

THE CASE FOR A NORTH AMERICAN CURRENCY UNION

Thomas J. Courchene

A North American Currency Union is certainly a big idea. But is it a good one? Looking to the successful adoption of the euro, one of Canada's leading economists makes the case for a North American Monetary Union (NAMU) in which the basic unit of North American exchange would be constructed around or anchored on the US dollar. Based, say, on an "entry rate" of 66 cents on the dollar, 150 Canadian cents would be exchanged for one new dollar. Then 100 new Canadian dollars would be equivalent to 150 current Canadian dollars, maintaining the existing relative price difference between Canada and the US. The US would maintain its twelve seats on the Federal Reserve Board, with Canada getting one seat on the board of the new Reserve Bank of North America. But Canada would maintain "seigniorial" sovereignty, with Canadian symbols on one side of the currency. Sir Wilfrid Laurier, not Abraham Lincoln, would be on our five dollar bill. Seigniorage would stay with Canada, Courchene maintains, but the exchange rate would disappear.



L'union monétaire nord-américaine est certes une belle idée, mais est-ce une bonne idée ? À la lumière du passage réussi à l'euro sur le Vieux Continent, l'un des économistes canadiens parmi les plus renommés défend l'idée d'une union monétaire nord-américaine dont l'unité de base serait le dollar américain. Avec un « taux d'entrée » de 66 cents US, 150 cents CAN vaudraient ainsi un dollar. De sorte que 100 nouveaux dollars CAN équivaldraient à 150 dollars CAN d'aujourd'hui, ce qui maintiendrait l'actuel écart relatif des prix entre le Canada et les États-Unis. Ces derniers conserveraient leurs douze sièges à la réserve fédérale américaine et notre pays en obtiendrait un au conseil de la nouvelle banque de la réserve nord-américaine. Nous conserverions en revanche notre souveraineté « seigneuriale » (au sens du droit de battre monnaie) grâce aux symboles canadiens imprimés sur un côté des billets. Sir Wilfrid Laurier figurerait ainsi sur nos coupures de cinq dollars, et non Abraham Lincoln. Ce seigneurage resterait la prérogative du Canada, mais il n'y aurait plus de taux de change.

In making the case for a Canada-US or perhaps a NAFTA currency union, I shall elaborate upon and hopefully substantiate the following propositions:

- that our system of flexible exchange rates has not served Canada well;
- that a fixed-exchange-rate system is preferable to our current floating rate system, given the degree of North American integration, the nature of this integration (north-south economic regions) and the shift away from a resource-based economy and society to a human-capital-based economy and society;
- that North American Monetary Union (NAMU) along euro lines is the logical longer term goal toward which a fixed-exchange-rate regime should evolve; and
- that the last time that Canada had a common currency with the US (the Pearson era) represented one of the most creative periods in terms of enacting policies that

have made us socio-economically unique in the upper half of North America.

Appropriately, however, the analysis begins with reference to one of the most significant events in the annals of monetary and economic history — the advent of the euro.

Whenever the subject of the euro arises, we are immediately informed by our policy officials that the political objectives that motivated monetary union in Europe do not have a parallel in North America. I agree with this. But now that the euro is alive and running it has major implications for currency arrangements in other trading blocs. Among other things, the euro signals:

- the "denationalization" of national monetary regimes;
- the emergence of common currencies as supra-national public goods; and
- a dramatic shift toward currency consolidation, with well over two-dozen countries already using or committed to using the euro.

One does not have to believe that the future will involve only a handful of currencies in order to recognize the wisdom of investigating the options for the future of Canada's exchange rate regime.

Admittedly, the Spring of 2003 would not appear to be the most propitious time to levy a broadside against Canada's flexible rate regime. After all, Canada has avoided the US recession, has the highest GDP growth of the G7 and is the only G7 country running a fiscal surplus. Moreover, the Canadian macro environment is, arguably for the first time ever, characterized by workable and transparent fiscal and monetary targets. While I am happy to assign excellent grades for implementation to our macro managers over this recent period, my quarrel lies with the longer-term appropriateness of the underlying framework itself. Why, in a progressively integrating North American economic space, and where Canada is more integrated trade-wise to the US than is any European country to its Euro partners, would we want to pursue a monetary policy independent of that of the US?

