

A COMMON CURRENCY FOR NORTH AMERICA

by

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Common Market, Common Currency?

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Outline of Presentation

- Lessons from the EURO
- Re-Thinking Canada's Float
- The Case for Exchange Rate fixity
- North American Monetary Union (NAMU)
- Why the US might Agree to a NAMU
- Nationalism / Sovereignty and NAMU
- The Road to NAMU

Lessons from the Euro

The Euro represents an unprecedented watershed in the annals of economic and monetary history.

Indeed, the distribution, over roughly a weekend, of billions of notes and coins across 12 member countries as well as much of eastern Europe must rank as the largest logistical undertaking ever.

Nonetheless, there is a view that the Euro is only for Europeans. Former Bank of Canada Governor Gordon Theissen is representative:

The introduction of the Euro ushers in an exciting new era for the Europeans, and we should all wish them well. But the Euro is not a blueprint for a North American monetary union. The political objectives that motivated monetary union in Europe do not have a parallel in North America.

This is of course true in terms of the origins of the Euro, but...

Lessons from the Euro (2)

- Once the Euro is alive and running, the focus shifts to what it implies and signals:
 - Denationalization of national currency regimes;
 - Currencies emerging as a supranational public goods;
 - Dramatic shift toward currency consolidation
- By 2030 the world will have two major currency zones – one European and the other American. The Euro will be used from Brest to Bucharest, and the dollar from Alaska to Argentina – perhaps even in Asia. These currencies will form the bedrock of next century's financial stability.”

(Zanny Minton Beddoes, “From EMU to AMU: The Case for Regional Currencies”, Foreign Affairs (July/August, 1999).

Re-Thinking Canada's Float (1)

First, the Theoretical Case for a Floating Rate

- With mobile international capital, if a country wants to pursue an independent monetary policy (i.e. if Canada wants to set an inflation rate different from that in the US), then it must allow its exchange rate to be flexible.
- Moreover, Canada has successfully pursued inflation targeting under flexible rates—our inflation rate is lower than the US rate
- For this, the Bank of Canada has earned a good deal of “credibility” in banking circles.

- Targeting a lower inflation rate than the US is a questionable policy in a progressively integrating NA economic space
- Arguably, the result has been lower growth, falling living standards, and a volatile exchange rate with negative implications for productivity.

Re-Thinking Canada's Float (2)

Falling Living Standards

- In mid-1975, C\$ was worth about 105 US cents;
- In 1991, worth 89 US cents;
- In 2001, worth just over 62 US cents.

