Edited Transcript

Is It Time for Canada to Embrace Monetary Union?

From "The Art of the State" Conference
The Institute for Research on Public Policy (IRPP)
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Editor's Note:

The following discussion about a common currency for North America took place between Executive in Residence in the School of Management at the University of Ottawa and former Bank of Canada Governor Gordon Thiessen and other prominent Canadian academics in mid-October at Château Montebello, Quebec.

The occasion was a seminar organized by the Institute for Research on Public Policy (IRPP) and the Canadian Institute for Research on Regional Development (CIRRD) on the theme *The Art of the State in a World without Frontiers.* The discussion was informal and there were no prepared remarks.

Thiessen opened the currency discussion and was followed by Richard Harris, Telus Professor of Economics at Simon Fraser University in B.C.; Thomas Courchene, the Jarislowsky-Deutsch Professor of Economics and Financial Policy at Queen's University and Senior Scholar at the IRPP and Pierre Fortin, Professor of Economics at the Université du Québec à Montréal and a Fellow of the Royal Society of Canada. This is an edited version of their remarks.

Gordon Thiessen:

Some of the interest in a common currency comes out of the European experience with the euro. I think it is important to remember what lay behind that experience, which is a 50-some-years of increasing economic cooperation and increasing political cooperation of various sorts. And in the end, even with all of that, the final decision to go for monetary union was basically a political judgement, rather than one that came out of the pure economics.

The real argument for currency union has to do with transaction costs. For cross-border movements, if you don't have to change currencies, then obviously there is a lower transaction cost, and if you don't have to worry about the fluctuations in those currencies, then there is less uncertainty than there otherwise would be. But it is very important to remember that to get the full benefit of all of that, you do not just want a fixed exchange rate. You really do have to have something that is stronger than that — some kind of common currency.

On the other side of the argument, a floating exchange rate offers flexibility and the benefits of assisting adjustments to economic shocks. And if your economy is rather different than your major trading partner's — in our case, the U.S. — then it is likely that those shocks are going to affect you differently.

The classic example in Canada is commodity price shocks. If commodity prices go up, Canada is better off and because the Americans are net importers of commodities, the Americans are worse off. And vice versa. So for example, after the Asian financial crisis when commodity prices went down by some 20 percent (weighted in terms of Canada's production of primary commodities), we as a country were worse off. The Americans as net importers were better off.

We have these two closely integrated economies, but at times they go in different directions. So it seems to me that what you need to make that system work well is some kind of shock absorber

between those two economies. And that's what the flexible exchange rate does for you. It provides you with that shock absorber.

The other thing a flexible exchange rate does is that it allows us to pursue a Canadian monetary policy. I think the very interesting case is with fiscal policy recently, where Canada got itself into quite a lot of fiscal difficulty, having built up a lot of public debt. And then, once that public debt got to the stage where it really worried investors and taxpayers, something had to be done about it, and you had to do it pretty fast. In those circumstances, we followed an extremely tight fiscal policy, both federally and provincially, starting around 1994-1995 in the federal case. And that meant we had this major fiscal drag on our economy.

Well, how do you make up for that? You make up for it with a monetary policy that's easier than it otherwise would be. Now if you didn't have that ability to pursue an independent monetary policy, the adjustment to that fiscal cutback would have been very severe indeed. And the only way to have an independent monetary policy is to have a floating exchange rate.

Now recently there has been a lot of concern because the Canadian dollar has tended to be weak relative to the US dollar. And there are a couple of things that worry people about that weak Canadian dollar. One of them is that somehow or other, we end up losing on the productivity side. Because the Canadian dollar is weak, therefore the cost of capital goods is higher since typically they are imported from the U.S., priced in US dollars. And therefore Canadian companies will not invest as much in machinery and equipment, and we will not get the productivity growth that we otherwise would get.

But the question you have to ask yourself is why has the Canadian dollar been weak in US dollar terms? It is usually because of differing economic developments between Canada and the U.S. And most recently, that difference has tended to be in the commodity price area with commodity prices going down. And there has also been a differential in productivity growth and economic growth generally between Canada and the U.S.

Now take that recent situation where the US growth has been strong, and productivity in Canada and commodity prices have been relatively weak. If we had tried to prevent the exchange rate from depreciating in those circumstances, we would have ended up with very high interest rates and a much weaker economy. Is that going to lead to more investment than otherwise? I don't think it will.

