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A COMMON CURRENCY BETWEEN CANADA AND THE UNITED STATES: SOME KEY ISSUES

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INTRODUCTION

For 42 of the past 50 years, market forces have determined the value of the Canadian dollar, an arrangement known as a "flexible" or "floating" exchange rate system.(1) No other developed country can claim such a long and mostly crisis-free track record with flexible exchange rates, a system that came back into vogue in the early 1970s after the United States refused to guarantee delivery of gold in return for dollars, effectively destroying the Bretton Woods fixed exchange rate system it played an important role in creating.(2)

Since 1998, however, there has been renewed interest in setting up a fixed exchange rate regime (vis-à-vis the U.S. dollar) similar to the one Canada had from 1962 to 1970. Most of these modern-day fixed-rate proposals do not seek a fixed exchange rate as an end in itself but rather as a necessary *step* towards full monetary union with the United States. Table 1 (see Appendix) defines exactly what is meant by each of these currency regimes and provides a summary of their strengths and weaknesses.

Several factors have played a role in rekindling interest in a fixed exchange rate *cum* monetary union.

- First, currency union supporters say weakness in the Canadian dollar has hindered productivity growth and consequently Canada's standard of living. Fixed exchange rates, on the other hand, promise microeconomic benefits, such as: lower or no transaction costs from exchanging one currency into another; less volatility from the day-to-day fluctuations in currency values; and less uncertainty about the future value of the domestic currency.

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(1) There is, of course, no such thing as a "pure" floating exchange rate because policy actions by the federal government as well as the Bank of Canada can always in some indirect way influence the *direction* of the exchange rate, if not its level.

(2) John Murray, *Why Canada Needs A Flexible Exchange Rate*, Paper prepared for a conference hosted by Western Washington University, 30 April 1999, p. 2.

- Second, others argue that the creation of the European Economic and Monetary Union (EMU) and its progeny, the Euro, have increased both the plausibility and desirability of a North American Monetary Union – a so-called NAMU – between Canada, the United States and Mexico. If the world is indeed moving inexorably toward a smaller number of principal currencies (e.g., the U.S. dollar, the Euro, possibly the Japanese Yen), then some argue Canada must act quickly and decisively to become part of the U.S. dollar block before a currency union is imposed through *de facto* dollarization (see Table 1 for a definition of this term).
- A third influence is the increased support for fixed exchange rates or a currency union among emerging nations in the western hemisphere, especially Argentina which already has a currency board (again, see Table 1) and Mexico, which has indicated an interest in a North American currency union. Canada, it is thought, would not want to be left behind in this process.
- A fourth reason stems from the fact that the 1999 Nobel Prize in economics went to Robert Mundell, a Canadian who developed the "optimal currency areas" (OCA) theory in the 1960s. OCA theory lies at the heart of the EMU, and Mundell has been labelled by some as the father of the Euro. Mundell and other supporters of fixed exchange rate/currency union have used this high-profile award to promote the idea of a monetary union for Canada, garnering media coverage along the way. OCA theory is discussed at length in the next section of this paper.

Not surprisingly, a sometimes vigorous and public debate has ensued, pitting those who believe that fixed exchange rates and an eventual monetary union will improve Canada's economic situation against those who think that flexible exchange rates have served Canada well and who fear that monetary union might threaten Canada's monetary, fiscal and ultimately political sovereignty. This paper examines the key issues underlying the debate on the potential merits and drawbacks of adopting a common currency between Canada and the United States. As the reader will no doubt deduce, there are strong arguments on both sides of the divide.

KEY ISSUES

A. Is North America an "Optimum Currency Area"?

Most analyses of whether a set of countries is ripe for monetary integration usually begin and end with Mundell's OCA theory. This theory holds that countries are good candidates for membership in a monetary union if they satisfy four key conditions (discussed below):

- the member countries should display relatively high levels of trade integration;
- countries contemplating entry into a currency union should have similar economic structures;

- an effective currency union requires capital and labour mobility between participating countries;
- a transfer system designed to provide insurance relief against region-specific shocks would be helpful.

First, the member countries should display relatively high levels of trade integration. Indeed, the most persuasive argument in favour of a North American Monetary Union (NAMU) is probably the already high degree of trade integration within member countries of the North American Free Trade Agreement (NAFTA). For example, more than 85% of Canada's exports are shipped to the U.S., and two-way trade has more than doubled in the past decade. Not surprisingly then, exports to the U.S. explain an increasing percentage of Canada's overall economic output and the fact that Canada's trade links are increasingly north-south rather than east-west. On the other hand, the NAFTA is not even a customs union, let alone a common market as is the case with EU countries. Despite this, the fact remains that both Canada and Mexico are heavily integrated with the U.S. in trade.

Second, countries contemplating entry into a currency union should have similar economic structures so that outside economic shocks – such as a sudden increase in energy prices – influence member countries relatively evenly.(3) Moving to a fixed exchange rate or monetary union may not be useful when countries are affected differently (or "asymmetrically") by the same economic shocks. Many opponents of monetary integration maintain that the U.S. and Canadian economies are in fact quite different. Canada is, for example, a net exporter of commodities while the U.S. is a net importer. In volume terms, commodity-based exports continue to account for 40% of total Canadian exports and commodity production a full 15% of our annual output. Even though commodities' share of Canadian exports is now only one-half of what it was 25 years ago, it is still much higher than in other industrialized countries and is likely to remain so in the foreseeable future. Canada also relies more on commodities for its economic performance than does Mexico, whose industrial structure, if anything, is more similar to that of the United States.(4)

Our reliance on commodity-producing industries means that Canada is relatively more exposed to changes in commodity prices. The 1997-1998 Asian economic and financial crisis made this amply clear. Canada's terms of trade (the ratio of export prices to import prices) *fell* 6% starting in 1997 compared with a 5% *increase* in the United States. A key feature of a flexible exchange rate

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(3) It would also help if the countries' business cycles did not vary greatly.