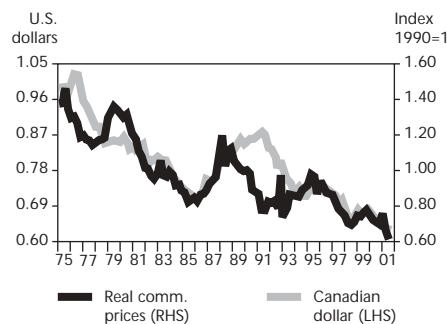
Among the concerns that have been raised about the falling and volatile Canadian dollar over the last decade are that it has

- led to a quite dramatic fall in living standards for Canadians (relative to those of Americans);
- led to fire-sale prices for those of our assets that generate a Canadian-dollar income stream;
- led to cost and competitive uncertainty as a result of the inherent exchange rate volatility, which uncertainty becomes more problematical as we shift to a knowledge-based economy and may be playing an important role in our falling share of inward North American foreign direct investment.
- led to a serious currency "misalignment" for long periods of time, where substantial overvaluation leads to downsizing, offshoring, and exit, while underval-

uation provides incentives for migration of human capital and underinvestment in productivity-enhancing technology, the net result of which will be a more resource-based and less human-capital-intensive economy than would otherwise be the case.

At one level, there are some easy counters to these claims — the falling dollar provides an important stimulus to exports and, a related point, that having the dollar fall in line with falling resource prices (see the figure "Canadian Dollar and Real Commodity Prices") provides a "buffer" to price shocks to the commodity sectors. I

CANADIAN DOLLAR AND REAL COMMODITY PRICES



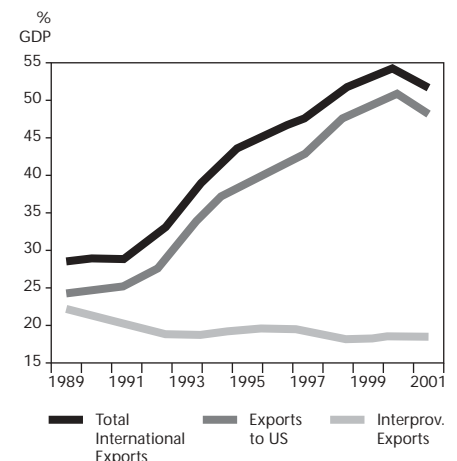
Source: Bank of Canada, Statistics Canada

agree with both of these "facts." However, this stimulus and/or buffering is a very mixed blessing over the medium term. Specifically, commodity-price buffering may well be one of the causes of our productivity shortfall vis-à-vis the Americans. The story would go as follows. Cushioning Canadian dollar commodity prices, that is to say, depreciating the Canadian dollar in line with the fall in relative commodity prices provides incentives for labour and capital to remain in the commodity sector rather than shift to the "new economy." Moreover, assuming that the capital equipment and technology that drives the new economy is priced in US dollars, a falling Canadian dollar means that the price of this equipment will have risen apace.

These incentives point in the direction of a smaller new economy, and less technology investment in both the old and new economies. In turn, this implies lower productivity growth than would be the case if there were no buffering, namely lower productivity growth than if there were a fixed exchange rate. As an important corollary, this also suggests that Canada's relative productivity slowdown will gradually offset the impact of the depreciation, so that any export stimulus from a falling dollar may well be temporary, that is, eroded by lower productivity growth. While this theoretical approach fits well into the managerial theories of the firm, and while there is plenty of anecdotal evidence suggesting that this actually may be the case in many sectors, flexible-rate advocates let alone our macro officials steadfastly maintain that there is *no* causation going from exchange rates to productivity. In the interests of our collective economic futures, they had better be correct. I do not believe that they are.

