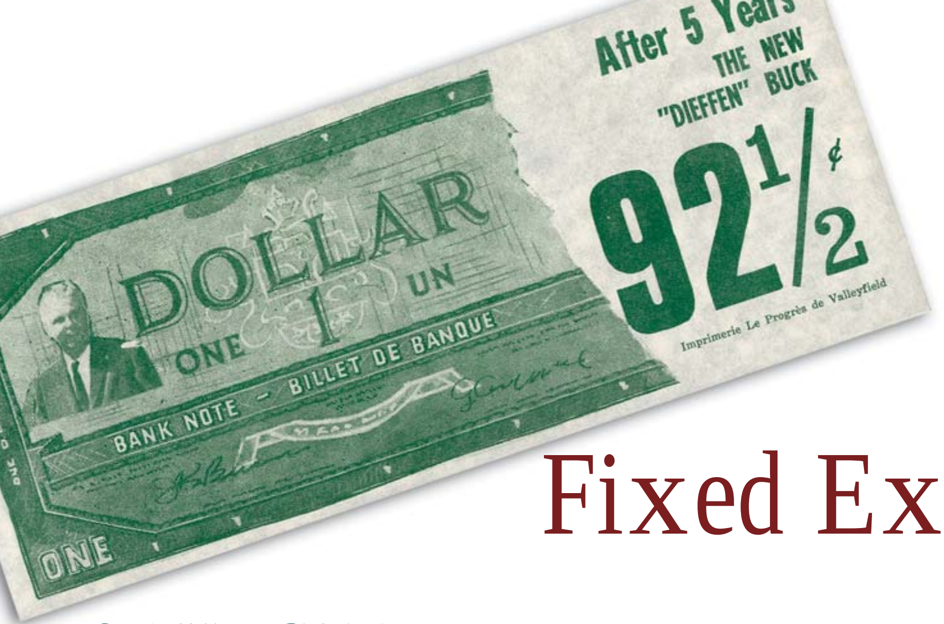

Return to a Fixed Exchange Rate (1962-70)

Canada, 92 ½ cents, Diefenbuck
"Political currency," so-called because it satirizes a politician or a political party and its policies, is private scrip that resembles a bank note but has no monetary value. The "Diefenbuck" was the result of the devaluation of the Canadian dollar against its U.S. counterpart during the 1960s that resulted from certain policies implemented under the administration of Prime Minister John Diefenbaker.

During the late 1950s, Canadian authorities became concerned about a deterioration in Canada's international competitiveness, aggravated by its strong dollar, which continued to be supported by substantial capital inflows. After the investment boom of the mid-1950s, economic activity had slowed significantly, and the unemployment rate more than doubled from 3.4 per cent in 1956 to 7.2 per cent in 1961. In this environment, the government sought to ease policy in order to support demand and reduce the economic slack in the economy.

James Coyne, who became Governor of the Bank of Canada on 1 January 1955, focused monetary policy on avoiding excessive domestic demand, keeping inflation in check, and reducing Canada's reliance on foreign savings. In favour of "sound" money, he was convinced that

> to engage in further large over-all monetary expansion in an attempt to drive down interest rates generally, with or without the motive of thereby reducing the inflow of capital from abroad, is an unsound and dangerous approach and would prove to be an ineffective approach, to the problems of the exchange rate, of the recession, and of achieving more consistent economic growth (Bank of Canada *Annual Report 1960*, 22).

Restrictive monetary policy at a time of relatively high unemployment and low inflation led to a sharp deterioration in relations between the

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Bank and the academic community.[80] In late 1960, twenty-nine prominent Canadian economists signed a letter calling for the dismissal of Governor Coyne.[81] At the same time, relations with the Diefenbaker government were also deteriorating. Determined to pursue an expansionary policy, the government did not believe that it had the support of the Governor.[82] The situation worsened when the government objected to the size of the Governor's pension, which had been agreed upon by the Bank's Board of Directors. The dispute, which became increasingly acrimonious and personal, came to a head on 30 May 1961, with the government requesting the resignation of Governor Coyne. The Governor refused. On 20 June, the minister of finance introduced an expansionary budget and announced that the government would take steps to lower the value of the Canadian dollar, including, as necessary, purchasing substantial amounts of U.S. dollars in the exchange market (Fleming 1961a). The government also introduced a bill in Parliament (An Act Respecting the Bank of Canada) to declare the position of Governor vacant (House of Commons 1961). The bill passed the House of Commons on 7 July, but after testimony by Governor Coyne, the Senate Standing Committee on Banking and Commerce concluded on 12 July that there had been no misconduct on

