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November 25, 1952

The Canadian Dollar: A Fluctuating Currency
Samuel I. Katz

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The Canadian Dollar: A Fluctuating Currency

Samuel I. Katz

In September 1950, the Canadian authorities abandoned the fixed par value (90.9 US cents) of the Canadian dollar. During the following twelve months, the Canadian dollar fluctuated within a two-cent range (94 to 96 US cents), but in November 1951 it started to move upward at a rapid pace. By February 1952, it had attained parity with the U. S. dollar; it continued to rise, reaching a peak monthly average of (US) $1.0417 in September. During November, however, the currency declined to around (US) $1.02.

During the period from the middle of 1950 to November 1951, capital imports from the United States provided the main source of strength for the Canadian currency but since then an improved trade balance has become the important factor. In addition to the inflowing capital, the increased foreign need for Canadian currency to pay for the expanded Canadian export surplus during the past 15 months led to the appreciation of the Canadian dollar since the Canadian authorities have pursued a policy of non-intervention in the foreign exchange market. Had the Canadian authorities been prepared to offer Canadian dollars more freely to the market in exchange for foreign currencies (U. S. dollars or gold), they could have moderated the appreciation and augmented official holdings of foreign currencies.

This policy of non-intervention was maintained even during the third quarter of 1952 when the premium exceeded 4 per cent; it seems, therefore, that the Canadian authorities have not altered their thinking about exchange rate policy since September 1950. When the fixed par value for the Canadian dollar was abandoned in 1950, the authorities announced that they would intervene only to maintain orderly market conditions; official operations were to be limited to smoothing out minor daily fluctuations or to offsetting exceptional orders which might disturb the market. This policy was reaffirmed by Finance Minister Abbott in Parliament on June 25, 1952 in these words:

> ". . .it will be our purpose . . . merely to operate so as to minimize extreme fluctuations - to smooth a trend somewhat rather than to attempt to resist a trend in either direction". 1/

This policy of non-intervention appears to indicate official acquiescence to the currency appreciation. Thus far, favorable market conditions for important export products have prevented the Canadian economy from feeling the full deflationary impact upon export prices which is usually associated with currency appreciation. Although there is a slight export surplus despite the appreciation, Canada's trade has

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1/ House of Commons Debates, June 25, 1952, p. 3692.

moved in the direction of greater regional unbalance. This has been reflected in a growing deficit in trade with the United States, due primarily to heavier imports of American products, which somewhat offsets the enlarged Canadian trade surplus with third countries. Moreover, a net outflow of capital from Canada may well occur during 1952, as an indication of the effect of appreciation on capital flows. It appears, therefore, that the appreciated currency has set into motion tendencies moving in the direction of eliminating Canada's external surplus; the decline of the Canadian dollar in November indicates that this adjustment process has already made considerable progress.

The apparent official acquiescence in the appreciation of the Canadian dollar also has long-run implications. Analysis of the reasoning behind the policy of non-intervention suggests that exchange flexibility may be looked upon as a means to insulate the Canadian domestic economy from the consequences of external developments. If this analysis is accurate, it follows that the exchange rate would be permitted not only to rise with an export boom but also to decline when the boom subsides. A country such as Canada might be able to carry out such a policy of insulation without causing widespread disturbance in the world economy, but it appears doubtful whether such a program could be reconciled with the spirit of the Bretton Woods agreements. On the other hand, if exchange rate flexibility is not meant to be an instrument of long-run policy, then the Canadian authorities might consider replacing the current practice of non-intervention by an attempt to use the process of market experimentation as a guide to a long-run equilibrium rate.

Why the Canadian dollar was freed

The Canadian dollar was allowed to go free in 1950 because the authorities saw no other means by which serious internal and external economic difficulties arising from an unprecedented inflow of American capital could be ended. During August and September, the net capital inflow was at an annual rate of over (US) $1,000 million. Immediate appreciation of the currency to parity with the U. S. dollar would have raised the danger that this volatile capital would return to the United States and leave Canada with an appreciated par-value which could not be comfortably maintained.

The American capital inflow, which aggregated $960 million 1/ during the calendar year of 1950 as shown in Table I, was mostly of a short-term character, attracted by the expectation that the Canadian dollar would be restored to parity with the U. S. dollar. Net direct

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1/ Unless otherwise indicated, all value figures are in terms of Canadian dollars.