Apart from the commodity-price buffering argument, much of the rest of the case for flexible rates rests on the related assumption that only floating exchange rates can accommodate asymmetric Canada-US shocks. This

ONTARIO'S INTERPROVINCIAL AND INTERNATIONAL EXPORTS



Source: Trade Update 2002: Third Annual Report on Canada's State of Trade, Department of Foreign Affairs and International Trade Canada

TABLE 1
INTERNATIONAL AND INTERPROVINCIAL TRADE
1989-2001

	1989 Exports as % of GDP				2001 Exports as % of GDP			
	International			Inter- provincial (4)	International			Inter- provincial (8)
	% of GDP (1)	US Share (2)	US as % of GDP (3)		% of GDP (5)	US Share (6)	US as % of GDP (7)	
Canada	25.4	73.2	18.6	22.5	43.1	87.3	37.6	19.7
NFLD	31.0	68.4	21.2	11.9	37.1	65.6	24.3	20.3
PEI	14.7	60.2	8.8	30.6	31.8	89.9	28.5	27.7
NS	15.8	66.0	10.4	21.0	29.0	82.7	23.7	21.1
NB	26.2	66.5	17.4	30.0	45.7	89.1	42.3	31.2
Que	21.2	75.7	16.0	22.9	39.6	84.8	33.6	19.4
Ont	28.6	85.9	24.6	22.6	51.5	93.3	48.0	18.7
Man	18.5	62.6	11.6	28.0	30.7	80.0	24.6	29.7
Sask	22.7	45.0	10.2	25.6	44.2	59.0	26.1	25.4
Alta	24.5	75.7	18.5	28.5	41.3	88.8	36.7	22.1
BC	28.7	83.4	12.5	13.5	31.3	70.9	22.2	14.1

Source: Canada Department of Foreign Affairs and International Trade (2002), Tables 1A and 9E.
Notes: NFLD (Newfoundland), PEI (Prince Edward Island), NS (Nova Scotia), NB (New Brunswick),
Que (Quebec), Ont (Ontario), Man (Manitoba), Sask (Saskatchewan), Alta (Alberta), BC (British Columbia).

too, I believe to be incorrect, especially once one recognizes that Canada's trade has dramatically veered north-south by region (see Table 1 for Canada and the chart for Ontario's interprovincial and US trade). In effect, these trends suggest that Canada is moving in the direction of becoming a series of north-south, cross-border economies. In this context, assume that both the Canadian and American components of each of these cross-border economies (e.g. Ontario and Michigan, B.C. and Washington) are in some sort of cost/competitive equilibrium. Now assume that there is a commodity price increase. Initially, this affects both sides of the cross-border regions similarly (Michigan and Ontario; B.C. and Washington; Alberta and the Texas Gulf; Prairies and Montana, Quebec and New York).

But if we attempt to *buffer* this price hike by appreciating the exchange rate, then *all of the Canadian regions are offside vis-à-vis their US counterparts*. Why

would we do this? The key continental asymmetries are typically east-west, that is between B.C. and Ontario (Washington vs. Michigan), or Alberta vs. Ontario (Texas vs. Mid-West) and not between the two sides of the cross-border regions. National flexible rates *cannot* address these internal east-west asymmetries. Much better to keep exchange rates fixed and to address east-west asymmetries via national redistributive instruments such as taxation, equalization, employment insurance and, where appropriate, sub-national stabilization policies. Phrased differently, let Ontario and B.C. adjust in the same way that Michigan and Washington adjust with the caveat that Canada, unlike the US, has regionally redistributive instruments to provide a helping hand, as noted in the previous sentence.

Given, therefore, that it is clearly possible to mount a case for fixed exchange rates, what range of options is available?

