‘GOD SAVE THE QUEEN’: BRITAIN AND CANADA AND THEIR LARGE NEIGHBORING MONETARY UNIONS

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INTRODUCTION

A traveler who has visited both Britain and Canada will no doubt have noted that both Britain and Canada share the same head of state on their banknotes and coins: Queen Elizabeth II. Of course, though the Queen is an important symbolic figure to the United Kingdom (UK), the Queen plays a less prominent role in the Canadian national identity. Yet one should not underestimate her importance. Besides this observation there are a number of more substantial similarities that these two countries share. They are both located next door to a neighboring monetary union that has a leading currency that has been adopted by other countries in an attempt to increase their economic prosperity. Britain is confronted with the European Union (EU) and its Economic and Monetary Union (EMU) or the ‘eurozone’ – an area of twelve EU Member States in which the euro is the single currency. Canada’s neighbor to the south is the United States of America (US) that has the world’s leading currency which has been adopted by other states in the region and beyond. One can differ in opinion over whether the US is a monetary union in the conventional sense, but there is no doubt that the US is a

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currency union, one of its many features as a federal state. Furthermore, there have been talks about creating an actual North American Monetary Union (NAMU) which would expand the use of the dollar into Canada and Mexico. At a time in which the discussion revolves around the future of (smaller) national currencies, this special issue looks at the question of monetary integration for the cases of Britain and Canada. This special issue adopts a comparative, multi- and interdisciplinary perspective on these matters.

In the final years of the 1990s and into the infancy of the new millennium a discussion took place both in Canada and the United Kingdom on the usefulness of monetary unification and on the appropriate exchange rate policy to implement in response to economic uncertainty resulting from increased capital mobility and global economic instability. Concerns over instability have been exacerbated since the so-called ‘Tequila crisis’ (Mexican currency crisis of 1994), the South East Asian currency crisis of 1997-98, the several more minor crises associated with the European Monetary System (EMS) in 1992-94, and were fuelled further by the Argentinean and Turkish currency crises that occurred in the years following. Moreover, interest in monetary unification has been triggered further as a result of the successful introduction of the euro in financial markets in 1999 and its banknotes and coins in 2002. Indeed, in recent years many nations have engaged in this debate, leading to developments such as dollarization in Ecuador and the previous currency board in Argentina. Nations have begun to seek solutions which will deliver sustained domestic economic stability in a global environment which delivers continued economic flux. However for some, namely Canada and the UK for our purposes, the waters have been muddied by the presence of a large single economy or monetary union as their neighbor. The days of ‘one nation, one money’ (Helleiner, 1997) appear to be waning or at the very least subject to debate. The time is ripe to look at the future of national and international monetary orders.

From the perspective of theory both from an economic vantage point and a political one the debate over monetary order is an interesting one which provides fertile ground for the operationalization and creation of theory. Most remarkable is the revitalization of Robert Mundell’s Optimum Currency Area (OCA) Theory. This theory had lost some credibility in the late 1980s and early 1990s as research showed that not even federal states such as Canada or the United States met the criteria of the OCA. But the late 1990s saw a resurgence of literature reflecting

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2 The British Treasury has provided a study that argues that the US is an example of a monetary union in which different states with different economic developments can actually prosper (HM Treasury, 2003).
(and revisiting) this theory. Beyond OCA though there is extensive opportunity for the application and enhancement of theories of integration, regionalism, governance and globalization. Monetary unification also raises practical implications: monetary policy has an effect on adjacent areas of policy-making and to the overall performance of the economy. The practical and theoretical significance of monetary union provided the impetus for the conference upon which these two special issues are based.3

At first glance it may seem odd to look at whether or not the UK should join the euro at the same time as considering whether there is reason for Canada to seek some kind of hard fix or currency union with the United States. The chances are that the UK might join the euro one day. Although they are currently largely opposed to joining EMU, when asked, most UK citizens believe that within ten years they will have joined the eurozone (News of the World/ICM poll 2001). This result will come as little surprise seen that EMU is part of the larger European integration process and that the introduction of the euro has been deemed a success by most people. The Canadian case, by contrast, has largely been an exercise in academic speculation about currency union in response to a number of factors. One of these was a perception that in the late 1990s and early 21st century the Canadian economy was on the decline relative to that of the US. A few years later, however, after the September 11, 2001 attacks, and in light of a rising Canadian dollar and a stronger economic recovery in that country, there does not seem to be any significant interest on the part of either Canada or the United States to consider changing the current currency arrangements.

On what ground then can one make this comparison and in what way is it of use to our understanding of monetary unions? First, the fact that Canada and the UK are both medium-sized economies provides a certain degree of similarity in the experiences they have of the global economic context. Furthermore, if they chose to join a monetary union, both would face broadly similar challenges with regard to issues of sovereignty and protection of political ‘voice’ in the monetary policy domain (although as we will argue below the specifics are different due to

3 A conference was held at the University of Victoria on 17-18 October 2003 in which first versions of all articles in this special issue were presented. The editor wishes to acknowledge financial support from the European Commission and from the Social Sciences and Humanities Research Council of Canada (SSHRC). The support enabled the holding of the conference and provided the funds for Melissa Padfield and Patricia Young to provide (excellent) editorial assistance for this special issue. At a late stage it was decided to have two special issues of this journal rather than one long one. But for the ease of the reader we will refer to papers in these issues as being part of ‘one issue’.
the nature of the monetary union they would join). They also face similar challenges if they stay outside a currency union or collaboration by virtue of their proximity to and reliance on a large neighboring economic entity. In addition, the most frequently suggested model for any North American Monetary Union (NAMU) is that of EMU, which necessarily makes the situations of the two more alike and increases the opportunities for the UK’s situation to be instructive for Canada and vice versa. Finally, the comparison of the two not only increases the breadth of current scholarship – which at present deals with each only in isolation – but it also highlights the central themes of the monetary union debate.

