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North American Monetary Union (NAMU)—A Critical Assessment

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Background and Introduction:

The free trade-driven integration of the Canadian economy with the US has spawned proposals for a North American Monetary Union (NAMU) that would replace the current system of national currencies and floating exchange rates. Exchange rates of the NAFTA countries would be permanently fused in a single North American currency. (Monetary union is an extreme version of a fixed exchange rate system). NAMU, once thought to be far fetched, has gained further credibility with the establishment of the European Monetary Union (EMU) in 1999.

The proposal for monetary union has come from several prominent conservative academics (Harris and Courchene 1999; Grubel 1999). It also has some support within the business community. Politically, both the Bloc Quebecois and the Conservative party (both wings), have publicly supported the concept.

The policy establishment as well as most economists—conservative and progressive—support the existing independent floating exchange rate system and do not favour NAMU. Although supporters of both views can be found within the business community, the major Canadian business lobby groups: the Chamber of Commerce, the Alliance of Manufacturers and Exporters, the Conference Board, and the Canadian Council of Chief Executives, also currently prefer the floating exchange rate system. Notably, the Bank of Canada governor, David Dodge, has left open the door to the possibility of a NAMU at some future point *if* there is sufficient convergence of the two economies.

What is being proposed*:*

Proponents of a North American Monetary Union argue that the logic of globalization is intensifying pressure for dollarization—greater use of the US dollar in international business transactions, and the formal adoption of the US dollar by several developing countries. Moreover, they say, the logic of globalization is moving eventually towards the creation of (three) regional currency blocs and Canada should act now to negotiate monetary union on more favourable terms than would be available when imposed on Canada down the line.

The proposed NAMU would be similar to the European Monetary Union. At an agreed upon date (and transition period), the three NAFTA countries would replace their currencies with a new currency unit at an agreed upon rate of exchange. At the same time the central banks of all three countries would be replaced by a North American Central Bank. New notes and coins would be produced for the North American monetary unit, replacing the notes and coins of each country.

As occurred in the European case, the first phase of the transition to NAMU would be to set up a system of fixed exchange rates between the three countries. NAMU would also, like the EMU, be accompanied by binding fiscal rules adopted by the three countries—for example rules limiting the size of deficits and debt.

According to proponents, the new North American Central Bank would be beyond the political control of any one government. How each country would be represented on the governing NAMU bank board is not clear, but in the decision making structure of European Central Bank each government has an equal voice.

Some NAMU proponents concede that the idea of a NAMU might be a difficult sell in the US. They suggest that while the US dollar would likely become the single North American currency, Canada (and Mexico) would negotiate a place within the US Federal Reserve System as the 13th Reserve District, where it would have influence over North American monetary policy comparable to that of member countries of the European Central Bank.

The existing system—independent floating exchange rate:

Canada, like many countries, has an independent flexible, or floating, exchange rate system. This means that the price of our currency in relation to other currencies--the exchange rate--is allowed to move freely according to demand and supply (with rare interventions by the Bank of Canada). For example, when demand for Canadian dollars by holders of US dollars to pay for Canadian exports (or to make investments in Canada), exceeds the supply of Canadian dollars, the Canadian dollar rises in relation to the US dollar. Conversely, when demand for US dollars to pay for imports from the US (or to withdraw investments from Canada), exceeds supply, the Canadian dollar falls in relation to the US dollar.

Since the 1930s, Canada has maintained a floating exchange rate system, except for two brief periods—1962 to 1970 and 1939 to 1950--when the price of the dollar was fixed in relation to the American dollar.

Key Issues and Arguments:

Claimed costs of the floating exchange rate system:

In order to make their case for NAMU, proponents argue that the existing floating exchange rate system has a number of costs or weaknesses that the NAMU would eliminate. They also claim that NAMU would have additional benefits over the existing system. We examine these claims and then present counter arguments. We also outline several key advantages of the floating exchange rate system.

1. *Under the floating exchange rate system the Canadian dollar been on a downward course since the mid-1970s—falling from parity with the US dollar to the current rate of 75 US cents. This, they say, represents a large drop in Canadian living standard*s.

Counter-argument: Economists are generally agreed that, even if in the short-term changes in the exchange rate may affect economic activity and living standards (positively or negatively), in the long term (certainly the 30 years mentioned here) money is neutral. There is no causal relationship between exchange rate movements and living standards.

In the late 1990s, when the Canadian dollar dropped 10% against the US dollar, inflation did not rise, national income was higher and more people were employed than if adjustment to the Asian financial crisis had occurred under a fixed exchange rate(see #7). People did have to pay somewhat more for imported goods and foreign travel.

While the record shows that *average* US living standards (per capita income) have increased faster than in Canada over the last two decades, the causes are complex. They have to do with employment and productivity growth, and the changing relationship between prices of exports compared to prices of imports, which in turn are rooted in economic structures and institutions.