Finally, there is that issue about a weak Canadian dollar causing a fire sale of Canadian firms. It seems to me that if a company is selling internationally traded goods, those goods tend to be priced internationally in US dollars. Then the company of course translates that into Canadian dollars, in terms of its income, revenue and so on. The problem I have is, if that's the way it works for internationally traded goods output, how is it that the assets that are used to produce those goods don't get looked at in that same way? I think it is highly unlikely that somehow the weak Canadian dollar makes those assets really cheap internationally, and makes them very subject to foreign takeover but does not affect the international price of the product they produce.

If you are talking about Canadian companies generating only products that are sold in Canada, then those products are going to be priced in Canadian dollars. And even though you might think, as a foreigner, that the price of that company is very cheap, because the Canadian dollar is low, if

it's going to be producing goods only sold in Canada, and only generating Canadian dollars, then the foreign company is not going to be any better off as it takes its profits and translates them back into US dollars. Unless a foreign company is speculating that the Canadian dollar is going to go up one day. Is there any reason to think that foreigners are better at speculating in the Canadian dollar than Canadians? I don't think so.

Professor Rick Harris:

I think the next step in this debate is going to be when Britain makes a decision to stay in or out of the euro. Because I do not really see the debate here in Canada moving much until that happens. Gordon Thiessen emphasizes the role of commodity shocks in defining an optimal currency area but this misses the important question regarding the optimal size of a currency area. If commodity price shocks are that important then that logic would suggest Alberta should have its own currency. You can push the commodity price argument to these illogical extremes without coming to the only reasonable conclusion which is that makes no sense for Alberta to have its own currency.

Let me ask an alternative question for Canada. If we had been in a monetary union with the U.S., it is absolutely clear that the macro adjustment mechanisms that took place within Canada, which was a substantial real depreciation of the currency, would not have occurred. There would have been another set of adjustment mechanisms that would have taken place. And so my argument is, if you want to look at what those adjustment mechanisms would be, you look to US states and industries that look like similar ones in Canada. Look at the automobile industry in Michigan — which is just next to Ontario — or, the lumber industry in Washington and Oregon compared to BC. Or you look at the oil industry in Texas compared to Alberta. The big difference is that in Canada, all of those industries and regions experienced large real depreciation of the currency while similar US industries and regions did not.

Now is it the case that the macro economic adjustment mechanism was that much better in Canada? Clearly not, because the fact of the matter is that our growth performance was much worse than in comparable US regions.

A more general argument about the questionable wisdom of accommodating commodity price declines with currency depreciation is somewhat deeper. I think that we made a mistake. Commodity prices have been steadily falling for a very long time, even though we occasionally get periods in which energy prices blip up. But real commodity prices are going down. One of the things I think we did, probably inadvertently, was that by accommodating weak commodity prices with the currency depreciation, we locked ourselves into a old pattern of comparative advantage, that has resulted in relatively low productivity growth. In our high technology and non-resource based industries, productivity growth would have been higher, and they would have expanded faster had they faced the same set of relative prices that prevailed in the United States.

In the absence of the exchange rate depreciation, would those resource industries have had adjustment problems? Absolutely, but no more so than was the case in comparable US regions. What about the issue of exchange-rate induced fire sales? The fire sale issue is partially an empirical puzzle. If you take two firms, one located in the United States and, one located in Canada who do more or less the same thing in the same industry. Call one MacMillan Bloedel and the other

Weyerhaeuser. A substantial currency depreciation should not have led to a substantial depreciation in US dollar terms of the market value of the Canadian firm. But it did.

For whatever reason, there is some cross-border segmentation in capital markets, not only in the non-traded or service sector but also in the traded goods sector and this is in part due to the existence of separate national currencies.

Of course, the consequence of the weak Canadian dollar was that Weyerhaeuser took over MacMillan Bloedel, as opposed to the opposite. I agree it's a puzzle, but what are the longer-run consequences for an open economy like Canada when most of the country's valuable corporate assets are marked down for substantial periods of time due to currency depreciation? I agree that is an open question and one that needs a great deal more research.