80. A 12 May 1962 article in *The Economist*, entitled "Inquest on a Floating Exchange Rate," opined that while a floating exchange rate arguably served Canada well in the period 1950–57, it was less clear thereafter because "domestic monetary policy itself began in these years to follow a perverse road." With interest rates remaining very high, the rate "ceased to behave in an anti-cyclical manner, and by its continuing buoyancy, did in fact exacerbate both the domestic problem of under-employment and the long-term problem of a yawning trade deficit."

81. See Gordon (1961).

82. The controversy over Coyne's policies provided the impetus for Robert Mundell's seminal work entitled, "The Appropriate Use of Monetary and Fiscal Policy for Internal and External Stability" (Mundell 1962).

his part. The following day, the full Senate confirmed the Committee's findings. Governor Coyne then resigned, viewing the decision of the Senate as a vindication of his conduct. Louis Rasminsky succeeded Coyne as Governor on 24 July 1961.[83]

Not surprisingly, the Canadian dollar began to weaken in this environment. From a level of about US$1.01 prior to the June budget statement, the dollar quickly fell to US$0.97. It weakened further in October 1961 to under US$0.96, following an announcement by the minister of finance that the appropriate discount of the Canadian dollar against the U.S. dollar "might well turn out to be greater than the present 3 per cent" (Fleming 1961b).

The introduction of a "managed" flexible exchange rate regime, under which the government would intervene to keep the Canadian dollar at a significant discount to its U.S. counterpart, as opposed to just smoothing fluctuations, was in some ways a compromise with the IMF. The Fund was encouraging Canadian authorities to return to a fixed exchange rate regime within the context of the Bretton Woods system. No new par value for the Canadian dollar was recommended, however. Additional time was seen as necessary to prepare for the re-establishment of a fixed rate.

After stabilizing at about US$0.95 between November 1961 and March 1962, the Canadian dollar began to weaken further, despite significant intervention by the Bank of Canada on behalf of the government to support the currency. On 2 May 1962, the government, in agreement with the IMF, established a new par value for the Canadian dollar, fixing it at US$0.9250 with a fluctuation band of ±1 per cent.

A press statement released by the Office of the Minister of Finance, Donald Fleming, stated that although a floating exchange rate had its advantages

> the Government has concluded that it would be desirable to give those engaged in international transactions firm assurance of stability with regard to the exchange rate . . . . The new rate of 92½ has been established after careful assessment of all the factors involved including the attitudes in the foreign exchange market and the nature of the exchange transactions which have been taking place in recent months.[84]

Fixing the exchange rate at a markedly lower level did not, however, relieve the pressure on the Canadian dollar. Doubts remained about the viability of the new rate, particularly given the prevailing political uncertainty.[85] Heavy official intervention was therefore required to hold the Canadian dollar within its allowed fluctuation band.

83. See Bélanger (1970) for a review of events.
84. It has been reported that Fleming wanted assurances that the dollar would not drop below US$0.90 if it were to float freely. Naturally, officials could not give this assurance, despite their belief that an equilibrium rate was well above that level. The US$0.9250 rate at which the Canadian dollar was fixed was apparently chosen by virtue of it being halfway between US$0.95 and US$0.90 (Helliwell 2005–06).
85. On 18 June 1962, a minority Conservative government was elected.

On 24 June 1962, the government announced a major economic and financial program aimed at restoring confidence in the Canadian dollar and indicated its determination to defend the currency's new par value. Measures taken included a tightening of fiscal and monetary policy, the imposition of temporary import surcharges, and the marshalling of US$1,050 million in financial support from the international community. This support consisted of a US$300 million drawing from the IMF,[86] a US$400 million line of credit from the U.S. Export-Import Bank, US$250 million under a reciprocal swap facility between the Bank of Canada and the Federal Reserve Bank of New York, and US$100 million from the Bank of England under a similar arrangement.[87] Other European central banks were also willing to provide additional assistance, if necessary (Bank of Canada *Annual Report 1962*, 8).

