# ECO 407
# Competing Views in Macroeconomic Theory and Policy

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# Lecture 12
## Should Countries Float, Fix, or Dollarized?

# The Foreign Exchange Rate

- The foreign exchange rate is one of the most important ***macroeconomic prices***
  - The exchange rate is one instrument to be used to achieve goals such as ***growth***, ***price stability***, and ***income distribution***

- The ***real*** exchange rate must be ***stable*** and ***competitive***
  - ***Volatile*** exchange rates may turn many sectors uncompetitive

- ***Different*** exchange rate arrangements might be needed at different times depending on policy priorities
  - No exchange rate system is devoid of ***problems*** and no system can be ***efficient*** in all situations
  - Exchange rate arrangements must maintain a certain degree of ***flexibility***

# Fixed Exchange Rate Regimes

- It reduces ***uncertainty*** about an important price and thus speculation becomes less attractive
  - Favoured by ***heterodox*** economists when accompanied by capital controls
  - Favoured by ***orthodox*** economists because it serves as an anchor for domestic prices

- Different types of ***fixed-exchange-rate*** arrangements:
  - ***Dollarization***: Elimination of the domestic currency
  - ***Monetary Union***: Adoption of a common currency
  - ***Currency Board***: Permanently fixed against a foreign currency
  - ***Target*** a particular exchange rate: Central bank must buy and sell foreign currency to keep that rate

# Flexible Exchange Rate Regimes

- The exchange rate is allowed to fluctuate according to changes in the ***demand*** and ***supply*** of foreign currency
  - It presumes that the central bank does not intervene in the foreign exchange market
  - It avoids ***balance-of-payment disequilibria***
- The adoption of ***free-floating*** regimes is quite uncommon
  - Countries usually adopt ***managed-floating*** regimes
  - ***Fear of floating*** due to possibility of ***foreign exchange crises***
- ***Consensus*** in 1990s: Either let currency ***float*** or establish a credible commitment to a ***hard peg*** to avoid financial crises
  - This ***"bipolar view"*** was discredited as a result of the Asian financial crisis of 1997

# Intermediate Exchange Rate Regimes

- ***Adjustable peg***
  - Currency is ***fixed*** against a foreign currency or a basket of foreign currencies
  - ***Changed*** as needed but not too often though
- ***Crawling peg***
  - Currency is initially fixed but ***adjusted*** at regular intervals
- ***Band regimes***
  - Slightly more complex ***quasi-pegged*** regimes
  - Central exchange rate is announced together with a ***fluctuation band***
  - Central exchange rate is ***managed*** (e.g., fixed or crawling)

- Increasingly clear that there is no single exchange rate regime that is right for all countries at all times

# Heterodox Argument for a Fixed Exchange Rate Regime

- No exchange rate regime can completely prevent ***macroeconomic turbulences***
  - But in some circumstances one exchange rate regime is better than others to achieve specific objectives
- Policy trade-offs can be represented by the ***"impossible trinity"***
  - Countries cannot achieve ***exchange rate stability***, ***monetary policy independence***, and ***free capital mobility*** simultaneously
  - Only two of these goals can be achieved at the same time
- Keynes defended ***capital controls*** as a complement to ***low rate of interests*** to promote full employment
  - Critics argued that it promoted demand-pull ***inflation***

# Orthodox Argument for a Fixed Exchange Rate Regime

- Fixed regimes that abandon ***monetary independence*** are seen as central to maintaining ***price stability***

- Advocates do not consider ***unemployment*** to be a serious problem
  - Economy will eventually return to the ***natural rate of unemployment***

- Further, free capital mobility is essential to promoting the ***efficient allocation*** of resources
  - Therefore, ***markets*** (and not government officials) should be trusted to promote welfare improvements