Professor Tom Courchene:

Let me begin with a few plaudits directed toward the Bank of Canada. From a central banking perspective, we can be proud of the Bank of Canada. The Bank demonstrated, admittedly at some considerable cost, that in addition to achieving lower inflation than the U.S. it could also achieve the so-called "interest-rate crossover," namely Canadian nominal interest rates lower than US nominal interest rates (consistent with our lower inflation rates). In central banking jargon, the Bank of Canada has "credibility." Thus, the fact that I favour a North American common currency has nothing to do with the inability of the Bank of Canada to operate as central banks are supposed to operate. Nor has it anything to do with the reason why some other nations, for example, Mexico might want to be part of a common currency of the Americas, namely to achieve a low and stable domestic inflation rate. Canada has done this. Rather, the case for a North American Monetary Union (NAMU) lies elsewhere.

Let's begin where Governor Thiessen did – with Europe and the euro. The Governor is clearly right – the factors that led to the creation of the euro have few counterparts in North America. But once the euro is up and working, its origins are no longer are that important. What is important is that the euro is a supra-national currency and is triggering a major drive toward currency consolidation. While the formal euro area encompasses 12 nations, this will double soon and probably triple in terms of the outer countries that link themselves to the euro area. Hence, there will be many fewer currencies in the world in the near future and I doubt whether the Canadian dollar will be one of them. But even if I am wrong, good old Canadian prudence suggests that we ought to begin thinking and researching into the range of alternatives for Canada's floating dollar.

I now turn to what is arguably the key analytical rationale for flexible exchange rates – the role for the exchange rate to act as a buffer or a shock absorber. I think that this role is way overrated. To see this, consider the following (realistic I would suggest) scenario. Canada is composed of a series of quite different economies – Atlantic, Quebec/Ontario, Manitoba/Saskatchewan, Alberta and Pacific-Rim British Columbia. Each of these economies is integrated north-south with its US counterpart. Assume, that Ontario/Quebec is in cost equilibrium with the US Great Lakes states, that Alberta is matching policies with the Texas Gulf, that BC is in competitive harmony with the Pacific northwest, etc. Now there is a sudden increase in resource prices (i.e. a commodity shock). Initially, nothing different happens to either side of these cross-border economies – the shock

affects Windsor and Detroit the same way. Likewise for Houston and Calgary and for Vancouver and Seattle. But if the Bank of Canada "accommodates" or "buffers" this commodity price increase by appreciating the exchange rate, then *every* Canadian region becomes off-side vis-à-vis its US counterpart. Why would we do this? Much better to keep these cross-border exchange rates fixed. The only way to do this is to have a fixed rate with the US which means, in effect, that Ontario will adjust to the shock the same way as Michigan does. Two caveats are in order. First, the real shock is not cross-border but rather between Ontario and Alberta or between Texas and Michigan, i.e. it is an internal east-west shock. Changing the Canada-US exchange rate does not buffer this. Second, because resources are a larger component of the Canadian economy than the US economy, we have to have policies in place to accommodate this "macro" shock. But we do have such policies – fiscal policy, EI, equalization, etc. Arguably, the "buffering" mechanism under a fixed rate regime or a currency union is every bit as effective as the flexible rate version. And as the north-south integration intensifies, the common-currency adjustment mechanism is progressively preferable.

However, the really problematic aspect of the Bank's buffering argument is that it appears to be a not-very-disguised policy for offsetting the longer-term downward trend in commodity/resource prices. To this extent, we are effectively providing subsidies to keep labour and capital in the "old economy" and providing disincentives for investing in the new economy, i.e. a fall in the Canadian dollar means that information technology and equipment become more expensive since they are typically priced in US dollars. Arguably, this is why Canadian productivity has been lagging U.S. productivity.

On a related point, flexibility itself may be a problem. The wild swings in the Canadian dollar – from $1.05 US in the mid-1970s to 70 cents in 1986 to 89 cents in 1991, to 62_ cents in the summer 1998 currency crisis, then back to the 67-cent range before falling back again to historic lows – are anything but salutary in a progressive human-capital era where cost predictability is more important than it was when we were a resource-based economy. Moreover, some market analysts predict a further falling dollar while others suggest a return to the mid-70-cent range is likely. This is simply too much in the way of uncertainty for us to maximize our economic prospects in NAFTA economic space.

