CANADA'S FLOATING RATE NEEDS FIXING

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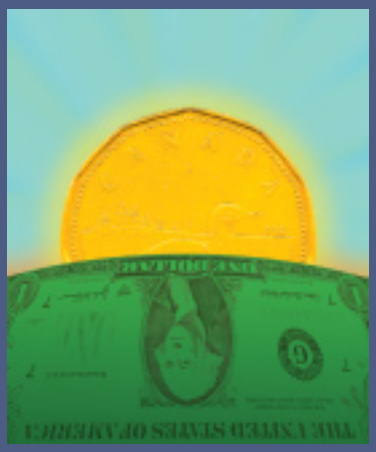

The Canada-US exchange rate is the most important price in our economy. Yet volatile energy prices are generating exchange rate swings that are rendering some sectors uncompetitive. The underlying problem is that our currency area is too small to accommodate a dynamic energy sector and a world class manufacturing/services sector. We need to immerse the Canadian economy into a larger currency area via a fixed-exchange-rate regime with the US in the near term and to work toward a North American version of the euro in the longer term.

Le taux de change Canada-États-Unis est la valeur la plus importante de notre économie. Or la volatilité des prix de l'énergie provoque des fluctuations de taux qui diminuent la compétitivité de nos entreprises dans certains secteurs. La taille de notre zone monétaire est le problème de fond, car elle trop petite pour abriter un secteur de l'énergie dynamique et un secteur manufacturier et tertiaire de calibre mondial. C'est pourquoi l'économie canadienne doit se fondre dans une zone monétaire plus vaste par le biais d'un système de taux de change fixes, d'abord avec les États-Unis et, à plus long terme, avec le reste du continent, de manière à créer une version nord-américaine de l'euro.

Canada's civil servants are more than hard-working and dedicated. They are highly motivated and very talented, easily the match of civil servants anywhere and everywhere. Intriguingly, this poses an awkward problem for students of public policy: namely, that policy approaches that are analytically or structurally flawed can, in the guiding hands of our capable civil servants, be made to perform more than tolerably well. Hence, the policy reform process becomes more difficult because the pressures for reform have been contained or overcome by adept implementation and/or internal program restructuring.

This situation is doubly awkward for those who toil in the area of monetary policy reform. Here, the Bank of Canada's pursuit of inflation targeting under the leadership of governors Crow and Thiessen and Dodge has been exceptional and has been recognized as such not only in Canada but in central banking circles internationally. In addition, the bank's inflation-targeting model is widely viewed by the vast majority of Canada's policy community as "state of the art" in terms of a monetary strategy for a small open economy. And the evidence speaks for itself: the bank has been impressively successful in keeping Canada's inflation rate well within the announced target range. As a result, the Bank of Canada has gained enormous credibility, and deservedly so on this count, among the Canadian policy community and more generally among Canadians at large. One might even go so far as to suggest that inflation targeting has made the leap from being the preferred monetary policy instrument to donning the mantle of a policy goal.

This, then, is the environment within which any criticism of Canadian monetary policy must of necessity proceed. In the critique of monetary policy that follows, my disagreements are not related to how our successive governors implemented inflation targeting. Indeed, as the above comments suggest, I would join the Canadian policy community in awarding them top marks. Rather my questioning of Canadian monetary policy goes deeper: namely, that the underlying philosophy is faulty. Not only is floating-rate inflation targeting not a policy goal, it is the wrong policy instrument. What Canada needs, the analysis will maintain, is some version of exchange rate fixity, initially a fixed exchange rate with the US but, hopefully, evolving in the direction of a common currency (e.g., a Canada-US or North American version of the euro). Since the choice of exchange rate regimes rests with the government, the ensuing critique is probably best viewed as being directed to the government (and particularly Finance Canada) rather than to the Bank of Canada.

The fundamental issue is straightforward: in the face of highly volatile energy prices, the Canadian currency area is way too small to accommodate at the same time one of the world's most diversified and dynamic energy sectors and a world-class manufacturing and services sector. This is abundantly clear from figure 1, which plots the movements in the Canada-US exchange rate (expressed as the number of US cents per

Canadian dollar) and the movements in the per-barrel price of oil. The correlation between the two is so high that "petro-loonie" is now an apt title for our currency. This of course is the Dutch disease in action, so named because Holland's North Sea energy exports so appreciated its currency that the result was to clobber the Dutch manufacturing sector.