(4) *Monetary Union in the Americas*, Economic Research note, Morgan Guaranty Trust Company Economic Research, JPMorgan, New York, 12 February 1999, p. 4.

regime is its ability to cushion the blow from an outside shock. This is discussed further in a later section of the paper.

Third, an effective currency union requires capital and labour mobility between participating countries, so that if, for example, one of the parties in the monetary union experiences an economic downturn, wages and prices would be forced down until workers and investment are driven out of the affected area into more productive parts of the economy. Eventually, the relatively low cost of capital and wages should be enough to draw new investment back to the region in question. In reality, of course, wages are often "sticky" for institutional reasons (minimum wage laws, unemployment insurance, societal norms) and consequently these adjustment mechanisms rarely work as advertised. Interestingly, Canada and the U.S. are much more likely to satisfy the labour mobility condition because for the most part they share a common language (English) and many cultural reference points, Quebec being the obvious exception. The only real impediment is institutional. The opposite is true in Europe, where language barriers are still formidable and where national boundaries have in the past prevented the kind of migration within Europe that is taken for granted within Canada and the United States. In reality, as John Helliwell of the University of British Columbia has shown, labour movement within Canada continues to be many times greater than to the United States.

Fourth, a transfer system designed to provide insurance relief against region-specific shocks would be helpful. As a proxy, participating countries could coordinate their fiscal policies so that revenues and spending smooth out business cycle variations. This is the idea behind the financing conditions set out in the European Growth and Stability Pact. Member countries that incur deficits greater than 3% and debt-to-GDP ratios greater than 60% can be fined up to half a percent of their annual GDP.

Historically, the preconditions for an optimal currency area have rarely been met even within existing currency areas otherwise known as countries. That is not to say, however, that these conditions cannot be imposed through institutional mechanisms. In Canada, for example, the "logical" direction of trade, at least in terms of transportation costs, is probably north-south but the building of the Canadian Pacific railway and the Trans-Canada highways, as well as the imposition of tariffs on imported goods (especially in manufacturing) early in Canada's history, imposed what some such as Thomas Courchene at Queen's University have called an artificial or politically motivated east-west bias that only recently has been challenged. Of course, much depends on historical accident. If the United States wasn't the world's wealthiest country with the biggest single consumer market, even the north-south trade links would be called into question.

On the other hand, Canada's sprawling east-west geography has led to a very diverse economy, with resource- or extraction-based companies mainly in the east and west, agriculture in the prairies, and manufacturing in the centre. Adverse economic shocks such as the Asian crisis can and do affect the provinces differently. Ontario and Quebec, for example, were able to pull through the Asian economic crisis relatively unscathed while British Columbia suffered an economic slowdown. A similar pattern was seen in the United States, where the industrial heartland benefited from lower commodity prices while some states such as Washington and Oregon suffered from these same low prices, although a burgeoning high-technology sector there probably cushioned the shock.(5) In both countries, differential short-run effects are also usually dampened by the movement of people and capital out of the affected areas and into the higher-growth areas, even without perfect wage and price flexibility. Government fiscal policy as well as institutions (minimum wage laws, welfare policy) can play a role in helping or hindering this process and would ultimately have to be coordinated under any kind of theoretically sound currency union arrangement.

B. Does Monetary Union Require Supranational Political Institutions?

Although most of the debate has focused on the *economic* rationale for monetary union with the United States, some economists argue that *political* considerations cannot be left off the table. In very simple terms, they insist that currencies have almost always been defined by political boundaries more than economic ones and that successful monetary unions *require* supranational political institutions with the power to tax and spend.

To understand the thrust of this argument, it is important to step back and delve briefly into monetary theory and why, for the most part, it ignores political considerations. Economic theory is based on deductions whose conclusions are embedded in its premises. Thus, assumptions are extremely important. They define the contours of the debate or the figurative "box" in which the debate occurs. Of these assumptions, perhaps the most important but least often acknowledged relate to the origins, nature and role of money in a modern-day market economy. At its core, mainstream economic theory – which underlies OCA theory – argues that money's main function is to act as a means of exchange, a tool that allows for the efficient exchange of goods and services from one person to another, one firm to another, or one country to another.

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(5) Microsoft, for example, is headquartered in Seattle, Washington.

Historically then, this theory holds that money arose because pure barter (i.e., the exchange of one good for another, not involving money) is hugely inefficient, requiring among other things a "double coincidence of wants" which is just another way of saying that each person involved in a trade must want what the other person is offering. Eventually, so the theory goes, people settled on gold and other precious metals as means of exchange because of their durability. Unlike horses or pigs and other farm animals, the quality of gold could be made almost perfectly uniform. Of course, farmers and peasants probably had a better idea of the value of a horse than they did of an ounce of gold, so large transaction costs persisted: it takes a lot of expertise to know the true quantity of gold in a coin just as it takes a jeweller to gauge the quantity of gold in a wedding ring. Eventually, the government stepped in to reduce transaction costs by stamping its seal of approval on coins.

