The Exchange Rate Regime and Economic Policy in Theory and in Practice

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This essay examines the recent rekindling of interest in fixed exchange rate systems. Throughout, emphasis is on expositing possible policy implications, both for restructuring the world monetary system and for the conduct of policy in a single country; special attention is paid to examining recent Canadian experience and policies. The basic conclusions that emerge are that Canada, by pursuing a 'dirty fixed rate' while on a de jure floating rate, missed a golden opportunity to avoid the take-off into two-digit inflation experienced by many of her trading partners in the mid 1970's. Further, flexible exchange rates cannot be viewed as a panacea to current monetary disorder and, in fact, while appearing to be the best solution for individual countries, may serve to exacerbate current problems when adopted on a system-wide basis.

Cet essai examine les causes du renouveau d'intérêt marqué envers les systèmes de taux de change fixes. Nous soulignons particulièrement les implications possibles en ce qui concerne la politique économique tant pour la restructuration du système monétaire international, que pour l'application de politiques dans un pays donné: nous étudions en particulier les expériences et les politiques canadiennes récentes. Les conclusions les plus importantes auxquelles nous arrivons sont que le Canada, en poursuivant une politique de 'taux de change fixe sale' tout en étant de jure sous un système de taux de change flottant, a manqué une occasion en or d'éviter des taux d'inflation à deux chiffres qui ont été le lot de nombre de ses partenaires dans le courant des années 70. De plus, les taux de change flottant ne peuvent pas être considérés comme une panacée pour résoudre le problème actuel du désordre monétaire et peuvent même, tout en semblant offrir la meilleure solution aux problèmes de certains pays, servir à exacerber nos difficultés actuelles s'ils sont adoptés par tous.

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The analysis of exchange rate regimes and their implications for key micro and macroeconomic variables and for the efficacy of alternative types of economic policies has occupied a central place in the development of modern economics over the past two hundred years. The fact that the debate over the central issues continues, and perhaps may be more intense now than ever, is testimony both to the importance of the issues and to the lack of resolution that the analysis has so far given rise to.

The ongoing debate on fixed versus flexible exchange rates has been such as to engender a great deal of potential confusion and insecurity for any student of the subject. In the post-Bretton Woods period, academic economists began an almost universal move towards general agreement in favour of increased flexibility of exchange rates. But imagine the frustration of the student who was taught in the classroom that the case for flexible exchange rates was so strong that there were really no interesting issues remaining, but who read in the newspapers that policy makers were so certain that the opposite was true that they did not seem to be giving serious consideration to flexible exchange rates.

This gulf between theory and practice has been only very superficially bridged by recent increases in the degree of exchange rate flexibility. First, there is little reason to believe that the increased flexibility reflects any general recognition by policy makers of the merits of the theoretical case in favour of flexible rates; rather the move to flexibility appears to be a stop-gap arising by default as a result of the breakdown of the Bretton Woods adjustable-peg system and the inability to negotiate a feasible and politically-acceptable fixed-rate alternative. Second, simultaneous with the increase in flexibility in practice, there has been a significant amount of theoretical work done which reconsiders the case for flexible exchange rates and which suggests potential benefits from a system of fixed exchange rates which must be taken seriously.

In this essay, I propose to outline these developments with a view to exposing their implications for economic policy: throughout, special attention is given to examining recent Canadian experience and policies. A recurrent theme in the essay is that much (although by no means all) of the potential confusion referred to above can be alleviated by distinguishing between analyses related to policy prescriptions for an individual country and those related to reform of the international monetary system.

I THE CASE FOR FLEXIBLE EXCHANGE RATES

Arguments for flexible exchange rates abound in the literature and in the textbooks, and hence the treatment given here can be kept very brief. Of course we cannot do justice to the sophisticated arguments in the literature – the key references here are Milton Friedman’s now classic essay ‘The Case for Flexible Exchange Rates’ in Friedman (1953), and the essays by James Meade (1955) and Harry G. Johnson (1969).