2. *Under a floating exchange rate system, wide fluctuations in the Canadian dollar against the US dollar, have impeded trade and investment flows.*

Counter-argument: Notwithstanding the major currency fluctuations under the existing system, there has been a massive increase in Canada-US trade and investment flows since 1989. Trade as a share of GDP jumped from 25% to roughly 40% of Canada's GDP, and Canada's exports to the US jumped from 75% to 87% of total exports.

3. *Under the flexible exchange rate system the dollar has been allowed to fall and as a result Canadian manufacturers and workers have been shielded from the discipline of international competition that would otherwise force businesses to become more efficient and productive, and workers to temper their wage demands*.

Counter-argument: This is the so-called the lazy manufacturers' thesis. A comprehensive Bank of Canada study (cited Seccareccia 2002)) found *no* statistical correlation between manufacturing productivity growth and Canada-US exchange rate movements.

Furthermore, this thesis ignores the fact that a falling dollar also makes imports of machinery and equipment more expensive. Since Canadian manufacturers depend heavily on these imports, a falling dollar could as easily be seen to be adversely affecting their ability to compete. In the late 1990s, the low dollar did help many firms expand exports and increase profits, but these were used to boost investment in equipment, which improved productivity. Nor did wages rise.

Canadian manufacturing productivity growth during 1992-2002, a declining loonie period, actually outperformed US productivity in most manufacturing sectors, but greatly under-performed in two key sectors—machinery and equipment and electrical/electronics. Canada's lagging productivity in relation to the US is rooted in such factors in relatively lower use of capital in economic activity, an underdeveloped high-tech sector, low levels of R&D and innovation.

Claimed benefits of NAMU over the existing system:

4. *It would eliminate the cost of currency transactions between the two countries—a saving to people and business engaged in cross-border transactions. Grubel (1999) estimates this "efficiency gain" at 0.1% of the National Income.*

Counter-argument: Transaction costs are very small and have not been a source of complaint from Canadian business generally. They can easily protect themselves through currency hedging instruments-swaps, futures, etc.

Transaction costs, small as they are, tend to be overstated. For example, 60% of Canada-US trade takes place among different affiliates of the same transnational corporation. As intra-firm transactions, they appear merely as book entries and involve no cost. Moreover, the very small estimated savings to the public would be mostly neutralized by the costs of conversion to the new currency. Finally, the losers, namely the banks that profit from brokering currency transactions, would use their market power to recoup these losses through higher service fees for related activities. This is what in fact European banks did after the transition to the Euro, thereby offsetting any potential saving from reduced transaction costs.

5. *It would lower real (inflation adjusted) interest rates because it would eliminate the risk to foreign holders of Canadian securities (especially holders of long term bonds), of a depreciating Canadian dollar. As such, it would reduce the spread, or difference, between Canadian and US interest rates.*

Counter-argument: Monetary union would be analogous to a situation of fixed exchange rates, which Canada had during 1962-70. The evidence shows that real interest rate spreads between the Canada and the US were not lower during this period. Moreover, during 1980 to 2001, a period of greater exchange rate volatility, the real interest rate spread did not increase. On the contrary, the spread during this period was in fact slightly lower on average than the period 1950-79, a period of much less exchange rate volatility.

Government monetary and fiscal policies (as they affect the perceptions of currency traders) are the key determinants of short and long term real interest rates and hence the spread between Canadian and US interest rates.

6. *NAMU would impose monetary and fiscal discipline on governments. Like the EMU it would establish rules that place limits on governments' ability to incur deficits and accumulate debt. This would constrain governments, present and future, from pursuing expansionary monetary and fiscal policy (including countercyclical deficit financing).*

Counter-argument: Under a floating exchange rate system, Canadian authorities have imposed tighter (low inflation) monetary policies than their US counterparts for the last 15 years or more. The federal government has also imposed very tight fiscal discipline for more than a decade— compared to both the US government and European governments in the lead up to EMU and its aftermath. (One can debate whether or not these policies were wise, and in general, the government's role in managing the economy, but that is another issue).

<u>Benefits of Canada's floating exchange rate system:</u>

7. It plays an effective role as a shock absorber, easing the negative impacts of external shocks to the economy on Canadian businesses and workers. In Canada, unlike the US, resources form a much larger share of exports. The Asian financial crisis and recession of the late 1990s cause demand for, and prices of, Canadian resource exports (especially British Columbia forest products) to fall sharply. With a fixed exchange rate, Canada would have been forced to raise interest rates to maintain the value of the dollar causing a decline in exports, recession and job losses in Canada. (Under monetary union, Canada would permanently lose control over interest rates). As it happened, the dollar fell, cushioning somewhat the blow to the resource sector by lowering costs, spurring exports of manufactured products and shifting some of demand for imports (because of now higher prices) to domestic producers. As a result, growth remained steady and unemployment did not increase overall; resource prices eventually strengthened and the dollar recovered its previous exchange rate.

   With a fixed rate system, the burden of adjustment would have fallen heavily on production and employment cutbacks, resulting in more damaging effects to the economy. Under a flexible rate system the burden of adjustment is more equitably shared and spread out. Exchange rate volatility is substituted for output and employment volatility.