With increasing trade came banks that would hold currency for customers worried about theft, fire or other calamities. Over time, the bankers realized they could create coupons that could circulate as if they were gold without any of the hassles of cumbersome coins. This eventually led to "fractional" reserves, whereby only a small quantity of gold supported a great many of these coupons whose face value far exceeded what the bank held in its vaults. The banks could get away with this because they knew that it was very unlikely that everyone would demand their gold at the same time. Eventually, the government got in on the act, printing money that was in theory at least, backed in a similar way. Of course, the government was subject to many of the same incentives and was apt to "print" far more money than it had in gold, usually to finance wars. This led to inflation and caused serious economic disruptions.(6)

This theory implies that modern-day money historically arose for relatively spontaneous, free-market reasons. Even when government intervened, it was because this was an optimal response to inefficiencies. In other words, the state came onto the scene *after* the fact, not before. This theory of money is the underlying rationale for most of what lies behind Mundell's optimum currency area theory and, indeed, the European currency union: economic efficiency demands that currencies be defined over some economic space rather than a political one and in the absence of a nation-state, these currency areas would have arisen spontaneously. In other words, the nation-state imposed artificial boundaries on otherwise optimal currency areas. What are these boundaries? Obviously, they are first and foremost geographic. But they are, secondly and almost as importantly, institutional. An area that would otherwise be "optimal" in the Mundell sense can be

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(6) Historically, most hyper-inflationary periods have coincided with wars or reparations payments from wars (Germany after World War I, for example).

disrupted by national institutions ranging from different minimum wage legislation to different taxation policies to east-west railways. From this perspective then, currency unions are a means of undoing years of needless and inefficient government involvement, levelling these institutions and erasing national borders. The theory is clear: efficiency demands an implicit and irrevocable drive towards policy and institutional homogenization, a rapprochement of reality to theory. This was precisely the underlying *political* rationale for the European Economic and Monetary Union – a project which, not coincidently, has its roots in the reconstruction of Europe following the devastation of the Second World War. Economics and its theoretical core was a mere means to an end.

Although this perspective is implicitly accepted by most who engage in the debate, it is certainly not a unanimous view. Charles Goodhart, a former Bank of England economist and now a professor at the London School of Economics, has argued for a reverse causality, what he and others have called the Chartalist position. While less known, it has an impressive pedigree starting with Adam Smith running through to John Maynard Keynes all the way to modern-day economists such as Goodhart. The theory says that money has probably always been a creature of the state or of some powerful person within a given geographic area. The value of a currency therefore reflects in large part the state's ability to control a given area and impose taxation. It is the state that "writes the dictionary" by defining what physical entity will play the currency role and what entity it will accept in payment of taxes. Taxes, in other words, ultimately gird the currency's value because they create a liability for each taxable citizen that can only be settled by whatever the state deems to be "legitimate" in its dictionary, i.e., the law. Citizens are therefore forced to work to acquire the currency in order to settle their liability, just like they would work to pay off a debt. The difference, of course, is that debts are mostly voluntary while taxes aren't.

Why is this theory important? Because it suggests that currency unions such as the European Monetary Union are not likely to succeed unless they are accompanied by a supranational political body with the legislative power to tax and spend. A debate in the *National Post* between Mundell and another well-known Nobel Prize winner, Milton Friedman, inadvertently gets to the heart of this argument.(7) Friedman suggested that Ireland's fast growth and accelerating inflation could put pressure on the European Central Bank to raise interest rates. At the same time, other parts of the union are seeing an economic slowdown (Germany, for example) that could easily turn into a recession given higher interest rates. Although this kind of trade-off might be reconcilable in a union with powerful

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(7) "Nobel Money Dual: Two of the Leading Currency Experts (Mundell and Friedman) Debate Some of the Key Economic Issues of our Time," *National Post*, 11-16 December 2000.

supranational political institutions (i.e., the United States or Canada), this is not the case in Europe, where national attachment is, arguably, still stronger than attachment to the union itself. In other words, monetary policy for one country (or province) might not be suitable for another country (or province), and the only way that these conflicting needs can be reconciled is through political means and a commensurable deep attachment to the union over the nation (or province).

Absent a quick transit of political power to the European level, Chartalists would suggest that this currency union is doomed much like other long-forgotten currency unions. Examples of earlier attempts at monetary union include the so-called "Latin Monetary (Silver) Union" between France, Belgium, Switzerland and Italy, which lasted from 1865 through to 1914 and the "Scandinavian Monetary Union" between Sweden, Denmark and Norway, which lasted from 1873 also until the First World War. To the extent that Canada is not willing to cede a large degree of political and hence fiscal sovereignty, Chartalists would predict that any North American union would be unlikely to survive even if the underlying economics were sound.

C. How Different are the North American and European Situations?

Although monetary developments in Europe may have served as a trigger for the currency union debate on this continent, the political and even the economic rationales for the EMU are qualitatively different from those in North America.(8) For one thing, the EMU is the latest in a series of political efforts at European integration, with the original goal being to minimize the risk of future conflict. This, of course, makes eminent sense given the horrors of the Second World War. As Gordon Thiessen, the then Governor of the Bank of Canada, noted, "the Euro does not provide a blueprint for a North American monetary union. There are no parallels here to the profound political forces that have been behind the move to greater integration in Europe over the past 50 years."(9) The NAFTA is simply not politically intertwined the way that Europe is, although even there the links are tenuous and much of the decision-making – especially taxation and spending – remains at the state level.

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(8) Twelve members of the European Union (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain) have now formally adopted the Euro as their official currency. The Euro will be introduced in day-to-day transactions in January 2002. All national currencies will be withdrawn from circulation by July of that year.

(9) *Opening Statement by Gordon Thiessen Governor of the Bank of Canada before the Standing Senate Committee on Banking, Trade and Commerce*, 20 April 1999, p. 3.

Moreover, the EMU differs from the North American example in that it is much more of a marriage of equals, at least insofar as the inner core of the EMU countries is concerned. The economies of the major European countries such as Germany, France and Italy are of a more similar nature than those on this continent and are therefore better able to balance their respective interests and conduct a dialogue on policy interests. There is, in other words, some semblance of a balance of power and this is reflected in the fact that the European Central Bank (ECB) voting structure is close to one vote per country. The only real imbalances within the EMU are in the differences between the smaller Euro participants on the periphery of the monetary union (e.g., Finland, Ireland, Portugal) and the dominant, more centrally located economies in the region, such as Germany. Yet it was precisely the desire to narrow the differences in employment, investment and incomes that encouraged smaller countries to join the monetary union in the first place. Obviously, the same motivation could also apply to Canada and, indeed, did during the free trade debates in the late 1980s and early 1990s.

