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e-brief

Fixing the Exchange Rate: Still a Bad Idea

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The idea of a pegged Canadian-U.S. dollar exchange rate is in the air again, perhaps as a first step towards a North American monetary union.[1] Though some supporting arguments have changed since last time around — such as the peg's potential to defuse rising tension between Canada's resource-driven and manufacturing regions — it is still a bad idea. Economic fundamentals suggest that fixing the exchange rate would expose Canada once again to the swings in inflation and unemployment that successful inflation targeting, supported by a *floating* rate, has done so much to mitigate since 1991.

Canadian proponents of fixing have become sensitive to the serious economic and political obstacles to a full North American monetary union, and no longer treat the latter as a near-term goal. Nor do they argue, as they did when the dollar hovered near 62 cents, that the floating Canadian dollar is under imminent threat of extinction by market forces. They do assert, however, that a pegged rate would add stability to the business environment, as well as reduce domestic economic and political tensions.

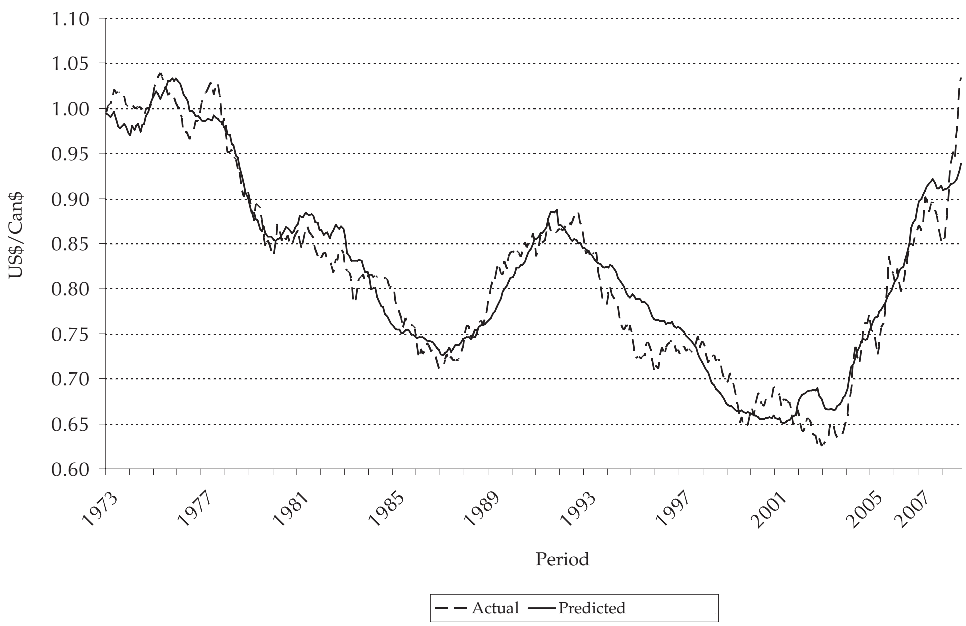
Now, other things being equal, a successfully fixed exchange is an attractive prospect, but the trouble is that those other things would not remain equal. Canada's floating exchange rate does not move around gratuitously, but responds to influences that would still exist even if it were pegged, and would be felt through other channels.

For example, pegging the Canadian dollar would have no effect on the behaviour of world markets for Canada's commodity exports. It is now widely understood that the currency's slow but steady slide in the 1990s was a response to weakness in commodity prices, and that the dollar's recent ascent has been in part a consequence of their revival, spurred by a strong demand in China and India. In fact, a simple econometric equation shows that the Canada/US dollar exchange rate is mostly explained by changes in the world prices of non-energy commodities, energy commodities, including oil, and the differences between the two economies' short-term interest rates and inflation rates. (Figure 1). [2]

1 See for example Thomas. J. Courchene, 2007, "The Loonie and the FTA," *Policy Options* October: 55-61; Neil Reynolds, 2007, "Dollar woes: a monetary union solution," *The Globe and Mail*, November 16, p. B2; and Steven Chase, 2007, "Consider an continental currency, Jarislowski says," *The Globe and Mail Report on Business*, November 23, p. B3.

2 This chart first appeared in Robin Banerjee, 2007, "The Petroloonie: The Bank of Canada can't keep down a dollar that's now tied to oil," *National Post* November 15, p. FP 19, where its derivation is ...

