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Monetary Union with the U.S.: The Pros and Cons

Introduction

In recent months, there has been much discussion about the possibility of a monetary union between Canada and the United States. Various scenarios have been put forward for implementing such a change. The public, however, is often confused because experts switch between different concepts of "monetary union."

A monetary union with the United States would strictly involve creation of a new currency, such as the "amero" proposed by Professor Herbert Grubel, to replace the present American and Canadian dollars. This option is generally considered unrealistic, given the strong attachment of Americans to their own dollar. The two countries could, however, find another way of using the same currency, through "dollarisation." In brief, under dollarisation Canada would adopt the American dollar, as some countries have already done (Panama and Liberia), or are considering (Argentina). Dollarisation would involve the most loss of sovereignty over Canadian monetary policy.

Money performs three functions: it is a unit of account, a means of transaction and a store of value. Different monetary regimes will have different effects on these functions.

Arguments in Favour of a Monetary Union between Canada and the United States

Canada and the United States have already established an agreement on trade called the Free Trade Agreement (FTA) that now includes Mexico (NAFTA). This agreement, together with the development of vastly enhanced economic integration between the two countries, has considerably increased the volume of trade over the past decade. A common currency would eliminate many irritants and uncertainties with respect to the floating exchange rate and would consequently reduce the costs associated with these uncertainties. In fact, many argue that a common currency would be a good complement to the NAFTA and would enhance the benefits of this Agreement.

Canadian industries that trade with their American counterparts must, in addition to bearing the costs related to uncertainty, bear foreign exchange transaction costs. John Murray, the Chief of the International Department at the Bank of Canada, has estimated these costs to be nearly $3 billion per year. Thus, using the same currency as the United States would save these industries a significant amount of money.

Removing the risk associated with the exchange rate would also help to lower interest rates on debt, especially long-term bonds, mostly because of the reduction in the risk premium. Canadian interest rates are now lower than their American counterparts, owing mainly to our lower inflation rate, but our real interest rates still tend to be higher. A common currency would lower real rates that would encourage more investment, benefiting the economy through higher productivity.

Under a common currency, prices in Canada and the U.S. would be easier to compare. Such ease of comparison would facilitate the application of antidumping laws and reduce tension between the two countries. Moreover, it would help to enhance competition and efficiency. The message from many companies is that, as they already have to quote their merchandise and services in U.S. dollars, it would be logical to dollarise the economy as soon as possible.

Entering a monetary union with the U.S. would stop Canada from using currency devaluation, a tool it has employed in the past. Many argue that a weaker

dollar conceals lower productivity. Industries do not feel the need to make substantial structural changes to adapt to changes in the market, and the result in the medium and long term is a lack of competitiveness. Using the U.S. dollar would prevent such an occurrence.

Another argument in favour of a monetary union with the United States is the need for a defence against the euro; adopting the American dollar would perhaps offset the effect of the eurozone on the Canadian economy. This policy response would avoid the marginalisation of the Canadian dollar in a world where three major currency zones could appear: the euro in Europe, the yen in Asia, and the dollar in the Western Hemisphere. Indeed, proponents of a common currency see it as inevitable and believe that Canada should enter into negotiations quickly, while we still have some bargaining room.

Economists also observed that, during last year's crisis in Asia, short-term capital flowed in great quantities to investments denominated in U.S. dollars. Nobody was surprised by that situation since the U.S. dollar is a well-known refuge for investors. Thus, adopting the American currency would shield against speculative attacks during high-turmoil periods.

Finally, American monetary policies have historically been better at controlling inflation than Canadian policies, although this is not true today.

Arguments against a Monetary Union between Canada and the United States

For a currency union to work, theory suggests that countries need to be in an "optimum currency area." Participating countries need to have similar economic structures as well as full mobility of the factors of production (capital and labour). Many argue that this is not the case for Canada and the U.S. Canada's economy is still strongly commodity-based and thus is quite different from that of its neighbour. Since Canada and the United States do not represent an optimum currency area, a monetary union between them would not be optimal, especially for Canada.

Responses to external shocks — which at present are made through movements in the Canadian exchange rate — would have to be made through fiscal policy, movements of capital and labour, and changes in factor prices. Given factor price rigidity in this country, this would lead to lower output and lower employment. The "shock-absorbing" capability of the present flexible currency would be completely lost. Gordon Thiessen, the Governor of the Bank of Canada, has argued that without a flexible exchange rate system, we would possibly have experienced a deep recession over the last year.

Another important argument is that under a common currency regime Canada would be overwhelmingly dominated by the United States. Inevitably, Canada would lose a substantial degree of control over its monetary policy. Canada could not aspire to be more than just a thirteenth district of the Federal Reserve — and this is a best case scenario. Americans would look after their own interests, notwithstanding the presence of Canada. Moreover, since there are many structural differences between the two economies, American decisions could affect the Canadian economy adversely. We already see something similar; many people argue that the Bank of Canada conducts its monetary policy to satisfy Ontario's needs while British Columbia, for example, would benefit from a more expansionary monetary policy. Under a common currency agreement with the U.S., the situation could become even worse for small, resource-based provincial economies such as those of New Brunswick, Nova Scotia and Newfoundland.

Finally, such an agreement between the two countries would imply a $1.4-billion reduction per year in Canadian government revenues now obtained from domestic seignorage (right to print money).

Conclusion

There are as many arguments for as against a monetary union between Canada and the United States. Which arguments are better is hard to say. What is at present only a debate of ideas may soon become one that is political and financial in nature. The debate is active and is now being put before Canadians through newspapers and the politicians and analysts who are in favour of it. In view of its nationalist aspects and its implications for Canadians' everyday life, the debate promises to be even more important and controversial than that which occurred on the FTA.