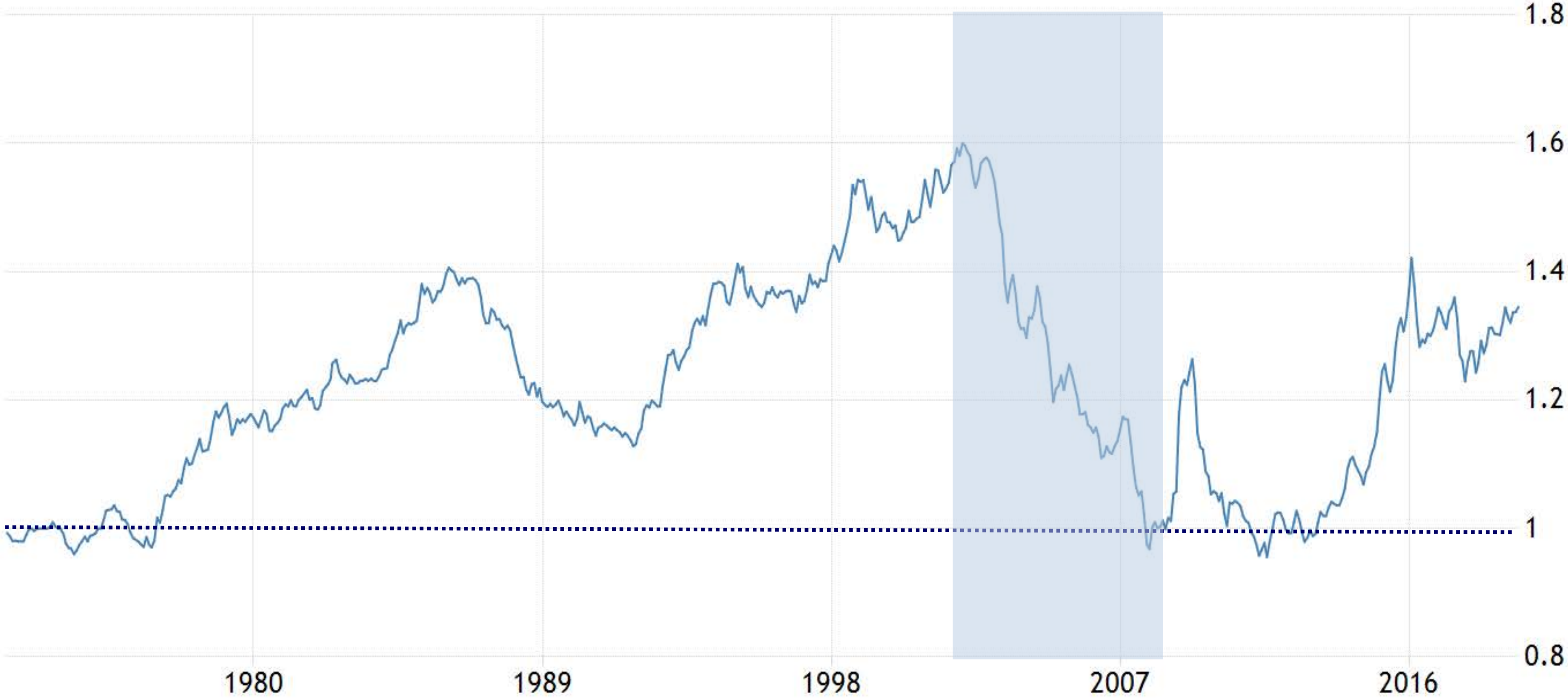
- Critics argue that lack of concern with level of activity may lead to high levels of ***unemployment*** for a prolonged period

# Fixed-Exchange Rate for Canada?

- Current currency area is too small to accommodate a dynamic ***energy*** sector and a world-class ***manufacturing/service*** sector
  - Need to immerse Canadian economy into a larger currency area via ***fixed-exchange rate*** regime with the U.S.
- High correlation between the value of the Canadian dollar and the ***price of oil***
  - This is the ***Dutch disease*** in action
- Canada is no longer an ***east-west economy*** but rather an east-west series of north-south, cross border economies
  - ***Appreciation*** of the Canadian dollar drives a wedge between Canadian and U.S. partners in each of the regions
  - Therefore, Canada should adopt a ***fixed-exchange rate*** regime

