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THE POLITICAL ECONOMY OF MONETARY INTEGRATION: LESSONS FROM EUROPE FOR CANADA - CONFERENCE REPORT

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If all goes as planned, the French Franc, the German Mark and the Italian Lira (among others) will virtually disappear from day-to-day use by the middle of 2002, closing at least one chapter in the long history of European nationalism. At that point, the Euro will become *the* medium of exchange for the 11 countries that make up the Economic and Monetary Union (EMU).(1) This means that the Euro will be used to pay salaries, fund social programs, and buy goods and services throughout the Euro-11.(2) The road to 2002 has not been easy. Since its inception in January 1999, the Euro has fallen roughly 27% (see Figure 1) against the U.S. dollar, defying the predictions of most economists and observers who thought the strict conditions laid out in the Stability and Growth Pact, as well as the more general edicts in the Maastricht Treaty, would ensure a strong currency.(3) Indeed, most recent academic research suggests the Euro is at least 15% cheaper than it should be.(4)

Despite the less-than-stellar performance of the Euro so far, some prominent Canadian economists have suggested that Canada, the United States and Mexico pursue a similar path. Thomas Courchene of Queen's University and Richard Harris of Simon Fraser University (1999), for example, have argued in favour of a North American Monetary Union (NAMU) and some prominent politicians have said they would not dismiss the idea out of hand.

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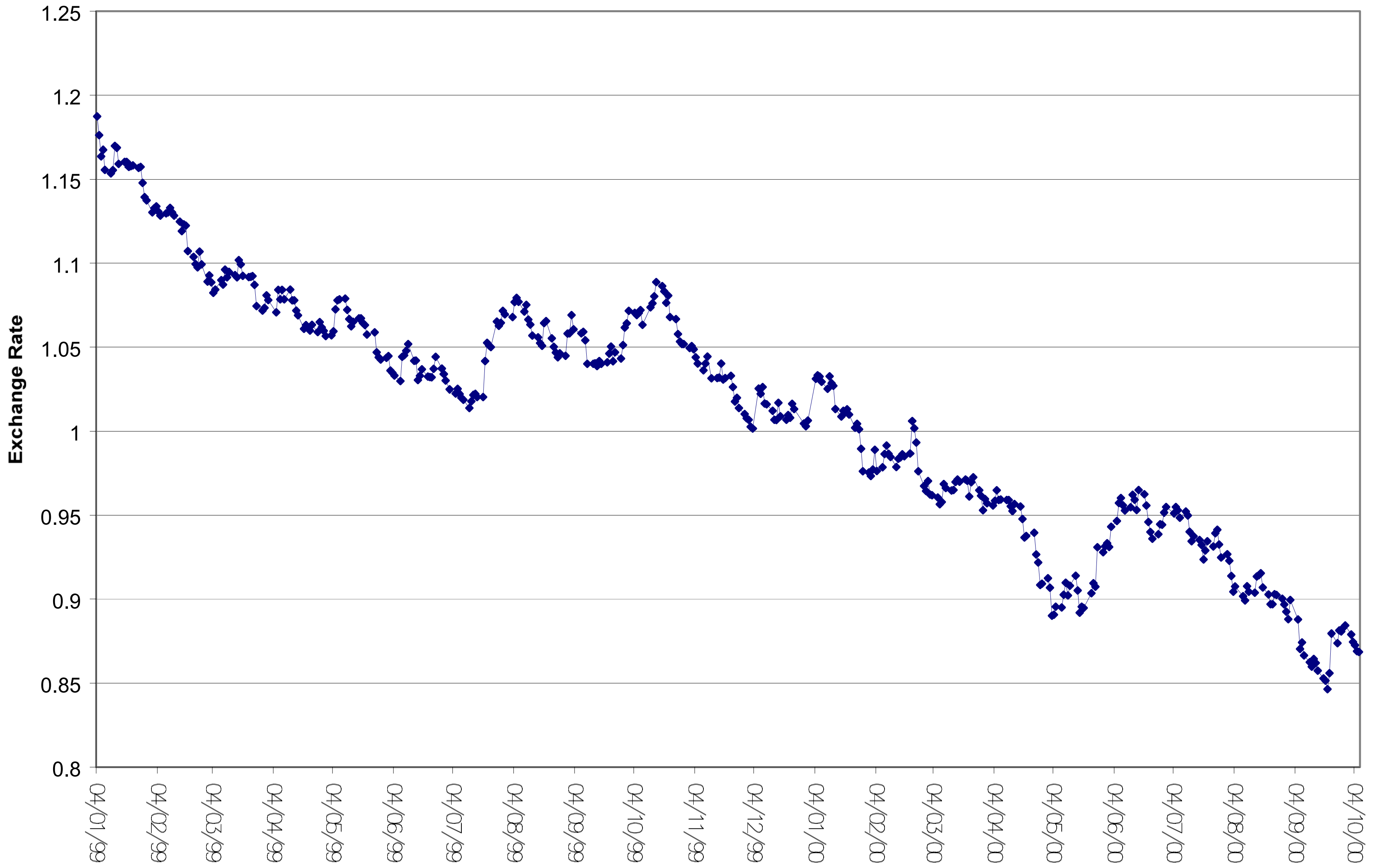
(1) The EMU acronym is frequently and mistakenly thought to mean European Monetary Union. Note also that France, Germany and Italy have the biggest economies of the Euro-11. Other countries involved in the currency union include Austria (Schillings), Belgium (Franc), Finland (Markka), Ireland (Punt), Luxembourg (Franc), Netherlands (Guilders), Portugal (Escudo), and Spain (Pesetas). The European Union includes 15 countries. Four have opted out of the Economic and Monetary Union. They are Sweden, Denmark, Norway and the U.K.