Table I

CANADA: Balance of Payments with the United States

(In millions of Canadian dollars)

	1949	1950	1951
I. Balance of Payments with U. S.:			
1. Current account balance	-589	-403	-955
2. Capital account balance	+ 49	+960	+560
Total above items	-540	+557	-395
3. Receipts of U. S. dollars from third-countries	+674	+137	+434
4. Increase in official holdings of gold and U. S. dollars	+134	+694	+ 39
II. Net capital transactions with U.S.:			
1. Direct investment a/	+100	+240	+255
2. Security transactions:			
Trade in outstanding securities b/	+ 41	+428	+ 35
New issues of Canadian securities	+105	+210	+404
Retirement of Canadian and other securities	-135	-256	-157
3. Short-term balances and other capital movements c/	- 62	+338	+ 23
Net capital flow	+ 49	+960	+560

Source: The Canadian Balance of Payments, 1951 and 1950, Dominion Bureau of Statistics

a/ Includes U. S. direct investments in Canada and Canadian direct investments abroad.

b/ Includes both Canadian and non-Canadian debtor securities

c/ Includes an errors and omissions item of uncertain magnitude.

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investment, which was of a long-term nature, amounted to only \$240 million, or 25 per cent of the total flow. The short-term capital movement took the form of purchases of outstanding securities (largely obligations of the Government of Canada) and, to a lesser extent, of holdings of cash balances at Canadian banks. 1/ In addition, a "leads and lags" in payments for current transactions was estimated to total more than half the \$338 million "other" capital movement figure shown in the table, since individuals with payments to be made in Canadian currency tended to speed up their remittances and those with payments to be made in U. S. currency tended to delay transmission of funds. 2/

Because of economic developments favorable to Canada following the Communist invasion of South Korea, a speculative flow of American funds commenced moving into Canada in volume in the middle of 1950. The accelerating rate of this inflow during the third quarter was reflected in the growing accumulation of official reserves of foreign exchange between July and September, as shown in the bottom section of the chart. During these three months, Canada's reserves rose by about 43 per cent from (US) \$1,255 million to (US) \$1,790 million.

This heavy accumulation of foreign exchange raised for the monetary authorities the problem: how was the Canadian dollar equivalent of the accrual to be financed? Under the arrangements in effect in Canada, the Treasury is called upon to provide the Canadian funds needed to finance the country's foreign exchange holdings. The official reserves of gold and foreign exchange are concentrated in the Exchange Fund Account, a special fund in the name of the Minister of Finance, which obtains its Canadian currency by borrowing from the Canadian Treasury. The Finance Minister is authorised by law to make advances to the Account out of the Consolidated Revenue Fund "on such terms and conditions as the Governor in Council may prescribe." 3/ The Account usually maintains only a small working balance in Canadian currency; consequently, the Account tends to borrow from the Treasury when reserves are being accumulated and to repay the Treasury when official holdings are being reduced.

The Canadian authorities tended to place much emphasis upon the problem of Canadian dollar financing. In its Report for 1950, for example, the Bank of Canada noted that no increase in the total liquid assets of the public 4/ would result from the Canadian dollars provided to the Account