That the petro-loonie is serving to clobber Canada's manufacturing is clear (see figure 2). Canada's unit labour costs in manufacturing have increased dramatically relative to those in the US — by roughly 50 percent, as seen in figure 2. Note that this does not capture the full competitiveness deterioration since it only goes to the end of 2005.

Two qualifications are needed in interpreting these charts. The first is that the deterioration in competitiveness triggered by the appreciating loonie relates to Canadian value added, not to the full value of the product in question. Specifically, products that are heavily dependent on imported inputs, which are then converted into Canadian exports, are more or less unaffected since the high dollar reduces the costs of these foreign inputs. The second caveat is that while most of the discussion of the Dutch disease focuses on manufacturing, the Dutch disease is far more general. Essentially, it affects any sector whose product prices have not risen in line with the exchange rate increase. This can even have a major impact on aspects of the resource sector. Forestry is an excellent example here, one that illustrates both of these clarifications. Thanks to the mortgage-related financial debacle and the associated collapse in new housing starts on both sides of the border, some prices in the forestry sector are presumably falling, which means that the risk to these forestry firms is even worse than the predicament captured by figure 2. Secondly, a high percentage of the price of forest products would come from Canadian value added. That this sector is reeling under the influence of the petro-loonie should hardly be surprising.

There is another way to come at this underlying issue, one mentioned in an earlier *Policy Options* article (October 2007). This relates to my claim that Canada has become less a single east-west economy and more an east-west series of north-south, cross-border economies. To see the implications of this for the Dutch disease, let us assume that the two sides of each of these north-south economies are in rough equilibrium: BC is competitive with the Pacific northwest, Alberta is in line with the Texas Gulf, central Canada has accommodated itself to the New York/Chicago trading area, the Maritimes are in sync with Boston and New England, and so on. Now assume that fossil energy prices spike upward. Initially, this energy price increase affects both sides of each cross-border region in the same way — hence Vancouver would continue to be onside with Seattle, Winnipeg with Minneapolis, Windsor with Detroit, Halifax with Boston, etc. What has changed is that the energy regions (Alberta and the Texas Gulf) have changed relative to other areas of their respective countries. But now let us further assume that the Canadian dollar appreciates or "buffers" the energy price spike. Suppose that this is in the order of 60 percent, roughly in line with what occurred as shown in figure 1. Now *every* Canadian region is thrown off side vis-à-vis its US counterpart.

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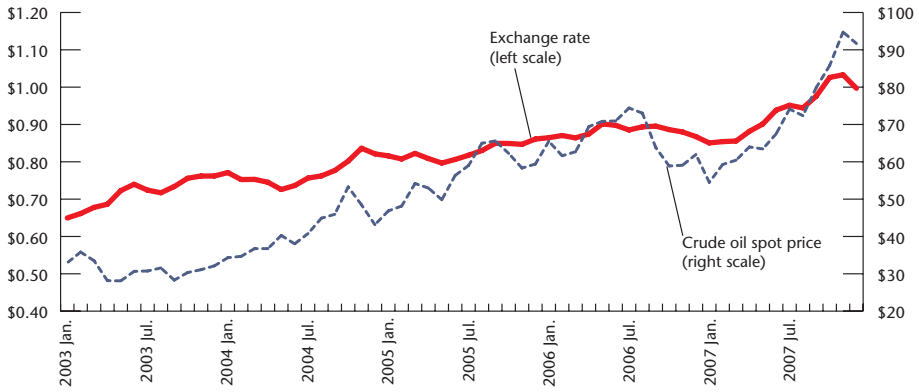
Note what has happened here. It is the exchange rate appreciation, not the original energy price spike, that is driving a wedge between the Canadian and US partners in each of the regions. While Canada has diversified it's exports (away from the US) in recent years, something like two-thirds of our exports are still destined for US markets, so that this is a very questionable policy. Canadians would hit the roof, as it were, if the US put a 60 percent import tariff on the Canadian value added of our exports. Yet we do not seem to mind when our chosen monetary policy strategy is effectively levying a 60 percent export tax on the Canadian value-added component of our shipments to the US.

Along similar lines, we spend a great deal of time and effort attempting to ensure that, in the wake of 9/11 and concerns for homeland security,

FIGURE 1. CANADA-US EXCHANGE RATE AND CRUDE OIL PRICES (US$)



Source: Bank of Canada (xrate); US Energy Information Administration (Oil).

the border policies are such that we still have timely physical access to the US market whereas we make no similar effort when it comes to "economic" access.