(2) Foreign-exchange and money-market transactions are already conducted in Euros.

(3) These conditions include a provision forbidding deficits in excess of 3% of GDP and requiring a debt-to-GDP ratio of less than 60%.

(4) See, for example, an investigation by Deutsche's Bank Research (2000).

Figure 1: Daily Exchange Rates : U.S. Dollars per Euro



THE CASE FOR A NAMU

Before considering the various arguments presented at the conference on the Political Economy of Monetary Integration: Lessons from Europe for Canada, held in Ottawa in September 2000, it is worth briefly revisiting the key elements of the Thomas Courchene and Richard Harris argument. It hinges on two key propositions.

- First, that a flexible exchange-rate regime has *not* served Canada well, contrary to statements by Bank of Canada Governor Gordon Thiessen and other prominent economists. In fact, they suggest that flexible exchange-rate regimes are plagued by a tendency for currencies to "overshoot" their long-run purchasing power parity rate and to be consequently "misaligned" relative to the economic and financial fundamentals.(5) This imposes severe and distortionary costs.
- Second, Canada must seek a NAMU now or suffer the consequences of creeping dollarization, a process they argue is already well underway and that would not prove so advantageous to Canada.(6)

Courchene and Harris outline three key benefits that might flow from a currency union similar to Europe's.

- First, a currency union would eliminate some of the uncertainty inherent in a flexible exchange-rate regime. Uncertainty is costly to firms because it forces them to adopt complicated and sometimes risky hedging strategies. They have to hire university graduates with doctorates in public finance and mathematics to ensure that abrupt changes in currencies do not cause losses on otherwise sound investments. Currently, firms wishing to avoid these risks and costs would tend to favour investments in the United States. Furthermore, Courchene and Harris suggest that the misalignment of the Canadian dollar (because of the flexible exchange rate) has distorted price signals and consequently sheltered many Canadian

(5) In other words, we are always in disequilibrium and so our relative prices are more often than not, wrong.

(6) Little evidence is offered to support this position. In fact, Laidler and Poschmann (2000, p. 9, quoted by Spotton Visano, p. 10) argue that the degree of dollarization today is roughly where it was in the 1970s.

exporting firms, which has also hurt Canadian productivity. In other words, the flexible exchange rate has so distorted prices that firms have made bad long-term investment decisions. Similarly, Canadian firms would no longer have to worry about losing workers to the United States because they cannot afford to pay U.S. dollar salaries.