In this special issue we will discuss these matters through an interdisciplinary perspective, mainly by looking at them through the lenses of economics and political science. The articles contained in this issue all attempt to acknowledge the interdisciplinary nature of the questions while also fleshing out the nuances that are explored in their respective domains. Given this interdisciplinary approach, even if the particularities of the context may change, the frameworks developed within these articles should have far reaching applicability and, we hope, will be relevant over time. We believe the collection of scholarly papers which follows is both timely and timeless and will inform those interested in monetary policy also in the years to come. It is clear to all authors that Britain has to deal with EMU in the near future, whereas no one expects Canada to opt for monetary integration with the US or the creation of an NAMU in the immediate future. We leave the door open as to whether that topic might attract more political salience as time goes by. In fact, we expect it may.

This introductory article offers a contextualization rather than a detailed summary of the articles that follow. After a short introduction, the first section gives a brief history of monetary collaboration and unification in Europe and North America until 1999. The second section explores the economic and political theoretical dimensions of the debate. The third section looks at the background to the debates in Europe and North America and discusses the developments since 1999. The fourth section offers our reflections on the topic and provides a brief description of the articles in this special issue. The fifth section concludes.
1. BRIEF HISTORY OF MONETARY UNIONS AND MONETARY COLLABORATION IN EUROPE AND NORTH AMERICA

1.1 Europe

When the euro was introduced into financial markets on January 1, 1999 as the realization of the third stage of EMU, it was the completion of a long and difficult process to monetary integration, one which had begun over forty years earlier. It has been argued that the origins of EMU date back to 1956 with the Spaak Report and the formation of the Common Market as part of the European Economic Community (EEC) in 1957. While some may find it a little exaggerated to trace EMU back to the Rome Treaties, it is worth stressing that it is part of the wider integration process which was founded at that time, and is therefore part of the broader economic and political integration process in Europe.

The real plans for EMU began with the Werner Report in 1970, subsequently adopted in 1971, which set out a three-staged plan for macroeconomic policy convergence and fixed exchange rates (with possibly a single currency). The plan was a direct response to the completion of the customs union in 1968 and the belief that a fixed exchange rate would: (a) best serve the nations of Europe after the collapse of the Bretton Woods system of fixed exchange rates; and (b) facilitate Europe’s most central unified policy, the Common Agricultural Policy (CAP). The immediate result was the ‘snake’ – a system of fixed but adjustable exchange rates and additional plans for EMU. While the snake and macroeconomic coordination were successful for some countries they were not manageable in the long term and under the pressures of the 1973 OPEC oil crisis and the subsequent economic crisis. EMU plans ultimately collapsed.

The idea of further European monetary cooperation was once again resurrected in 1978 when French and German governments put a renewed exchange rate mechanism on the agenda. In 1979 the European Monetary System (EMS) came into being and with it the Exchange Rate Mechanism (ERM) which held national currency fluctuations to within ± 2.25% of an announced central parity. By the mid-1980s, due to the strong performance of the deutschmark and the low inflation policies of the German central bank, the ERM had become more of a de facto peg to the deutschmark and German monetary policies than a proper ‘European’ system.
The impetus for change came in the mid-1980s as a result of EU Member States' concerns over competitiveness. As such, pressure increased to complete the internal market which formed the backbone of the 1986 Single European Act. Once again the political and economic conditions seemed right to put EMU on the agenda. There was the desire for integration certainly, but also the push to rival the US economically. The 1989 Delors Report outlined the necessary institutional changes and European convergence needed to support EMU. As a result the Rome Treaties were changed and the Treaty on European Union (or Maastricht Treaty) stipulated the institutional, economic and political provisions (such as the creation of the European Central Bank (ECB)) that would lead to the creation of EMU. This treaty, combined with the 1997 Stability and Growth Pact, form the central architecture of EMU that exists today.

1.2 North America

No one would argue that the history of North American monetary collaboration approximates the European experience. However, it is similar insofar as it is a history of change in response to the pressures on and within nations and the region.

Aside from a brief period during the American Civil War, Canadian exchange rate policy has been exacted independently, though heavily in reference to the United States and not the reverse. As such, the focus here is on the Canadian choices of monetary regime under these conditions. As Eric Helleiner points out in this issue, the Canadian monetary authorities have mostly preferred a floating exchange rate regime. Since the end of World War II there have been only thirteen years in which Canada followed a fixed exchange rate regime (1945-50 and 1962-70); both periods in conjunction with the so-called Bretton Woods system (of fixed exchange rates). In all other years the Canadian dollar (or

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4 Until November 1993 the EU member states should strictly speaking be referred to as 'European Community' or 'EC' Member States. We will refer to them as EU Member States for the sake of simplicity.

5 It should be mentioned at the outset that, while we acknowledge the central role of Mexico in North America, for the purpose of our argument we focus on Canada and the United States. This choice has partially to do with ensuring the manageability of the topic, but also because the long standing relationship between Canada and the US both economically and politically is not found to the same extent between Mexico and its Northern neighbors. Furthermore our comparison with the British case makes us more interested in finding parallels and differences between those two countries rather than with other members of the (potential) monetary union.
'loonie') has been allowed to float. Despite the preference to float, however, there has been discussion on more than one occasion about the pursuit of a more substantive monetary collaboration or monetary union.

In 1968 the Québec separatist party, the Parti Québécois under René Lévesque, looked into the potential for a monetary union between Québec and Canada following separation. This was once again looked into by a separatist party, Bloc Québécois, in reference to the US following the 1995 referendum. While both of these failed to yield any substantive results, it does suggest an interplay between the domestic political climate in Canada and the monetary policy debate.

