Intelligence MEMOS

From: William B.P. Robson

To: Canadian-dollar Watchers

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Re: **Canada's Exchange Rate: No Fear of Floating**

Bank of Canada Deputy Governor Tim Lane noted in a speech this week that it is more than 20 years since the Bank intervened in the foreign exchange market to support the Canadian dollar. His topic was "The Canadian Approach to Foreign Reserves Management," and delivered at the Peterson Institute for International Economics in Washington – so not likely to make headlines in Canada.

More than two decades of a freely floating exchange rate is a big deal, however – especially since our buck is down about 5 US cents over the past year, which would once have caused, not just consternation, but maybe even an interest-rate hike that would have tipped Canada into recession.

Most of us now take a freely floating Canadian dollar for granted. A fixed exchange rate, with currency controls and black markets seems outlandish. The notion that governments should buy and sell foreign exchange, and move central bank interest rates up and down, to prevent the currency from rising or falling too far, too fast has also become weird.

How times have changed! Canada and its allies came out of the Second World War convinced that fixed exchange rates were a foundation for international prosperity. Our first foray into floating in the early 1950s was an aberration – condemned by the International Monetary Fund and unpopular with business. Our second foray in the early 1970s foreshadowed a general breakdown of fixed exchange rates – unsettling, especially when subsequent high inflation seemed to show that floating enabled monetary mischief.

And though the Canadian dollar was nominally free to move, we stepped in if we didn't like how it moved. Reluctance to see it rise during the resource booms of the 1970s kept monetary policy looser – and inflation higher – than it otherwise would have been. When US Fed Chairman Volcker tightened at the end of that decade, our sagging dollar led the Bank of Canada to tighten harder, hammering the economy in 1980-1982. In the later 1980s, the dollar's rise again led the Bank to keep interest rates too low and inflation rose. Then, when the Bank tightened and a sagging economy made the dollar dip, the Bank tightened more, precipitating the recession of the early 1990s.

That painful episode prompted the Bank to make inflation the main focus of monetary policy. It had long been known that a central bank cannot control domestic prices and the foreign exchange rate simultaneously, and inflation targets made plain that we had chosen: inflation control was the goal. But policymakers and the public still disliked a volatile Canadian dollar – and the next few years, as C.D. Howe Institute reports like this one pointed out, we went through perverse cycles. A strong dollar in a boom prompted overly easy policy – and an even stronger dollar. A weak dollar in a bust prompted overly tight policy – and an even weaker dollar! Only after several years of that did we let the buck float truly free.

Like the Bank of Canada's 2 percent inflation target, the freely floating exchange rate is a policy improvement that can seem just part of the landscape. Yet it is central to why our economic performance since then has been among the best in the developed world. As Deputy Governor Lane noted in his speech, our dollar dipped to US$0.62 in 2002, soared to US$1.08 five years later, plunged to $0.76 during the financial crisis, recovered to parity after that, and is now around US$0.75. Resisting those swings would have sent the Bank's interest rates, and the economy, through all kinds of twists and turns. Instead, the Bank pursued its inflation target, and the latest CPI reading shows it up exactly 2 percent from a year earlier.

Here's the headline Tim Lane's speech did not get: "Two decades of a free-floating dollar is a Canadian economic triumph."

We have other economic challenges – trade frictions, big debts, and keeping inflation on target amid demographic and other headwinds. Happily, we now face them without letting the ups and downs of the exchange rate push us off course.

We have lost our fear of floating, and have set the exchange rate free. Not a headline, just a happy reality.

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