- Second, moving away from a floating exchange rate towards a NAMU-type arrangement would reduce transaction costs associated with converting one currency into another. Similarly, a currency union would reduce the (menu) costs associated with publishing financial results in two currency "languages."
- Third, a fixed exchange rate or NAMU regime would encourage wage and price flexibility much as is starting to happen in Europe. In other words, demand and supply shocks would no longer be absorbed by the exchange rate but by wages and prices "as firms and workers become more conscious of their competitive positions in North America" (Courchene and Harris, Introduction: "Main Findings," 1999).(7)

THE UNDERLYING THEORY: MUNDELL'S OPTIMUM CURRENCY AREA

Most of the arguments in favour of NAMU or, for that matter, any notion of a common currency, rest on the work of Robert Mundell, who earned a Nobel prize in part for his "optimal currency area" (OCA) theory. At its core, this theory says that OCAs should have high labour and capital mobility, a high degree of product market integration, and a synchronized business cycle both in timing and amplitude. In other words, there should *already* be strong economic linkages in the area under consideration. In his original 1961 paper, Mundell proposed a two-currency area for Canada and the U.S.: one linking eastern Canada with the eastern U.S. and another linking western Canada with the western United States. The Courchene and Harris argument falls back on a similar observation, namely that Canada's economic links are increasingly (much more so than in the 1960s) north-south rather than east-west.(8)

(7) What is known is that if the currency does not absorb the shock, the real sector must. What we are not sure about is the extent to which the shock will be absorbed by prices or by output.

(8) These arguments ultimately rest on the standard, textbook analysis that places primacy on money's medium of exchange role and that posits, consequently, the long-run neutrality of money.

Alain Parguez, a conference participant and professor at the University of Bourgogne in France, argued that the OCA argument has even deeper theoretical roots. The 19th century economist Karl Menger argued that the choice of the medium of exchange occurred historically without any intervention by government. In straightforward terms, everyone eventually realized it was in their own best interest to adopt a common currency to minimize transaction costs. The existence of many currencies, in other words, is costly. Economic efficiency demands a single currency which a free market will provide. This is the historical and, indeed, theoretical foundation for Mundell's theory.

THE CASE AGAINST A NAMU

A number of prominent Canadian economists – including David Laidler (1999) and John McCallum (2000) – have come out against the NAMU proposal, arguing in essence that the existing flexible exchange-rate system has served Canada well. They have two arguments.

- Their basic argument is that a floating exchange rate helps cushion the economy from adverse economic shocks such as an increase in oil prices or a financial crisis such as the Asian debacle in 1997-1998. Absent this kind of currency system, a negative shock would quickly and painfully translate into higher unemployment and reduced output, assuming some sort of wage "stickiness." Wage rigidity theory says that workers rarely accept cuts in their nominal wages although they may allow inflation to erode the real value of their wages. They may, in other words, suffer from some kind of monetary illusion where they allow themselves to be fooled into thinking that their income has not changed when in fact it has in real terms. Alternatively, they may be more concerned with their relative place in society. In that case, workers may be willing to accept a real-wage cut brought on by a generalized price increase for a purely rational reason: Everyone is affected in roughly the same way so that there is no relative loss of social standing, especially in one's more immediate peer group. A nominal wage cut, however, will generally worsen one's relative

position in a peer group.[9] If wages are not sticky, than money wages and prices bear the full brunt of the shock and this could have consequences for demand, again implying slower output and higher unemployment.[10]

- Their second argument, complementary to this first one, says that the Canadian economy is in fact quite different than that of the United States because much of Canada's output comes from the commodity sector and must be exported because of insufficient internal demand. The U.S., on the other hand, suffers from a chronic excess of demand and insufficient exports. This suggests, says Laidler (quoted by Spotton Visano, p. 11) that "the real Canada-U.S. exchange rate, the relative value of a representative Canadian-produced bundle of goods and services in terms of its U.S. counterpart, must change, regardless of the regime governing the behaviour of the nominal exchange rate." In other words, given the different natures of the U.S. and Canadian economies, a shared currency cannot be justified economically.