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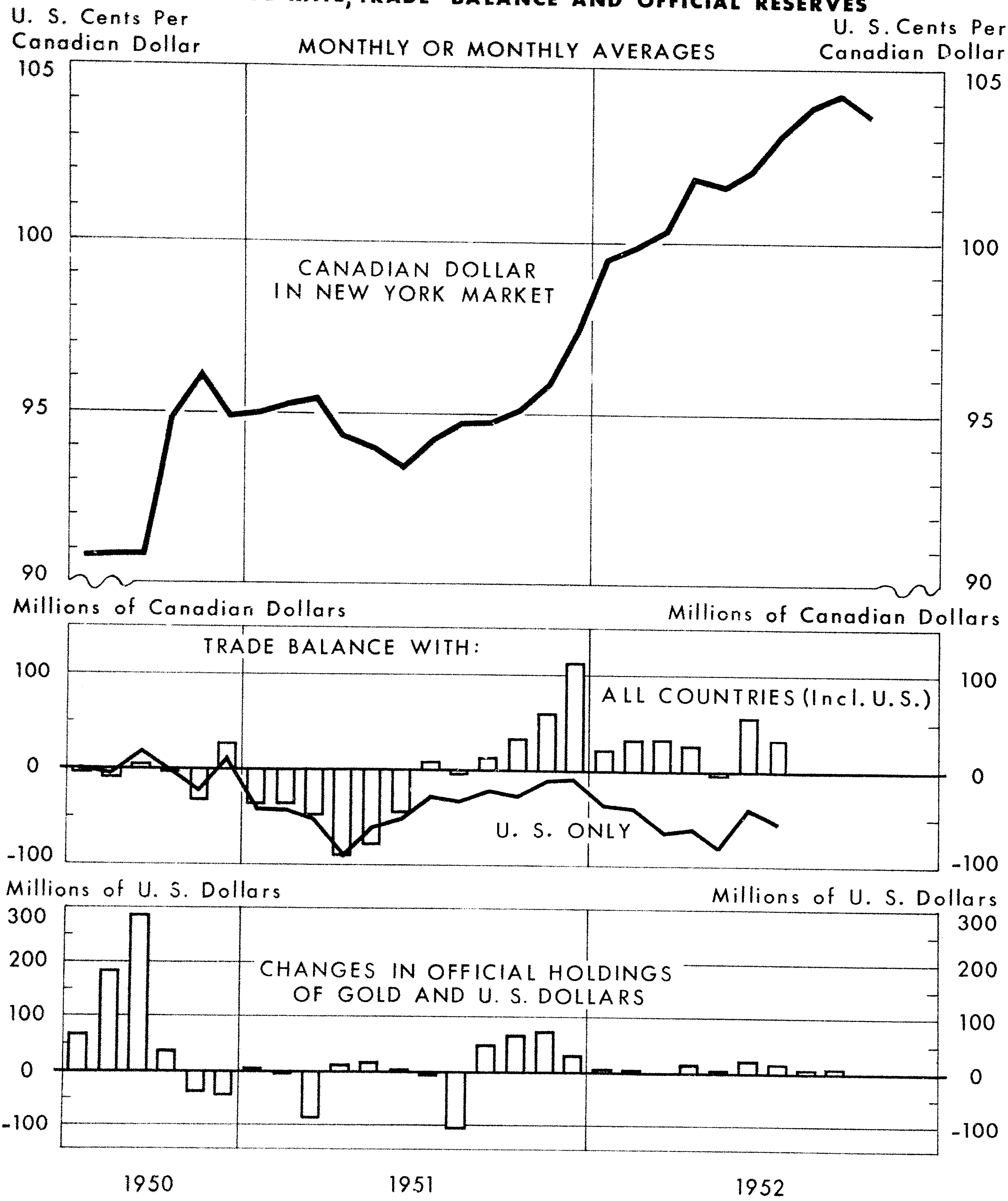
1/ Although speculative in character, some portion of the security inflow could be expected to remain in Canada for the six-month period required under U. S. tax legislation for exchange profits to be treated as a capital gain rather than as earned income.
2/ Foreign Exchange Control Board, Annual Report for 1950, p. 14.
3/ An Act respecting . . . the EXCHANGE FUND, as passed by the House of Commons June 26, 1952, paragraph 23 (Bill 390, 6th Session, 21st Parliament 1 Elizabeth II, 1952)
4/ Defined as currency, bank deposits and Government Security held by the public.

CANADA

EXCHANGE RATE, TRADE BALANCE AND OFFICIAL RESERVES



insofar as the Treasury had an "overall cash surplus of receipts over (other) disbursements." 1/ For 1950, the Treasury's realised surplus amounted to $447 million, "part of which was used to effect a net retirement of domestic debt in the first half of the year and part to provide for increased advances to Foreign Exchange Control Board." 2/ The Bank's Report continues:

> "Other means of providing necessary Canadian dollar financing such as the use of existing Government cash balances, issue of securities to banks or to the public, or the acquisition of foreign exchange by the Bank of Canada, all involved an increased in the aggregate liquid assets held by the general public." 3/

In practice, the Canadian authorities used up first the cash resources of the Treasury; thereafter, funds were borrowed from the commercial banks and, at the same time, the authorities took the unusual step of having the Bank of Canada acquire large amounts of foreign exchange for its own account. Of the total of $588 million of foreign exchange purchased during the third quarter, $295 million was financed by advances from the Treasury and $293 million was acquired by the Bank of Canada. 4/ Until the end of July, the Treasury financed the accrual out of its current resources. On August 30, some $200 million of Deposit Certificates were sold to the chartered banks. Throughout the months of August, September and October 1950, the Bank of Canada made outright purchases of foreign exchange; the operations reached a peak of $393 million in the week of October 18. To absorb the additional reserves made available to the banking system as a result of these purchases of foreign exchange, the Bank of Canada reduced its portfolio of government securities by $337 million, as a temporary measure until its foreign exchange assets could be reduced.

