep-seated changes, either by talk or exchange-market intervention, is not just misguided but also dangerous. Our dollar's appreciation is simply announcing their onset. Canadians need to receive and act upon this message, and policymakers should provide an economic environment that reduces their chances of error as they do so. Under current circumstances, therefore, the Bank of Canada's prime responsibility is to keep the transmission of information as clear as possible, not to garble it with talk about a variable that, within the current monetary-policy framework, is beyond its control.

If the Bank now believes that it has been underestimating the monetary stimulus needed to close the domestic output gap and get inflation back to 2 percent in a timely fashion, it should say so and act accordingly. It has plenty of scope for further expansionary measures – a further injection of liquidity into the clearing system, for example. But it should not confuse Canadians with statements that could be read as suggesting that the exchange rate is becoming a policy goal in its own right. The Bank can do nothing about the economic fundamentals affecting the Canadian dollar's real long-term external value. The more clearly it communicates this fact and refocuses public attention on the variables that it can affect, namely the output gap and the domestic inflation rate, the better.

References

Bank of Canada. 2009. *Monetary Policy Report.* October.

Avery Shenfeld. 2009. "Is No Policy the Right Policy?" *CIBC Economic Insights.* October 27.

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