A CLOSER LOOK AT THE EUROPEAN EXPERIENCE: ANALYSIS FROM THE CONFERENCE

Interestingly, the EMU has gone ahead despite a general consensus that the EMU-11 do not, in fact, meet the OCA criteria.[11] U.S. economist Thomas Palley, of the AFL-CIO (a large U.S. union), argued at the conference that pursuing monetary union and especially the so-called "Harmonized Index of Consumer Prices" (HICP) inflation target of 2% – given the lack of an OCA – could therefore prove costly especially to workers, who would bear the brunt

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(9) This argument is obviously closely tied to notions of fairness and social standing. George Akerlof and Janet Yellen explored this issue in a seminal 1990 article from the *Quarterly Journal of Economics* called "The Fair Wage Effort Hypothesis and Unemployment."

(10) This can be seen by remembering that debt is valued in nominal terms. In other words, a $100 debt before the economic shock is still a $100 debt after the shock. If the shock is a deflationary one (like the Asian financial crisis), then people will find it harder to pay off their debts and consequently will have to devote a greater portion of their income to debt repayment instead of consumption. The "real value" of their debt, in other words, will have increased. This can be seen by remembering that real debt is simply debt/price: a fall in prices increases this ratio; the converse is true for an inflationary shock.

(11) See Tamim Bayoumi and Barry Eichengreen, "Shocking Aspects of European Monetary Unification," F. Giavazzi and F. Torres, eds., *The Transition to Economic and Monetary Union in Europe*, New York: Cambridge University Press, 1993.

of this policy in the form of even higher unemployment. The thrust of his argument is that monetary policy can have dramatically different effects across regions because these regions are not well integrated.[12] Later in his paper, Palley presented some new empirical tests for evaluating whether a region really is an OCA. Much like Mundell and Courchene and Harris, he found some evidence suggesting that Canada and the United States are a good fit. Palley did not, however, conclude from this that currency union is a good idea for Canada. His objection boils down to concerns about the reduced scope for fiscal policy, a view echoed by many at the conference.

Stephanie Bell, a professor at the University of Missouri at Kansas City, was equally concerned about the loss of fiscal manoeuvring room implicit in a currency union. She suggested that adopting the EMU – and, by implication, the NAMU – was tantamount to driving the economy without a steering wheel. The thrust of her argument is that the EMU effectively robs nation-states of their fiscal power with or without the limitations on deficit-financing or debt-to-equity ratios imposed by agreements such as the Maastricht Treaty and the Growth and Stability Pact. Her reasoning is straightforward: because national central banks are no longer permitted to issue treasury bonds on behalf of their governments and because the European Central Bank (ECB) is not allowed to directly or indirectly monetize government debt, governments that want to deficit spend have no choice but to float bonds on the capital market, where they must compete with the financing needs of private borrowers. "It may well be that financial markets – if they can price risk correctly – will be able to impose discipline by constraining public spending without the need for penalties for fiscal violations" (Bell, p. 21). The corollary to this argument, of course, is that nation-state debt (in the Euro-11) will no longer be considered default-risk-free, as is currently the case for the United States, Canada and other

(12) To understand Palley's argument, it might be useful to use an analogy. Consider a teacher facing a single classroom with many students, all of different abilities. If the teacher teaches at too high a level, then the weaker students suffer. Likewise, if the teacher makes the material too easy, then the best students find themselves bored with too much time on their hands. The first scenario is analogous to a high interest rate environment that hurts the poor and increases unemployment. The second is analogous to a low interest rate environment that is inflationary. Of course, the different students and their abilities is analogous to the very different nature of the Euro-11 economies and their relative unemployment rates.

major countries who can, as a last resort, always repay their debt simply by "printing money."(13) The end result is that Euro-11 countries with high debt-to-equity ratios will likely face higher interest rates when they borrow and, consequently, have less scope for fiscal policy. The implications for Canada are clear: any attempt to adopt a system similar in structure to the EMU will effectively reduce the Canadian government's room to adopt independent and cost-effective fiscal policy.

