CANADA AND THE NEW AMERICAN EMPIRE

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CANADA-US MONETARY UNION

Background and Context

From about 1999-2002 there was a debate in Canada about whether we should fix our exchange rate with the US and, in particular, do so irrevocably by entering into a form of monetary union. The issue was debated vigorously within the academic community and was given play by various research institutes, including the CD Howe Institute, the Fraser Institute and the Institute for Research on Public Policy (IRPP). Several conferences were held where proponents and opponents debated the merits of monetary union. One former Bank of Canada Governor and two sitting Governors weighed in. Yet neither the Canadian business community nor the media seemed to take up the issue and give it the impetus one would expect if it were to become a priority agenda item for policy. And two years later the debate seems to have dissipated, though it may arise again. This note reviews some of the key issues and offers some conclusions about the debate, for further discussion.

There were three contextual developments that converged during that period and gave the monetary union debate particular salience.

First, the protracted and large decline in the value of the Canadian dollar vis-à-vis the US dollar. The dollar depreciated from slightly more than 100 cents per US dollar in the early 1970's to a low of 62.5 cents in January of 2002. The downward trend was fairly steady, with the exception of the second half of the 1980's (when the dollar moved from the low 70-cent level to the high 80-cent level) and there was considerable volatility around this downward trend. The decline in the exchange value of the dollar reflects a decline in Canada's standard of living, as it reduces our purchasing power of foreign goods and services. As well, the decline through the 1990's occurred at the same time as Canadians experienced a marked relative decline in average real incomes compared with Americans. As the dollar fell toward new historic lows it was inevitable that questions would be raised about whether the exchange rate regime was simply reflecting the reality of our economic circumstances or was, itself, contributing to them by imposing real costs on the economy. Did depreciation lead to lower rates of productivity growth?

Second, over the decade of the 1990's – largely in response to free trade – the Canadian and US economies had become much more economically integrated. In the early 1980's interprovincial exports exceeded international exports. By the end of the 1990's international exports were twice the level of interprovincial exports. Exports accounted for more than 40% of GDP, up from about 25% at the beginning of the 1990's and more than 80% of exports went to the US. It is clear that north-south economic integration has increasingly dominated east-west integration, and this led to questions about the real costs and inefficiencies to trade that arise from exchange rate volatility. Clearly, a fixed exchange rate would reduce transaction costs (including the cost of hedging against exchange rate movements) and would facilitate trade.

Finally, the success of the EU countries in introducing the Euro, effective January 1999, gave additional impetus to the monetary union debate. The fact that 15 countries had agreed to replace their national currencies with a new, supra-national currency was extraordinary and suggested to some observers that what might appear on the surface to be impossible could indeed be accomplished with sufficient political will. As well, it was argued that the advent of the euro would lead, over time, to the existence of two dominant currencies for purposes of trade and international reserves. With the emergence of a strong euro-zone and a dollar-zone, the logical reach of the dollar zone would include much, if not all of the Americas. Proponents of this view saw NAFTA as the embryo of this new dollar-zone, and to the extent that market forces would lead to eventual 'dollarization', there could be political benefits to be had by negotiating a Canada-US monetary union, or even perhaps a North American monetary union involving Mexico as well. In August 2000 President-elect Vicente Fox proposed, among other ideas for closer integration of the NAFTA economies, an eventual single currency for NAFTA members.

The issues are complex and this briefing note cannot cover all of them in detail. For further information readers are referred to Courchene and Harris (1999), Grubel (1999), Harris (2000), and Courchene (2001) who argue the case for monetary union and to Crow (1999) and Robson and Laidler (2002) who argue against abandoning the current exchange rate regime.

Key Issues

The starting point for a discussion of alternatives must be whether the current exchange rate system serves Canada well. None of the alternatives is costless and there must therefore be tangible and presumably substantial benefits that will flow from switching. If one concludes that abandoning a flexible exchange rate will provide such benefits, then the next set of questions are how feasible are the alternatives, what costs will they entail, and what –if any – related issues need to be considered. The balance of this note discusses each of these questions.