Exogenous and endogenous political and economic pressures led to another discussion of monetary order in the late 1990s in Canada. From 1991 until 1999 the Canadian dollar saw a progressive and substantial fall against the American dollar, which had many worried about the effectiveness of the float. Moreover, various currency crises across the globe and in the Americas in the 1990s prompted an exploration of how best to achieve economic stability in Canada. These discussions took two routes; one focused on dollarization the other on monetary union with the US.

Dollarization refers to the adoption of US dollar as the national currency in a country outside the US. It has two forms, the first is a ‘market dollarization’ under which domestic business is carried out in American dollars, a trend which some perceived as occurring in Canada at the present time. The second form is ‘policy dollarization’, such as in Panama and Ecuador, where the US dollar is the currency in circulation. This form of monetary policy, unlike a currency board (e.g. as in Argentina), can be pursued unilaterally without the formal consent of the issuing country, the US. Policy dollarization alleviates the need for domestic manipulation of the money supply and avoids currency crises. The ‘price paid’ is the loss of seigniorage and the exchange rate as an instrument of economic policy. Yet the advantages are attractive to some, which is no doubt why both Canada and Mexico considered it.⁶

Monetary Union, by contrast, was debated mainly in academic circles. It was triggered by the successful introduction of the euro, the continued development of North American Free Trade Agreement (NAFTA) and the potential Free Trade Agreement of the Americas (FTAA). The latter developments, some have noted, provide greater prospects for monetary unification in the future.

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⁶ In Canada the matter was discussed in the House of Commons in 1999.
2. THEORIES OF ECONOMIC AND MONETARY UNION

2.1 Political Science Theories of EMU

All articles in this special issue, regardless of disciplinary orientation, point out that political considerations ultimately determine whether Canada or the UK move towards closer monetary collaboration or indeed unification. Students of European integration will be familiar to the concept of neofunctionalism and its principle of spillover (Haas 1958). In the case of monetary union, this concept illustrates the mechanism by which monetary integration might necessitate the progressive integration of other policy-making areas, such as fiscal policy and public spending. Some have argued that even areas such as social and labor policies will be affected (see for example Bolukbasi in this issue). In order to make a monetary union function, long term labor markets need to be flexible so as to respond to the needs of the enlarged market in which interest rates and exchange rates are no longer instruments that can deal with shocks. Increasing labor mobility and protecting social policies, while appeasing domestic political interests, poses challenges to national governments way beyond any intrinsic economic rationale for monetary union. Thus, looking at the principles of spillover in relation to monetary integration provides a useful insight into the analysis of the pros and cons of EMU.

Of equal importance are the theories that relate to the issue of power distribution. The purpose of many theories of integration, be they neoliberal institutionalism, multi-level governance or one of the many others, is to explain how decisions are made and how power is distributed. If for example Canada were to pursue some sort of monetary union with the United States it would imply the integration of their two monetary policy making institutions, the Bank of Canada and the Federal Reserve. The same reality would be true for the UK after joining the euro: the Bank of England would be a national branch like all others in the European System of Central Banks, and monetary policy would be conducted by the European Central Bank (a British national would have a seat on the governing board). We know the way in which the UK would be integrated into the eurozone cannot be the same for Canada in the North American case. Even if NAMU followed the EMU model it is unclear as to how power would be distributed. Most scholars assume the US would hold the most, if not all the

7 The Bank of England is already a member of the ESCB but as long as it is outside the eurozone (stage 3 of EMU) does not have a say in ECB governance and policy-making.
power in any collaborative arrangement. It would be unthinkable that the model of NAMU would constitute a single vote for each of the three countries, Canada, Mexico and the United States. Analyses of power distribution would explain that such an institutional arrangement would not be attractive to the US (now or in the foreseeable future).

The literature on monetary integration also deals with questions of identity formation. The central role of money in the rise of the nation state and national identity has been discussed (see *inter alia* Gilbert and Helleiner 1998, Risse et al. 1999). There is usually a direct link between the formation of a collective identity and the presence of symbols such as a currency. Given this reality questions of what the effects would be on national identities in North American and in the UK is of significance when discussing whether monetary unification is likely to take place. In the UK the loss of the pound as a symbol of British identity plays an important role in the concerns over joining the eurozone (see Howarth this issue). Similarly, the role of the US dollar as symbol of US global power adversely affects the argument for the creation of a new North American currency which would replace it (see Cohen this issue). The point of raising this issue is to illustrate how the theorization on the symbolic function of money in the formation and maintenance of national collective identity is an element ignored by solely focusing on economic analysis, but is clearly a significant consideration for politicians.

Political economy theories, either those that look at the interface of politics and economics in the ‘real world’ or the more abstract theoretical approaches (see e.g. Jones/Verdun 2005) often engage with the issue of monetary union. With the increase in capital mobility there has been a progressive de-territorialization of money in the ‘real world’ (Cohen 1998), which has prompted states to respond with efforts to secure their economies through the formation and exploration of alternative currency options. The larger process of economic globalization also has a direct impact on the monetary orders within states. Speculative attacks resulting in currency crises like those in Asia and Latin America and the subsequent contagion effect of such problems has forced nations to reconsider how best to achieve stability under these conditions. As a result, discussions about monetary union and collaboration surface as a way to conceptualize a response to global economic insecurity. Some scholars, such as Barry Eichengreen, argue that the there has been a ‘hollowing-out’ of policy options which forces nations to the two extremes of the fix or float spectrum (Eichengreen 1994). While this hypothesis is debatable, the persistence of these global conditions does trigger discussions of how best to achieve economic security and position the issue of
monetary collaboration, or indeed unification, at the heart of contemporary political economy.