Marcello de Cecco, a professor from the Università di Roma "La Sapienza," looked at the Euro from an historical geo-political perspective, noting that Germany, France and (Northern) Italy form the core of Europe's industrial base and are the driving force behind the Euro zone. This area – whose economic might rivals that of the United States and Japan – has been largely driven by an export-oriented economy much like Japan. To some extent, this orientation was set in motion by the U.S., which guaranteed access to its market (and hence aggregate demand) after World War II as part of a broader attempt to stabilize the area (again, a similar policy was pursued with Japan). Relying on this historically rooted analysis, de Cecco accurately predicted at the outset that the Euro would lose value against the U.S. dollar if only out of necessity: Euro-11 politicians would make the appropriate noises – pressured by their respective manufacturing sectors – to drop the Euro's value because internal demand simply couldn't keep up with output. At the same time, the U.S. Federal Reserve has effectively assured a strong dollar by keeping (relative) interest rates high. The implications of de Cecco's argument for Canada are somewhat less clear, although Canada is highly reliant on its exports to the U.S. market. Still, de Cecco, like Bell, was concerned about the lack of fiscal control under a currency union and did not advocate such a system for Canada.

Simon Fraser University professor James Dean suggested that Canada is a poor candidate for dollarization based on his analysis of the "*de facto*" dollarization taking place in Latin America. He believes that Latin America should move to dollarize "*de jure*" (i.e., legally) for four principle reasons, none of which apply to Canada.

- Although most Latin American countries have putatively flexible exchange rates, real exchange rates almost never depreciate because exchange-rate fluctuations quickly translate

(13) Of course, any country that resorted to this act ("printing money") might lose credibility in the international financial community because the "real" value of its repayments could be very small if the repayment sparked inflation and caused the exchange rate to depreciate.

into higher domestic prices. This is due, at least in part, to cost-of-living adjustments (COLAs – or wage indexation) built into the wage structure of many Latin American countries. Exchange-rate policy is therefore impotent.

- Nominal exchange-rate depreciation (one of the key advantages of a flexible rate) have become too dangerous because of the large amounts of dollar-denominated debts held by residents of those countries.
- Informal use of U.S. cash is so widespread that it may be virtually impossible – short of draconian government action – to revert to a national currency. This is at least in part the result of so-called "network externalities," a term that captures the idea that frequent and public use of the dollar by some people makes it more generally accepted by others.
- *De facto* dollarization increases the currency risk premium on Latin American interest rates, at least in part because so many debts are denominated in U.S. dollars and the government has limited ability to pay these debts.

According to Dean, Canada faces none of these problems, at least to any serious degree. He explains his position by offering four arguments.

- First, use of the U.S. dollar in day-to-day transactions is very low in Canada compared with Latin American countries. Canada also does not have the same degree of wage indexation as Latin America, and the Bank of Canada has taken measures to keep inflation subdued.
- Second, although Latin American countries find it difficult if not impossible to sell bonds denominated in their domestic currencies, the same is not true in Canada.
- Third, although Canadian banks are net debtors in U.S. dollars, Canadian firms and banks generate significant U.S. revenues. Also, bank balance sheets tend to be much better managed than those of their Latin American counterparts. In other words, they have no difficulty meeting their commitments and are relatively immune to dramatic changes in the currency.
- Fourth, and more importantly, although Latin American interest rates are generally higher than in the U.S. because of a risk premium, Canadian interest rates have been lower than in the U.S. for quite some time. In other words, Canada still has room to conduct independent monetary and fiscal policy.

Parguez, for his part, looked at what a NAMU would mean in concrete terms. He asked, for example, how would Canadian dollars and Mexican pesos be converted into U.S. dollars? (Parguez argued that the U.S. is unlikely to abandon its currency, which means that Canada and Mexico would have to dollarize). How would the new central bank allocate the money supply between the three countries? What are the institutional consequences of NAMU? Drawing on his knowledge of Europe's move to the EMU, Parguez argued that Canadian dollars and Mexican pesos would probably be converted into U.S. dollars based on the average (or long-run) exchange rate since the NAFTA established a *de facto* economic union between the three nations. Canadians and Mexicans would lose out on this conversion to the extent that their currencies have been under-valued relative to that of the United States.(14)