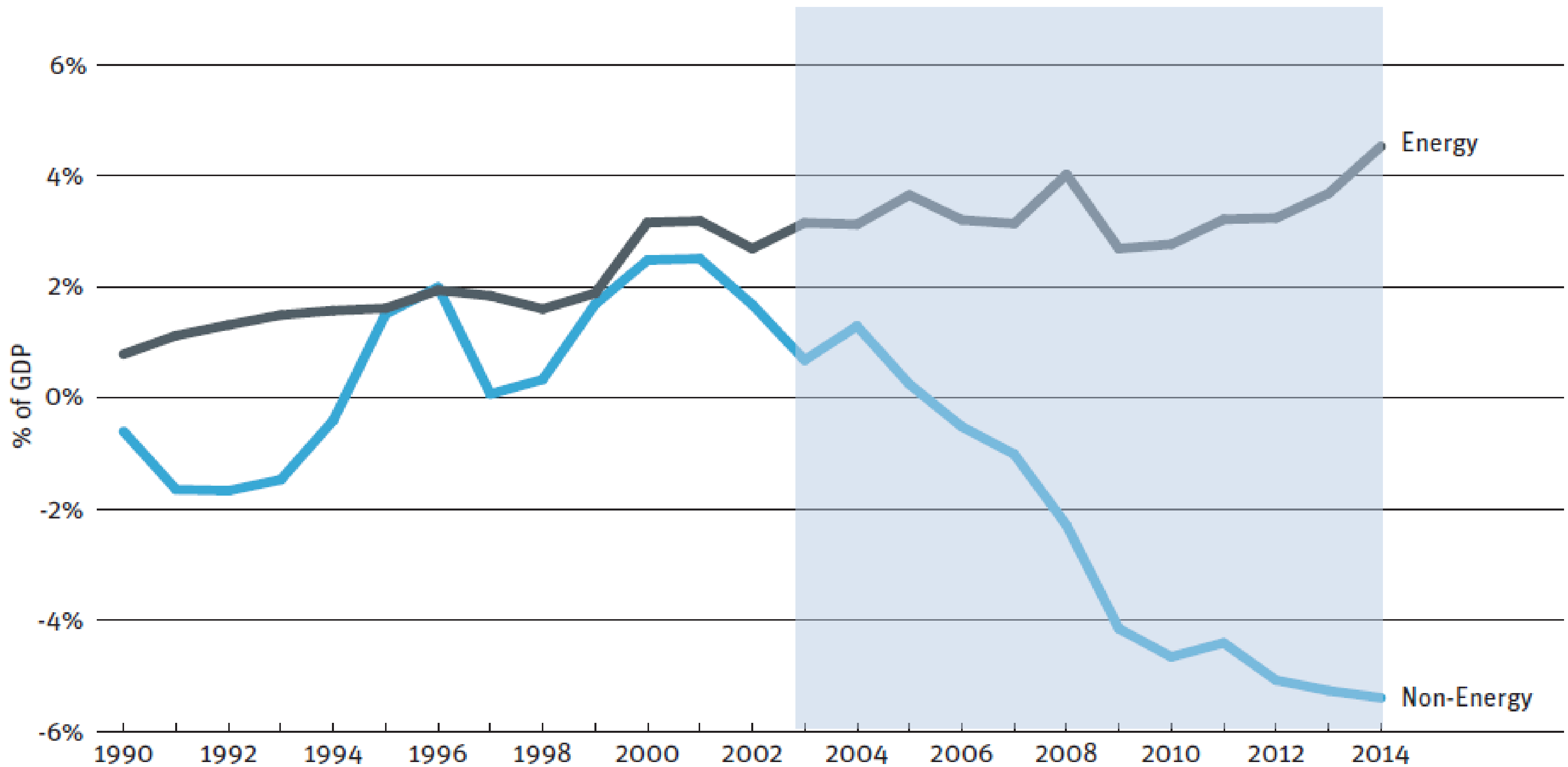
# The Exchange Rate Between the Canadian Dollar and the U.S. Dollar