Figure 1: *Dynamic Simulation of the Canada-US Exchange Rate 1973–2007*



Note: Predicted exchange rate based on changes in world prices for commodities in constant US dollars and differences between the two economies' short-term interest rates and inflation rates.

Sources: C.D. Howe Institute; Bank of Canada.

When markets for commodities boom, foreign buyers purchase Canadian dollars to pay for them and, under a floating exchange rate, bid up the currency's price. The Bank of Canada's only option for curtailing this pressure, were it required to fix the rate, would be to create more Canadian dollars for sale on the foreign exchange market. Once issued, however, those dollars would soon enter domestic circulation and exert inflationary pressure. Where commodity exporters now see their gains partly eroded by a rising dollar, they would see them eaten up instead by rising input costs under a fixed rate. Manufacturers now under pressure from that same rising dollar would instead find themselves hamstrung by domestic wage inflation and other escalating costs. And all Canadians would face an overall inflation rate significantly above the 2 percent average to which they have become so accustomed.

Proponents of pegging are wrong to attribute increasing East-West political and economic tensions within Canada to the dollar's recent rise. This tension stems from two more fundamental facts of economic life that cannot be eliminated by tinkering with exchange rate arrangements: namely, that the world market for commodities is currently very strong, and that the West is much more richly endowed with them than the East. Currently, the exchange rate is signaling that economic activity needs to expand in the West and shrink in the East, but were it fixed, the differential effects of domestic inflation on commodity exporters and manufacturers would deliver exactly the same message, and generate the same political tensions, too.

footnote 2 cont'd

... described in more detail. It represents the latest updating by the C.D. Howe Institute of work originated by Bank of Canada researchers Robert Amano and Simon van Norden in the early 1990s.

The Canadian dollar's recent ascent is an episode in a story that will continue so long as Canada remains a major exporter of commodities — and price swings in their highly cyclical markets will be a recurring feature of that story. The commodity demands of India and China have recently grown dramatically and seemingly permanently. As a result, a floating Canadian dollar is likely to fluctuate around a higher average level than in the not-so-distant past. But fluctuate it will, nevertheless, because these economies' demands for commodities will also fluctuate along with their growth rates.

When commodity prices next fall, a floating Canadian dollar will decline, but should the currency by then be pegged to the US dollar, the Bank of Canada would have to use foreign exchange reserves to prop up its price. And, if commodity prices were to remain depressed for long, it might find itself borrowing abroad to replenish those reserves. Such measures would imply domestic monetary contraction, along with sluggish output and rising unemployment to the extent that domestic wages and prices are slow to adjust. In extreme circumstances, an exchange market crisis might also threaten. This could happen if foreign lenders begin to fear that defending the exchange rate is depressing domestic economic activity to a point that is hard to sustain politically. Canada has, fortunately, not experienced how painful propping up a fixed rate against depreciation can be, because both our post-war experiments with a fixed exchange rate (1945-1950 and 1961-1970) ended with upward floats to escape inflationary pressures emanating from world commodity markets. But recent history provides examples from which lessons can be learned: Britain's ignominious exit from the European Exchange rate mechanism in 1992, the crises in various Asian economies later in the same decade, not to mention the collapse of Argentina's once much-admired currency board.

Now, a full North American monetary union supported by a high degree of goods and labour market integration would mitigate many of these problems, but these are unrealistic goals at a time when even progress with the Prosperity and Security Partnership is stalled. Canada's current choice is between the status quo – stable domestic inflation supported by a floating exchange rate – and a pegged rate accompanied by greater domestic instability that would itself tend to undermine the very regime producing it.[3]

The status quo thus remains Canada's better option. We should face this fact and get on with policies that will make it easier to cope with continuing pressures from world commodity markets. Progress in creating a single domestic market for goods and labour, reducing disincentives to investment in manufacturing and elsewhere, and enhancing the labour force's skills and flexibility, will require hard work and take time. Unlike a quick exchange rate fix, however, it would actually help matters.

3 Herbert Grubel, a strong advocate of North American monetary union, argued that these problems make a pegged exchange rate inferior even to the floating regime of which he was so stringent a critic. See H. Grubel, 1999, "The case for the *Amero:* the economics and politics of North American monetary union," *Critical Issues Bulletin*, Fraser Institute.

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