The judgment of the Canadian authorities that the inflow could no longer be sterlized or otherwise financed without creating inflationary dangers was crucial to what happened thereafter. Having decided to abandon the fixed par value as a method of halting the capital inflow, the authorities "had no choice but to leave the rate free to find its own level in the market." 5/ Appreciation in a single step to a new par value at parity with the U. S. dollar was a possible alternative action; but the funds

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1/ Bank of Canada, Annual Report for 1950, p. 8
2/ Ibid, p. 8
3/ Ibid, p. 9
4/ Bank of Canada, Annual Report for 1951, p. 8
5/ Finance Minister Abbott's speech before the Vancouver Board of Trade, October 20, 1952, mimeograph press release, p. 8

might then have returned to New York in order to realise the exchange profit. In that case, Canada would have been left with an appreciated currency and would have faced a different, but almost certainly more serious, foreign exchange situation. 1/ In the words of Finance Minister Abbott:

> "In August and September 1950, the net inflow of capital was at an annual rate of over a billion dollars. It became clear that the existing rate could not be held. On the other hand, under the conditions prevailing in the autumn of 1950, no one could decide with any reasonable assurance what new fixed level could be maintained." 2/

In these circumstances, the freeing of the Canadian dollar in the foreign exchange market appeared necessary for both Canada's external and internal economic stability.

Changing character of external influences on the Canadian economy

The inflow of speculative American capital seeking merely to profit from the expected appreciation came to an end with the abandonment of the par value on September 30, 1950. Since then, there have been several changes in the external economic influences affecting the Canadian economy. Throughout 1951 there was an inflow of long-term American capital, estimated at about 60 per cent of, but of a character different from, the 1950 capital flow. A further change in the type of capital movement took place during 1952. Instead of the acquisition by American interests of short-term Canadian-dollar assets, the characteristic American capital flow during 1951 took the form of borrowing or sales of stock by Canadian govermental units and corporations, through the placing of new issues in the United States. Thus, the typical transfers during 1951 were "long-term movements connected with the financing of Canadian development" and the "decisions to borrow rested with residents of Canada, whereas in 1950 the decisions usually rested with non-residents." 3/ In addition, an unexpected improvement in Canada's foreign trade balance emerged as the major source of strength for the currency during the past twelve months.

This marked shift in the inflow of American capital is indicated in Table I. American purchases of existing (mostly Canadian) securities and "other" capital movements (mainly in the form of "leads and lags" in

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1/ The 1946 experience has made Canada sensitive to the dangers of an ill-timed appreciation.

2/ Abbott speech, p. 8

3/ The Canadian Balance of International Payments, 1951, Dominion Bureau of Statistics, p. 6

merchant payments for current trade transactions and in the form of deposits at Canadian banks) together comprised about 87 per cent of the 1950 movement but dwindled to insignificance during 1951. On the other hand, new issues (net) of Canadian securities in this country became important during 1951. Canadian provinces and municipalities, which accounted for two-thirds of this movement, moved into the American market because of the rise in Canadian interest rates and the general credit stringency in Canada.

American capital continued to move into Canada during 1952 but, again, the character of the inflow has altered. Corporate borrowing has replaced Canadian local government issues as the major type of new financing. The shift is reflected in the following data of the Securities and Exchange Commission covering Canadian flotations in U. S. markets (in millions of U. S. dollars):

	Calendar year 1951	January-June-1952
Canadian provinces and municipalities	269	70
Corporations	83	143
Total	352	213

In 1952, virtually all the municipal borrowing had been completed by early April, before the Canadian dollar attained a large premium. By contrast, a May issue of (US) $90 million by the Aluminium Corporation of Canada is responsible for the impressive rise in the corporation figures.

The U. S. balance-of-payments estimates in Table II indicate that the net capital flow from this country to Canada has been reduced since the middle of 1951. The net capital outflow of (US) $61 million during the second quarter was slightly below the average for the second half and less than half the average for the first half of last year. An exceptionally heavy gross outflow to Canada did occur but its effect was largely offset by the unusually heavy accumulation of U. S. currency assets by Canadians during the same period.

In contrast to the diminished net capital movement into Canada since mid-1951, Canada's trade position has shifted from a deficit during the first half of last year to a substantial surplus since October 1951. Canada's surplus with third countries has been larger than the trade deficit with the United States. The resultant third-country demand for Canadian dollars has been a major source of strength underlying the recent premium, since the bulk of third-country purchases of Canadian dollars pass through the New York or Canadian exchange markets, and price movements in these two markets are closely correlated. 1/

1/ A small volume of Canadian exchange is handled by the London market. Early in September, 1952, Canadian sterling accounts were made equivalent to American sterling accounts undeh British exchange regulations, thereby increasing arbitrage possibilites between London and North America. (See Economist, September 13, 1952, page 658).