D. The Microeconomic Gains from a Common Currency in North America

As Canada's overall economic well-being becomes increasingly dependent on external trade, especially to the United States, OCA theory suggests that the case for a common or fixed currency becomes increasingly strong mostly for the microeconomic reasons alluded to at the outset of the paper. Richard Harris, a key advocate of a common currency between Canada and the U.S., put it this way: free trade "requires stable and predictable rates of international exchange and cost calculations to support the volumes of trade and degree of specialization associated with it. This predictability becomes more important the larger the volumes of trade, the more international exchange on a long-term bilateral basis, and the lower the degree of entry barriers to an industry."(10)

The Canadian dollar has indeed experienced sizeable swings in its value relative to the U.S. dollar. For example, it moved from $1.04 in May 1974 to $0.71 in January 1986, back up to $0.89 in October 1991, then down to roughly $0.63 in August 1998, a level once again almost attained in November 2000 and April 2001.(11) These kinds of fluctuations – and the resultant uncertainty – can make it difficult for Canadian firms that want to plan long-term cross-border investments in the United States or, conversely, for foreign firms (especially American) that want to expand into Canada.

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(10) Richard G. Harris, "Trade, Money, and Wealth in the Canadian Economy," *C.D. Howe Institute Benefactors Lecture, 1993*, September 1993, pp. 39-40.

(11) The currency has rebounded slightly since that point.

A fixed exchange rate, whether it be a monetary union or otherwise, would eliminate these fluctuations and provide Canadian exporters and importers with greater certainty on which to base their day-to-day and long-term decisions. Economic efficiency, competitiveness and investment decision-making could all be enhanced as the risks associated with exchange-rate fluctuation and currency misalignment are eliminated. Both of these latter factors (i.e., volatility and misalignment) are problematic in that they contribute to greater uncertainty, which may permanently hamper trade and investment.

Proponents of a common currency also argue it could lead to lower interest rates on long-term government bonds. The logic here is straightforward: under a floating exchange rate, investors demand a "risk premium" to compensate for volatility and the potential for long-term declines in the currency. Consequently, a risk premium is built into the interest rate structure and this has the potential of discouraging investment, productivity and ultimately economic growth in the affected country.(12) Under a currency union, the potential for currency fluctuations and hence the risk premium cease to exist. The new, relatively lower interest rates could spur investment and this, in turn, should ultimately lead to higher productivity and growth.(13)

Another benefit associated with reduced exchange-rate volatility is greater transparency of costs and prices in both Canada and the United States. Under a floating exchange system, it is difficult to distinguish between changes in the exchange rate that are the result of real factors (such as changes in productivity) and those that are temporary or nominal. In the case of an appreciation in the value of the currency, this can lead to allegations of dumping or predatory pricing against foreign companies, not to mention large increases in import penetration domestically. "This issue would no longer arise under a fixed exchange rate regime; the level playing field would be easier for all to see, and confusion over real cost changes versus exchange rate changes would be reduced. This might reduce the existing tension over the application of U.S. antidumping and countervail laws against Canadian exports."(14) To the extent that a fixed exchange rate or common currency eliminates this problem, fewer trade disputes and greater economic efficiency – both of which should translate into lower costs – would be expected.

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(12) *Monetary Union in the Americas*, *supra*, note 4, p. 6.

(13) For this to be true, it must be assumed that the new central bank (or the Federal Reserve) does a credible job of managing monetary policy. It is, of course, entirely possible that the interest rate premium could rise if monetary policy after currency union is less credible than it was before.

(14) Harris, *supra*, note 10, p. 43.

A common currency or fixed exchange rate could also lead to lower transaction costs because firms would no longer need to worry about hedging their U.S. dollar sales. One estimate suggests the gain from removing currency conversion costs could reach $3 billion annually.(15) Lower foreign-exchange transaction costs would lead to expanded trade, and Canada's income would consequently rise as the resources previously devoted to managing exchange risk could be re-deployed to other areas such as production. According to a leading proponent of currency union, the "savings in the costs of foreign exchange will bring dynamic benefits much greater than suggested by the initial cost reductions alone."(16)

On the other hand, some have suggested that transaction costs related to foreign exchange may be exaggerated. Canada has had a flexible exchange rate system throughout most of the post-war period and still managed to develop the largest two-way trade flow in the world. Combined, the direct (e.g., cost of conversion) and associated costs of operating in more than one currency (e.g., hedging, accounting) normally do not represent a major proportion of the total cost of carrying out business across national boundaries. For example, with respect to Canada's commercial dealings with the United States, we only have to "stop at one window" to obtain U.S. foreign exchange. Contrast this situation with that in Europe, where the gains from eliminating exchange rate uncertainty and transaction costs will be multiplied many times over, in line with the large number of currencies. There, the prospects of lower transaction costs and greater economic certainty because of reduced currency risks are much larger motivating factors in the move to a common currency.

Finally, some analysts argue that a monetary union with the United States would encourage wage and price flexibility as companies and employees in both Canada and the U.S. pay more attention to their North American competitive positions. This should, all things being equal, improve economic efficiency as wages and prices adjust more quickly and accurately to economic conditions.(17)

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(15) Murray, *supra*, note 2, p. 8.

(16) Herbert G. Grubel, "The Case for the Amero: The Economics and Politics of a North American Monetary Union," *Critical Issues Bulletin*, Fraser Institute, September 1999, p. 11.

(17) Thomas J. Courchene and Richard G. Harris, "From Fixing to Monetary Union: Options for North American Currency Integration," *C.D. Howe Institute Commentary*, 1999, p. 2.