Finally, in a broader sense monetary union relates closely to globalization or regionalism, and thus to the theories that explain those two phenomena. Any decision by a state to join a pre-existing monetary union or to develop a new one implies a change to the global order in terms of power, political practice and practical realities of global governance. Thus, it is important to understand how these unions and regional monetary groupings come into being so as to speculate what their impact and their pitfalls might be.

2.2 Economic Theories of EMU

The choice of joining a monetary union is in essence an exchange rate policy choice because monetary unions are virtually equivalent to a hard fixing of exchange rates between the participating countries. This choice of exchange rate policy has wide implications in the economy through a variety of mechanisms. This subsection will look at how these implications are dealt with in the economic literature on both sides of the Atlantic.

One of the mechanisms through which exchange rate policy affects the economy is its relationship to monetary and fiscal policy. A basic explanation of the economic relationship goes as follows: say the central bank of a country increases interest rates, for instance in order to keep inflation at bay. Currencies that offer high interest rates are sought-after in international financial markets, so the value of the respective currency will increase, changing the exchange rate. As early as 1968, Robert Mundell introduced the notion of the ‘impossible trinity’, also dubbed the ‘unholy trinity’ according to which monetary policy independence, capital mobility, and fixed exchange rates cannot coexist. Indeed, one of the main advantages of flexible exchange rates is that they allow the pursuit of an independent monetary policy. Monetary policy independence also means that governments could conceivably finance high fiscal deficits by printing money, an option which is denied to a member of the monetary union. Therefore, monetary unions can also be said to restrict fiscal policy choices.

2.2.1 Optimal Currency Areas (OCA) Theory

OCA theory has recently become the economic benchmark for assessing the choice of exchange rate regime. According to the theory, introduced by Canadian Nobel-prize-winning economist Robert Mundell, a region should have a unique currency if its economies fulfill a broad range of conditions, such as that the
economies are affected symmetrically by external shocks and that there are few restrictions to the reallocation of labor in response to such shocks. If a region is indeed an OCA, there are considerable benefits flowing from monetary union (such as higher growth), which result from reductions in transactions costs, given the reduction in foreign exchange transactions and the transparency of pricing and ease of comparison. The number and relative importance of the specific requirements for monetary union to be an optimal choice remains, however, a subject of controversy among economists.

Most countries in the world fit some, but not all of the criteria for joining a monetary union with their neighbors. In these cases, OCA theory advises the adoption of an intermediate exchange rate regime, one that involves less than fully flexible exchange rates (i.e. some sort of peg), but not a hard fix like monetary union would imply. Intermediary options have however become discredited (although see Crowley and Rowley, 2002 for a political economy analysis for North America). These types of regimes have suffered from lack of credibility, due to political interference that have led to numerous changes in pegs, and consequently to speculative attacks as investors are uncertain about future levels of such pegs. Thus, economists and politicians alike have tended to lose their interest in intermediary regimes, in spite of their theoretical attractiveness. These days it seems that national governments have two extreme options to choose from: fully flexible exchange rates or a monetary union. Unfortunately, the dearth of choice does not make the decision any easier. If anything, it has intensified the debate. On the one hand, there are those who show that not even countries already sharing a common currency are ideal candidates for a monetary union (see Crowley, this issue), on the other, there are hard fix enthusiasts who will counter that monetary unions will not only result in more trade and subsequently higher economic growth, but will squeeze the rigidities out of prices and wages, forging more adaptable economies (see Grubel, this issue).

This last argument – which employs OCA theory to argue that increased labor market flexibility, more synchronous business cycles, more trade and less inflation will follow the establishment of a monetary union – has been labeled ‘endogenous OCA’ theory. Supporters of this strand of OCA theory believe that monetary union is a useful tool for making all these positive changes happen, while skeptics point out that the economy does not automatically adapt to a new situation and will probably pass through prolonged recession before resources are reallocated.

All of these arguments have developed in specific ways in the context of Canadian and European debates about monetary union, to which we shall now turn.
2.2.2 European Theoretical Debates

In the European debate over the economic benefits of the euro, endogenous OCA theory figured prominently. EMU was considered a possible solution to Europe’s unemployment problems because monetary unions are supposed to force labor markets to become more flexible. The experience to date does not entirely confirm this prediction (UK Treasury report on ‘EMU and Labor market flexibility’). Endogenous OCA theory also argues that monetary unions may be a cure for inflation problems (see Willett, this issue), and keeping inflation low was an important reason for both the EMS and the subsequent EMU (Verdun, 1999). Critics point out that by the time EMU came about, Europe was hardly a continent in need of more monetary discipline (Dean, 2002). In fact, the European Central Bank has been accused of having a deflationary bias which could have adverse consequences on economic growth (see Rollo, 2002; Artis, this issue).

When looking at the economic studies commissioned by HM Treasury to verify the five economic tests for the adoption of the euro it becomes obvious that the British debate on monetary union, like the European debate, is also strongly connected to OCA theory (see Artis, this issue). The widespread finding of the Treasury studies is that the UK business cycle is asynchronous with that of most EU countries, though the difference between the two business cycles may have diminished somewhat lately. This suggests that the UK economy is subject to asymmetric shocks and can better fend against them with a national monetary policy; hence a national currency.