For the purposes of this discussion, I believe it to be not too crude a generalization to suggest that the foundations of support for flexible exchange rates rest essentially on two (related) propositions. First, it is contended that a
system of flexible exchange rates is the only system under which complete autonomy is guaranteed for domestic authorities to pursue whatever monetary, fiscal or other policies they desire in order to promote the national interest; the elimination of the balance-of-payments constraint on policy choices means that domestic authorities are more able to act so as to maximize the welfare, as they perceive it, of their constituents. The second argument used to promote flexible exchange rates is that, conditional upon the evolution of efficient forward markets, it is the only system under which international commerce will be free to function without any interference. That is, flexible exchange rates are seen as necessary to preserve an environment for free trade since, in the absence of balance of payments problems, policy makers will not find it necessary to impose tariffs, quotas, exchange controls, or other such 'non-optimal' policies.

This favourable view of flexible exchange rates has remained pervasive amongst academics; gradually the viewpoint has also been creeping into more widespread acceptance amongst policy makers. It would be folly to suggest that the academic economists have persuaded the authorities, rather, I would suggest that increased flexibility has come to be accepted by default as the adjustable peg system became untenable. Alternatively, and not entirely flippantly, one could put forward a bureaucratic reason. As we shall see, recent theoretical developments suggest that under fixed exchange rates central banks are nothing more than tellers exchanging domestic for foreign currency and only under flexible rates is there a role for independent monetary policy. Therefore central bankers might prefer flexible rates in order to preserve the importance of their own role. In any event, one does find more and more international monetary authorities propounding the need for increased flexibility, and recent developments indicate that this view has been increasingly put into practice.

There is a sense in which the two arguments presented above for flexible rates are mutually inconsistent. This arises from a severe limiting feature of the basic model: it contains no behavioural analysis of government activity. While the literature is replete with analyses of how the efficacy of a given policy is influenced by the exchange rate regime, only very recently has any systematic discussion appeared concerning how the exchange rate regime might influence the choice of policies actually pursued. Before turning to a couple of examples, it is worthwhile elaborating on the general point. Although flexible exchange rates may remove one of the sources of the desire or need for government interference with international trade and financial transactions, they do not remove all such sources. In fact, they might be construed as giving an extra degree of freedom to policy makers wishing to pursue stabilization, equity or other objectives without having to worry about balance-of-payments repercussions, since the one cause of intervention that is removed – external balance – is also a constraint on other policy objectives. Of course, the government would recognize that any policy actions which would have had balance-of-payments repercussions under fixed rates would have exchange rate repercussions under flexible. The argument is, and I would be surprised if it were contentious, that under a wide range of cir-
cumstances the exchange rate implications would not be viewed to be as much of a cause for concern from the government's point of view. I turn now to two recent examples of flexible exchange rates inducing policy changes in a manner not wholly foreseen by proponents of flexibility.

In Canada, the increased flexibility of the exchange rate since 1970 has occurred simultaneously with two dramatic changes in the course of economic policy: an active concern for reducing regional disparities, as evidenced by the activities of the Department of Regional Economic Expansion and other government agencies trying to directly affect resource allocation within traded good sectors; and a sharp upsurge in economic nationalism, as manifest in the desire to restrict the flows of foreign investment and resources exports. It seems clear that increased exchange rate flexibility may well have created a situation where the pursuit of such objectives was in some important ways much easier. To the extent that flexible exchange rates have aided government interference with the market process, they have inhibited and not promoted free trade. Note also that to be a proponent of completely unrestricted foreign trade and commerce is not a necessary condition for being a proponent of flexible exchange rates; nationalistic motivations may also lead one to favour flexible exchange rates. For example, those who wish to restrict oil exports and capital inflows, and thus seriously restrict two large sources of foreign exchange, must also wish to restrict imports, either directly, or by advocating a flexible (and in this instance, depreciating) exchange rate.