## January 1970 to May 2019




**Source:** Trading Economics.

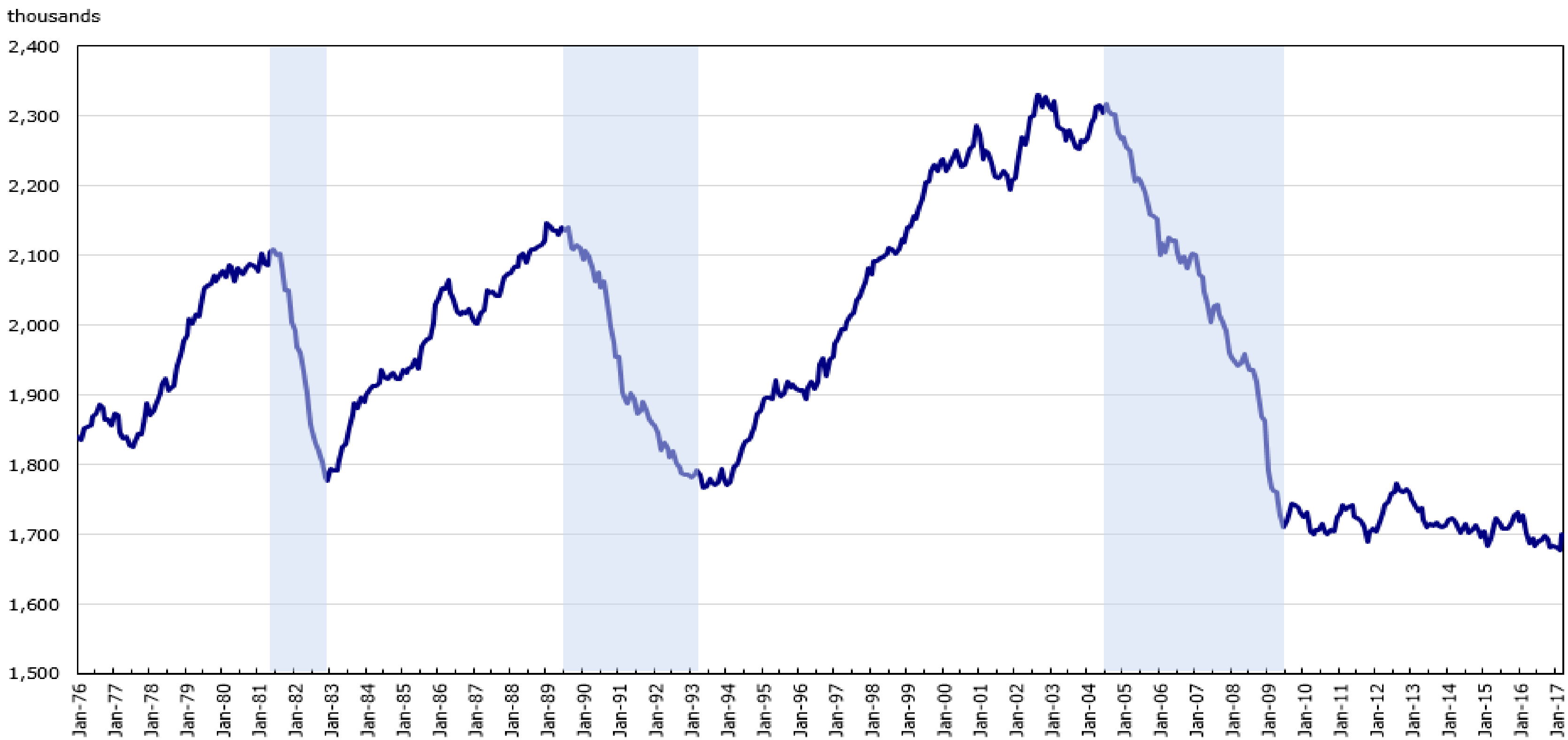
# Canada: Energy and Non-Energy Trade Balance, 1990-2014