Philip Arestis (South Bank University, UK) evaluated competing theories behind the Euro's dramatic decline since its inception in 1999 (see Figure 1). Arestis and his co-authors (see references section) dismissed arguments claiming the Euro's decline (15% away from its purchasing power parity, according to research by Deutsche Bank Group) is due to short-term circumstances that amount to little more than "bad luck." History, they argue, shows underlying and identifiable causes for these deviations. Others have suggested that interest-rate differentials explain the Euro's fall. However, a closer analysis of the data shows that the real-interest rate differential has remained roughly constant since January 1999. They conclude that most of the decline is probably due to long-term investment flows out of Europe because of the better returns offered in the fast-growing U.S. economy. These flows stem, at least in part, from a lack of confidence in the Euro which is in turn rooted in weaker European fundamentals (higher unemployment, larger debts, etc.). Unlike most commentators, however, Arestis does not conclude from this that Europe must weaken its labour market institutions and pursue more strict financial requirements (debt-to-GDP ratios, etc.). Rather, Europe is lacking what the U.S. has in spades, namely aggregate demand (albeit driven by record levels of consumer indebtedness). To achieve this will require, he argues, coordinated fiscal and monetary policies that are almost impossible to work out under the current system, with its divorced political institutions (working at the national level) and monetary institutions (working at the supra-national level).

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(14) Recall that this is a key element in the Courchene and Harris argument.

John Smithin (York University) and Markus Marterbauer (Austrian Institute of Economic Research) developed a model for a small open economy in a monetary union which showed that, given certain assumptions and the limitations imposed by the various European treaties, the scope for independent fiscal policy is much reduced. Under the Euro-11, "only differences in tax rates would allow for differences in expenditures rates" (Smithin and Marterbauer, p. 22). All other things being equal, their model shows that taxes can be higher in country A than in country B given higher productivity, higher expected prices and lower after-tax profit rates, nominal interest rates and after-tax wages. Given that nominal interest rates are set supra-nationally, this means that small open economies within a currency union can only increase taxes (and hence expenditures) through higher productivity and expected inflation or lower after-tax wages. Offsetting these possibilities, however, will be competitive pressure towards harmonized tax rates. A textbook analysis suggests that tax rates will fall for the most mobile factors (capital, highly skilled labour) and rise for the least mobile (less-skilled labour). The end result is, again, that labour bears the brunt of the move towards currency union. Again, the Smithin and Marterbauer argument hinges on the notion that the Euro-11 do not, in fact, meet the criteria for an OCA. In other words, although labour may be perfectly mobile in law, it is not in fact (due to language barriers, attachment to home, imperfect information, etc.).

Finally, Brenda Spotton Visano addressed the question of how technology might affect existing and future currency unions. More explicitly, she wonders whether technology has severed the (presumed) transmission mechanism from monetary policy to the real economy. "Recent advances in capital market structures and process suggest the potential of a real threat to central bank monopoly over the clearing of final settlements balances – a monopoly that is critical to any known story of monetary authority influence." In other words, rapid technological change – which may permit a private clearing system to operate without a central bank – could render the whole idea of a monetary union and, for that matter, central banks other than the U.S. Federal Reserve, obsolete.

CONCLUSION

Virtually all of the authors at the conference offered evidence and arguments suggesting monetary union with the United States and Mexico may not be in the best interest of a sovereign Canada, especially one intent on pursuing independent fiscal and monetary policy.

Although few disputed the presumed benefits of a monetary union (reduced uncertainty and transaction costs), most downplayed the size of these benefits, especially relative to the costs that might follow from a loss of control over domestic economic policy. Indeed, some commentators were not convinced that Europe or North America constitute OCAs. Some even suggested that the U.S. cannot logically be considered an OCA given the vast economic differences that exist between its western (entertainment, high-technology, and aircraft manufacturing) and eastern regions (industrial and financial centres), not to mention its northern (large-scale wheat, canola and dairy agriculture, some industrial base) and southern areas (agriculture, oil and gas). If anything, these differences were even more pronounced when the U.S. dollar first came onto the scene. The existence of a single currency in the United States and in most countries speaks to the fact that geo-political and historical factors are and will probably continue to be necessary conditions for a successful and strong currency. Indeed, most authors stressed that the great failing of the Euro has been the way it divorces the political from the economic. The only workable Euro solution, it seems, might be one that takes the process a step further by moving the political process – and not just the monetary and economic process – to a supra-national level. The same is true, they argue, for Canada.[15]

(15) Some commentators noted that this may account for the Bloc Québécois' support of NAMU proposals.

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