Other theoretical developments relevant to the British debate are the growing doubts about the efficacy of exchange rates as shock absorbers and the idea that monetary unions can be attractive to outsiders because of a superior monetary and fiscal policy framework that accompanies them. The first issue refers to the possibility that exchange rate changes are not reflective of true differences in the economic situation of the countries in question and are instead responses to exchange rate speculation in international financial markets. While exchange rate volatility appears to have increased somewhat it is an open question as to what extent it is the main factor influencing exchange rate levels. The second idea present in the British debate resonates with studies of the viability of the eurozone fiscal policy framework outlined in the Maastricht Treaty and the subsequent Stability and Growth Pact. Specifically, the economic rules that cap budget deficits at three percent of Gross Domestic Product (GDP) are considered by some economists to be conducive to recessions and higher unemployment (see Seccareccia and Lequain, this issue), as well as to a severe retrenchment of the welfare state (see literature reviewed by Bolukbasi, this issue). Even though there
is considerable debate on these issues, the policy framework of the eurozone does appear to hold more potential dangers than benefits for the UK.

2.2.3 North American Theoretical Debates

If in the British debate monetary union's benefits are more prominent, in Canada it is the flexible exchange rate that is under severe scrutiny from those who advocate a monetary union with the US. The economic arguments about transaction costs savings under monetary unions are prominent in the Canadian debate. The importance of these savings is debatable, however, given they are estimated at only 0.25% of GDP (Laidler, this issue). According to OCA theory, lower transactions costs have trade-enhancing effects of members of monetary unions. However, the higher transactions costs associated with flexible exchange rates do not seem sufficient to have hampered Canada's trade with the US, as evidenced by the strong increase in such bilateral trade in recent years (Schembri, this issue). In general, the virtual agreement among economists about the positive effects of reduced transactions costs on the economy are met by widespread skepticism (sometimes by the very same economists), if translated into large efficiency gains.

The importance of independent monetary policy is also a significant argument in the Canadian debate used by economists on both sides of the argument. Such independence does not guarantee a successful monetary policy, as evidenced by the numerous policy mistakes of Canada in the past. The point of debate is whether such past mistakes are a good enough reason to abandon monetary policy by pursuing a hard fix with the US. This would eliminate the uncertainty stemming from the Bank of Canada’s monetary policy decisions, but the uncertainty generated by US monetary policy would of course remain. Past mistakes suggest, however, that flexible exchange rates bring economic benefits only in conjunction with a sensible monetary policy based on a clear nominal target, such as inflation.

Among the main arguments in the pro-monetary union Canadian debate is the idea that flexible exchange rates delay gains in productivity when a low value of the currency prevails, as experienced by the Canadian dollar (Grubel, 2000, Courchene and Harris, 2000), as a low exchange rate obviates the need for productivity improvements. In this form, the argument states that a low exchange rate is equivalent to tariff protection for underperforming export sectors. Export prices are artificially low due to the low exchange rate, so important resource reallocations (e.g. between sectors of the economy or between capital and labor within an industry) are not forced to occur to ensure the most efficient allocation of resources. The above argument is basically the flipside of the 'con' camp’s
observation that flexible exchange rates serve as a buffer in the face of macroeconomic shocks, allowing the economy some adjustment time to the new conditions. The issue then becomes one about the desirability of buffers, the skeptics believing that an economy can only recuperate from an exogenous shock in due time if forced to do so by the absence of a buffer mechanism. The proponents of flexible exchange rates, however, point out that such adjustment is inevitably long and painful in terms of unemployment and economic growth (because wages and prices are sticky), and thus the impacts on the economy should be softened as much as possible.

This leads to another issue often discussed in the Canadian debate: labor market flexibility. Even though absent from the political agenda in the Canadian-US case, flexible labor markets are considered in traditional OCA theory as a prerequisite for monetary union if business cycles are not synchronous. Flexible labor markets make economic adjustments to exogenous shocks a lot easier, but many of the rigidities in labor markets are due to regulations that can only be aligned if specific attempts at labor market integration are made. That is why some economists consider a common market as a necessary non-monetary step on the road to a possible monetary union (see Pereira on this issue).

Finally, the issue of business cycle alignment (with the US) is also prominent in the Canadian debate. Canada’s dependence on natural resource trade is taken by some economists to mean that changes in world commodity prices will affect this country differently than the US and thus will require flexible exchange rates to ease the inevitable economic adjustment. By contrast, the camp favoring a monetary union argues that an unexpected change in commodity prices under a hard fix would be an invaluable opportunity for Canada to rid itself of its dependence on natural resources, by allowing labor and capital to be naturally reallocated to other sectors of the economy.

### 2.3 Canada-UK Comparison

Looking at the economic debates on both sides of the Atlantic, it is remarkable that in spite of some local flavor, the same types of economic arguments both for and against monetary unions are made, despite somewhat different situations. This suggests that insights can be gained by reflecting on the particularities prevailing in both countries.

The question of the value of independent monetary policy versus the benefits of reduced transactions costs is high on the agenda in both debates. Monetary independence was considered already lost for European countries during the
EMS. Likewise, it has been argued that use of Canadian monetary policy independence is restricted as long as the Bank of Canada follows the strict precepts of inflation targeting. Some argue independence is actually lost. One could then argue that by joining a monetary union that focuses on the same inflation rate as the Bank would not be such a big step. But in fact the issue of monetary independence is one about the ability to pursue monetary goals that are different from those of the neighbors, as exemplified by Canada’s inflation targeting in contrast to US monetary policy.

Whether the best way to achieve a reduction of inflation is by fixing exchange rates (a view favored in the European case) or, on the contrary, by keeping exchange rates flexible (as in the Canadian case) may be impossible to solve by merely theorizing about it. However, both the Bank of England and the Bank of Canada seem to have been quite successful at reaching their respective inflation targets, suggesting, contrary to the European conventional view, that monetary union need not be a precondition for low inflation.