Table II

CANADA: Selected Capital and Foreign Trade Statistics

(In millions of UNITED STATES dollars)

	1951 I	1951 II	1951 III	1951 IV	1952 I	1952 II
I. Capital flow to Canada: a/						
U. S. capital flow (net)	58	192	5	158	66	208
Foreign capital flow (net)	96	-48	66	-82	-13	-147
Combined net flow	154	144	71	76	53	61
II. Canada's trade balance: b/						
With third countries	15	- 11	96	242	226	269
With United States	-133	-192	-81	- 47	-142	-187
With all countries	-118	-203	15	195	84	82

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a/ U. S. balance-of-payments estimates prepared by the U. S. Department of Commerce. Signs have been reversed to show movement from point of view of the Canadian economy.
b/ Canadian trade statistics, coverted to UNITED STATES dollars at the monthly average buying rate in the New York market.

The recent trade surplus has been the result of record exports: during the first half of 1952, Canadian exports reached a level of $2,090 million compared to $1,740 million during the first half of 1951. The 20-per cent increase in value was accompanied by a 17-per cent expansion in physical volume. This remarkable export performance was the result of favorable market conditions for grain, non-ferrous metals, iron products and wood and paper products.

However, a growing regional imbalance in the trade accounts has accompanied Canada's recent export boom. Exports to the United States during the first half of 1952 have been virtually unchanged (in Canadian currency) compared to the first half of 1951 though they have been below the value recorded during the second half of 1951. The marked increase in Canada's trade deficit with this country, as shown in the chart and in Table III, has been due primarily to heavier purchases of United States products. At the same time, Canada's improved trade position with the world as a whole has been due to enlarged surpluses with Britain, continental Europe and Latin America; all these areas settle current balances

Table III

Canada: Exports, Imports and Trade Balances by Major Areas,

(In millions of Canadian dollars)

Quarter		All countries	U. S.	U. K.	Other commonwealth	Latin America	Europe
I. Exports:							
1951:	I	809	530	113	51	37	47
	II	931	580	140	55	43	68
	III	1,044	582	192	63	52	120
	IV	1,130	606	185	73	76	132
1952:	I	987	542	155	81	78	84
	II	1,102	571	239	67	70	108
2. Imports:							
1951:	I	944	678	92	62	62	30
	II	1,159	793	132	85	72	49
	III	1,040	676	111	107	69	51
	IV	943	666	85	53	71	48
1952:	I	916	694	68	42	65	33
	II	1,034	764	93	50	72	38
3. Trade Balance: a/							
1951:	I	-130	-140	21	- 11	-25	17
	II	-216	-205	8	- 30	-29	18
	III	16	- 86	83	- 44	-17	69
	IV	202	- 49	103	20	5	84
1952:	I	84	-142	87	39	13	51
	II	81	-183	147	17	- 2	70

a/ Includes re-exports which are not shown in Table.

in Canadian (or U. S.) dollars. Thus, the trade statistics in Table III suggest that third-country procurement of foreign exchange to settle their enlarged trade deficits underlies the recent premium of the Canadian dollar.

Economic consequences of the policy of non-intervention

The Canadian authorities have deliberately chosen to allow the exchange rate to move upward without restraint rather than to undertake offsetting market operations which would moderate the appreciation and, at the same time, would augment official exchange reserves. Indicative of the inactivity of the authorities in the foreign exchange market in the face of a mounting premium is the limited movement in gold and dollar holdings during 1952 shown in the chart.

Thus far, Canada has been fortunate in avoiding the full impact of a currency appreciation upon the prices and, hence, upon the scale of output and the cost structure in export industries. With domestic costs unchanged and the price to the foreign buyer raised, appreciation usually tends to produce buyer resistance which in turn forces the export sector to cut prices and, hence, to reduce costs and perhaps output. During the first half of 1952, however, Canada's export volume and export value were at record levels and export prospects for the coming months (particularly as a result of the record wheat crop of above-average quality harvested this fall) are promising.

Furthermore, Canadian exporters seem to have been able to maintain their prices in foreign currencies. To be sure, Canada's export prices index reached a peak of 126 in the fourth quarter of 1951 and fell back to 121 during the second quarter of this year, as may be seen in Table IV. The Canadian index, like the U. S. export unit value index, shows a decline in 1952 prices below the peaks recorded last year. But in the case of Canada, the currency has appreciated to a greater extent than the export price index has fallen. As a result, the adjusted cost of Canadian products in foreign currencies (expressed in terms of U. S. dollars) was substantially higher during the first half of 1952 than during the previous year. Since exports have been moving in record volume despite the higher cost of the goods to the foreign buyer, it is evident that the export boom Canada has been experiencing has prevented the appreciation from having a depressing impact on export prices.