Contrary to the majority view, fixed exchange rate regimes *are* sustainable a) when countries are highly integrated and b) where policy is geared to making the fixed exchange rate the keystone of national economic policy. The best examples are the very successful Austrian and Dutch fixes to the DM, which even held through the union of East and West Germany. And since Canada is more highly integrated,

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trade-wise, with the US than are Austria/Holland with Germany, this should be eminently feasible were we to clearly commit ourselves to a fixed rate.

If, nonetheless, even greater certainty is desired, one can go the currency-

board route. Currency boards are arrangements where circulating local currencies are fully backed by the anchor currency, usually the US dollar, e.g.

Suppose the “entry” exchange rate was 150 current Canadian cents for one US dollar. Then 100 new Canadian dollars would be equivalent to 150 current Canadian dollars — items that cost 150 old dollars would now cost 100 new dollars, and similarly for wages. Hence, we would maintain the existing relative price differences between Canada and the US.

Argentina and Hong Kong. Argentina’s unhappy experience with a currency board is usually raised in this context. However, in terms of the issue at hand, namely the sustainability of the currency board’s parity value, Argentina’s problem, among others, was that the currency board held too well. Hence, Argentina had no way to respond to Brazil’s 40 percent devaluation against the peso, short of abandoning the currency board which it ultimately did. The real lesson here is along somewhat different lines. Do not adopt a currency board that is anchored to the US dollar if the US is not your major trading partner. With 87 percent of our trade destined for US markets, this would not be our concern if we established a currency board relationship with the US dollar.

Over the longer term, however, the appropriate evolution would be toward a euro-type North American Monetary Union (NAMU).

When up and running, NAMU might be organized along the following lines. There would be a supra-national central bank — say the Reserve Bank of North America (RBNA). The Bank of Canada would be on the board of the RBNA, just as the Bank of France is on the board of the ECB (European Central Bank). The US would retain majority control of the RBNA — indeed, they would likely retain 12 seats, corresponding to their current Federal Reserve Districts, while probably granting Canada only one. The US dollar would continue to exist (why would anyone, least of all the Americans, want to replace the world’s most important currency?) and would be the circulating cur-

rency in the USA. Canada would create a *new* currency that would exchange one-for-one with the US dollar. Suppose the “entry” exchange rate was 150 current

Canadian cents for one US dollar. Then 100 new Canadian dollars would be equivalent to 150 current Canadian dollars — items that cost 150 old dollars would now cost 100 new dollars, and similarly for wages. Hence, we would maintain the existing relative price differences between Canada and the US. For example, if it now takes one day’s work to pay the weekly rent, this would also be the case under the new currency. *This is exactly the currency-conversion process that every euro country has just come through.* Note that our new currency could still have Canadian symbolism on one side, with one side adorned with a picture of the rockies and the other indicating that this new \$5 bill, for example, is the liability of the RBNA and identical to and freely exchangeable for a US \$5 bill. At the eleventh hour, the Europeans abandoned the notion of allowing one side of their new currency to vary across countries. But they have allowed this for the 1 and 2 euro coins. Seigniorage would stay with Canada, but the exchange rate would disappear.

As befits a unified monetary area, the RBNA would control the amount of currency outstanding at any given time, presumably in line with RBNA goals such as price stability, economic growth, etc. Canada’s share of this total currency would be “demand determined” — for example, faster Canadian growth under NAMU would result in a larger Canadian share of the overall North American currency.

It took the Europeans more than a decade to converge to a series of “entry rates” for the various currencies. We would likely have to repeat this gradual entry process for NAMU as well, hopefully replete with some version of the Maastricht guidelines. One frequently expressed concern is that if we lock ourselves in at, say, 66 US cents for one Canadian dollar (or 150 Canadian cents for 1 US dollar) then we are underpricing our assets, vis-à-vis the Americans, *for all time*. This is *not* the case. Suppose we enter NAMU, or a fixed-exchange-rate regime, at 66 cents. 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 current income gap with the Americans.* And this is precisely what happened to the Irish — they entered the EMS/euro at an undervalued rate and have performed so well that they now have per capita incomes above the EU average.