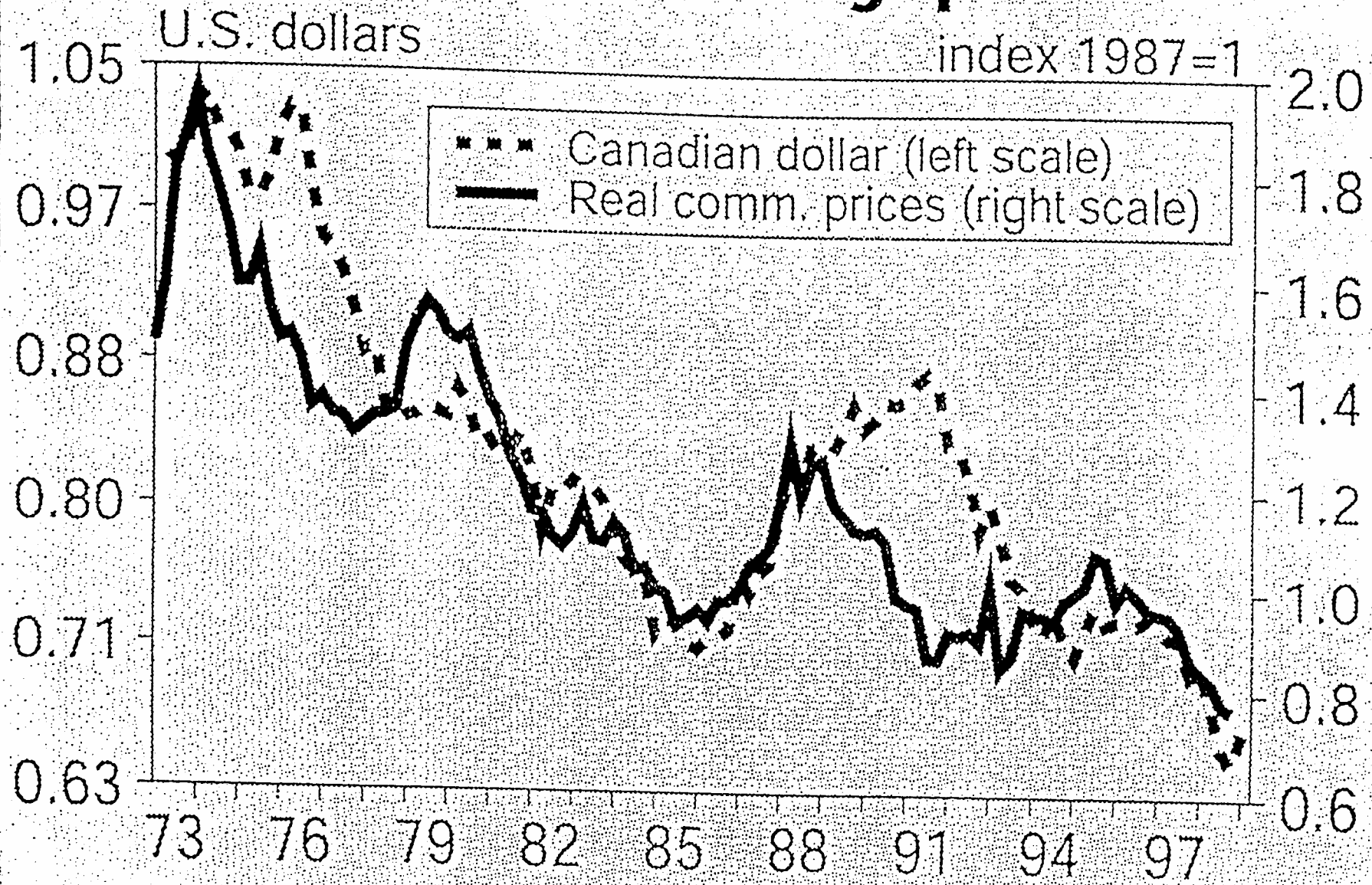
See next chart for volatility of C\$

A low dollar need not lead to a drop in living standards. But since...

- Our wage and inflation has been similar to US rates;
- Our productivity has been lower than in US ; and
- Our roughly 40% export/import share is priced in US dollars,

This has resulted in a dramatic fall in Canadians' living standards relative to those of Americans

Canadian dollar and real commodity prices



Re-Thinking Canada's Float (3)

Exchange-Rate Buffering and Productivity (A)

- As shown in the previous chart, the exchange rate closely follows the trends in commodity prices. Not only does the Bank view this as appropriate but it has an econometric equation that “predicts” that this should happen.
- The Bank argues that this exchange rate “buffering” of falling commodity prices shores up output and employment.
- But the result could well be a decline in productivity – the “lazy dollar” hypothesis. Producers take advantage of the low dollar to increase exports, but fall behind competitors in implementing productivity-enhancing equipment and technology.
- John McCallum notes that it appears that a 10 percent reduction in the C\$ is associated, two years later, with a 7% reduction in the ratio of Canadian to US productivity in manufacturing.
- More recently Richard Harris has formalized all this in a model, the intuition of which follows.

Re-Thinking Canada's Float (4)

Buffering and Productivity: A Theoretical Model

- Two sectors—New Economy (knowledge-based) sector where wages are flexible and an Old Economy (commodity-based) sector where wages are determined by C\$ price of output
- Two shocks hit economy :--i) a fall in commodity prices (i.e. a negative shock to the Old Economy), and ii) the emergence of general purpose technologies (GPTs), priced in US\$ (a positive shock to the New Economy)
- Assume that the GPT increases productivity

Re-Thinking Canada's Float (5)

Buffering and Productivity (cont.)

- If we buffer (depreciate C\$ as commodity prices fall), then...
 - entices capital and labour to stay in old economy;
 - increases C\$ price of GPT and, therefore, we underinvest in new economy;

 - RESULT: New economy is smaller and less capitalized and our productivity falls relative to the US

- If we have common currency (no depreciation/buffering)
 - commodity price fall leads to an increase in unemployment and a transfer of labour and capital out of old economy;
 - This provides an incentive to invest in the GPT, as does the fact that the C\$ price of the GPT remains constant.