E. Do Flexible Exchange Rates Harm Productivity Growth?

Those advocating a common currency argue that the decline of the Canadian dollar over the past 25 years has been excessive and counterproductive to the country's economic aspirations. The existing currency regime, they suggest, has merely brought about a vicious cycle of currency devaluation and lower productivity, and a drastic decline in the Canadian standard of living. A common dollar, on the other hand, would help stop the erosion of our currency and productivity, the key factors underlying a country's long-term wealth.

The argument about the link between the currency and productivity is twofold. First, empirical studies have shown that the value of the Canadian dollar over the past 25 years has closely followed the trend in commodity prices. As a result, flexible exchange rates have delayed the resource sector's necessary adjustment: the declining value of the Canadian dollar has shielded commodity producers from the full brunt of the drop in world prices and delayed the necessary movement of labour and capital out of the production of commodities towards other, more advanced, productivity-enhancing industries.(18) The trouble with this development is that the long-term trend for commodity prices has been downward, yet our dependence on commodity exports – and thus an implied reduction in our standard of living – continues to be reinforced by current exchange-rate policy.

Second, it is sometimes argued that a weak dollar helps keep exports competitive without the need for increased productivity. Although a decline in the value of the national currency may provide Canada with a short-term competitive advantage, it puts less pressure on industry to make the required structural changes that might improve productivity. Moreover, if the technologies and equipment required to innovate have to be imported, any sizeable depreciation of the dollar will cause import costs to rise. A weaker dollar may also make it more difficult for firms to pay the competitive salaries needed to draw workers from abroad or keep their existing employees. Thus, the persistent depreciation of the dollar's value has made Canadian companies less interested than they would have otherwise been in making the sound investments or hiring the workers they need to improve productivity. "In the Canadian case, the robust demand growth in the recovery plus the low exchange rate probably delayed appropriate productivity-improving investments in our manufacturing industry

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(18) This argument hinges on two assumptions: first, it implies that the currency depreciation does not translate directly into higher domestic prices for other goods, especially inputs used by the commodity sector. If it did, domestic commodity producers would face rising production costs and would have to increase their prices to hold onto their profit margins (assuming constant demand), undoing some of the beneficial effects of the devaluation. Second, it assumes that the lower prices will either keep demand (in terms of physical units of the goods) constant or result in an increase in demand.

until much later in the decade."[19] Thus, it is argued, fixing one's currency to a stronger entity would take away the "competitive crutch" provided by the floating exchange rate.[20]

This perceived effect is known in the economic literature as the "lazy firm" hypothesis because it assumes that companies are no longer interested in profit-maximizing behaviour but rather are engaged in what is known in the literature as "profit satisficing." This assumes, in other words, that firms do not behave in the competitive, cutthroat way that economic theory says they normally do. After all, if the weaker currency does in fact give them an added temporary advantage, then theory suggests firms should maximize the opportunity to gain market share at the expense of competitors (which is implied by dumping complaints tied to nominal changes in the currency) all the while investing in new technologies. Even if the depreciation of the currency makes machine imports prohibitively expensive, there should be sufficient incentive for local firms to fill the gap. This was precisely the strategy pursued by Japanese firms during much of the post-war period, in both the Bretton Woods period and much of the 1980s.

Advocates of flexible exchange rates argue that the "lazy firm" hypothesis is a myth, pointing to examples such as Japan as proof. After all, they say, companies' boards of directors are paid to ensure that management is constantly on the lookout for ways to maximize profits and the firm's share value, no matter what the exchange-rate situation. If companies fail to operate in this manner, they will feel the sting of the market and jeopardize their competitive standing.

They also claim that the critics have not brought forward evidence of a cause-and-effect relationship between the Canadian dollar's long-term fall (in real terms) since the mid-1970s and weak productivity growth. In fact, they argue that the causality actually runs in the reverse sense: changes in productivity bring about changes in real exchange rates, and exchange rate depreciations merely represent a symptom of declining economic welfare.[21] According to empirical research by the Bank of Canada and elsewhere, the decline in Canada's economic performance since 1970 can essentially be attributed to two factors: changes in commodity prices (leading to real economic shocks), and differences in Canadian and U.S inflation rates.[22]

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(19) Harris, *supra*, note 10, p. 36.

(20) There is some empirical support for the view that the weak currency has harmed Canada's productivity record. See, for example, "What Do We Do With The Dollar?" *Policy Options*, January/February 1999, p. 32.

(21) Murray, *supra*, note 2, p. 16.

(22) Indeed, Canada's inflation rate from the early 1970s to 1992 was higher than that of the United States. Interest rates in this country were also at more elevated rates, which meant less investment, less productivity and a continuation of the downward spiral of the dollar.

Moreover, it is pointed out that not all the recent decline in global commodity prices has been offset by the depreciation of the Canadian currency. Whereas the decrease in commodity prices from the early part of 1997 to the end of 1998 (Asian financial crisis) was approximately 20%, the exchange rate fell by only 8%, with the result that commodity producers were not totally shielded from the outside shock. As such, labour and capital retained an incentive to transfer to other sectors of the economy, such as manufacturing. Therefore, the existence of flexible exchange rates has not totally restrained the industrial adjustments that otherwise might have occurred.

F. Flexible Exchange Rates as a Shock Absorber

Proponents of the flexible exchange rate point out that a key advantage of the status quo is its ability to absorb or act as an adjustment mechanism or safety valve in the event of economic shocks such as the Asian financial and economic crisis. In the absence of such flexibility, theory says the adjustment would have to take place primarily through changes in wages and prices. However, many economists believe that wages and prices are at least somewhat sticky and therefore do not adjust "perfectly" to economic changes. For example, firms with a unionized workforce are legally prevented from reducing wages in the face of a drop in demand. Instead, they cut back production and resort to layoffs. At the macroeconomic level, this translates into unemployment and slower growth.

