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EXCHANGE-RATE POLICY:
EXPERIENCE WITH CANADA'S
FLOATING RATE

A. F. WYNNE PLUMPTRE



INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

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The author, A. F. Wynne Plumptre, is Principal of Scarborough College and a Professor of Political Economy in the University of Toronto. Before World War II he published books and articles relating chiefly to international financial affairs. From 1941 to 1965 he was a member of the Canadian Public Service, including the Departments of External Affairs and Finance. He was an Executive Director of the International Monetary Fund from 1962 to 1965. The present essay has been prepared for inclusion in a volume of **ESSAYS IN HONOUR OF THORKIL KRISTENSEN** *that is being published by the Organization for Economic Co-operation and Development in Paris on the occasion of his retirement as Secretary General and appears in this series by special arrangement.*

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International Finance Section

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EXCHANGE-RATE POLICY: EXPERIENCE WITH CANADA'S FLOATING RATE

With our international monetary system under challenge from speculators on the one hand and from economists on the other it is natural that there should be an active interest in "deviant behavior." An example of such behavior was that of the Canadian exchange rate when, between 1950 and 1962, it was "floating." It is not the purpose of this essay to hold up that experience either as a shining example for others to copy or as an awful warning for others to avoid. The purpose is rather to identify points of general significance that may be of some practical or theoretical importance for the present and for the future.

A feature of the Canadian experience that has attracted much attention, and most examination in books and learned journals, is the remarkable stability that was exhibited by Canada's floating dollar. The attempt to defend an existing par value (\$1.00 U.S. = \$1.10 Canadian) was abandoned in September 1950, in the face of massive capital imports, and the value of the Canadian dollar immediately floated upward. By February 1952 it had risen to a premium over the U.S. dollar. Then continuously for a period of rather more than eight years, from 1952 to 1960, it floated with remarkably little movement at a premium which never exceeded 6 per cent and was usually between 2 and 4 per cent. The period of float came to an end *de facto* in 1961, when the Canadian Government took a position in regard to the rate, and *de jure* in May 1962, when a new par value was established (\$1.00 U.S. = approximately \$1.08 Canadian).

Various causes have been advanced by various writers in explaining this prolonged stability of the Canadian floating rate. These include:

- the inherent tendency of Canadian imports of capital to be accompanied by Canadian imports of goods (particularly capital goods),
- the tendency for business-cycle movements in Canada and the United States to be similar,
- the fact that the Canadian rate floated on a "Sea of Tranquillity" resulting from the fact that other major currencies were pegged,
- the fact that the Canadian dollar began by floating upwards on the basis of confidence in the Canadian economy and its financial management,

- the widely held view that the Canadian dollar had a sort of long-term natural parity with the U.S. dollar,
- the moderate and acceptable behavior of the Canadian Exchange Fund, and,
- the equilibrating effects of private short-term capital movements.

One may perhaps be permitted to express some surprise that stability should seem surprising. After all, the exchange rate of a currency is formed by a market, and in the case of an important currency by a broad and responsive market. In a reasonably stable economic environment, such as existed for the Canadian dollar during the 1950's, a broad and responsive market may be expected to be reasonably stable, rather than subject to sporadic or self-aggravating oscillations. Our beliefs about the normal behavior of exchange markets are perhaps perverted by the fact that there have been relatively few occasions when an exchange market has actually been left alone to look after itself, without even the anticipation of official direction. Further, floating rates have so often been associated with unstable economic conditions, as they were during the aftermath of World War I and during the Great Depression, that they have acquired for themselves an aura of inevitable instability.

Be that as it may, the element in the Canadian situation that has been most closely examined is the equilibrating effect of short-term capital movements. The statistical evidence has been investigated by several writers. There is general agreement that short-term or speculative capital movements, including "lags and leads," exercised an important stabilizing influence. Some writers also remark on the fact that such movements were not self-aggravating or cumulative.