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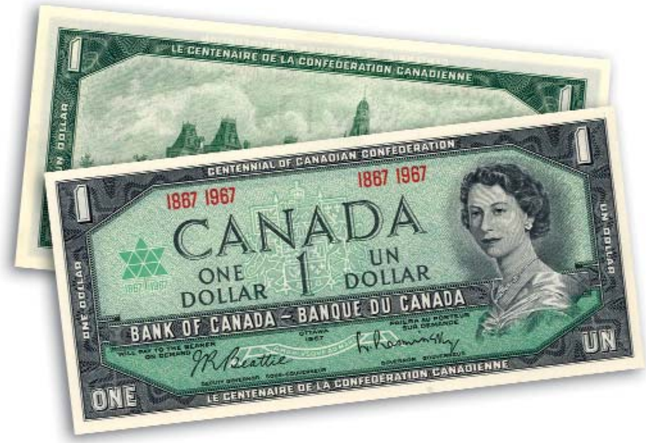
This program restored confidence in the Canadian dollar. The resumption of private capital inflows during the second half of 1962 enabled the Canadian authorities to gradually ease the emergency measures imposed earlier. Much of the international financial assistance received, excluding that of the IMF, was repaid by the end of the year. Funds owed to the IMF were fully repaid by 1964. For the remainder of the decade, the Canadian dollar was maintained, relatively easily for the most part, within the permitted fluctuation band of ±1 per cent around its US$0.9250 par value.

The dollar did, however, come under significant, temporary downward pressure during the summer of 1963, following the U.S. announcement

86. A large proportion of the resources drawn from the IMF represented the liquidation of Canada's "reserve position in the Fund," which forms part of Canada's international reserves. Actual use of Fund credit amounted to US$138 million.
87. Through 1962, the Federal Reserve System entered into a series of reciprocal facilities with the central banks of most industrialized countries aimed at providing mutual short-term financial assistance. The arrangement with the Bank of Canada was originally for US$250 million. Over time, it increased and currently stands at US$2 billion. While most of these reciprocal facilities have been discontinued, the facility with the Bank of Canada is renewed annually.

on 18 July that it would impose an "Interest Equalization Tax" on foreign borrowings in U.S. capital markets.[88] Although Canada's current account deficit had narrowed significantly over the previous two years, it was still large. Consequently, there was a general fear that unless Canadian interest rates rose by an offsetting amount (roughly 1 percentage point per year), capital inflows from the United States would cease. On 31 July, the United States agreed to exempt Canada from the tax, with the proviso that Canada would not increase its foreign international reserves through the proceeds of borrowing in the United States (Bank of Canada *Annual Report 1963*, 6). Downward pressure on the currency ceased with this agreement, and Canadian markets stabilized.



Bank of Canada, $1 commemorative note, 1967
To commemorate Canada's centennial, the Bank of Canada issued $1 notes modelled on the 1954 issue but including special features such as the stylized maple leaf and the dates 1867–1967. This was the second and, to date, last commemorative note issued by the Bank.

The Canadian dollar experienced another bout of temporary downward pressure in March 1968, after the U.S. announcement of controls on capital outflows. The pressure eased with an agreement on 7 March that exempted Canada from all such controls. Similar to the exemption from the Interest Equalization Tax, Canada agreed that the U.S. balance-of-payments position would not be impaired as a result of its actions.

Because of concerns about the Bank of Canada's ability to conduct monetary policy in light of these accords, there was a follow-up agreement with the United States on 17 December 1968, which stated that no particular level of reserves would have to be targeted (Bank of Canada *Annual Report 1968*, 13). This made it easier for the Bank to intervene in foreign exchange markets during periods of upward pressure on the currency.[89]

88. The objective of the Interest Equalization Tax was to restrain capital outflows from the United States. As Canada was a large borrower in the New York market, it was feared that capital flows to Canada would be reduced unless Canadian borrowers were exempted from the tax.
89. The U.S. Interest Equalization Tax, as well as the capital controls, were eliminated on 29 January 1974.