The second example of induced policy change pertains to monetary policy. Perhaps the most important policy freedom claimed for flexible exchange rates is that it gives a country the right to conduct independent monetary policy. But Robert Mundell, one of the few to talk about induced policy changes, has long voiced opposition to flexible exchange rates on the grounds that they will be inflationary because once monetary authorities are freed from the balance-of-payments constraint, they will tend to follow much more expansionary policies. This argument has of course long been recognized by many observers, but as Jude Wanniski (1975) persuasively argues, Mundell (in collaboration with Arthur Laffer) has pushed the analysis of the alternative adjustment mechanisms and policy reactions much further, and was able to forecast the recent rapid world inflation as a necessary consequence of the move to flexibility. And if that recent experience is not enough to convince us that the arguments are to be taken seriously, Mundell (1976) has recently offered the following example: Consider what would happen in 1976 if New York City were given the right to print her own money and maintain a flexible exchange rate. A fairly safe prediction would be that New York City would be experiencing rampant inflation and her currency would have a low and depreciating value. Without offering any judgment about the desirability of that outcome, it forcefully brings home the inflationary potential of flexible exchange rates.

While flexible exchange rates are thus generally conceded to create additional policy freedom for the individual country, recent developments have

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1 If it turns out that the government does care about the exchange rate, as I argue below has recently been the case in Canada, then the policy freedoms usually claimed as a beneficial aspect of flexible exchange rates simply do not occur.
stressed the point, obvious after the fact, that the desirability of this policy freedom depends entirely on how the policies are used. Two additional arguments which receive a lot of attention in the next section are that the policy freedom is largely illusory since no real long-run differences in options are created for the economy by flexible exchange rates, and that most short-run benefits also involve beggar-thy-neighbour effects so that arguments in favour of flexible exchange rates for any one economy do not carry over to the system as a whole.²

II THE CASE FOR FIXED EXCHANGE RATES

For the purpose of this essay, I group recent arguments for fixed exchange rates into three (obviously related) broad categories — arguments propounding the beneficial effects of a world money, arguments evolving out of the recent intellectual flurry surrounding the monetary approach to the balance of payments, and arguments related to the concept of optimal currency areas.

Arguments for a World Money
Arguments for a World Money relate not so much to the individual country's desired degree of exchange rate flexibility, but rather raise issues germane to reform of the international monetary system. A world money necessarily implies fixed exchange rates; arguments from this point of view propose a return to a system very much like a 'strict' gold standard, strict in the sense that sterilization of reserve flows would not be allowed so that monetary policy would of necessity be accommodating to external forces. Countries could retain individual currencies but would also have to commit themselves to rigidly maintaining their relative values. The overall system commitment to rigid rates is emphasized as that which would be required to defuse the highly volatile speculative flows which have plagued the recent pegged rate system.

The arguments under this topic are tied closely to the recent attempts of monetary theorists to delineate precisely the role of money in an exchange system, and to identify the benefits accruing from the 'social contrivance of money.' The role of uncertainty and the necessity of incurring transactions costs in searching markets and filtering information in the exchange process is emphasized, and money is treated as a vehicle through which such transactions costs are minimized and hence exchange is made efficient. Writers in international finance have attempted to extend this line of thinking to exchange between countries and arguments presented include the contention that a unified international monetary system of fixed exchange rates efficiently performs the same functions for international markets. Mundell (1972) has emphasized the increased information costs inherent in a world of

² A major possible exception to these arguments is exogenous world inflation. Michael Parkin has pointed out that if one is persuaded by the mounting evidence in favour of the natural rate of unemployment hypothesis, then the monetary independence afforded by flexible exchange rates amounts, in the long run, only to being able to choose an independent rate of inflation (for elaboration, see Parkin, et al., 1971). Dombusch and Mundell have stressed that in a world of capital mobility, flexible exchange rates will have only limited ability to provide insulation from foreign inflation.
changing exchange rates, and Kindleberger (1970) has emphasized the (previously ignored) resource costs of establishing and maintaining a system of forward exchange markets conceded to be necessary for efficiency under flexible exchange rates.