The idea that exchange rate fluctuations are due to speculation rather than to changes in economic fundamentals is also present in both debates. Advocates of monetary union argue that a currency that is close to a monetary union but stays outside it will be more likely to be used as a reserve currency and might actually rise in value, putting the neighboring leading currencies under pressure. Having reviewed the theoretical debates in political science and economics and on both sides of the Atlantic, let us now turn to the immediate debates on monetary union that took place in Canada and the UK in the period 1999-2004.

3. Recent Debates


The debates in Europe on EMU resurfaced with the onset of stage three of EMU on 1 January 1999. In May 1998 the European Council determined that eleven Member States were ready to join the third stage of EMU and thus adopt the euro in financial markets as of 1 January 1999. The eleven countries were Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain (when banknotes and coins started circulating on

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8 Note, however, that once Canada joins a monetary policy, the area in which the aggregate inflation would be measured is much larger and hence the inflation rate in Canada per se could actually fluctuate more.
1 January 2002 Greece had also joined the euro and hence the euro was introduced in twelve Member States. The skepticism of the mid-1990s died away and was replaced by a sense of euphoria that was felt in light of the fact that so many Member States had been able to meet the so-called 'Maastricht convergence criteria', which stipulated the entry conditions to EMU.

EMU in the first few years was subject to considerable speculation about whether it would be successful or not. Some US scholars commented that the euro could possibly lead to a catastrophe and could cause another war in Europe. A factor that led to further speculation about the success of the project was the fact that the euro depreciated 25-35 percent from its introduction value in the first years after having been launched in the financial markets. When the euro had been conceptualized it had been influenced by German monetary policy principles that had been based on keeping the currency stable and inflation rates low, which usually meant that the German deutschmark appreciated against other currencies. However with the euro depreciating (1999-2002) speculation emerged suggesting that the euro would not be as strong as the German deutschmark, and instead be a low value currency. In the fall of 2000 the European Central Bank (ECB) intervened in financial markets to boost the value of the euro that was hovering below the US$ 0.90 (having been introduced in 1999 at US$ 1.17). The ECB intervention was much criticized as it had not been the task of the ECB to support or undermine the value of the euro, instead its only task should have been to focus on price stability (low inflation).

The introduction of banknotes and coins on 1 January 2002 was deemed a major success overall. The logistics had been well-prepared and it seemed that no major hiccups occurred. Some have argued, however, that there has been a considerable increase in prices of some smaller consumer goods. But the official aggregate statistics do not indicate this phenomenon to have had a major impact (much to the dissatisfaction of consumers in Italy and Greece who claim that going out to dinner has doubled in price!) By spring 2002 the euro started to pick up and appreciated against the US dollar and other leading currencies, a trend which continues today (although at the time of writing the euro has now seemed to have returned to its introduction rate of US$1.17!). Exporters realized that the low euro had been good for business and were unhappy to see their competitive edge disappear. So ironically, although at first observers commented on the fact that the depreciating euro was a disaster, the appreciating euro was seen as a problem as well (for growth and the export sector).

Yet, even though there was much talk in the media of the importance of the exchange rate of the euro, the official view remained that it was of only marginal importance that the euro was high, low or otherwise fluctuating. The view was
that the lion’s share of trade in the eurozone was among the eurozone countries which meant that the external exchange rate left most transactions unaffected.

Some further discussions emerged in these early years and into the new millennium about the relationship between having a single currency and budgetary deficits and public debts. The Treaty on European Union stipulates that Member States need to treat their macroeconomic policies as a matter of common concern, but also that excessive deficits could be punished. In light of the sluggish economic development in the period 2002-2003 a major debate emerged about the value of the Stability and Growth Pact and what its effect would be on economic growth. The consensus in 2004 was that the SGP should be kept intact but some alterations should be made (as eventually happened in spring 2005).

The most recent years have seen an increased attention on the question of relating monetary policy with rules on budgets and the question of how to improve economic growth in the EU. There are large divergences between a country such as Germany (economic growth and rate of inflation) on the one hand and those same indicators in Ireland on the other. These countries both have the same interest rate that is set by the ECB, but both would benefit from a lower respectively higher interest rate. In the period 2003-2004 the euro stabilized and remained relatively strong vis-à-vis the US dollar and other major currencies, became increasingly used in international trade and held as reserves by central banks throughout the world.

Not all Member States were keen to join the euro. The Danish population rejected the euro in a referendum in 2000. The Swedes did the same in 2003 and the United Kingdom has yet to hold a referendum on the matter. Those critical of joining EMU argue that there is no need to harmonize monetary policy and that the fixed exchange rate can be obtained without transferring monetary sovereignty. However, recent research indicates that most of the citizens who voted against joining EMU in a referendum were mostly voting in response to either their wider fears about European integration penetrating too much into the everyday policy-making of national governments or the fact that they were critical of their government more generally (seeing that the government was in favor of the euro, these citizens voted against just to be contrary).

3.2 Debates in Canada on NAMU (1999–2004)

The discussion in Canada on the value of creating a monetary union reappeared largely in response to the entry into stage three of EMU in the EU, with the prospect of the euro as legal tender in a dozen Member States. The
debates in Canada focused on the question of whether or not it would be beneficial for Canada to join a similar enterprise, which was labeled NAMU, with monetary policy shared among the three participating Member States (Canada, the US, Mexico). Realizing that the US was not going to share monetary sovereignty evenly with the two other nations, the question became whether it would be attractive to Canada to join a NAMU if it only had 1/20th of the influence of the United States. Other options that were explored were whether it might be beneficial to Canada to have a fixed exchange rate with the United States rather than a float, as had been the case over the past decades. It was argued that times had changed due to the fact that the North American Free Trade Agreement (NAFTA) led to increased trade and ease of economic transactions in Canada. With as much as 85 percent of all Canadian trade being done with the US it was argued that benefits of fixed exchange rates might outweigh its costs.

