and cost inflation declining in Canada that the Bank of Canada has been concerned about the exchange rate.

Interest rates

Many factors go into the determination of the exchange rate, one of which is the level of interest rates in Canada relative to interest rates in the United States. When Canada has, as it now has, a large deficit in its international trade in goods and services, and when therefore foreign capital must flow into Canada to finance that deficit, it is very important to maintain a level of interest rates in Canada high enough to attract funds from foreign sources and high enough to encourage Canadians to keep money here. Otherwise the impact of the interest-rate differential on capital flows puts downward pressure on the exchange rate.

During 1978, interest rates in the United States rose rapidly. If interest rates in Canada had risen less rapidly, interest-rate incentives would have emerged that added to the downward pressure on the Canadian exchange rate. That is the state of affairs that the Bank of Canada has wanted to avoid. At the same time, because of our concern for the disadvantages in other respects of rising interest rates in Canada at this time, the Bank of Canada has not gone beyond preventing the interest-rate situation from becoming a strong independent source of downward pressure on the exchange rate. In the event, for many months now the increase in interest rates in Canada has barely kept pace with that in the United States. When assessed in that perspective our interest-rate actions have been moderate, and not in any sense extreme. Had we not taken those initiatives the exchange rate would unquestionably have fallen faster and further than it has....

Intervention policy

Another way of influencing the movement of a floating exchange rate is for the authorities to intervene in the country's foreign-exchange market. The usual way this is done is for the authorities to respond to movements in the rate, satisfying in part any excess demand for the national currency by selling it in return for foreign exchange, or satisfying in part any excess demand for foreign exchange by selling it in return for the national currency. Such intervention moderates the movement of the exchange rate from hour to hour, and if the movement of the rate in either direction continues, such intervention will cumulate as it moderates the speed of the movement. The degree to which exchange-rate changes are moderated by such intervention varies with the scale of the intervention.

Exchange-market intervention of this kind has been carried out in Canada during all of the time that Canada has had a floating exchange rate....

I believe that the intervention policy followed has been reasonable in the circumstances. I am certain that it has resulted in an appreciably less steep decline in the exchange value of the Canadian dollar than would have occurred over the last couple of years had there been no intervention. I am well aware that the announcement on occasion of the use of a rather large quantity of reserves in satisfying the demand for foreign currency can have adverse psychological effects that tend to offset some of the benefit gained. It would be a mistake, however, to suppose that the effect on expectations of a "hands-off" policy would not be more serious, since such a policy would create the impression that the authorities do not care about the exchange rate and this in turn would arouse widespread fear and concern. My judgment is that on balance, intervention has had a worthwhile stabilizing effect on the exchange market.... The same basic principle of using monetary policy and intervention policy together to moderate exchange-rate movements is employed, for example by Germany, Switzerland, Japan and the United States, as well as other countries. The first three countries have intervened very heavily to resist too rapid an appreciation of their currencies. In 1977 and 1978, Germany accumulated \$19 billion (U.S.) in reserves, Switzerland \$8.5 billion (U.S.) and Japan almost \$17 billion (U.S.) in the pursuit of this objective. The fact that they continue to use this approach even though their currencies have strengthened a good deal is clear evidence that they regard it as worthwhile. These three countries have, of course, also used interest-rate policy. The United States has used both intervention policy and interest-rate policy to resist the decline in the exchange value of the U.S. dollar. Moreover, in recent months the United States Government has taken action, just as we have in Canada, to acquire additional reserves by borrowing abroad. It has been selling Deutschemark-denominated securities in Germany, Swiss franc-denominated securities in Switzerland and has indicated that it will enter the Japanese-yen market later. The Federal Reserve has also, of course, pushed up interest rates in the United States to very high levels.

It is not just the example of other countries that lends support to the approach followed in Canada in order to moderate the movement of its exchange rate. One can also look at the possible alternatives, all of which seem to me to have their own difficulties.

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It is my judgment that the monetary and intervention policies followed have considerably moderated the decline in the exchange value of the Canadian dollar. There is no point in saying that they have been ineffective solely because the exchange rate has not turned around and has declined somewhat further in recent weeks. What has to be taken into account is what would have happened if these policies had not been used. As we have seen, it takes considerable time for trade flows to change and in the meantime how would a deficit of close to \$5 billion have been financed except with a really drastic fall in the exchange rate? I am somewhat disappointed that the Canadian dollar has come down as far as it has and I regret its effect on our prices and costs. It is true that firmer action could have been taken. Interest rates could have been pushed up higher. That option continues to be available; it can be used if necessary....

Promising signs

I would like to conclude by saying that although the Canadian dollar has come down somewhat further than many of us hoped it would, we should not exaggerate the difficulties or be frightened of the future. There is much to reassure us. The Canadian economy is now very competitive with the rest of the world. It will take time for us to reap the full benefits although I think they are already in evidence to some degree. One promising sign is the remarkably strong growth in employment that we have been experiencing recently. The main point is that we still have a reasonably good chance of emerging from our present difficulties in a strongly competitive position, with lower rates of inflation, and in time with lower interest rates. Will we fail to take advantage of this opportunity? I do not think so. I think it unwise to sell Canada short.