In the case of both import prices and import value, Canada's recent experience has been consistent with the usual expectations of the consequences of currency appreciation. Canadian import prices have fallen to a greater extent than have U. S. import unit values. During the second quarter of 1952, for example, the Canadian index stood two points below the September 1950 level, while the U. S. index was 14 per cent higher. However, when the Canadian index is adjusted for the rise in the currency unit, the two series follow very closely together and the gross discrepancy disappears.

At the same time, the volume of Canadian imports has expanded. The value of imports has been well maintained in terms of Canadian currency and, hence, has increased in terms of foreign currency. The physical volume index averaged 147 per cent of the 1948 volume during the second quarter of 1952 compared to an average of 126 for the January-to-June period and 120 for the July-to-December period during 1951. These larger imports have been concentrated in purchases from the United States. The relative decline in imports from third countries may reflect foreign supply inelasticities because of rearmament or inflation or Canadian demand inelasticities; in any case, the failure of Canadian imports from third countries to expand at a rate parallel to the expansion in imports from the United States has aggravated disequilibrium in the world trading community.

Table IV

Comparison of Canadian and U. S. Export and Import Price Series,

quarterly averages

(September 1950=100 for all series)

Year and quarter	Export price index			Import price index		
	Canada		U. S. export unit value	Canada		U. S. import unit value
	in Canadian currency	in foreign currency a/		in Canadian currency	in foreign currency a/	
September 1950	100	100	100	100	100	100
1950:						
IV	112	117	104	102	107	105
1951:						
I	118	123	109	109	114	115
II	122	126	114	114	118	122
III	125	130	112	113	118	121
IV	126	133	111	108	115	116
1952:						
I	125	137	113	104	114	117
II	121	136	112	98	110	114

a/ Adjusted for appreciation of Canadian dollar after September 30, 1950, using monthly average rates in the New York market.

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The premium on the Canadian dollar has already induced some capital movements out of Canada. The heavy increase in Canadian holdings of U. S. dollar assets during the second quarter of 1952, as shown by U. S. balance-of-payments estimates in Table II, is one example of capital export. Similarly, Canadian statistics show that August was the fourth consecutive month during which a net outflow of capital from Canada took place with Canadian purchases of outstanding U. S. - held securities exceeding U. S. purchases of existing Canadian securities. 1/ In addition, a short-term capital flow through "leads and lags" in merchant payments of uncertain magnitude has taken place because the third-quarter premium encouraged foreigners to delay payments in Canadian currency and encouraged Canadians to accelerate foreign currency out-payments. 2/

The gross outflow of long-term American capital to Canada has proceeded without apparent interruption. That this flow has continued despite currency appreciation is attributable to the fact that these investments are of a very long-term nature in petroleum, iron ore and other basic industries in response to industrial requirements for basic raw materials; exchange rate changes, within the range of the recent fluctuation of the Canadian dollar, could not be significant in determining investment decisions where the returns are projected over a very long period. However, because of a high degree of capital mobility enjoyed by American firms with plants on both sides of the boundary, Canada's manufacturing industries may be vulnerable to the consequences of an exchange value for the Canadian dollar out of line with the comparative cost structure in the two countries.

Defense of present exchange policy

Apparently one of the purposes of the Vancouver speech of Finance Minister Abbott was to defend the Government's foreign exchange policy against criticism from Canadian exporting interests. In response to demands that the Government do something about the appreciation of the currency, Minister

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1/ "Sales and Purchases of Securities Between Canada and Other Countries" monthly, Dominion Bureau of Statistics, for July, Canadian repurchases totalled \$22.6 million compared to net sales to the U. S. of only \$5.1 million. For August, Canadian repurchases totaled \$30.1 million compared to sales of \$4.5 million.

2/ With respect to Canadian exports, where the merchandise is quoted in U. S. dollars, the Canadian exporter has an interest in delaying transfer of U. S. dollars into Canadian currency; where the merchandise is quoted in Canadian dollars, the U. S. importer has an interest in delaying procurement of Canadian currency. Since Canadian imports of American products are generally quoted in U. S. dollars, Canadian importers have an interest in accelerating the procurement of American currency.

Abbott pointed to the difficulties in determining the "right rate" for the Canadian currency and to the inflationary consequences of large-scale official operations in the foreign exchange market.