However, the political cost to national sovereignty of joining an NAMU or fixing the exchange rate seemed unattractive to politicians and citizens which meant that the debates died down. It was probably not a trivial matter that the September 11, 2001 attacks occurred before the euro banknotes and coins had been introduced. In the aftermath of those terrorist attacks US policies became much more focused on military as opposed to economic objectives, and the US was less interested than before to share sovereignty over issues (such as monetary policy, or seigniorage in case of dollarization). Hence the Canadian government was discouraged to focus on such issues seeing that the US administration was so reluctant to collaborate on these matters with partners.

The issue of dollarization has become quite relevant in the wider Americas. The Argentinean case showed how a fixed exchange rate was no guarantee for irrevocably fixing the exchange rate. When the Argentinean government decided to float the peso it immediately depreciated. In the first forty-five business days since floatation in January 1999 the peso lost close to sixty percent of its value. The currency crisis consequently triggered a major economic crisis in that country.

Other Central and South American countries in the same period did not fare quite as badly, but a few did reflect on what would be the appropriate exchange rate policy for their country in light of fostering economic development, stability, and encouraging foreign direct investment (and avoiding major capital flight).
3.3 Comparing the Debates in Europe to North America

EMU in Europe offers a clear mix of politics and economics. It also features a broader legal framework that applies not only to monetary policies but also to related policies (budgetary and macroeconomic policies). EMU implies a sharing of sovereignty over monetary policy, in which all Member States have a voice, and an embedding of monetary policy in a broader set of policies. Yet Member States are still sovereign insofar as being able to determine how to obtain certain commonly agreed outcomes (and reflect on best practices). If the United Kingdom joins EMU a British national (likely a former Bank of England official) would have a voice in monetary policy decisions, have the right to decide how to obtain budgetary outcomes and other macroeconomic policy objectives, but would have to surrender the important formal sovereignty over monetary policy to the ECB. It would also have to accept that the policies on interest rates and thus the politically sensitive mortgage rate would be set in Frankfurt by the ECB. Finally, British citizens who are generally ‘anti-European’ would have to accept that further European integration would have penetrated British monetary affairs and would have to also accept the symbolism on the European currency that would be in circulation around in the UK (although remarkably the Queen’s head would remain on the coins⁹). A majority of the British public would likely consider supporting the idea of joining EMU if a number of conditions are met: (1) the government makes the case that political and economic factors are in place to support moving to adopting the euro; (2) the public is not too upset with the Prime Minister or the cabinet (on other issues); (3) European integration in general is seen as a positive thing (there are no major quibbles over other European issues, or any other major negative publicity involving the EU).

NAMU in today’s North America would be completely dominated by the United States. The economic power of the US is such that it would set monetary policies for the whole zone (it would not share sovereignty). Furthermore, the US would likely be disinclined to share any benefits of monetary union (seigniorage) with members of NAMU. So even if the economics suggest that fixed exchange rates or indeed a single currency would be beneficial for North America, the political circumstances are far from right; NAFTA ensures free trade but not much collaboration in other areas of policy-making. The result of this comparison is that

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⁹ Banknotes are all similar and have symbols on them representing European unity (bridges and other architectural buildings). Eurocoins, by contrast, have one side that is similar whereas the other has a national symbol on it that Member States were free to
one is able to speculate why there might be little interest in Canada today to join a NAMU with the US. Ironically, the fact that Canada is as dependent on the US for its main export market might actually work against the desire to have a monetary union in North America. The reason is that Canada feels it still needs to diversify so as not to be completely dependent on the US. For Canada (government and public opinion) to become interested in creating an NAMU three conditions would need to be met: (1) Canada would need to receive guarantees from the US that that country would share some sovereignty over monetary policy with Canada; (2) Canada would need to be less dependent on the US (so as not to be terrified by the idea of joining an NAMU with the US); and (3) the situation emerges such that the Canadian government can no longer benefit sufficiently from having an independent currency. If those conditions are met, Canada might reengage in the debate on whether or not it might be attractive to join NAMU.

4. Reflections on Theories and Debates and Contents of this Special Issue

The first major insight to be obtained from the present debate is that monetary unions are political choices with significant distributional and economic impacts. These impacts are often hard to assess. Thus, we can reverse a favorite economist phrase about politics, and argue that monetary unions are too important to be left to economists. Yet, it is vital that politicians realize that monetary unions can make or break the economic fortunes of a country.

A second insight from the debate has to do with sequencing of integration, specifically the desirable level of economic and political integration prior to joining a monetary union. The arguments of endogenous OCA theory imply that if further integration of a region is the goal to be pursued, monetary union would be an important stepping stone. It would bring the different entities of that region economically closer together. Thus, a monetary union can be considered a tool for building political, or further economic integration of a region, rather than merely an end in itself.

With respect to the sequencing of integration in North America, there is a case for establishing a single or a common market between Canada and the US prior to engaging into a currency union. This progression would follow the example set by European countries that achieved a degree of economic integration design as they see fit. Countries that still have a monarchy have typically chosen to display a picture of the ruling monarch.
commensurate with a common market well before engaging in monetary integration. NAFTA has substantially increased the levels of trade and Foreign Direct Investment (FDI) between Canada and the US, reducing the Canadian ‘home-bias’: the tendency to trade within national borders substantially more than across these borders. Yet it has not compelled Canada and the US to start negotiating elements of economic integration with more political implications, such as the common standards that would be needed for a single market. In fact, Canada and the US have appealed to the World Trade Organization (WTO) several times in order to find solutions to commercial conflicts. The free movement of people is also not an issue that is open to negotiation presently, although Canada’s potential inclusion into American security concerns after September 11 might ease the movement of people across the Canadian-US border. This would indicate that more political integration is a necessary step in achieving further economic integration in North America. Thus, the question of what kind of integration should come first is not easy to answer; although in the Canadian case small steps towards both further political and economic integration appear more likely than large political and economic leaps such as a NAMU. The British choice over joining EMU appears in this light to be more about deciding whether further political integration with the European continent is desirable.