How well does the flexible exchange rate system work?[1]

[1] A variant of this question is how well does domestic monetary policy work. If monetary policy is not effective in attaining an acceptable rate of inflation, the option of tying one's currency to a low-inflation currency, and foregoing the ability to conduct an independent monetary policy, may be attractive. This has been the case for some countries that have adopted the US dollar, with varying degrees of success. This argument is not relevant in the Canadian case since monetary policy works well and our inflation performance is satisfactory.

Under the current system, the exchange rate has floated since the early 1970's and since the early 1990's monetary policy has been focused solely on attaining a target rate of domestic price inflation, leaving the level of the exchange rate to be determined by the market. Only when it appears that short-term volatility in exchange markets is based upon speculative forces and risks creating dynamic instability will authorities intervene, and then with a view to stabilizing the market rather than achieving any particular level of exchange rate.

A flexible exchange rate provides an important buffer against external economic shocks. A deterioration in Canada's terms of trade, for example through a decline in commodity prices, will reduce Canadians' purchasing power. To the extent that consequent exchange rate depreciation allows for some of the required adjustment to occur through trade, domestic output and employment are buffered from the full effects of the shock.

Two desirable conditions for defining an optimal common currency area are that the structure of the economies in the area be similar and that there be full mobility of the factors of production among the various regions. The first condition suggests that external shocks will have much the same effect on the various regions sharing a common currency. The second condition provides for easier and more rapid adjustment where the first condition does not hold. The Canadian and US economies, though becoming more integrated, are still distinct with respect to the relative importance of commodity production and export. For example, a fall in commodity prices will reduce Canada's terms of trade while increasing US terms of trade.[2] Similarly, although trade is much more liberalized and capital flows are unimpeded, the mobility of labour between the two countries is far from free and restricted labour mobility would complicate adjustment within a common currency area.

Against this background, there are two main arguments that are advanced for fixing the Canadian dollar to the US dollar.

The first is that the flexible exchange rate regime has contributed to lower rates of productivity increase than would have occurred in Canada had our dollar been effectively pegged to the US dollar. Proponents of this argument sometimes allege that there is a "lazy dollar" or a "lazy manufacturer" phenomenon at work. That is, Canadian manufacturers of traded goods have not faced the competitive pressure to modernize their operations and increase productivity because the declining dollar has 'bailed them out' in international markets. As a result, Canadian productivity has lagged US productivity and our relative standard of living has declined.

The problem with this argument is that there is very little evidence to support it.[3] And there are two empirical observations that strongly suggest it is not the case. The first is

[2] As a share of GDP, the production of commodities is roughly three times higher in Canada than in the US and while Canada is a substantial net exporter of commodities, the US is a net importer. (Robson and Laidler).

[3] Courchene (2001) cites some earlier empirical work by McCallum that found a lagged relationship between exchange rate depreciation and relative productivity deterioration in manufacturing.

that movements in the Canadian/US real exchange rate over a very long period can be explained very well by movements in commodity prices and relative interest rates, as one would expect.[4] Robson and Laidler (2002, Figure 3) present forecasts of the real exchange rate produced by the dynamic simulation of such a model and the model is extraordinarily good at tracking the exchange rate within the sample period (even when simulated dynamically) and also at forecasting the exchange rate outside the sample period. If there were a 'vicious circle' (leading from depreciation to productivity deterioration to further depreciation to further productivity deterioration etc.) over a period of 30+ years, one would expect that commodity prices and relative interest rates alone would not satisfactorily explain exchange rate movements. The second observation is that the relatively poorer performance of Canadian manufacturing productivity over the period of the 1990's was not widespread. Indeed, it was not primarily in traded manufactures but was totally explained by substantially worse productivity performance in Canada in two sectors: machinery and electrical and electronic equipment. While lower productivity in these sectors is an important policy issue, particularly given their importance in the 'new economy', there is no intuitively plausible argument as to why a lower exchange rate should adversely affect productivity in these sectors and not others.[5]