A final point with respect to the world money argument arises immediately from the recent 'hot topic' in monetary theory – the 'optimum quantity of money' (see for example Friedman, 1969). The issue arises as to whether the postwar experience represents a fair test of the effectiveness of the provisions for adjustment in the Bretton-Woods agreements, or whether the system has been unduly hindered in its operation by an insufficient world money supply. The resultant co-joining of the 'liquidity problem,' the 'adjustment problem' and the concepts of 'optimal reserves' and 'optimal world money supply' emphasizes the intertemporal nature of international financial adjustments. Only very recently has the standard apparatus of modern welfare economics been brought to bear on problems of international disequilibrium, and the costs of such disequilibrium are no longer treated as the net flows of foreign specie (as in the simplistic mercantilist approach) but, rather, as the loss of potential consumption and the inefficiency of world production due to possible resulting suboptimal resource allocation. The different adjustment mechanisms implicit under fixed and flexible exchange rate systems imply different time paths for certain macro variables, and hence imply different possible welfare effects. Under fixed rates, capital flows are accommodating to current account flows when overall payments balance and full employment are pursued as policy targets. To the extent that such capital flows manifest real investment, production will (at least temporarily) be diverted to countries with current account deficits regardless of real differences in marginal efficiencies of investment. Under flexible exchange rates, the current account is accommodating to any autonomous capital flows since the exchange rate adjusts to maintain overall balance. If adjustment to such exchange rate changes is sticky, real resource flows may again be created as apparent comparative advantage differs from true comparative advantage (see Dunn, 1973). Any analysis of the welfare costs of the two systems must incorporate adjustment, transactions and information costs in order to model the alternative adjustment paths.

A proposal which has been receiving a lot of interest lately, and which has, at least in part, the above mentioned characteristics of fixed and flexible rates as its motivation, is that of a dual exchange rate system wherein separate markets would exist for current and capital account transactions, with the former rate fixed and the latter a free market rate. In practice, such a system would be hampered by the troubles attached to maintaining two prices for the same good while limiting 'black market' activities, and by the arbitrariness of defining current and capital account transactions. The potential benefits of such a system may, however, be significant, and final judgment as to its feasibility must await further analysis and, perhaps, experience.

*The Monetary Theory of the Balance of Payments*
For the purpose of the present discussion, this can be viewed as an extension of the basic, well-known proposition that under fixed exchange rates, an open
economy cannot control her nominal money stock, a proposition implicit in the 18th century writings of David Hume and recently put forcibly by Mundell (1968: Ch. 18). The money stock is demand determined since, given the central bank’s commitment to buy and sell foreign exchange at fixed terms, the private sector can export or import money; any domestic credit policy intended to influence the money supply will simply give rise to offsetting foreign reserve flows. The balance-of-payments is represented as the difference between desired additions to the money stock and domestic credit creation. Monetary policy has no long-run effect on the money stock, but can exert temporary influence over the balance-of-payments and hence affect the stock of foreign exchange reserves held by the central bank. (Note that this approach is not necessarily related to the monetarist view of domestic stabilization policy, and some unnecessary controversy might have been avoided had the original proponents used the title “The Balance of Payments Theory of the Money Supply.”)

A useful by-product of this approach is the necessary recognition of the exchange rate as a monetary variable, being the price of the foreign currency in terms of the domestic currency. Thus the distinction between this variable and the terms of trade, the latter being a real variable expressing the average price of export goods in terms of import goods is immediate. Devaluation raises the price level and acts as a tax on holders of domestic assets, in turn affecting income-expenditure patterns so as to bring about improvements in the trade account. Two points appear noteworthy. First the trade surplus so generated (and not dependent upon elasticity conditions since there is not necessarily any change in the terms of trade) is inherently temporary, disappearing when domestic asset stocks have been replenished. Second, in the long run the exchange rate is neutral in the sense that nothing can be accomplished using exchange rate changes that could not be otherwise accomplished with other policy instruments; the long-run real equilibrium is independent of the value of the exchange rate. Of course the very essence of this theory of the exchange rate is that changes are not neutral in the short run; exchange rate changes give rise to asset disequilibria which in turn elicit changes in flows of goods and services.