In a flexible exchange rate system, the Canadian dollar – rather than wages and prices, or employment and output – adjusts to economic shocks. Given the close relationship between the value of the Canadian dollar and global commodity prices, the Canadian dollar has played an important buffeting role. When world commodity prices rise, the Canadian dollar is strong. When they are weak, our flexible exchange rate tends to act as a shock absorber, making Canadian exports more affordable in world markets.

Many point to the recent Asian crisis as an example of how a properly operating floating exchange rate can prevent a recession. The Canadian dollar's decline versus the U.S. dollar partially offset the effect on Canadian commodity producers of the global plunge in commodity prices, which are almost all priced in U.S. dollars. Moreover, Canadian (and U.S.) manufacturing firms benefit from the plunge in the value of the domestic currency, especially if they sell a lot of their goods overseas. This somewhat offsets the loss of national income from falling commodity prices. Without these "shock absorbers," adjustments would have had to come entirely through lower output, lower employment, or lower wages and prices or a combination of all three, outcomes that might not be viewed as desirable by the Canadian public. For this reason alone, proponents maintain, Canada should not fix its currency to the U.S. dollar.

G. Loss of Sovereignty: Monetary and Otherwise

Countries joining currency unions, or contemplating doing so, are often motivated by the prospects of gaining credible monetary policy. Major benefits can accrue when the major trading partners are less tolerant of inflation than the domestic central bank. In this light, the policy constraint imposed by a fixed exchange rate regime is actually viewed as a positive development. For example, many still argue that certain Latin American countries with floating exchange rates are less inclined to follow appropriate economic policies than those with fixed rates.

The flip side of this story is that currency union members lose a degree of economic and political independence by ceding monetary policy-making. Historically, many national governments have been reluctant to adopt another country's currency out of fear of losing control over monetary policy, such as the ability to independently set interest rates or print money. Many economic nationalists and individual Canadians are also, rightly or wrongly, concerned that adoption of a currency union might ultimately lead to political union.

Given its hegemonic position in North America and, indeed, the world, the United States has no pressing need or apparent desire to sponsor a NAMU (North American Monetary Union) arrangement. Any move towards a NAMU would, therefore, likely have to come from either Canada or Mexico and would almost certainly result in both countries adopting the U.S. dollar.(23) This seems especially true given the Americans' strong attachment to their dollar. The U.S. government would also probably not be willing to give up decision-making power – or seigniorage income for that matter (see below) – to help the NAMU movement. Canada and Mexico would therefore have to surrender substantial control over independent monetary policy to the U.S. Federal Reserve. The most Canada could probably hope for would be for the Bank of Canada to become the 13th Federal Reserve District.

Even then, the U.S. monetary authorities would more than likely make their monetary policy decisions on the basis of mostly domestic economic considerations. For example, the Federal Reserve could very well set interest rates at levels that Canadians do not appreciate, perhaps to cool off a robust U.S. economy out of step with Canada's economic cycle. Such action would not pose much of a problem if individual Canadians could move readily to the United States to take advantage of superior economic opportunities; however, labour is rather immobile between the two countries for mostly institutional reasons. As of yet, there is no common market or free movement of labour in North America to support a currency union.

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(23) Official dollarization would involve the most loss of sovereignty over Canadian monetary policy of any fixed exchange rate option.

In the long run, theory holds that monetary policy can only influence the rate of inflation. Flexible exchange rate supporters argue the Bank of Canada has done a better job of keeping inflation under wraps than has the U.S. Federal Reserve, and so there is little or no reason to form a currency union on this count. As proof, they point to the fact that Canada's inflation rate was below that of the U.S. for most of the 1990s. Critics of the flexible exchange rate system, on the other hand, question whether the loss of sovereignty would be that significant, arguing that the Bank of Canada has not displayed much monetary policy independence from the Federal Reserve during the past 20 years and that the *recent* evidence of lower inflation has been purchased at a steep price, namely the prolonged recession of the early 1990s. Given that Canada's business cycle is highly dependent on that of our southern neighbour, the Governor of the Bank of Canada has, for example, often had little choice but to adjust interest rates in Canada following a shift in U.S. rates.

H. Seigniorage

Currently, the Bank of Canada collects a total of $1.5 billion per year in domestic seigniorage, or income accruing to the government from issuing currency on an interest-free basis.(24) Any move to a straight adoption of the U.S. currency could jeopardize the receipt of seigniorage-related revenues. Under a North American monetary union, on the other hand, seigniorage could be preserved; the Canadian Mint could continue to produce currency notes and coins (with a possible North American designation on one side and a Canadian one on the other). This, of course, would have to be negotiated.

CONCLUDING REMARKS

From the analysis presented in this paper, one can reasonably conclude that there are virtually as many arguments for a currency union with the United States as there are against. Choosing between the two sides represents a formidable challenge, with both proponents and opponents making strong and valid points.

It took a full 50 years of integration before European policy-makers launched their common currency. Even so, they did not wait to ensure that all of these preconditions were in place, but acted when they did to satisfy the driving motivations (both political and economic) for greater

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(24) John Murray, "Going with the Flow: The Benefits of a Floating C$," *Canadian Business Economics*, December 1999, p. 24.

monetary union. Indeed, Mundell, in his original pathbreaking paper,(25) quoted Tibor Scitovsky as arguing in favour of a common currency "because he believes that it would induce a greater degree of capital mobility, but further adds that steps must be taken to make labour more mobile and to facilitate supranational employment policies."

A similar case can be made for a NAMU. Even if the OCA conditions haven't been met, these differences are not insurmountable or necessarily permanent. Moreover, over time, the ability of flexible exchange rates to buffer commodity price shocks will probably become less valuable as both manufactured products and services come to increasingly dominate Canadian exports, as they do in the United States. With commodity exports representing a declining feature of the domestic economy, a re-examination of the costs and benefits of a North American currency union could have merit in the future.