 - RESULT: Canadian productivity matches US productivity

Re-Thinking Canada's Float (6)

Buffering, Misalignment and Productivity (conclusion)

- C\$ has departed both upward and downward from underlying fundamentals for long periods of time. This volatility is typically referred to as the “misalignment problem”.
- When C\$ is way overvalued (1989-91), this leads to downsizing, off-shoring and exit.
- When C\$ way undervalued, exports and profits *do* increase, but human capital begins to move in response to high wages (brain drain).
- Result: Repeated bouts of exchange-rate misalignment lead to shifting our industrial structure, relative to the USA, toward resource-based activities and toward an employment base that is less diversified and less human-capital-intensive than if exchange rates were fixed. Hardly appropriate as we move toward a knowledge and human-capital future!

The Case for Fixed Exchange Rates (1)

Asymmetric Shocks and Fixed vs. Flexible Rates

Bank and others claim the flexible rates are needed to accommodate asymmetric Canadian and US shocks.

This is not true. Fixed rates can handle shocks as well.

North-South Integration

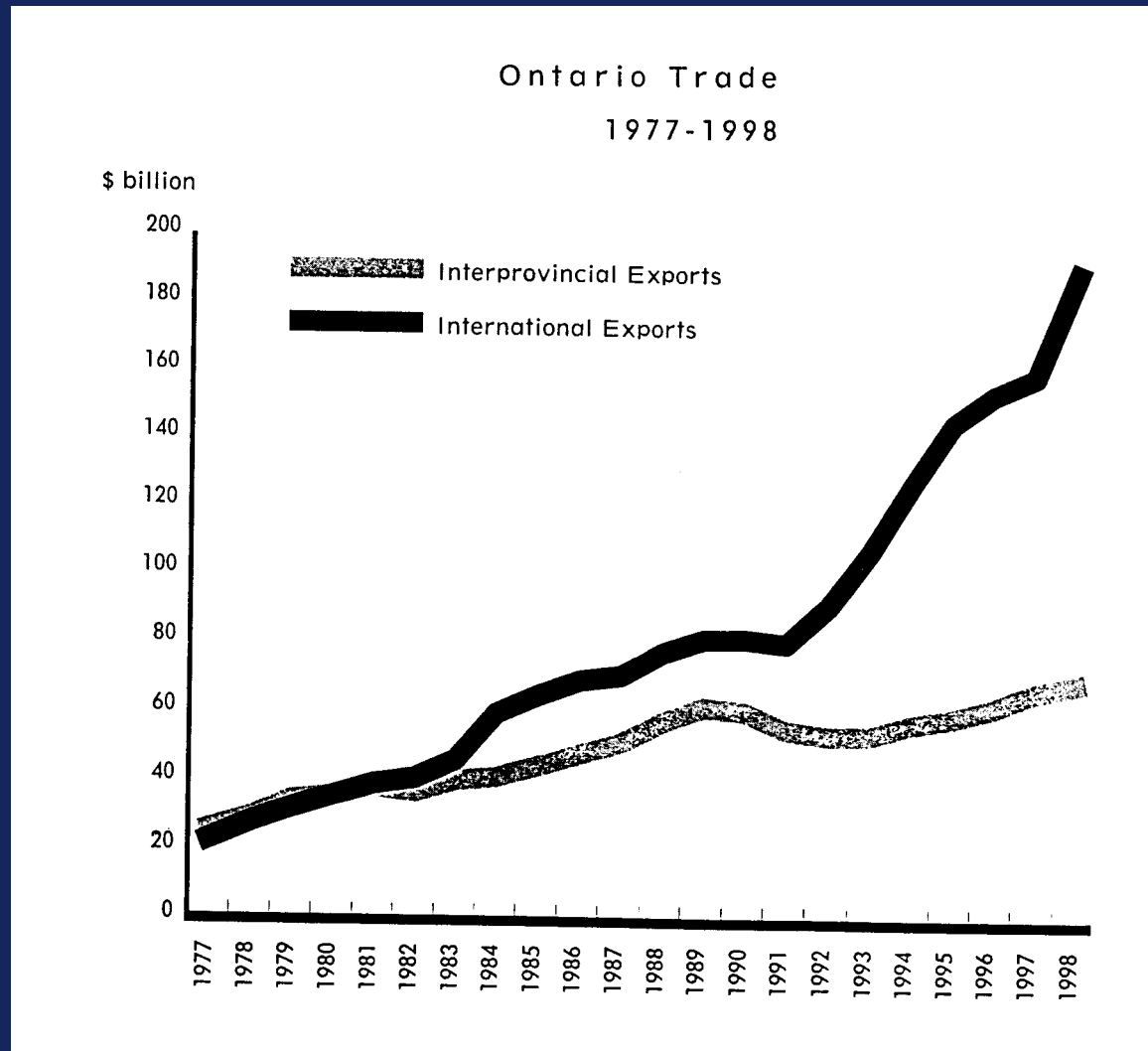
- All provinces have dramatically increased their N-S trade
- Ontario's N-S trade is now nearly 3 times its inter-provincial trade (see Ontario chart)