One last issue arising from the debate is that of credibility of rules. The move towards monetary union is based on the belief that hard rules are preferable to discretion in monetary and fiscal matters because they are more credible, allowing investors to make long-term choices without worrying about exchange rates fluctuations. Monetary unions qualify as hard rules (firm commitments) because they are more difficult to reverse than a government’s commitment to fixed exchange rates. The supporting rules of EMU, embodied in the Maastricht Treaty and the Stability and Growth Pact, are also considered ‘hard’, due to the sanctions they include. However, once hard rules are in place, questions about not only who is favored by the rules, but also who can break the rules arise. The recent case of Germany and France breaking the rules of the Stability and Growth Pact without suffering due punishment could easily be replicated by the US in the event of NAMU. Just as monetary unions are embraced because of the lack credibility of maintaining ‘merely’ fixed exchange rates, so monetary unions could be considered non-credible fixes if the powerful countries within these unions bend the rules.

The special issue contains thirteen other major articles. Thomas Willett applies OCA theory to exchange rate policies and offers some theoretical insights in recent adoption of OCA theory. Michael Artis examines the British situation and the Treasury reports on the five economic tests from a predominantly
economic perspective. David Laidler reflects on the start of the debate on NAMU following the introduction of the euro in 1999 and what it means for Canada. Lawrence Schembri examines exchange rate policy in Canada and basically argues why Canada logically does not seek to fix the exchange rate to the US dollar. Herbert Grubel offers an opposite perspective making the case why Canada would benefit from NAMU. Patrick Crowley adopts a clustering methodology to examine the existence of OCAs in Europe and in North America.

The part two contains further seven major articles. Eric Helleiner offers a political economy article and looks at the historical experience of Canada with exchange rate regimes and offers reflections on the British case from this perspective. David Howarth examines the British case from various political science theoretical perspectives. Benjamin J. Cohen makes the case why the US dollar is hegemonic and why its government is unlikely to hand over any control over monetary policy to its neighbors. Alvaro Pereira examines the dollarization issue in North America and discusses the differences between dollarization and a proper NAMU. Paul Bowles offers a comparison of Canada and Australia and reflects on how geography and relative size within that area make a difference on the choice for a specific exchange rate policy regime. The next article, by Seccareccia and Lequain, delves deeper into the lessons from EMU for a possible Canadian monetary union. Tolga Bolukbasi’s article takes the argument a step further and considers how monetary union might influence the Canadian social model.

5. Conclusion

Britain and Canada face a world in which their choice of maintaining a floating exchange rate is challenged in light of the successful currency next door. These countries share numerous characteristics from which we can draw lessons. First, they each see having a national currency as crucial to their national identity. In the case of Canada, the currency is an important symbol of national identity seeing that so much of the economic exchange is with the US (85 percent of trade) and also the fact that there is so many similarities between Canada and the US (language and culture). The British pound is a symbol of British ‘greatness’ and its unique history and heritage. Second, both countries are unsure exactly how close they want to get to the large neighbor. Canada does not really strive for even closer integration as it is concerned that integration might come at the expense of national distinctiveness. The United Kingdom has a similar concern in that it sees the eurozone as representing a deepening integration process that the British
people are still wary of. Third, both countries are unsure what the exact economic costs would be if they stayed outside a monetary union (or indeed what the costs would be if they join). Both countries know that their economic relationship with the neighbor does not really depend on the existence of a single currency (or fixed exchange rates) although they are aware that a fix would likely have an effect on trade and economic and monetary relations more generally.

There are also numerous differences. First, the UK faces an EMU that is part of a broader European integration process in which the UK has a say. Canadians face a dominant partner unwilling to share sovereignty with any of its neighbors. The EU is more balanced in terms of numbers of small, medium-sized and large countries, whereas a NAMU would imply three countries coming together. Even if shared proportionally, the US would represent a much larger part of the whole. Second, joining EMU would mean for Britain a much smaller degree of further integration exactly because so much of the related integration has already occurred (single market, financial market integration, rules on budgetary deficits are in the treaty and so on). The Canadian decision to fix, to dollarize, or to join a NAMU would be a much larger step for Canada, for North America and for economic and political integration in the region (and as said, because the US will not want to pool its sovereignty with others, the US would fully dominate a would-be NAMU, if on offer). Third and finally, the geographical, economic and political situation in Britain and Canada is fundamentally different. Canada has an almost symbiotic relationship with the US and is almost lacking a real clear cultural basis to continue to stress its national difference from the US. Thus giving up monetary sovereignty and the important symbolic national currency could have a devastating effect on Canadian identity. The case of Britain is significantly different. For the foreseeable future, that country will remain a distinct culture that is different from its neighbors on the continent. It will not easily lose its identity by giving up its currency.

Britain and Canada both face a challenging future insofar as their currency regime is concerned. Though Britain faces the prospect of joining its neighboring monetary union in the next decade – whilst Canada does not – both countries face an international political economy in which minor currencies no longer automatically survive as important international trading currencies. Both countries will have to position themselves within this context. This issue aims at providing insights into how this positioning takes place by looking at the experiences and debates in these two countries, as well as the economics and politics of monetary union.
REFERENCES