**Source:** Canadian Centre for Policy Alternatives, *2016 Alternative Federal Budget*, 2016.

# Canada: Changes in Employment in the Manufacturing Sector

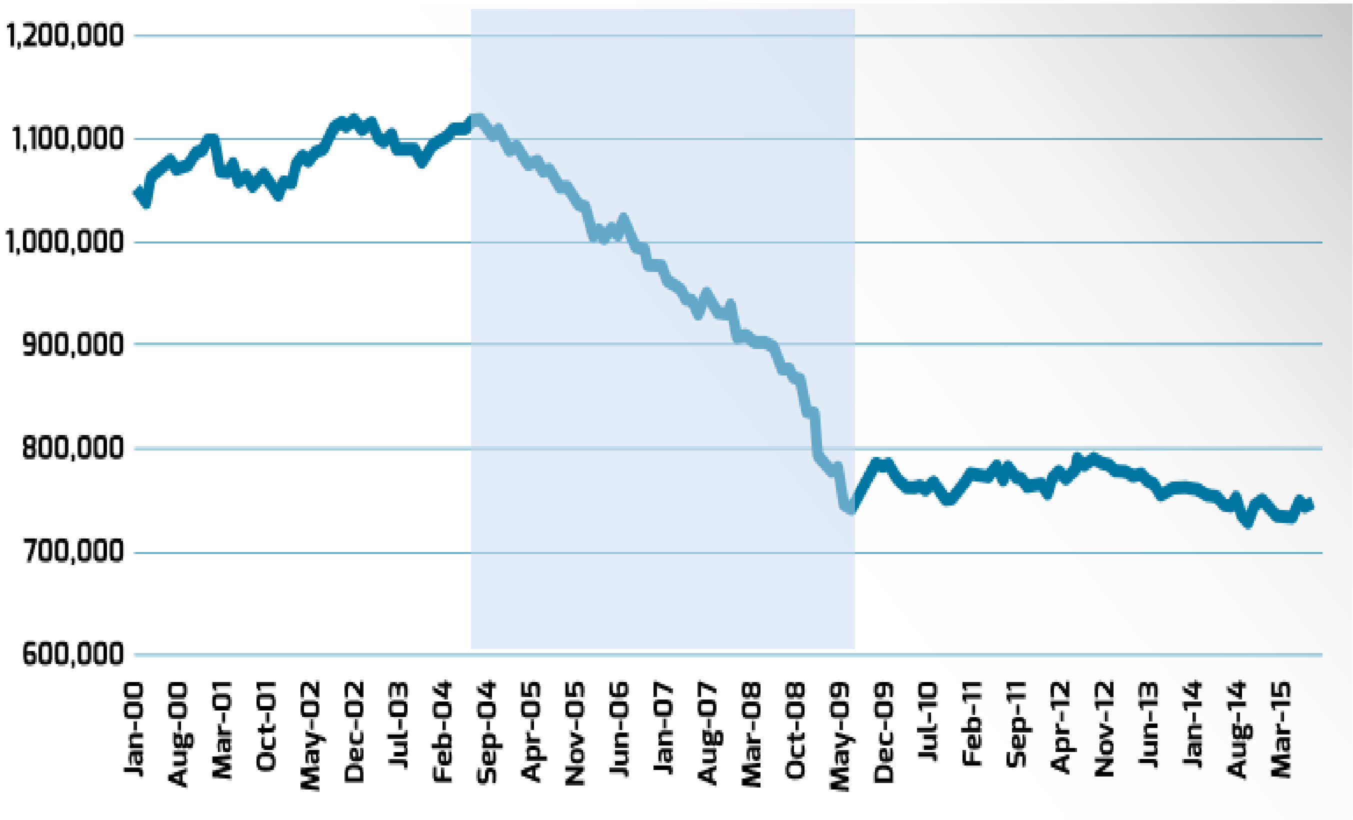
## January 1976 to January 2017




**Source:** Statistics Canada.

# Ontario: Changes in Employment in the Manufacturing Sector

## January 2000 to March 2015




**Source:** Canadian Centre for Policy Alternatives with data from Statistics Canada.

# Should Canada Dollarize?

- Advocates of ***inflation targeting*** argue that a fixed exchange rate would increase the money supply and put upward pressure on prices
  - The result will be a ***real appreciation*** of the Canadian dollar

- Therefore, the ***Dutch disease*** effect would take place under both a ***flexible*** or a ***fixed*** exchange rate regime

- The solution would be for Canada to use the ***same currency*** as the U.S.
  - That is, the adoption of either a ***common currency*** (the ***NAMU***) or the ***U.S. Dollar***
  - The former would not be acceptable to the U.S.
  - The latter would be politically difficult to sell to Canadians

# Arguments Against Dollarization

- Little to gain having the U.S. dictating ***monetary policy*** for Canada
  - It could be desirable for countries that cannot trust their central banks
  - During the recent crisis, Canadian monetary system proved to be superior to that of the U.S.