Alternatively, we could simply adopt the US dollar as our currency. Many or most of the above benefits on the economic front would also apply to dollarization. However, there would be some significant policy and societal costs. We

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would lose seigniorage and lose currency symbolism. The clearings system would likely follow the north-south trading patterns and become north-south by region, (e.g., Toronto clearing with the US eastern seaboard and Vancouver with San Francisco), thereby beginning a process of undermining our east-west comity. In contrast, under NAMU, clearings would occur nationally before we cleared inter-

nationally, as is the case in Euroland. Under dollarization, our financial structure and financial policy would likely fall under the US ambit and orbit. Not only would there be no rationale for maintaining the Bank of Canada, but with no fall-back institutions in place, this option would be difficult to reverse, at least over the short term. Indeed, one of the reasons why I got involved in this issue in the first place was to provide a range of currency options that would dominate and/or preclude dollarization.

Would the US ever agree to NAMU?

The almost unanimous answer from both sides of the border appears to be *No*. But many on both sides of the border would have also claimed that the US would never sign a free trade agreement with Canada, let alone with Mexico. At the very least this answer surely needs to be nuanced. First, the euro is making a big splash — one can foresee a day when close to 50 countries could be in the Euro zone, which will make the euro highly competitive with the dollar as a means of payment, as a unit of account, and as a store of value. At some point, the United States and the Fed will surely get concerned: Can one maintain and sustain economic hegemony without also having the dominant currency? Second, while we fully recognize that Canada's regions and the northern tier of Mexican states are progressively integrating into North American economic space, it has gone largely unnoticed that 38 US states now have Canada as their largest (international) trading partner, and I would guess that many of the remaining states would have Mexico as their largest export market. While it is true for many of these states that exports to the rest of the US dominate exports to Canada, the fact remains that the US itself is becoming more fully integrated into North American economic space, and it is not difficult to foresee a day when Canada and Mexico will account for 50 percent of US exports. Beyond this, the spate of cur-



Laurier or Lincoln on our five dollar bill? Canada would retain control of "seigniorage" and could put Canadian icons on one side of the NAMU.

rency crises across Central and South America and their cost to the US in terms of loan guarantees, bailouts, lost markets and the like suggest that, at some point, US self-interest will force it to play a larger and more interventionist role in enhancing hemispheric currency stability.

Yet none of this is intended to suggest that the US will, out of the blue as it were, offer to internationalize its central bank, even if it were to maintain the overwhelming decision-making authority. Rather, if a move to a NAMU or a hemispheric monetary union emerges it will probably come about in a roundabout way. For example, several key countries would dollarize, perhaps responding to US incentives so that they choose the dollar rather than the euro. After a while, these countries will quite naturally want some input into US monetary policy. Among other things, they

What might drive the system toward fixed rates and, perhaps NAMU? One factor will be the position that Britain takes on the euro. The British do not want political union with Europe, so that in this they are like Canada in the North American context. Their options are — keep the floating pound, fix the pound to the euro, allow eurorization, or embrace the euro and the ECB.

will request periodic meetings with the US or the Federal Reserve System as to the likely evolution of US monetary policy, during which meetings they will also state their own priorities. Gradually, these meetings will become more fre-

quent and perhaps more formalized and, almost unwittingly, this process begins to move in the direction of a US-dominated RBNA and NAMU. Alternatively, as part of deepening NAFTA, Canada, Mexico and the US might acquire "observer status" on the boards of some of each others' institutions, including the central banks. Again, these informal linkages could then become more formalized and eventually prepare the way for some version of a RBNA.

Our last experience with fixed rates was over the period 1962-70, when the Canadian dollar was set at 92.5 US cents. As already noted, this covered the Pearson years when we initiated, or finalized, our comprehensive range of social programs that distinguish us from the Americans. This provides tangible counter-evidence to the claim that we lose "sovereignty" over a wide range of policy areas if we tie our currency to the US dollar. Naturally, under fixed exchange rates, we do lose "monetary sovereignty": this is the very reason for fixing the exchange rate. But the NAMU variant of fixing would restore some say in overall monetary policy.