The second argument is that a flexible exchange rate, regardless of how well it works as a buffer, imposes transaction costs (including costs of hedging against unanticipated exchange rate movements) that make trade inefficient and may act as barriers to trade for smaller and less sophisticated businesses. While there is no doubt these costs exist, it is not clear how significant they are. They do not appear to have seriously inhibited the growth of Canada-US trade since the early 1990's.[6]

On balance, the purely economic arguments for abandoning the current exchange rate regime appear weak. If, however, it became apparent that the current system were not serving Canada as well as now appears to be the case (perhaps because new evidence on the costs emerges, or because further integration of the two economies strengthens the case for a common currency area) one might wish to consider alternatives more seriously. It is therefore worth asking what alternatives might make sense, and what the implications of alternative regimes might be.

<u>What alternative regimes might be considered?</u>

[4] The real exchange rate is the nominal exchange rate adjusted for rates of national inflation. Movements in the real exchange rate reflect differences in relative price movements between the two economies.

[5] Courchene (2001) cites some recent theoretical work by Harris, based on integration of exchange rate and endogenous-growth literature, but his conclusion that there is a negative effect on productivity growth from the 'buffering' effect of the exchange rate appears to rest on an assumption that there is substantial labour mobility.

[6] A variation of this argument is that market forces are leading to the 'dollarization' of the Canadian economy in response to integration and over time the increasing use of US dollars by businesses and some individuals will somehow compromise the ability of the Bank of Canada to conduct an independent monetary policy in any event. The logic of this argument is not totally clear and the evidence (see Robson and Laidler, 2003) suggests that although dollarization increased in the second half of the 1990's it is not at historical highs and indeed appears to have leveled off towards the end of the decade.

In principle, alternative regimes range from simply fixing the dollar (and using monetary policy to defend the fixed rate), through a currency board[7], forms of monetary union that would see the adoption of the US dollar as Canada's official currency, to the possible adoption of a new North American currency.[8] In practice, neither a fixed rate nor a currency board would provide the certainty that would be required to offset the transaction costs of a floating rate. However, monetary union would likely be seen as irrevocable and would successfully eliminate transaction costs. The balance of this note discusses some of the issues that would have to be faced if monetary union with the US were to be seriously pursued.

<u>Issues in pursuing monetary union</u>

There is a spectrum of arrangements that can be envisaged when considering monetary union.[9] At one extreme, Canada could simply recall all Canadian currency, replace it with US dollars at a given exchange rate and legislate all contracts in Canadian dollars to be replaced by US-dollar contracts at presumably the same exchange rate. At the other extreme one could envisage the Bank of Canada becoming a 13th reserve district within the Federal Reserve System with consequent input, though limited, into the determination of US monetary policy. In between, one could postulate various degrees of cooperation on the part of US authorities to ease the transition to monetary union. An obvious, and critical, observation is that any monetary union arrangement other than the unilateral use of the US dollar by Canada involves cooperation with the US and the negotiation of new political arrangements. This requires a willingness on the part of the US to entertain such negotiations and presumably a willingness of Canada to offer something in return.

Any form of monetary union would carry with it at least four issues of some consequence.

First, it would be necessary to choose an appropriate rate of conversion. In the course of the debate about monetary union very little has been written about what rate would make most sense, or how one would decide. The European Union had many years of experience with relatively fixed exchange rates before moving to the Euro and intra-European exchange rates were much less volatile than the Canada-US exchange rate. Indeed, in the 18 months since the dollar reached its historic low of 62.5 cents US, it rose to a high of 77.1 cents in January of 2004 before falling back to its current 75-cent range. Many observers predict it will continue to increase in value.