Although there is no immediate urgency in the pursuit of a currency union, proponents suggest that the need for this kind of currency system would be considerably enhanced if Canada, the United States and Mexico negotiated additional economic or political agreements and if other countries in the Americas were to engage in official dollarization. Canada might be compelled to act in favour of a currency union if only to ensure that its trade interests within the NAFTA were protected. Already, there are signs these pressures may soon grow in importance, not the least of which is that Mexico's macroeconomic indicators and business cycles are coming into closer alignment with those of the United States, making dollarization both easier and more plausible.

On the other hand, flexible exchange rate protagonists and Chartalists alike would suggest that the biggest obstacle to a NAMU may not be economic but rather political, namely the diminished sovereignty that they argue necessarily follows from a viable currency union. Even if the underlying economic rationale is agreed upon, this will probably be the future battleground for the NAMU debate.

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(25) Robert Mundell, "A Theory of Optimum Currency Areas," *The American Economic Review*, Vol. 11, No. 4, 1961, p. 661.

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Figure 1: The Value of the Canadian Dollar, 1971-2000

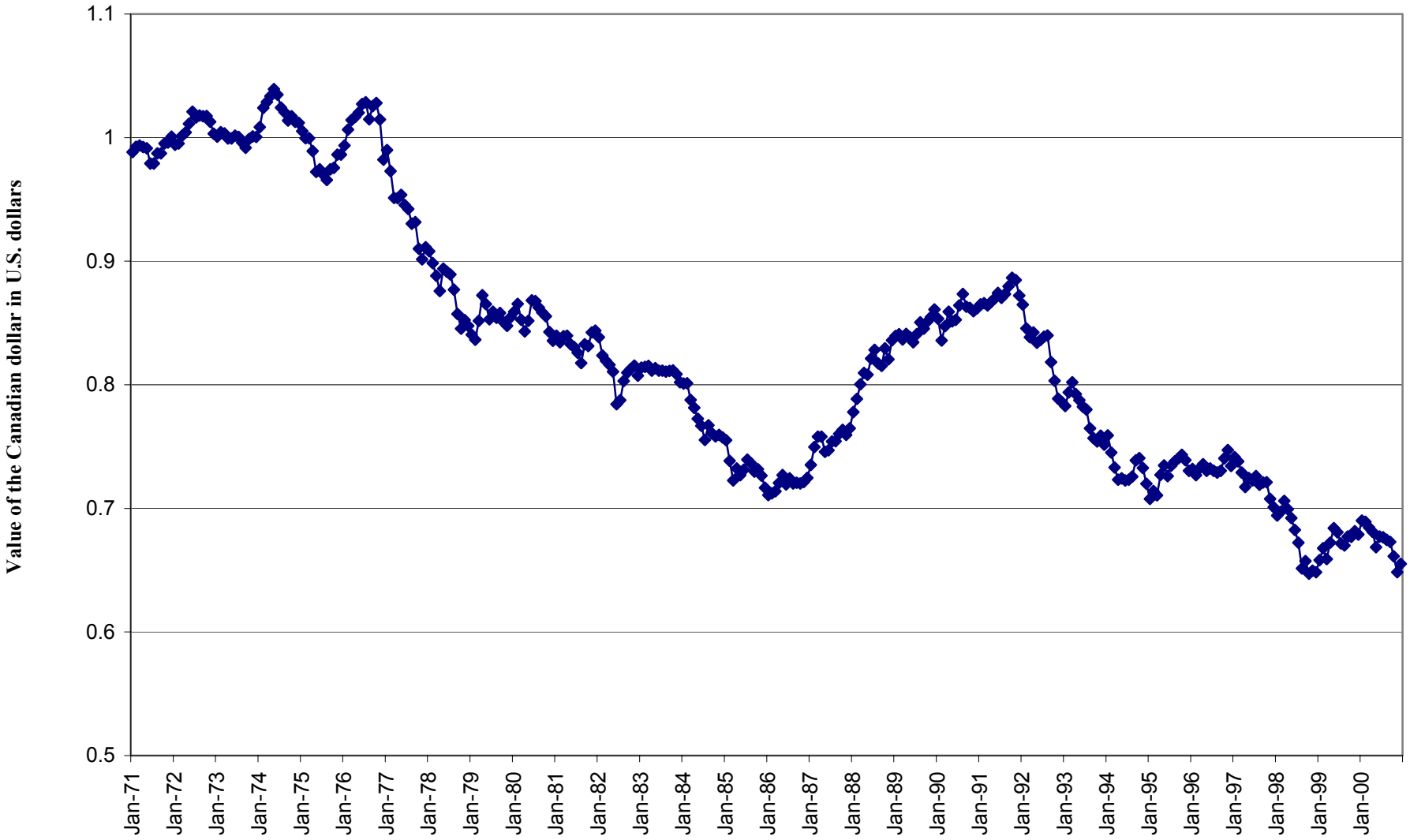

TABLE 1

Alternative Currency Regimes

Type	Description	Pros	Cons
Floating Rate	Theory suggests that the forces of supply and demand determine the value of the currency. The currency can then be thought of as the "price" that investors are willing to pay for a claim on Canada's ability to efficiently convert its natural resources and the skills of its citizens into goods and services. The value of the Canadian dollar adjusts to outside demand for Canada's goods and services – i.e., Canadian exports – and its investment opportunities (factories and government bonds for example) as well as the desire of Canadians for foreign goods (imports) and investments.	A floating exchange rate works like any other market price and should therefore, in the absence of government intervention, provide the most efficient outcome, allowing resources to be allocated in a non-distortionary way to where they are most needed. If, for example, a country is running a balance of payment surplus, foreigners are buying more Canadian assets than they are selling.(26) This translates into an increase in the domestic money supply and an increase in prices, assuming all else is equal.(27) Strong demand for the Canadian dollar results, which puts upward pressure on the exchange rate. Both effects reduce the demand for Canadian exports and increase imports, leading to an equilibrium that preserves each country's comparative advantage.(28) Given wage and price rigidity, flexible exchange rates are also said to "cushion" temporary economic shocks.	Markets sometimes do a poor job of "pricing" currencies, leading to prolonged periods of misalignment that distort price signals. This can harm productivity and long-term growth by delaying the necessary shifts of labour and capital into more productive areas. For example, critics suggest that the weak Canadian dollar has protected some inefficient commodity producers who would otherwise be out of business. The continued influx of their supply of goods onto the domestic and world markets only exacerbates the initial problem.

(26) A balance of payments surplus occurs when there has been a net purchase of Canadian assets over any predetermined period of time.

(27) It also assumes an economy operating at full capacity with full employment; otherwise, the additional funds could translate into additional growth rather than price increases.

(28) Currency markets are among the most liquid, instantaneous, least controlled and informed anywhere and should, therefore, be the most efficient. No other market wipes away arbitrage opportunities more quickly (this is a necessary condition for purchasing power parity theory) and few other markets have access to so much high-quality and instantaneous data.

Alternative Currency Regimes

Type	Description	Pros	Cons
Monetary Union	Monetary unions are marriages of two or more national currencies into one. They usually involve the creation of supranational institutions that assure the integrity of the currency and implementation of the underlying rules. The EMU is a classic example.	Monetary unions eliminate the transaction costs of exchanging one currency into another. They also eliminate uncertainty about the future value of a currency. In Europe, monetary union was also used for political purposes, to dampen the nationalism that played a role in bringing about the Second World War. Although Canada shares no such history with the U.S., a currency union would probably reduce trade tensions as the regulatory regimes converge to assure the free flow of labour and capital across the border.	A currency union with the U.S. would almost certainly mean adopting the U.S. dollar. At best, the Bank of Canada would become the 13th Federal Reserve Branch, with only a small influence on interest rate policy. This is especially problematic to the extent that the Canadian economy is different from that of the United States. Interest rate policy that may make sense for the U.S. may not work in Canada. Opponents also worry about a loss of sovereignty and seigniorage revenue.