To what rate should the Canadian dollar be "forced"? The Finance Minister noted that "however convenient it may be, there is no inherent logic in equality with the U. S. dollar" and added that in 30 out of the past 40 years the Canadian and American dollars have exchanged at varying rates.

During the past 24 months during which the currency has been allowed to respond freely to market forces, the Canadian dollar has fluctuated within a range of about 10 US cents (between 94 and 1.04 US cents) or about 5 per cent above and below a 99 US cent midpoint. While existing analytical tools do enable the observer to recognize whether or not an exchange rate is grossly out of line, they are hardly adequate to make an estimate of an appropriate exxhange value within a 5-per cent margin of error. 1/ It is precisely because of the limitations of the specialist that there has recently been renewed recognition that market experiment, perhaps limited in time, has a vital role to play in the process of determining an appropriate exchange value. But the process of market experimentation will provide useful guidance as to the appropriate exchange rate only if the experiment is conducted by the monetary authorities according to well-defined policy objectives.

Return to a formal par value in accordance with current Fund practice is not the only alternative to present Canadian exchange policy. The immediate choice facing the authorities is not necessarily whether or not the Canadian dollar should return to a fixed parity but the practical question of the extent to which they should operate in the market to maintain more stable exchange rate conditions. To be sure, increased official intervention might well be a necessary step preparatory to a return of the Canadian currency to a fixed par value; however, the case for greater exchange rate stability does not depend upon the longer-term consideration of a fixed par value.

1/ In September 1949, it was clear that the British pound could not be held at $4.03. While a rate of $2.80 was selected as the new value, nobody was then able to argue that the "right rate" was $2.80 rather than $2.94. In fact, many observers maintained at the time that the pound was undervalued at $2.80 and subsequently some of them even recommended appreciation. But experts would probably have agreed that $2.64 would have been a movement in the wrong direction since $2.80 was generally thought to be on the low side. One recalls, perhaps as the classic case, Mr. Keynes' criticism of the British decision in 1925 to restore the pound to $4.86 at a time when its value in the foreign exchange market was around $4.40. In this case where the difference between the alternate parities amounted to 10 per cent, there was wide agreement among economists that the exchange movement was in the wrong direction but even this position was not universally accepted.

The domestic inflationary results of official intervention constituted the second argument presented by the Finance Minister. If the Government decided to reduce the premium by buying U. S. dollar exchange in the market, he stated, "I am convinced it would be a very substantial amount indeed" that would have to be bought. He pointed out that official reserves had risen during the past year by $246 million despite the policy of attempting only to maintain an orderly market. In passing, it might be noted that some $169 million of this increase occurred during the fourth quarter of 1951 (see chart).

If the Treasury found it necessary to borrow from the banks to finance the accrual of foreign exchange, a monetary expansion would take place or private credit would be curtailed. If the banking system had excess reserves, security purchases by the banks would only expand their deposits and reduce excess reserves; if reserves were being fully utilised, the banks would either have to dispose of other earning assets or the authorities would have to provide additional bank reserves. Treasury borrowing from the public would tend to raise interest rates on Treasury obligations and would probably have some impact upon a broad range of commercial rates. If the authorities were determined to keep a rather firm hand over the volume of credit, competition for loanable funds and the hardening of rates would act as a brake upon internal investment activity.

Under present arrangements, the inflationary effect of an external surplus would operate through requiring the Treasury to obtain additional financing within Canada. Under the classical rules of the gold standard, or under any other system where the central bank monetizes a current external surplus, the result would be an expansion of central bank liabilities, commercial bank reserves and the deposits of the public: the resultant expansion in incomes and prices was expected eventually to eliminate the export surplus. During the 1930's, however, foreign exchange holdings were concentrated in the hands of a Treasury account in Canada, as in Britain and the United States, as a means to insulate the Canadian banking system from the immediate impact of such external factors. Under this arrangement, the effect of the external surplus upon the banking system depended primarily upon the means used in each instance by the Treasury to obtain its cash requirements. The present Canadian exchange policy avoids this form of pressure upon the Treasury's cash position at the expense of foregoing an accrual of official reserves.

With this policy of non-intervention, the adjustment of the Canadian economy to the export boom proceeds in the first instance through the appreciation of the Canadian currency which may be expected in the long run to induce changes in major current-account and capital factors in the balance of payments in the direction of eliminating the export surplus. Appreciation will eventually have to expand imports and to encourage an outflow of capital from Canada and, at the same time, to curtail exports and to discourage the inflow of capital. The policy of allowing adjustment through exchange appreciation serves thus to insulate the internal monetary situation from the expansionary effect of the external surplus, but it cannot permanently prevent the Canadian economy from adjusting itself to the rising value of the currency.