These considerations have implications for the use of devaluation as a macro policy tool. It is commonplace to answer the question ‘Under what circumstances should a country devalue?’ in terms of the existence of a ‘fundamental disequilibrium’ in the exchange rate. The monetary approach makes clear that for any value of the exchange rate there exists a constellation of domestic prices, wages and government debt corresponding to which there would be external and internal equilibrium. The existence of perpetual imbalance in the foreign sector is not prima facie evidence of a ‘fundamentally

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3 While the distinction is obvious once it has been made, in discussions of devaluation a good deal of confusion arises precisely from a failure to recognize the distinction. The extreme case, of course, arises in relation to a ‘small country’ where the terms of trade are treated as fixed: the exchange rate, however, can change and devaluation operates by effecting a change in domestic absorption. At the other extreme is the Marshall-Lerner analysis of exchange rate changes—a case where the exchange rate and the terms of trade are synonymous since the price of each country’s home good is constant in terms of its own currency.
wrong’ value of the exchange rate any more than it is of ‘fundamentally wrong’ values of any of the above mentioned variables. The argument for an exchange rate change must rest on ‘least adjustment cost’ grounds. That is, a disequilibrium position exists such that one or other variables must change to restore equilibrium; different control over different variables implies a different time path for the economy and each such path has associated with it different welfare implications.\(^4\)

This suggests a major advantage of the monetary approach: it is explicitly intertemporal, as is evident from our discussion of Mundell’s work (see also Dornbusch, 1973). While exchange rate changes are still conceded to be an efficient method of correcting a ‘fundamental disequilibrium,’ it is recognized that they are not the only way. This literature presents a model in which one can delineate more precisely what the costs of adjusting to disequilibria are; hopefully, further research will attempt a more complete comparison of the costs of alternative adjustment patterns. For example, the prescription to devalue only in the case of a fundamental disequilibria seems to mean, then, that for small displacements away from equilibrium it is best to let the rest of the economy adjust to the exchange rate whereas for large displacements the exchange rate should change. It would be interesting to see a careful analysis of the conditions under which such a prescription is optimal. With regard to the question of fixed versus flexible exchange rate systems, the analysis gives rise to arguments very similar to those encountered above under the topic of world money. Both systems can yield the same long-run equilibrium but entail different adjustment patterns and costs for the economy. It seems an interesting question to ask how these costs compare, and under what circumstances might, from this point of view, one system be preferred to another; this question arises naturally in the optimal currency area literature, to which we now turn.

**Optimal Currency Areas**

A concept first introduced more than a decade ago by Robert Mundell (1961) and elaborated on by Ronald McKinnon (1963), was received as something of an intellectual curiosum bearing the simple but not unimportant message that since the political-geographic boundaries of countries do not correspond to boundaries suggested by economic considerations, flexible exchange rates cannot be counted on to solve all international adjustment problems. Mundell defines optimal currency areas along regional lines while McKinnon emphasizes the importance of ‘openness,’ i.e., the fraction of economic activity involved in tradeable goods. It is obvious from both the multi-regional structure and the openness of the Canadian economy that the issues are important for the analysis of the Canadian exchange rate.\(^5\)

\(^4\) Mundell (1968: Ch. 11) suggested that a main source of the difference in adjustment paths would be due to ‘money illusion,’ i.e., sticky nominal wages in the face of price level changes arising from exchange rate changes.