Result: Canada is less and less a single east-west economy and more and more a series of cross-border, north-south economies

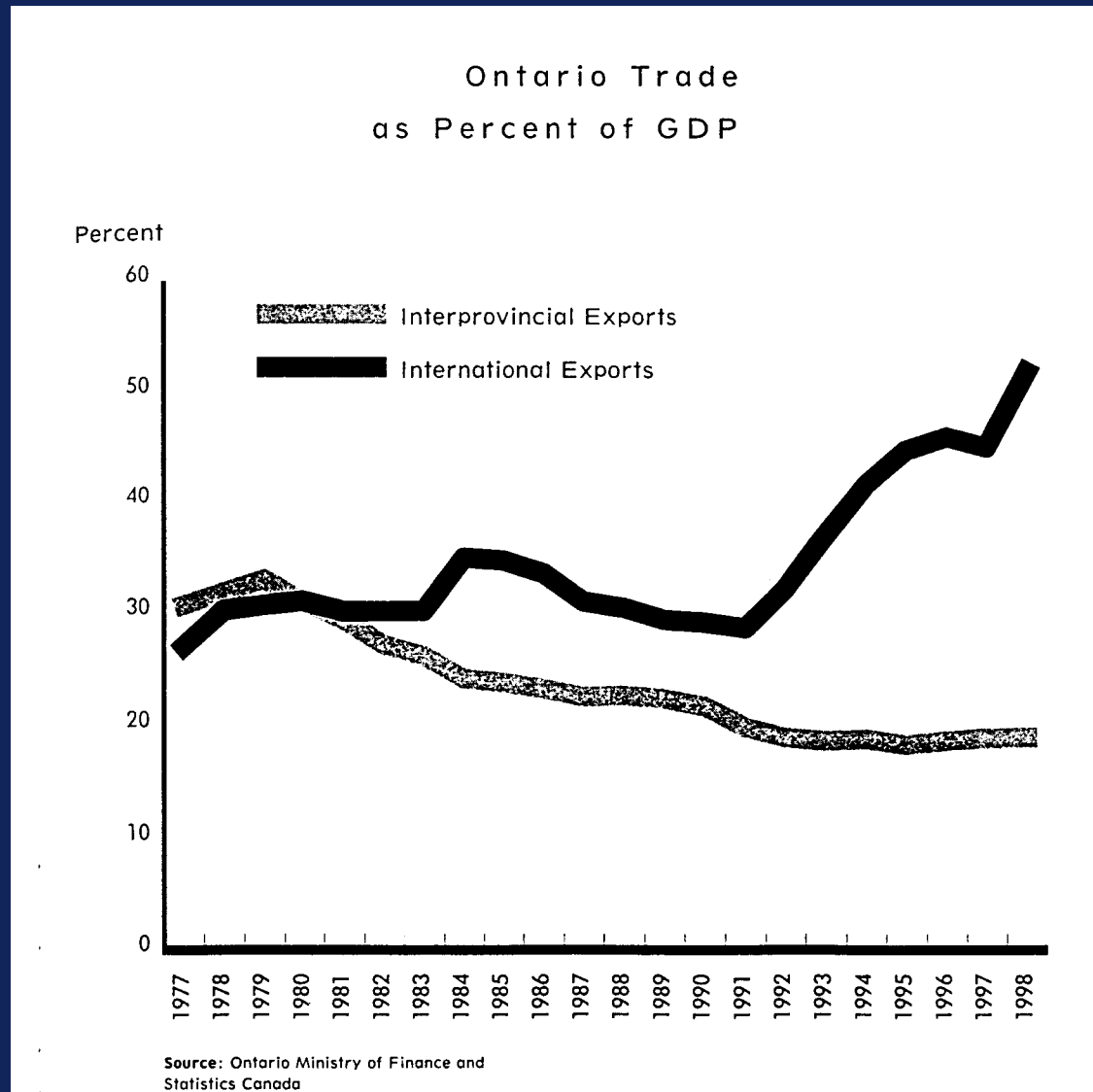
This enhances the case for fixed rates as a response to asymmetry