The declared intention of the Canadian authorities was stated as follows in the Annual Report to the Minister of Finance by the Foreign Exchange Control Board, Ottawa, for the year 1951, on page 19: "Transactions of the Exchange Fund Account in the market in United States dollars were directed to helping to maintain orderly conditions without preventing basic supply and demand factors from determining the level of the rate." Published statistics have been closely analyzed for the purpose of shedding light on the actual operations of the Exchange Fund. Writers seem generally agreed that these operations were small in size and stabilizing in their effect, at least until the developments of 1961-62 which are discussed below. Those writers who have questioned the stabilizing influence of the Exchange Fund have, I believe, attached a rather special meaning to the word "stabilizing." In fact, as official announcements generally make clear, the Exchange Fund

was operated neither to promote stability in the sense of immobility nor to promote stability in the sense of conformity to a predetermined trend but only to lean against the wind briefly in either direction in the event of sudden gusts. The authorities stood ready, at any time, to "make a market" on either side of the existing rate. They formed no opinion about where the market ought to go, or even as to where it was in fact going to go. The only opinion they held and on which they acted was that the market ought not to move sharply in either direction at any time. In giving effect to this opinion they may have lessened the likelihood of self-aggravating speculative movements of the rate. Further, they did establish that it is possible for an authority to "tend" a floating exchange rate without engaging in battles with the private market and without provoking market speculation about the nature and intentions of their own dealings.

Actually, the Canadian exchange market had, in an earlier decade, shown that it was able to look after itself without any attention from the authorities. During the 1930's, until the outbreak of war and the introduction of wartime controls, the Canadian exchange rate was afloat and it behaved well. Throughout this period the market was entirely on its own; there was no official intervention. This was as true after the establishment of the Bank of Canada (1934) and the passage of the Exchange Fund Act (1935) as it was before. (See A.F.W. Plumptre, *Central Banking in the British Dominions*, 1940, pp. 408-421.)

Indeed, during the 1930's, the Canadian dollar was afloat in a broader sense than was probably true of any other currency at that time. It was neither tended, as the various key currencies were tended by their respective authorities after sterling was driven off gold in 1931, nor was it tied to any particular key currency as were all or almost all of the satellite (non-key) currencies of the world. This was due to the fact that the Canadian economy had traditionally been attached, not to one, but to two metropolitan economies—the United States and Britain. Accordingly, when the Canadian dollar floated, it floated roughly half-way between the U.S. dollar and sterling and without particular stability in relation to either of them. Yet, despite all this, despite the generally disturbed economic and financial conditions of the time, and despite (or because of) the fact that no attempt was made at official tending, the Canadian dollar did not behave in an unstable fashion and short-term capital movements were self-correcting, not self-aggravating. While the Canadian dollar may have floated on a "Sea of Tranquillity" between 1950 and 1960, it did not do so two decades earlier; it did not need such a sea in order to establish its inherent seaworthiness.

During the 1930's the Canadian exchange rate was less stable, in the

sense of less immobile, than it was during the 1950's. None the less, it was stable in the sense that its movements were orderly, not erratic or oscillating, and it was obviously performing its proper market function in equilibrating demand and supply. Indeed, too much attention has probably been paid to the "remarkable stability" (that is, to the narrow range of movement) of the rate from 1952 to 1960. This stability was in a sense accidental in that at different times it was the result of quite different sets of forces. For the first half of the period the rate maintained its premium over the U.S. dollar as a result of what may be described as natural buoyancy; for the second half the premium was maintained as a result of what many consider to have been mistaken financial policy.

The year 1956 marked a turning point. Before that date all things seemed to work together for good. The initial and substantial appreciation of the Canadian dollar, in the year and a half after it was freed from control in 1950, laid the basis for a massive yet orderly and non-inflationary expansion of the Canadian economy based on a massive inflow of capital. Few commentators question that this was a good way, indeed the best way, for the economy to adjust to the capital inflow. With the higher value of the Canadian dollar, price increases were moderated, yet economic growth was strong and unemployment was low. Moreover the floating rate provided to those responsible for Canadian financial policy an extra dimension of flexibility, although not of irresponsibility, vis-à-vis the United States.

Subsequently, however, growth faltered, economic prospects clouded, and serious unemployment emerged. It was an astonishing piece of ill-luck for the Conservatives, who had previously managed to get themselves elected at the beginning of the Great Depression of the 1930's, that they next managed to do so in 1957. It was also ill-luck that Canadian financial management, which had previously appeared to be far-sighted and clearheaded, should have become schizophrenic about the same time. The tensions of the period culminated in a request by the Government in May 1961 that the Governor of the Bank of Canada should resign.

