Concluding Remarks

Canada's money provides a unique optic through which to examine this country's rich economic and political history. Through this lens, we can witness the clash of empires in the eighteenth century, the building of a continent-spanning nation during the nineteenth century, and the development of a "post-modern," bilingual, multicultural society in the late twentieth century.

We can also see the economic pressures brought to bear on Canada and the ingenuity of Canadians in dealing with them. Born of necessity, de Meulles' introduction of card money in 1685 is believed to be the first issue of paper money by a Western government. The Great Depression and deflation of the 1930s also challenged the orthodox monetary wisdom of the time, leading once again to monetary experimentation and to the creation of the Bank of Canada.

Canada's monetary history also illustrates the strong economic attraction of the United States, as well as the weakening economic and political ties with the United Kingdom. North-south economic linkages were the reason why Canada, over imperial opposition, chose the dollar instead of the pound as its monetary standard in the 1850s. However, in a typical Canadian compromise, both U.S. and British coins remained legal tender in Canada, alongside distinctive Canadian notes and coins, into the 1930s.

A similar tension can be found in Canada's choice of exchange rate regime. Through much of the nineteenth and early twentieth centuries, a fixed one-for-one exchange rate was maintained between Canada and the United States, supported by both countries' adherence to the gold standard. Such a relationship seemed natural in light of the close commercial and financial links between the two countries.

On the other hand, the Canadian economy, a major exporter of commodities, was, and remains, very different from that of the United States, a major supplier of manufactured goods. This distinction, as well as a desire in Canada to direct macroeconomic policy towards achieving domestic policy objectives, argues for a flexible exchange rate. These factors were the reasons why Canada adopted a floating exchange rate in 1950 and again in 1970.

Canada's history has shown, however, that no exchange rate regime is perfect. The choice of regime involves trade-offs that may change with the passage of time and with differing circumstances.

Dissatisfaction with the severe policy limitations of the gold standard led Canada and other countries to break the link between their currencies and gold during the 1930s. Dissatisfaction with the competitive devaluations and "beggar-thy-neighbour" policies of the Depression years led to the Bretton Woods system of fixed, but adjustable, exchange rates after the Second World War. Dissatisfaction with pegged exchange rates in an environment of global inflationary pressures and rising capital mobility led to the floating of all major currencies in 1973.

The launch of the euro on 1 January 1999 and the collapse of fixed exchange rate regimes in many emerging-market economies led to a renewed debate in Canada and abroad on appropriate exchange rate regimes. The debate in Canada was also fuelled by the persistent weakness of the Canadian dollar and a view held by some economists that a common North American currency was appropriate and, possibly, inevitable. But the weight of economic analysis and opinion continue to favour Canada maintaining its flexible exchange rate, and retaining its monetary policy independence.[94]

Until relatively recently, however, it was not clear that Canada and other countries with floating exchange rates had used their monetary independence to their best advantage. Immediately prior to the floating of the Canadian dollar in 1970, Harry Johnson, the great Canadian monetary economist, noted that

> [a] flexible exchange rate is not, of course, a panacea; it simply provides an extra degree of freedom, by removing the balance-of-payments constraint on policy formulation (Johnson 1972).

This observation was prophetic. Through the following decades, exchange rates, liberated from the constraints imposed by the Bretton Woods system, moved in a wide range, reflecting both real and monetary shocks in the domestic economy and in the anchor country; i.e., the United States. The Canadian dollar was no exception. While countries were now free to direct policy at achieving domestic objectives, the "extra degree of freedom" was often squandered. In Canada, the rationale behind floating the Canadian dollar in 1970 was to avoid importing U.S. inflation. In the event, Canada's inflation performance was very similar to that of the United States. (See Chart A3 in Appendix A.)

David Laidler, a noted monetary economist and economic historian at the University of Western Ontario, has argued that a flexible exchange rate, unlike a fixed rate, is not a coherent monetary order, since a flexible rate does not "define a policy goal, but merely permits some other goal . . . to be pursued" (Laidler 2002). For a country with a flexible rate to have a coherent

94. For a review of the economic arguments for flexible exchange rates in North America, see Murray, Schembri, and St-Amant (2003). See also Murray and Powell (2003) for a discussion of the extent to which U.S. dollars are used in Canada. See also Thiessen (2000) and Dodge (2002).

monetary order, other elements are required—a clear goal for monetary policy (and a broader supportive policy framework that includes sustainable fiscal policy), credibility, and public accountability. Laidler contended that such a coherent monetary order was not firmly in place in Canada until about 1995. This was four years after inflation targets were introduced and 25 years after Canada last floated the dollar. It was only when a coherent monetary order was established that the Bank of Canada was in a position to use its policy independence to its best advantage by focusing on preserving the domestic purchasing power of the Canadian dollar through low inflation, while at the same time allowing the external value of the currency to adjust to shocks.