Let's see why...focus first on regional, then national adjustment

The Case for Exchange Rate Fixity: (2a)



The Case for Exchange Rate Fixity: (2b)



The Case for Fixed Exchange Rates (2)

Asymmetric Shocks: Regional Adjustment

- Assume that Ontario is in equilibrium with Michigan, Alberta with the Texas Gulf, B.C. with the Pacific Northwest, etc.
- Now comes a price shock, an increase in commodity prices
- Initially, this affects both sides of the cross-border regions in the same way—Ontario is affected in the same way as Michigan
- At cross-border regional level, there is no N-S asymmetry
- But if we allow the exchange to buffer the shock (appreciate), then all Canadian regions are now offside vis-à-vis their US counterparts. Why do this? Better to keep rates fixed
- Asymmetry is between Ontario and Alberta, or between Washington state and Michigan, not between Ontario and Michigan. Flexible rates cannot offset east-west asymmetries

The Case for Fixed Exchange Rates(3)

Asymmetry and National Adjustment

- There still remains a “national” adjustment problem because resources are a larger part of Canadian GDP than of US GDP and because there is an E-W or inter-regional adjustment problem
- But we have tried and true methods for handling these. For the former there is fiscal policy. For the latter there is the operation of the tax system, equalization, EI and labour mobility. And wages and prices are much more flexible than they used to be.
- Therefore, it is not true that fixed rates cannot handle so-called “asymmetric shocks.”
- Indeed, as NAFTA integration proceeds our regional economies will progressively prefer the N-S exchange rate to be fixed . Ontario does not care much about tax rates in B.C., but it does care about them in Michigan, Ohio, New York, etc.

The Case for Fixed Exchange Rates (4)

Asymmetric Shocks and Canadian Consumption

- Previous adjustment focused on producers. What about consumers?
- Again, assume a price shock (fall in commodity prices) which affects Canada more than the US. If the C\$ falls in response, consumers assets denominated in C\$ fall relative to US assets. This serves to exacerbate the impact of the price fall within Canada.
- Under a common currency, we would hold assets in same currency as Americans. Fall in resource prices would not affect our generalized asset values vis-à-vis Americans.
- Result: Fixed Rates Buffer the Price Shock for Consumers

The Case for Fixed Exchange Rates (5)

Miscellaneous Benefits

- Volatility of C\$ is increasingly a problem in knowledge economy where predictable costs are key to ensuring that foreigners will look favourably on Canada as a location for producing for NAFTA and beyond
- Transactions costs decrease
- Capital markets will be deeper
- Evidence suggests that with a common currency trade will increase dramatically (Frankel and Rose).

- Conclusion: The Fix Is In!

- But what type of Fix?

Alternative Approaches to Fixity (1)

- Fixed Exchange Rates
- There is a further challenge to deal with from floating advocates:
Fixed exchange rates are unsustainable, and a common currency is unattainable, therefore the real choice is between flexible rates and dollarization. Since dollarization is unacceptable, flexible rates rule!
- This will not wash. Fixed rates *can and have* worked – look at the Austrians and the Dutch. They held their fix to the D-Mark even through German unification. And Canada is more integrated trade-wise to the US than these countries are to Germany. To be sure, we would have to make the fixed exchange rate the keystone of our national economic policy within NAFTA geo-economic space. But that is what a fixed rate is all about.
- But there are even more permanent forms of exchange rate fixity—currency boards and a common Canada-US or NA currency.