\(^5\) Mundell’s regions are defined by, among other things, specialization in production of a homogeneous export good. We retain his basic model where Western Canada produces Natural Resource goods and Eastern Canada produces manufactured goods. Mundell’s example is perhaps misleading in the sense of footnote 3 above. He creates a situation where relative prices
Presuming that the 'Energy Crisis' constitutes an increase in demand for Canada's resource exports, we can compare the implications of fixed and flexible exchange rate systems. Under fixed rates, the expansionary impact of the boom in exports would, via the usual monetary adjustment mechanism arising from a balance-of-payments surplus, be generalized throughout the entire economy. Under flexible exchange rates, the boom would cause the Canadian dollar to appreciate; since domestic wages and prices are 'sticky downwards' this in turn would cause a short-run increase in real wages in the export sector and likely generate unemployment in the manufacturing region of Ontario. Thus the choice between fixed and flexible exchange rates in this instance would relate directly to the desirability of external expansionary pressures; i.e., to the current state of the economy and the authorities' views as to unemployment/inflation trade-off. Similar analysis pertains to the potential under fixed rates for 'importing inflation' from abroad and the role flexible rates might play in insulating the economy therefrom.

The Optimum Currency Area concept seems also to have played a useful role in clarifying some of the issues pertaining to current discussion surrounding the possible formation of currency unions in Europe and North Africa. Arguments in favour of such currency unions include, in addition to the social saving from the pooling of reserves and the potential of a common currency strong enough to compete with the US dollar for seniorage, the point that small specialized economies - the mythical banana republic - may not gain unambiguously by fixing the value of their national currency in terms of home goods, this being the implication of adopting a floating exchange rate. Rather, as McKinnon's analysis suggested, such a country may be better off fixing the value of its currency in terms of some broader aggregation of goods by joining a currency area.

The broader issue concerns the transmission of business cycles as between countries under various exchange rate systems. The generally accepted view is that flexible exchange rates do play a shock absorber role so that if one believes that the domestic economy by itself is more stable than those of its foreign partners then this provides an additional argument for flexible rates. If, however, one believes that the domestic economy is less stable, then fixed exchange rates may be a method of dampening the effects of the instability by 'exporting' some of the instability to its foreign partners. Thus the McKinnon argument must be qualified by recognizing the difference between 'exogenously given' prices and 'stable' prices. An open economy may not want to tie its price level to international prices if the international prices are less stable (for example, if the demand for exports is uncertain and highly variable) than what the domestic authorities believe they might be able to achieve under flexible rates.

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have to adjust but where price levels are rigid in terms of the home currency. When North America is divided up so countries correspond to regions, a change in the exchange rate affects the required change in the relative prices (terms of trade) but when countries are multi-regional, exchange rate changes do not alter relative prices.

6 Of course, if a 'downward shift' in export demand were expected similar reasoning would lead one in an otherwise similar situation to favour the other regime. The more general case of uncertain export demand is addressed below.
This suggests an inherent source of the instability in the adjustable peg cum managed float system that appears to be evolving. It could be argued from the above paragraph that a major factor in the current move towards increased flexibility has been the poor price performance of the United States. But we have already seen that a potential consequence of such increased flexibility is a further deterioration in price performance.

III SOME POLICY IMPLICATIONS

While the lack of precise conclusions in the literature discussed above is striking, nevertheless some strong principles useful for policy purposes do emerge. One lesson is that many of the arguments related to flexibility of exchange rates can have very different implications depending upon whether one is talking about policies for a single country taken in isolation or about reform of the international monetary system as a whole. Further, the essentially monetary nature of the exchange rate means changes in it do not alter the real long-run equilibrium of the economy. Thus, except for the potentially important role of insulating the economy from international price instability (increases in either the variance or mean rate of change), flexible exchange rates are not seen as an interesting alternative on a country by country basis. However real and interesting issues remain concerning the question of the optimum degree of flexibility between such large entities as, say, a European currency area and the United States.