- ***Real shocks*** between Canada and the U.S. appear to be ***negatively correlated***

- ***Real shocks*** will affect the Canadian economy regardless of the currency adopted
  - But the ***path to equilibrium*** will be different under different ***monetary*** and ***exchange-rate*** systems

# What Is the Optimal Exchange Rate Arrangement?

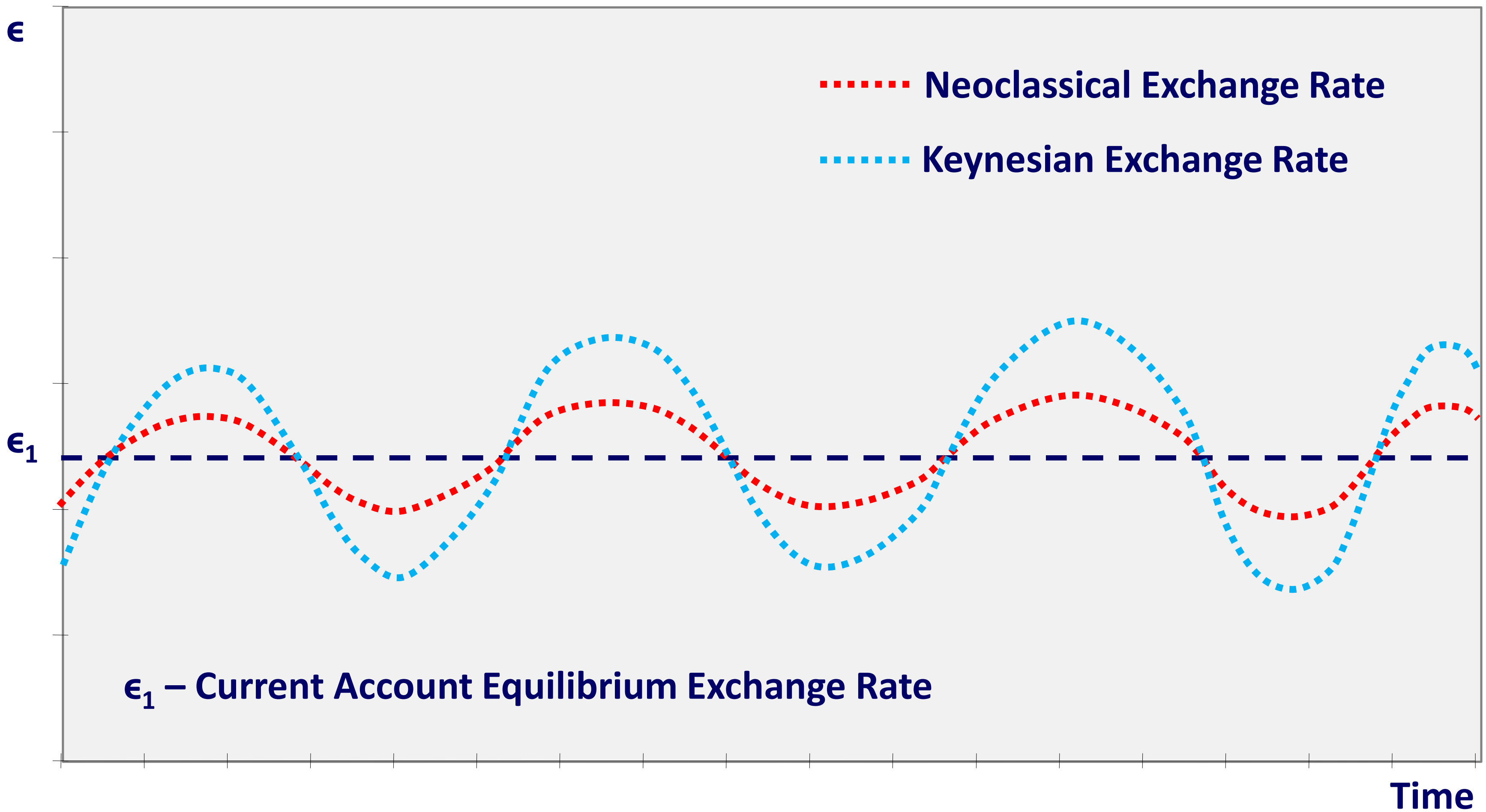
- ***Different*** exchange rate arrangements might be needed at different times depending on policy priorities
  - Exchange rate arrangements must maintain a certain degree of ***flexibility***
  - The objective should be to maintain a ***stable*** and ***competitive*** exchange rate

- It could be argued that it's best to have the most ***policy instruments*** as possible

- Therefore, it's best to have the possibility of implementing both ***fiscal*** and ***monetary policies*** as needed

- The implementation of independent ***monetary policy*** thus precludes the existence of ***free capital mobility***

# Conventional Trajectory of the Exchange Rate



# The Cyclical and Chronic Tendency to Overvaluation