Alternative Approaches to Fixity (2)

Currency Boards (CBs)

- Under a CB, the conversion rate is fixed precisely and the CB stands ready to buy and sell at this dedicated rate. There is no scope for domestic monetary policy because there is no central bank, as such.
- Two lessons from Argentina's experience:
 - Currency boards hold incredibly well,
 - Make sure that your anchor currency is that of your major trading partner. Argentina does not trade much with the US

North American Monetary Union (1)

Nature of NAMU

- Modeled along Euro lines.
- Supra-national central bank – Federal Reserve Bank of North America (FRBNA), for example
- Bank of Canada would still exist, as does Bank of France under the Euro.
- B of C would have a seat on the board of the FRBNA (but US would maintain control – has 12 Federal Reserve Banks).
- US dollar would continue to be US currency. Why destroy world's foremost currency?
- We would issue a new Canadian currency that would exchange one-for-one with the US dollar. (Suppose that the conversion rate was 150 Canadian cents for each US dollar. Then 100 new Canadian dollars would exchange for 150 old Canadian dollars, and items that formerly cost \$150 dollars would now cost \$100 of the new currency. Thus, we maintain *existing* price differences, i.e., no *real* change in relative Canada-US prices. This is the identical process that all Euro countries are going through.

North American Monetary Union (2)

Symbolism

- One side of the new currency, (say the \$5 bill) would say that this is a North American \$5 bill, identical to 5 US dollars. The other side could have a picture of the rockies, for example. Hence, Canadian symbolism could remain, as it has on the Euro coins.

Seigniorage

- The B of C would issue the new currency, in the same way that the 12 US Federal Reserve Banks issue the currency in their own regions. Thus, we would keep the seigniorage.
- There would no longer be an exchange rate.

North American Monetary Union (3)

The Exchange Rate Conversion Rate (“entry rate”)

- We would enter into some version of the European EMS in order to move toward an appropriate entry rate. This took nearly a decade in Europe.
- During this conversion process, we should work down our debt/GDP ratio at least to the US rate. This will ensure that we have similar fiscal flexibility as the US under NAMU. This is a variant of the Maastricht Guidelines.
- Suppose we lock in at 70 US cents to our dollar. If we perform better than the US, our wages and non-traded-goods prices will rise relative to those in the US. This is how we will close the existing income gap. This is exactly what happened to Ireland—they entered the Euro at an undervalued rate and they have performed so well that they are now above-average in income. This is the way that convergence occurs under a common currency or under fixed rates.

NAMU vs Dollarization

Why Not Simply Use US Dollars As Our Currency?

- We could do this unilaterally, whereas NAMU requires US cooperation.
- We would eliminate the exchange rate and generate much of the benefits noted earlier.

However:

- We would lose seigniorage and lose currency symbolism.
- The clearings system would likely become north-south by region, rather than a national clearings system which is then reconciled internationally;
- Financial institution regulation would fall into the US orbit .
- There would be no rationale for maintaining the Bank of Canada
- With no fall-back institutions in place, this option is irreversible at least short term.

The USA and NAMU (1)

Would the US ever agree to a NAMU? Perhaps not.

But the Euro will mount a global challenge to the US dollar:

- Euro coins and notes are the only legal tender in the 12 Euro nations. The Euro will be (likely already is) the currency of choice for the accession countries to the EU and EMU. As important, the Euro will begin to circulate in Russia, former Soviet countries, and perhaps as far away as South Africa and Brazil.
- The Euro member countries have a large current account surplus while the US has a large current account deficit. At some point this will mean a substantial appreciation of the Euro relative to the US\$ dollar.
- Thus, the Euro will begin to compete globally with the dollar on both transactions (including seigniorage) and store-of-value grounds.
- Moreover, there are efforts afoot for the Euro zone to coordinate their policies in forums like the IMF
- At some point the USA (and the Federal Reserve) becomes concerned

The USA and NAMU (2)

- The US faces currency issues in the Americas as well
- Several smaller countries and protectorates are using the Euro
- The hemisphere is prone to periodic currency crises
- Enormous pressures will build on the US for some help in providing hemispheric currency stability, particularly if the Euro users are stable and growing
- Such help is probably in the US interest, since the US bears some of the costs of monetary instability
- Forecast: For all these reasons the US may well become interested in expanding the formal dollar area