An Optimal World Monetary System
Since neither fixed nor flexible rates dominate the other in all dimensions, an optimal world monetary system would involve, in terms of relationship between countries, both fixed and flexible exchange rates. Earlier this decade, this seemed to be the road along which reform was moving as the possibility of a European Currency Union appeared to be a very real one. However, the lack of political agreement as to how to co-ordinate policy within that union seems to have seriously damaged any chances of eventual formation of a European monetary union. In the (now unlikely) event of the evolution of such a ‘mixed’ international system, we note the obvious problems that such an institutional arrangement would create for Canada. As soon as the exchange rate between the two currency areas changed, Canada could only maintain a fixed exchange rate with one or the other; presumably the question as to which she should do is one to which the currency area concept addresses itself.

A striking feature of the arguments in favour of fixed exchange rates presented above is that all are limited to favouring rigidly fixed rates, and none are a defence of the adjustable-peg system of the 1960’s. However, the concept of controlled flexibility (managed float, snake, crawling peg, etc.) is one that has been getting a good deal of attention and support of late. While a careful review of such proposals is beyond the scope of this essay, the following points can be made. A country cannot maintain monetary independence and control her exchange rate simultaneously; hence the above mentioned proposals, once they admit that the exchange rate is to be kept within
some desired range, cannot also claim the freedom for an independent monetary policy afforded by truly flexible exchange rates. What they do provide is one possible formulation of optimal monetary policy under flexible exchange rates, i.e., monetary policy which has the exchange rate as one of its targets.

Policy in the Open Economy

For policy in the open economy, the monetary nature of the exchange rate means that it is best suited as a policy device to deal with monetary problems, and can be expected to exert only limited influence (of limited duration) over real variables. Thus in dealing earlier with the ‘energy crisis,’ appropriate control of the exchange rate did not eliminate the real adjustments necessary in the face of the change in the relative price of raw materials and manufactured goods: it was credited only with creating a monetary environment in which such real adjustment could most easily be accomplished. These considerations render the exchange rate an especially important role in the current inflationary situation since they make clear the direct and important role it plays in affecting the current price level. In the integrated world market of today, the latter follows very closely the foreign price level adjusted by the exchange rate. Thus any country resolute in its desire to wage an independent fight against inflation clearly must adopt a flexible exchange rate, and be prepared to accept a revaluing exchange rate.\(^7\)

This latter qualification is very important for, as much of the foregoing has suggested, if there are gains from flexible exchange rates they accrue only if the authorities do not use policies in such a manner as to offset the effects of exchange rate changes. There is nothing to guarantee that flexible exchange rates will actually perform the ‘shock absorber’ role they are capable of; actual performance of the system is completely dependent upon the conduct of stabilization policy. In the simplest model, a given rate of foreign inflation implies a given sum of domestic inflation and exchange rate change, the exact division depending upon the level of inflationary expectations domestically, the degree to which speculation in the exchange market is stabilizing, and the performance of domestic stabilization policy.

Consider, for example, the Canadian post-World War II experience.\(^8\) In the early 1950’s Canada was able to ameliorate the inflationary pressures of an overheated U.S. economy by allowing the Canadian exchange rate to revalue, and could have done so again in the similar situation of the late 1960’s. Instead, the exchange rate remained fixed (at approximately 92 ⅓¢ U.S.) and beginning in late 1968 restrictive monetary policy was used to combat (the mostly imported) inflation. These policies were obviously inconsistent; in May 1970, after a record trade account surplus in the first quarter of 1970 and in the face of large and growing capital inflows, the exchange rate was allowed to revalue significantly (by approximately 5 per cent). Although substantial costs were no doubt entailed by waiting so long to float the exchange rate,

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\(^7\) The converse is equally true for countries who wish to inflate faster than the rest of the world: witness the experience of some Latin American countries who have been inflating rapidly and simultaneously depreciating their currency.