In 1956 an important alteration was taking place in the nature of the capital inflow. Previously it had been largely in the form of direct investment, but from 1956 onwards it was largely in forms that were responsive to interest differentials between Canada and the United States. In 1956-57 the main flow took the form of portfolio investments of various types and lengths. Later it chiefly consisted of various forms of short-term capital. Moreover, from 1956 onwards the interest differentials tended to widen and the exchange value of the Canadian dollar,

which had hovered close to parity with the U.S. dollar early in 1956, rose on the strength of induced capital imports. Despite an unemployment index that ranged (seasonally adjusted) between 6 per cent and 8 per cent, the annual import surplus of goods and services persistently exceeded \$1 billion from 1956 onwards.

It has been suggested that the floating-rate system, which apparently worked so well after 1950, began to break down in 1956 and thus had to be abandoned in 1962. This interpretation of the course of events does not seem adequate. If anything broke down after 1956, it was not the system itself but rather the purposeful and perceptive financial management that Canada had previously exhibited.

By the end of 1960 it had become clear that the Government and the Governor were pulling in different directions. In a "baby budget" in December the Government announced a change in taxation designed to lessen the importation of capital. Nevertheless, interest-rate spreads continued to offer a strong incentive for such imports. In the next few months the Canadian dollar weakened slightly but did not even fall to parity with the U.S. dollar; net imports of capital, along with net imports of goods and services, remained high despite persistent unemployment.

In the budget of June 1961, the Government, having by this time requested but not yet received the resignation of the Governor, made an important announcement about the exchange rate. The words used were as follows: "No one can say today what the appropriate level of our exchange rate would be when our balance of payments is in a position better suited to our present economic circumstances. But the rate will certainly be lower than it has been of late, and it may well be appropriate for it to move to a significant discount. It will be government policy to facilitate such a movement" (Hansard, June 20, 1961, p. 6649).

Following this announcement, the Canadian dollar obediently fell past parity with the U.S. dollar to a modest discount. But the market now knew not only that the authorities had a view as to the proper level of the exchange rate but also that they intended if necessary to impose that view. From that time onwards anticipations regarding the future of the rate were no longer confined to economic and financial considerations. Speculation increasingly centered upon what position the Government was likely and able to take in the exchange market. Nor could the authorities, having once asserted their interest in the rate, credibly renounce that interest in the hope or expectation that the market would thereafter behave as if nothing had happened.

For some months after the June budget the market seemed to antici-

pate a return towards parity with the U.S. dollar. As the statistics show, the authorities were engaged in holding the Canadian dollar down. Early in 1962, however, and particularly after a general election was called (with strong financial overtones), market opinion altered sharply. The Government ran into increasing difficulty in supporting the Canadian dollar at about 5 per cent below the U.S. dollar. On May 2, with the election in full swing, the Government returned to the fixed-parity system at a discount of 7.5 per cent. At that unsettled moment the market was not willing to accept even this rate, and heavy downward pressure on the Canadian dollar continued. Immediately after the election, however, there was a tightening of financial policy, massive external support was mobilized, and within a few months the new par for the Canadian dollar was able to stand firmly on its own feet.

Canada's return to a parity was a source of rejoicing in the International Monetary Fund, and also in the Economic Policy Committee of the Organisation for Economic Co-operation and Development (O.E.C.D.) and its Working Party 3. There is more joy in heaven over one sinner that repenteth than over ninety-and-nine just persons that need no repentance.

The attitude of the International Monetary Fund towards this whole sequence of events, insofar as it is known, is interesting and instructive. In 1950 the Fund acquiesced, albeit without enthusiasm, in Canada's abandonment of an established parity. It had accepted a floating rate for the Belgian franc some weeks previously. That the Fund should have been willing to accept another important break in the new par-value system was no doubt due in part to the fact that Canada had experienced, over the five preceding years, real and demonstrable difficulties in establishing and maintaining an acceptable and defensible parity (\$.90 U.S. throughout the war; raised to \$1.00 U.S. at the time of the premature postwar disintegration of price controls in the United States in 1946; reduced to \$.90 again in September 1949 when the currencies of Britain and other normal outlets for Canada's overseas exports were devalued by some 30 per cent; and then, less than a year later, faced by a quite indigestible inflow of speculative capital). Moreover, while departing from the Fund agreement in respect of parity, Canada was clearly supporting other basic objectives of the Fund in regard to the expansion of international trade, the elimination of restrictions and discrimination, and the acceptance of currency convertibility.