Second, abandoning the Canadian dollar means giving up any ability to conduct an independent Canadian monetary policy. Canada, since 1991, has had inflation targets and a central bank with a transparent and accepted mandate to achieve them. This regime

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[7] A currency board would allow the continuation of Canadian dollars as official currency but would require that the Bank of Canada match all Canadian dollar liabilities with US dollar assets.
[8] Grubel (1999) proposed a new North American currency, called the AMERO. This seems politically unrealistic and is not considered further in this note.
[9] See Robson and Laidler (2002).

has served us well. To give it up one would have to have confidence that the US economy would be well managed.

Third, the Canadian government now earns 'seignorage revenue' from the issue of currency that is estimated to amount to almost $2.5 billion per year.[10] It might be possible to have the US allocate a 'seignorage amount' based upon Canadian use of US-denominated notes and coins but this would require negotiation.

Finally, the Bank of Canada now plays an important role as a 'lender of last resort' to Canada's financial system. In carrying out this role the Bank may choose to increase liquidity in the economy in response to general threats to system stability (as happened after the September 11 attacks in the US) or it may choose to lend to specific institutions that face liquidity problems but are still solvent. In the latter case the Bank will require validation from the regulator (OSFI) that an institution is solvent before making such loans. This 'lender of last resort' role is therefore an integral part of the overall financial regulatory structure, which aims at ensuring the soundness of Canada's financial institutions and mitigating threats to the stability of the financial system. In a monetary union, the US Federal Reserve would have to play this role. It is far from clear that it would be willing to do so, or what the implications of such a role might be for the ability of Canada to continue to regulate its own financial institutions. One might speculate that, at a minimum, the US would require some degree of regulatory oversight with regard to Canadian financial institutions (possibly working through arrangements with OSFI). It might also be the case that longstanding US-Canada irritants in the financial sector, such as the *de facto* restrictions on US ownership of Canadian financial institutions would become a subject of negotiation.

Conclusions

The monetary union debate lost steam through 2002 and has not been reinvigorated since. One can point to a number of plausible reasons:

- The issues were reasonably well-debated and proponents of monetary union failed to make a case that gained the broad support of opinion-makers or governments.[11]
- Since the Iraq War, and the way in which it changed the perception of the current US administration by Canadians, it has been more difficult politically in Canada to argue for greater integration with the United States. Monetary union would be a 'difficult sell' in the best of times and these are not the best of times.
- The post 9/11 economic policy of the US has left many observers concerned about the huge fiscal and trade deficits that now characterize the US economy. It is generally felt that the US will have to go through a serious, and possibly quite difficult,

[10] Seignorage is essentially the difference between the value of money produced and the cost of producing it. The estimate is based on the average interest rate on Government of Canada debt applied to the stock of notes and coin outstanding and is made by Robson and Laidler (2002).

[11] An exception is the Government of Quebec, which supported monetary union. But, as a separatist government, its support was viewed as being more in the interest of its own agenda than in Canadian economic performance.

economic adjustment over the medium term and it may not be appropriate to peg our currency to theirs since our fiscal and trade fundamentals are much healthier.

- The political impetus behind the Euro is totally absent in North America and, indeed, monetary union with Canada or Mexico is simply not on the US political agenda.
- As noted above, the Canadian dollar has appreciated substantially since late 2002 and, somewhat surprisingly, exporters have apparently been able to adjust to the higher level of the dollar more quickly than had been anticipated.

While it appears that monetary union may be one of those issues whose "future is all behind it", the debate has helped to illuminate the issues that would have to be addressed if future conditions made it appear more appropriate than it does today. For those who believe that further economic integration with the US is desirable, a more appropriate route to pursue would be to push for the removal of restrictions on labour mobility. This would not only enhance the gains from trade but assist in creating conditions where a common currency area might make more sense than it does today.

FURTHER READING

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