As an aside, when we finally floated the dollar in 1970, it *appreciated* from 92.5 cents to the 105 cent range in the mid-1970s. This is evidence that we *were* converging to the US (à la Ireland in Euroland) under this 1962-1970 "common currency."

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ization, or embrace the euro and the ECB. Note that they will have one vote out of thirteen now, and one vote out of 25 or so in a year or two. My guess is that they will opt to join the euro, which should send a key message to Canada that currency integration is not inherently about sovereignty.

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ily. In this context, it is important to recognize that any progress in the area of deepening NAFTA to incorporate framework policies relating to counter-vail, subsidy and anti-dumping will surely require that our exchange rates are fixed, or at least jointly managed. By way of illustration, it has not escaped the Americans that our exchange rate has depreciated significantly over the last dozen years. Phrased differently, the amount of the levy on softwood lumber is not unrelated to the amount of the depreciation.

There is a related storm cloud on the horizon. Over the 1990-2001 period, our real exchange rate depreciated from an index of 100 in 1990 to 70 in 2001. Over this same period our current account balance with the US went from a deficit of 1 percent of GDP in 1990 to a current account *surplus* of over 6 percent in 2001. If and when the Americans finally got around to focus on their trade deficit, we may well become the target for much of the adjustment in either or both of the exchange rate and the trade balance. I simply leave it to the reader to mull over the possible scenarios here, replete with how much sovereignty flexible rates will have provided us with.

On the purely domestic front, as was the case for the FTA, not much is likely to happen until business

comes on side. Were the recent statement by Alcan favouring a North American currency to be endorsed by several other prominent companies, the game would be afoot. It is important to note, however, that much of the Canadian economy is already outside of the Canadian dollar area. The fortunes of the largest Canadian companies can rise and fall with hardly an impact on the Canadian dollar since most of the stock trading takes place in US dollars. Let me speculate that this is

beginning to worry the Bank of Canada, in the following sense. In the current time frame, we are outperforming the Americans. If this is part of the long-awaited convergence (à la Ireland), one would expect wages to rise and the prices of non-traded goods and services to be subject to upward pressure as well. If this is really convergence, then productivity will increase and this will not show up as inflation.

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But measurement problems with respect to productivity are manifold, so that convergence may reveal itself in the data, initially at least, as inflation. And if this is so, it will be difficult for the Bank of Canada not to hike interest rates to choke off this inflation and, with it, *choke off the convergence*. One of the ways to interpret the Governor's recent statement that he would hope that the exchange rate will increase (appreciate) as Canadian economic activity increases is that this would help stem the potential rise in measured inflation and, therefore, facilitate convergence. This issue would not arise under a common currency, since there would be no assumption that Canada could affect NA inflation anymore than Ireland could affect EU inflation.

Those in favour of the flexible-rate status quo tend to take refuge in the following argument:

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 shall rule!

Except for "dollarization is unacceptable," this argument is, I respectfully submit, completely wrong. Given the pace of currency consolidation, it is unlikely that a floating or flexible exchange rate will even be in the longer-term choice set.

Rather, the choice will likely be between North American monetary union (or some version of exchange-rate fixity) on the one hand, and dollarization on the other. Faced with this decision set, most Canadians would surely vote for NAMU!

As a final comment, it is fair to say that it was because Canada had done its homework that we were able to say "yes" to the Canada-US Free Trade Agreement when the opportunity arose.

The situation with respect to NAMU or a common currency is analogous. We need to assess the pros and cons of alternative approaches to currency consolidation in North America, so that if and when a window of opportunity arises our homework/research will likewise be done. One cannot preclude that, as a result of this in-depth analysis, flexible rates will emerge as the "winner," so to speak. But let's do the requisite analysis first, before pre-judging the results.

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