As time went on, the International Monetary Fund was able to take further comfort from the fact that the Canadian dollar floated upward, not downward in the direction of the competitive depreciation, and then remained remarkably stable. By 1953, the Fund had become reasonably

accustomed to the Canadian aberration. The Annual Report of the Executive Directors for the year ended April 30, 1953, contains on page 70 a sympathetic review of the problems faced by Canada, of the action taken, and of subsequent developments. It concludes: "It thus appears that in the circumstances of Canada's economic position and governmental policies the freely fluctuating rate has in fact moved only moderately, and capital movements, on the whole, have been equilibrating rather than disturbing. Canadian trade and normal capital movements have accordingly not lost the important benefits that are commonly associated with rate stability. As the Fund's 1951 Report indicated, the Canadian Government remains in consultation with the Fund."

While the Fund could accept a floating rate which really floated on the basis of market forces, and which the national authorities either left alone or merely tended in order to moderate sharp movements in one direction or the other, it could not accept an allegedly floating rate over which the authorities in fact exercised positive directive influence. This was just the sort of action out of which the competitive depreciations of the 1930's had developed and which the Fund was specifically established to prevent. Accordingly, following the Canadian Government's announcement in its budget of June 1961, there could be no question what the Fund's attitude should and would be towards the Canadian exchange situation. This attitude was, of course, conveyed to the Canadian Government before they took the actual decision to return to the parity system in May 1962.

It is, perhaps, worthwhile to wonder whether the International Monetary Fund would have been able to accept a situation rather different from the one that did in fact emerge. Suppose that, following 1956, Canadian financial policy had been different: suppose that the interest differentials which kept the Canadian dollar at a premium over the U.S. dollar had not been allowed to develop, that the capital inflow had diminished, and that the exchange rate had fallen to a discount with alleviating effects on the current-account deficit and on the level of unemployment. Would the Fund have found such a situation acceptable or would the downward movement of the exchange rate, however explicable in terms of the economic circumstances, have precipitated pressure on Canada to abandon the floating rate? I was not closely associated with the Fund during that period but, to judge from the attitudes I found there a few years later, I would guess that such a situation could have been accepted by the Fund and also by the international financial community including the United States. In other words, I believe that the test of acceptability would not simply have been whether the exchange rate continued its remarkable stability. Rather, I believe that the

Fund would probably have taken a broad view of Canadian financial policy as a whole. If this policy were directed towards constructive domestic objectives, including the reduction of a level of unemployment that by international standards was clearly excessive, and if Canadian policy were at the same time nonaggressive and nondisruptive internationally, I believe that the Fund would not have rejected it merely because the exchange rate moved to a lower level. Moreover, particularly in the light of prewar experience, I see no a priori reason to believe that the market itself would have exhibited more difficulty in arriving in an orderly manner at, say, a 5 per cent discount in relation to the U.S. dollar than it had quite recently exhibited in arriving at a 5 per cent premium.

Whether or not my answer to this hypothetical question is correct, I believe, looking back, that there are two basic criteria on which the international community must insist in the case of any country that allows its exchange rate to float. First, in regard to the exchange market itself, the intervention of the national authorities must be limited to passive, defensive, and neutral action. The authorities must confine themselves to responding to, and cushioning, action on the part of others. They must never take active, aggressive action; they must never initiate movements. (Several writers, examining the published statistics, have concluded that the Canadian authorities took aggressive action occasionally, and particularly in June 1961. However I believe that, lacking at least some of the relevant information, in particular the position of the Exchange Fund on forward account, they may have been misled.)

The authorities must not only refrain from aggressive action; the defensive action that they take must be neutral. They must not be more defensive in one direction than the other. If they are, they will be open to the charge on the part of other countries, and the suspicion on the part of the market, that they are manipulating the rate rather than allowing market forces to dominate. (The Canadian authorities did limit themselves in this way from 1950 to 1960 but from early 1961 to May 1962 their actions, while still nonaggressive, could no longer be considered neutral.)