8. A fixed exchange rate system, unlike a floating rate, requires large buffer stocks of foreign currency reserves and, additionally, access to international lines of credit to protect against devaluation. Thus, under a fixed exchange rate system, the Canadian monetary authority would surrender to US or international monetary authorities, its ability to regulate financial institutions and provide emergency liquidity as *lender of last resort* during a financial crisis. (Examples include a domestic bank failure or a wholesale exodus of foreign investors holding Canadian debt.) Under NAMU, the US would effectively take over the role of financial regulator and lender of last resort.

9. A floating exchange rate system permits Canada to have an independent and politically accountable monetary policy. The Bank of Canada can set interest rates for reasons other than defending the currency value. Monetary policy is a vital tool of macroeconomic management to balance national inflation and employment objectives.

   Only two of three conditions, economists agree, can prevail at the same time--capital mobility, fixed exchange rates, or monetary policy autonomy—but not all three. Thus, in a world of highly mobile capital as we currently have, a move to a fixed exchange rates (or monetary union) would mean the surrender of policy independence. It would also increase pressure to reduce differences with the US in social program, labour market regulation, and other policy areas.

<u>Choices for Canadians:</u>

Several political agendas are behind NAMU. It is being pushed by conservative economists who are ideologically opposed to any kind of government activism or interference in the economy, and they see NAMU as a way to lock-in this vision. It also includes economists--globalization zealots--who see the writing on the wall for nation states, at least in the economic sphere.

The same ideological affinity drives interest in NAMU amongst many in the Conservative Party. Additional support stems from antipathy toward past Bank of Canada insensitivity to regional interests, and the lack of regional input into monetary policy decision making.

The support of Quebec sovereignists for monetary union is more complex. They (accurately) see it as facilitating the exit of Quebec from Canada. However, given the implications for political sovereignty, independence movements have tended to want their own currency and monetary policy control. Quebec sovereignists not only favour monetary union, they also would support unilateral adoption of the US dollar. The main reason is one of confidence. It would reduce fears about economic instability in the event of separation, and thus appeal to potential supporters in a future referendum who might otherwise be dissuaded by the prospect of instability. Quebec, according many sovereignists, has no control over monetary policy now, and thus, it is a matter of indifference to them whether control is exerted by Ottawa or Washington

Most observers, including many NAMU proponents, believe the possibility that the Americans would give up their dollar for a new North American currency is about as likely as a resurgence of the flat earth society. The overwhelming dominance of the US economy—almost 90% of North American GDP, the US dollar's primacy as a global currency, as well as the aggressive nationalism of American policy makers, make the proposal a non-starter.

The only realistic alternative would be for the smaller partners to adopt the US dollar. Dollarization has received some marginal attention within US policy circles and the Congress. They have made clear, however, that any country wishing to dollarize unilaterally would get no special deviations or concessions from US monetary authorities and US economic priorities.

Some NAMU proponents (Courchene and Harris) argue that Canada could negotiate Canada's entry into a North American dollarized monetary union as the 13th district within the US Federal Reserve System. This would provide Canada an influence, albeit small, over monetary policy, comparable to the member countries of the European Central Bank. Since, in a globalized financial economy in which, they say, Canada has limited influence anyway, this would not represent much of a concession.

The possibility that the Americans would seriously entertain such proposal is remote to say the least. And if they were to enter into negotiations, what control would the US be prepared to give up; and what concessions would Canada have to make to get a deal? The experience of FTA-NAFTA provides a foretaste of what to expect.

There are many additional problems with this proposal (see Helleiner, 2003). Although nominally a federal system, the Federal Reserve is in fact highly centralized, with the power residing in the Board of Governors the majority of whose members are appointed by the US Administration and a minority of five representing the 12 regional reserve banks. How would Canada negotiate itself a place of influence within the Board of Governors? Secondly, the regional banks are in fact private institutions owned by member commercial banks in each district. Inserting the Bank of Canada, a public, politically accountable, institution, into the quasi-privatized US system, would be challenging indeed.

The governing structure of the EMU also has problems, notably, a lack of political accountability. But member countries can argue with some justification that it constitutes a pooling of sovereignty with each country having an equal voice. No such claim could be credibly made for NAMU. Canada would almost certainly surrender sovereignty to the dominant partner. More importantly, unlike NAMU, European monetary union has been undertaken as part of a process whose stated goal is the political unification of Europe.

In the real world of today the best alternative for Canada is, indisputably, the status quo. The independent floating exchange rate system has served Canada reasonably well over the last 75 years. An independent monetary policy and a national currency have long been vital instruments of economic management, nation-building and national identity for Canada. Over and above the questionable economic benefits claimed by NAMU proponents, the political issues of sovereignty, national identity and democratic accountability will no doubt dominate any future debate around NAMU.

In multilateral forums, Canada should advocate reforms that both promote international monetary stability and enhance the policy tools available to all national governments to promote the well being of their citizens to whom they are (or should be) democratically accountable.

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