Currency Board	The government passes a law that declares a fixed "par" exchange rate between the national currency and the U.S. dollar (or some other major currency). Under such a system, the central bank must make sure it has $1 U.S. for each equivalent unit of domestic currency (say, $1 Canadian). Like the gold standard in the 19th and early 20th century, the backing is outside of the control of the currency-board country and must be earned through exports or investment flows.	Like a monetary union, a currency board promises reduced transaction costs and reduced uncertainty. Unlike a monetary union, the central bank retains some ability to earn seigniorage by replacing lost or destroyed currency and can also earn interest on its foreign exchange reserves. Finally, it allows the nation to retain national symbols on its currency, something that would probably be lost in a currency union.	Currency boards are not immune from speculative attack. This can pressure the central bank to raise interest rates even when this may not be the outcome for the domestic economy. The central bank also loses its ability to play a credible "lender-of-last resort" role in times of banking crises. Also, unlike under a monetary union, Canadian banks would have to secure credit and reserves from U.S. banks, putting them at a competitive disadvantage (because the U.S. banks would retain their access to the U.S. Federal Reserve's discount window).
Pegged Rate	Under this system, the exchange rate is "pegged" to some other currency (usually the U.S. dollar) at the policy-maker's discretion and can therefore be changed to suit economic conditions. The peg becomes the object of monetary policy rather than inflation or employment targets, which tend to dominate under floating regimes (although the three are clearly related). This implies a substantial amount of intervention by the central bank. The Bretton Woods system of international economic institutions, developed after World War II, was based on this kind of fixed-rate regime.	Pegged rates offer the same benefits as other fixed exchange rate regimes, namely fewer transaction costs and reduced uncertainty. The key strength of this type of arrangement, however, is that it gives the central bank some discretion in "resetting the peg" if the underlying real economic conditions change. For example, a permanent increase in exports associated with increased productivity would put upward pressure on the currency. If the central bank were able to identify this trend, it would be able to readjust the peg upward with relative ease. The central bank would also retain the ability to play a lender-of-last-resort role.	The pegged exchange rate's strength can also be a weakness if central bank staff are unable to properly distinguish between a real and nominal change in the exchange rate or if the bank is subject to too much political pressure. A speculative attack could also ensue if there's a hint that the central bank is either unable (because it lacks adequate foreign exchange reserves) or unwilling (for political reasons) to keep the currency at its pegged value. Critics argue therefore that a peg is one of the least stable and credible forms of fixed exchange rates.

Alternative Currency Regimes

Type	Description	Pros	Cons
Legislated Fixed Rate	The legislated fixed exchange rate is a close cousin to the pegged rate. Under this system, the "peg" is backed by law. The central bank cannot change the peg on a whim.	The legal backing reduces the chance of speculative attack on the currency because "undoing" the fixed exchange rate would require a highly visible and potentially lengthy and destabilizing process. This type of arrangement also allows the bank to keep its lender-of-last-resort role.	This regime is, notwithstanding the legal backing, still subject to speculative attack, especially if it is thought that the central bank has insufficient reserves to defend the peg or if the nation is performing poorly economically.
Dollarization	Dollarization can be done either voluntarily or officially. Under the latter, Canada would declare U.S. currency "legal tender." In the former, the process would happen without government intervention.	Like a monetary union, there would be reduced transaction costs and uncertainty.	All the disadvantages of a monetary union plus absolutely no say in U.S. monetary policy.