The USA and NAMU (3)

Expanding the Dollar Area

- Presumably the preferred way for the US to expand its formal currency area is to encourage countries to dollarize
- US could do this by proposing to share seigniorage with any country that declares the dollar to be legal tender (not necessarily the sole legal tender)
- But even with seigniorage sharing, countries will want some influence over monetary policy. Moreover, under general dollarization power would begin to shift to these dollarizing countries.
- Fed will attempt to internalize these externalities—monitoring, providing information, informal briefings, informal meetings, etc
- Eventually, the contacts become more formal

Forecast: This is one way to conceptualize the origins of a Central Bank of the Americas and a common currency

The USA and NAMU (4)

Impact of 9/11

- US vulnerability bubble burst
- In era of “borderless networks” as the defining organizational structure, USA needs help from elsewhere to achieve internal security
- Withdrawal into economic protectionism or political isolationism is not a viable option
- Intriguingly, perhaps, my reading of the implications of 9/11 is that the US will need to become more, not less, engaged internationally
- Arguably, this means more scope for cooperating on political, economic and security matters

Speculative Result: This might extend to NAFTA deepening (customs union, common market), more enthusiasm for the FTAA, and more willingness for the US to play an pro-active role in securing currency stability in the hemisphere, and in turn enhancing NAMU prospects

Nationalism, Sovereignty and NAMU (1)

- A common currency means that we buy into US monetary policy. But this is why we are doing it!
- Not obvious that we have much independence now:
 - Low dollar is resulting in “fire-sale” prices for Canadian assets.
 - Is the softwood lumber challenge independent of the fact that the C\$ is at 63 US cents? Evidence suggests that US is also threatening in grains, electricity, sugar syrups, etc.
 - The last time this occurred was in the early-to-mid 1980s when our dollar was also way undervalued. Our response that time was to take advantage of the window of opportunity and negotiate the FTA
 - What we need this time around is to develop a subsidies code. But the US will never agree to a subsidies code without some exchange rate agreement.
 - We have to follow US monetary policy closely in any event

RESULT: Flexible rates are not synonymous with monetary sovereignty

Nationalism, Sovereignty and NAMU (2)

Domestic Policy Sovereignty

- We Canadians are proud to have created a special place and space in the upper half of North America.
- The Pearson years (63-68) were critically important in creating a social vision that differed from that in the US – the CPP/QPP, the final version of Medicare, the Canada Assistance Plan, making the Equalization program comprehensive, and DREE, among others.
- But the Pearson years represented the only post-war period where Canada was using US monetary policy – our exchange rate was fixed at 92.5 US cents over 1962-70
- RESULT: Where is the evidence that a common currency would limit our ability to legislate in our own likeness and image across a broad range of policy areas? Quite the opposite may be true!

Road to NAMU (1)

Britain vs Canada

- The Brits have, in some respects, similar choices:
 - They do not want political union with Europe
 - Their options: keep the floating pound; fix the pound to the Euro; allow Euroization; or embrace the Euro and the ECB.
 - The British will have one vote of 13 on the Board of the ECB, and a lesser role as more countries join.
- My guess is that the British will join the Euro.
- This will probably have an influence on Canada and on Canadians
- Likewise, a move by Mexico to dollarize might trigger moves to deepen NAFTA on economic and eventually monetary fronts

Road To NAMU (2)

- We could issue a new currency that trades 1 for 1 with the US dollar (as elaborated earlier) under a CB arrangement. We might get US cooperation for this, which would be a move toward an eventual NAMU
- A recent CRIC survey indicates that 55% of Canadians think a common currency is a good idea, whereas only 36% think using the US\$ is a good idea. These are encouraging results
- But the important push would come if business backed NAMU.

Concluding Perspective

Currency consolidation around the dollar and the Euro (and eventually, perhaps, one or two others) will likely imply that an independent C\$ will not be viable. Thus the longer-term choice will not be between dollarization and the status quo, but rather between NAMU and dollarization. Nationalist that I am, my rationale for engaging in this research is to ensure that NAMU, or a similar variant of a common currency, emerges as the winner.