Concluding observations

The appreciation of the Canadian dollar, and particularly the large premium recorded from July to October, has already set into motion tendencies which move in the direction of eliminating the external surplus. Mr. Abbott's statement last month that "on balance the sum total of all kinds of capital transactions this year may show, if anything, some net outflow of capital" is evidence that the adjustment process has proceeded quite a distance. The tendency for imports to expand operates in the same direction. Criticism by exporters of the present policy suggests that the impact of currency appreciation upon the export sector of the economy is also beginning to be felt. The steady decline in the Canadian dollar during the early part of November to a point below (US) $1.02 reflects the effect of this equilibrating movement as well as the impact of temporary political or other factors such as the U. S. election. 1/

This adjustment process, therefore, induces the Canadian economy to expand merchandise imports to a level which can be maintained only so long as the export boom persists. When the export surplus disappears, imports will have to be reduced either through raising the Canadian price of foreign goods by means of a decline in the value of the Canadian dollar, or through reducing Canadian incomes by means of domestic inflation. The second alternative presumably is out of the question as a matter of practical policy. Instead of allowing the exchange rate to decline, the authorities could reintroduce import controls, but this line of policy would be unpalatable to a country which successfully eliminated all trade and exchange controls last year. Thus, the present exchange policy does not seem to lead to exchange stability in the near future but, on the contrary, to a prolonged period of exchange fluctuation. By contrast, a policy of restraining the rise in the exchange rate under temporarily favorable circumstances would reduce the need for opposite movements after the force of the export boom had been spent.

Canada's recent experience with a free exchange rate is of particular interest in view of the widespread current discussion of floating exchange rates. Referring to the varying external pressures confronting the Canadian economy in the post-war world, Mr. Abbott stated:

> "We realised ... that in the kind of world we faced, split between the sterling area and the dollar area, with trade discrimination rampant and inconvertibility

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1/ The Canadian currency averaged (US) $1.0417 in September and (US) $1.0368 in October. On November 3 it was quoted at (US) $1.0355, but declined steadily to a low of (US) $1.015 on November 13.

> of currencies almost universal, the "right rate" for the Canadian dollar at one time was unlikely to be the "right rate" at another, and that we might soon have to face again the problem of altering the official rate, with all the inconveniences and disturbances that these sudden and substantial changes create." 1/

Although Canada has had a fluctuating currency, it is noteworthy that the range of fluctuation of the Canadian dollar has been within a spread of 10 US cents or about 5 per cent above and below the mid-point of that range. This fluctuation of 5 per cent was all the flexibility required in the exchange market to enable Canada to ride out a series of varying influences from abroad over a two-year period.

This fact focuses attention upon the requirement of the Fund's Articles of Agreement which obliges members to maintain spot transactions within one per cent of parity. 2/ Perhaps this limited variation in spot trading is a more rigorous requirement under present conditions than the stipulation that an official par value be established for the currency unit. For the Canadian experience indicates that the Canadian dollar could have been maintained at a fixed par value without discomfort, had the permitted range for spot transactions been 5 per cent in each direction rather than 1 per cent.

While it is clear from the post-war experience of many European countries that spot exchange rates can be maintained within narrow limits where controls are used to bolster the rate, there is evidence in the Canadian experience to suggest that widened spot rates may be necessary for the country which abandons all import and exchange controls and allows market forces to play the pivotal role in the country's economic processes. Moreover, with a wider spot spread, the selection of the "right" par value at any time becomes a less absolute and decisive action than it is under current Fund practice. Finally, the authorities are more able to avoid commitments to purchase an "excessive" volume of foreign exchange under temporarily favorable external developments in that a greater range of price fluctuation enables them more easily to withdraw in the face of market pressure. With exchange stability defined in terms of a 1 per cent range both sides of the official parity, Canadian officials feared that any rate selected for the Canadian dollar would be valid for only a brief period of time. Had a wider spot range been practical, a new par value might have been selected since it would not have seemed so likely to become obsolete in a little while: the declaration of a par value might not have threatened to raise "the problem of altering the official rate, with all the inconveniences and disturbances that these sudden and

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1/ *Ibid*, p. 7
2/ *Articles of Agreement*, International Monetary Fund, Article IV, Section 3, (i).

substantial changes create." Perhaps a system allowing a wider range of spot transactions around the official par value might thus have produced a greater degree of exchange stability in Canada during the past two years than has in fact been maintained.