A word, finally, about sovereignty. Under the version of a common currency that Rick Harris and I favour, some Canadian symbolism could still remain on the currency. But the more important sovereignty issue is that those policies that Canadians value most highly – Medicare, equalization, CPP/QPP, the Canada Assistance Plan, even regional development – were put in place (or finalized in their current form) during the 1960s. Yet the 1960s were the only period in the post-war period where Canada had a fixed exchange rate with the USA. Therefore, tying ourselves to US monetary policy did *not* lead to a decline in our ability to legislate in our likeness and image elsewhere in the policy arena. Indeed, what sovereignty is there in a 62-cent dollar if this leads to US/foreign purchases of our assets? More speculatively, how long will it be before the U.S. begins to question our low dollar, especially in light of our large trade surplus with the U.S.? And would we have a softwood lumber problem on our hands if our dollar was 80 cents rather than 63 cents?

It is hard to predict the next episode that will trigger some further evolution toward a common currency. In terms of US interests, I expect that the presumed success of the euro currency launch in 2002 and the number of non-euro countries whose citizens will want to hold euros will cause the

US Federal Reserve to wish that the formal dollar area was also expanded. And on the domestic front, Canadians will be influenced by the British decision toward the euro. Since the British want no part of a political union with European nations, adopting the euro would send a message that a common currency is all about economics and market access and not about sovereignty. I think Canadians are increasingly sensing this.

Professor Pierre Fortin:

In discussing the future of the Canadian dollar, we ought not to forget that the Canadian dollar could appreciate sharply in the not too distant future. The Canadian-US exchange rate is so low that a representative basket of goods and services worth US$100 in the U.S. currently costs C$160 to buy in that country, but only some C$117 to buy in Canada, according to purchasing power parity calculations done by Statistics Canada and the OECD. This means it is 35% more expensive to buy goods in the United States than in Canada. The only game in town is to buy Canadian and sell American. As long as this situation persists, our export-to-GDP ratio and our trade and current account surpluses will go only one way: up. This will not only result from Canadian firms exporting more to, and importing less from, the U.S., but also from US and other foreign firms producing in Canada for the US market. A large fraction of recent foreign acquisitions of Canadian firms and foreign start-ups in Canada are part of this process.

Back in 1994, Canada had a $330 billion external debt. We are now down to $220 billion as we speak. In the past two years, we have begun to generate huge trade and current account surpluses. This has had our external debt falling at a very rapid rate. If the Canadian dollar remains low, our external debt will likely continue to fall as our trade surplus continues to forge ahead. Morever, the debt will decline at a faster and faster rate. This is because less debt means less interests and dividends to pay, and therefore an even larger surplus, which in turn means that the debt will fall even faster.

At one point, the financial-market herd will suddenly realize that Canadians are becoming net lenders to the rest of the world for the first time since Leif Erikson. The Canadian dollar will instantly become extremely popular, and could appreciate very rapidly from 63 cents to 75 or 80 cents. This will send our exporting firms berserk. The behaviour of world financial markets is extremely difficult to predict in the short run, but over the medium to long run, they can't get around economic fundamentals. This is something we should bear in mind – if we continue to allow the Canadian dollar to float.

Gordon Thiessen, final remarks:

Well, I don't know how you sum all this up. I think the European experience is interesting here. The fact that they adopted a common currency caused many people to think about it here. However, that didn't necessarily make it relevant to us. You have to look at that long period of economic integration that went on in Europe. It took a very long time. And it increasingly had political elements attached to it. Now if you imagine that we're going to go down that same road in North America, then the notion of a common currency may become more plausible. But monetary union is something that should only be contemplated at the end of the process, or very close to the end,

just as in Europe. And it surely should only be contemplated after you've made some kind of political accommodation with the United States. I do not think a common currency is where you start. If you are adjusting to increasing economic integration, a flexible currency is very helpful. If you're going to lock in the Canada-US exchange rate, you want to lock it in at the end of the process, when you've made some kind of political accommodation, and when you think you've done most of the economic adjustment.

In the end, the problem of any kind of currency union here without political union basically implies that Canada adopts the US currency. We have none of the comparable arrangements that they have in Europe. If, for example, the British join the euro, they will be another large country along with France, Germany and Italy, in the European Central Bank. They are going to have a lot of influence relative to those other countries in making European monetary policy. The North American situation is just not comparable. And the Americans really do make it quite clear they're not about to make any comparable accommodation here. So if you're talking about currency union, let's remember you are talking about adopting the US dollar. If you are contemplating a decision to adopt the US dollar, then I think you had better think very hard about what kind of political arrangements with the United States you want to go with that decision.

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