\(^8\) The interested reader is referred to the informative and enlightening book by Courchene for a more detailed analysis of these events.
nevertheless the stage was now set for insulation of the Canadian dollar from the foreign inflation. But, as documented so well by Courchene, monetary policy – in apparent reaction to the excessive unemployment generated by the overly restrictive policy of the late 1960’s – simultaneously took on a markedly more expansionary posture, and the potential for insulation was not realized. Since 1970, although maintaining a de jure flexible exchange rate, Canada has maintained that rate fairly stable and continued to ‘import’ inflation, even in the face of the recent acceleration into two-digit inflation of many of her trading partners. In fact, during late 1975 Canada managed to have a higher inflation rate than did the United States.

It appears that during this period Canada missed a golden opportunity to avoid the take-off into accelerated inflation that so many countries experienced. By the second quarter of 1970 the effects of the 1968–1970 tight monetary policy had worked their way through most of the economy; inflation was low and falling and the necessary price of unemployment had been paid. A continuation of that policy would have allowed Canada to maintain that low rate of inflation in the face of the rapid world-wide acceleration. But it would have entailed a further appreciation of the Canadian dollar. The fact that Canada instead chose to inflate with the rest of the world indicates either our unwillingness or our inability to take advantage of the one certain advantage of flexible exchange rates.

I suggest that this failure arose as a result of a ‘dirty fix’ of the exchange rate; the authorities fixed the exchange rate, not by direct intervention in the exchange market, but indirectly as a result of inappropriate stabilization policies. Instead of using the independence afforded by the flexible exchange rate to pursue slow monetary growth and restrict inflation, the authorities expanded the money supply too quickly, thus exacerbating the inflation problem (during the post-1970 period, the behaviour of both the money supply and the price level in Canada virtually replicated the American patterns) and simultaneously ‘pegging’ the exchange rate below what it otherwise would (and should) have been. The evidence seems clearly consistent with the hypothesis that monetary policy in Canada has had the stabilization of the exchange rate as one of its principal targets during the past half decade.9

The question of why this happened is an interesting one. That such an expansionary policy might be a natural reaction to the removal of the balance-of-payments constraint has already been suggested above. Harry Johnson (1975) has earlier indicated two possible reasons why the value of the exchange rate might be of interest to policy makers. First, there is a view that the revaluation would harm the competitive position of the export industries. The export industries would appear to want it both ways, for they are now concerned with the erosion of their competitive position due to the inflation that we have argued is a consequence of not allowing the currency to appreciate; the above analysis suggests that their real position would not have been much altered in either circumstance. The second reason Johnson suggests is that a lower rate of inflation in Canada than in the US means that Canadian nominal interest rates would, in contrast to the historical relation-

9 For a more formal analysis which supports this view, see Caves and Feige.
ship, also be lower. If monetary policy reacts so as to maintain that historical relationship it will also maintain the historical close relationship between inflation rates, and little or no movement in the exchange rate is likely to be observed.

By failing to take advantage of the opportunity for independent monetary policy under the _de jure_ floating rate, the authorities reverted to a _de facto_ fixed rate system. Only if the authorities had chosen to pursue a more independent path of monetary aggregates as part of a stabilization policy attempting to fight inflation would the beneficial 'shock absorber' role of flexible exchange rates have been brought into play.  

**CONCLUDING COMMENT**

In the context of the existing institutional arrangements it seems clear that the 'shock-absorber' role of a flexible exchange rate is a strong argument in favour of its adoption. But appropriate conduct of stabilization policy is required before the potential benefits can be realized. It is not only wrong to think that flexible exchange rates are a *panacea* for the vast array of domestic and world economic problems, but there is a very real possibility that for the system as a whole they may make things worse rather than better. A critical component of control of world inflation is control of the world money supply. Fixed exchange rates approximate, to some extent, the gold standard solution to this problem, and the break-down of the Bretton-Woods system in the early 1970's can largely be attributed to peculiar institutional arrangements which circumvented that control mechanism. In the continued absence of institutional arrangements to provide for such control, flexible exchange rate solutions to international monetary disorder will likely continue to contribute to increased inflation.

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There is some evidence that the Bank of Canada, following its public announcement of November 1975 of target growth rates for monetary aggregates, is now intent on pursuing more independent monetary policy.