Second, since any exchange rate, whether floating or pegged, is affected by monetary, fiscal, and other economic policies, a country with a floating rate must expect to expose and discuss its whole range of such policies with others in the international community. The consultations that take place, country by country, in the International Monetary Fund and also in the O.E.C.D. and other bodies, do not become irrelevant or unnecessary merely because one exchange-rate policy is substituted for

another. It may in fact be argued that the need for consultations, designed to minimize the adverse economic effects of economic actions of one country on its neighbors, may be even greater under a floating than under a fixed rate. The rules of the game, the codes of acceptable behavior are of course different; but rules and codes there must be if economic warfare is to be prevented and if economic peace is to prevail.

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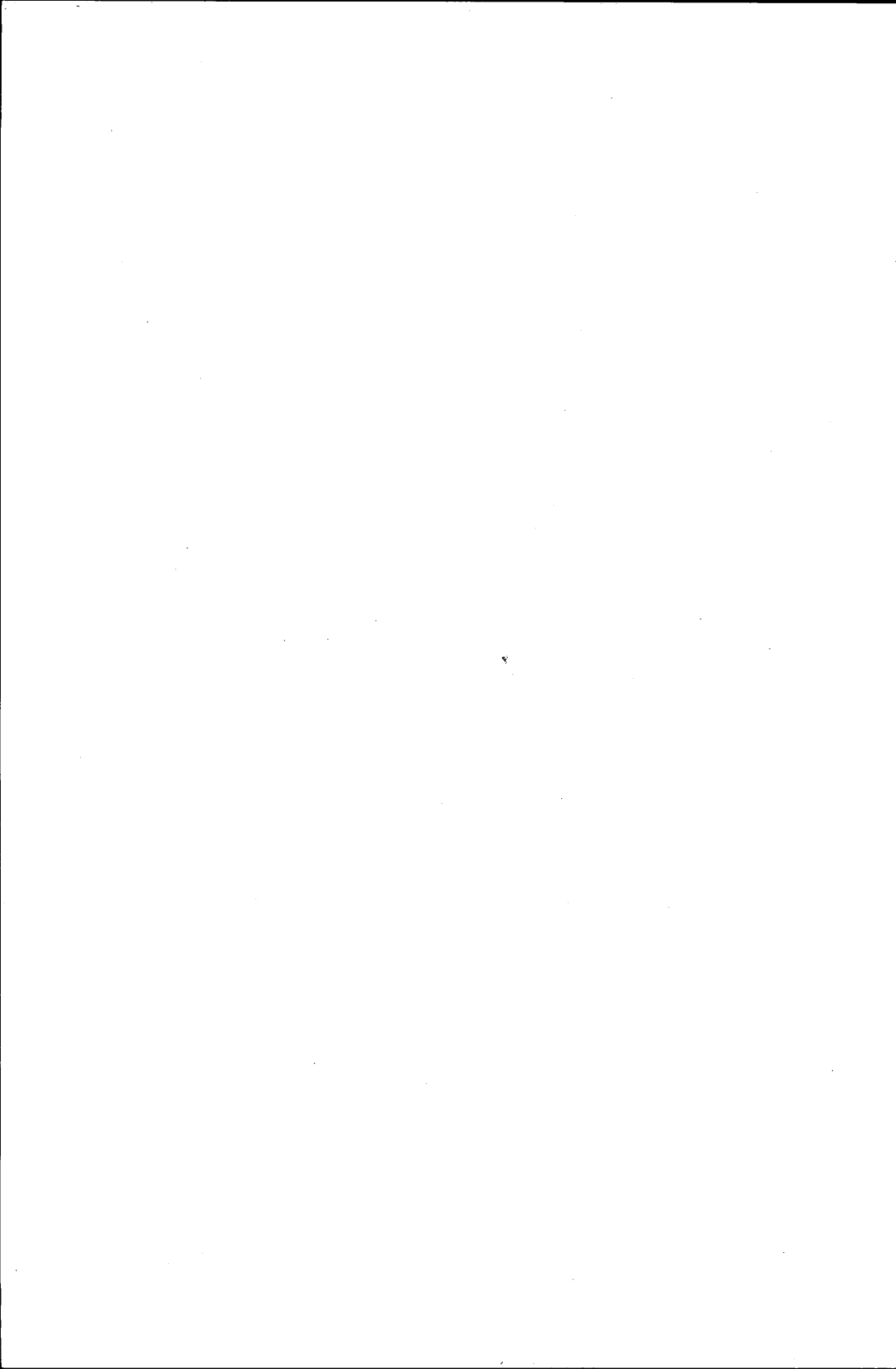
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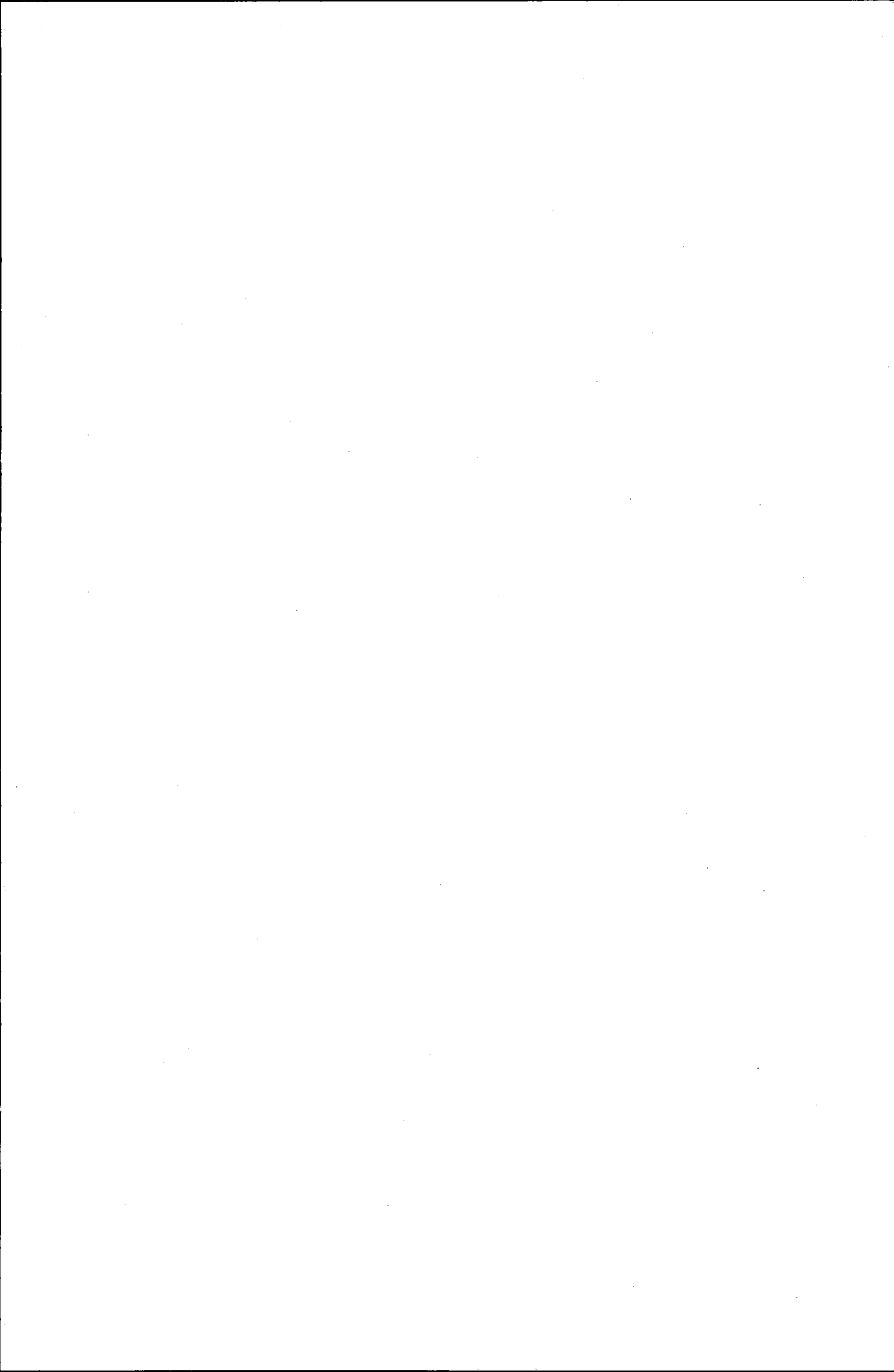
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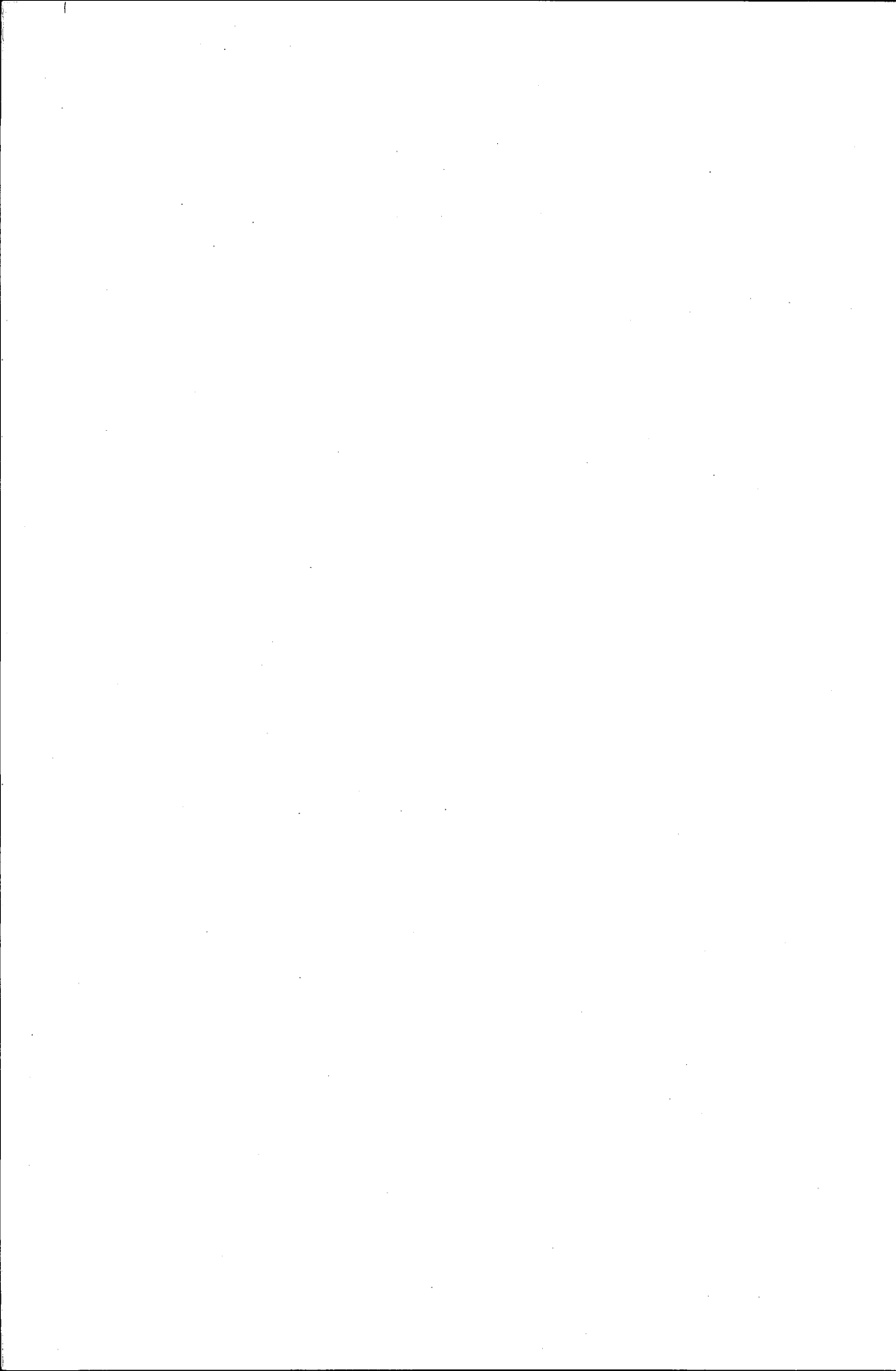
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