It is important to emphasize that the challenge here is not so much the fact that the exchange rate is at, say, US$1.05, but rather the speed at which we arrived there. For much of the 1990s the Canadian dollar was in the low-70-cent range, then falling to the low 60-cent range over 1998 to 2002 in the wake of the Asian currency crisis. During this period the purchasing power parity (PPP) value of the exchange rate was probably in the mid to high 80-cent range, so that Canadian producers became accustomed and adjusted to an undervalued dollar. This certainly exacerbated the difficulties of grappling with the impacts of a very rapid rise in the dollar to parity and beyond. Had we been appreciating at a few cents per year over a long period, we could much more readily handle a dollar at parity or at US$1.05.

This substantial undervaluation of the dollar over the 1992-2002 period is arguably the author of another of Canada's economic challenges: namely, productivity growth lower than that experienced by the Americans. Specifically, the fall in the dollar (from 89 cents to 62 cents over the 1990s) meant that the price of any machinery and equipment rose apace (assuming that it is priced in US dollars) so that Canada underinvested in machinery and equipment, with the result that our capital-labour rate fell and so did productivity (both relative to the US).

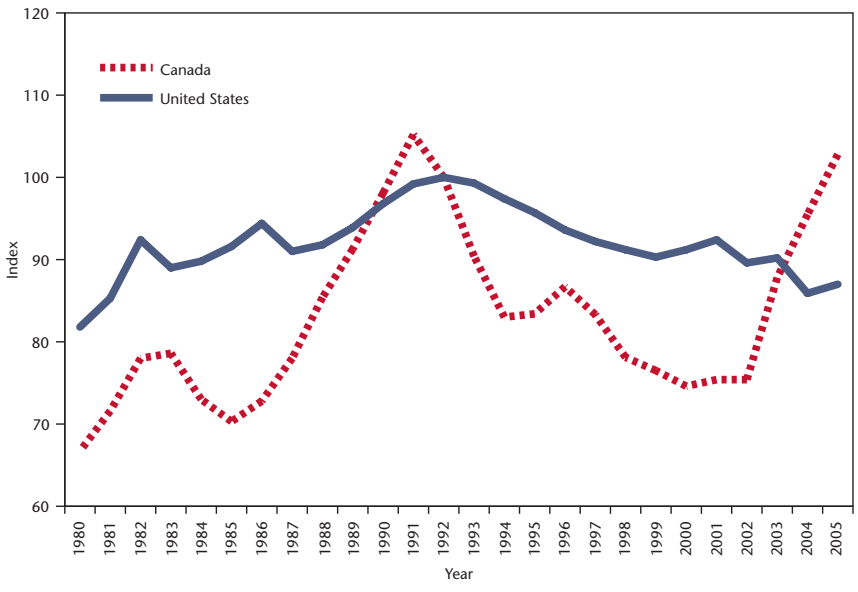
To be sure, this should be rectified now that the loonie is overvalued. Finance Canada thinks that it will, and Finance Minister Jim Flaherty has cut corporate tax rates and introduced accelerated depreciation to speed along the process of capital deepening. The problem here is that the appreciation has been so rapid that some firms are engaging in downsizing, outsourcing and off-shoring so any recapitalization will likely be on a reduced domestic base. Moreover, with the US now supercompetitive vis-à-vis Canada (at the new exchange rates), and with some reputable market analysts calling for much higher energy prices (and a potential worsening of the picture contained in figure 2), capital investments in some industries will likely remain low, or at least delayed.

I conclude this section with a further puzzle. I understand why we are allowing markets to buffer energy prices via currency appreciation (because of macro/inflationary implications, which I address below) but nonetheless it is passing strange to do so. This is because no matter where the exchange rate ends up, the oil is still in Alberta. However, one can easily pick an exchange rate where plant X or Y will move south or otherwise disappear. Hence, to buffer the price increases of immobile assets will end up making footloose or mobile firms even more footloose and mobile

Relatedly, Canada has great "national assets" or trump cards — a sharing community, a quality labour force, a good public education system, safe neighbourhoods, medicare and the like. But it is hard to play these trump cards when we cannot guarantee cost certainty for access to NAFTA's economic space. Perhaps this is why Canada's share of North American inward foreign direct investment has continued to fall in spite of the FTA and NAFTA.

One answer to all this is "Why worry?" The economy is doing quite well, our fiscal position is rosy, unemployment is at a 30-year low, economic activity is appropriately shifting toward the resource sectors and will continue to do so as India and China continue their economic ascent. Moreover, Canadians are much better off in that the higher value of the dollar has substantially increased their purchasing power. Most important of all, however, advocates of inflation targeting would point out that the above critique misses the entire point of inflation targeting. As David Laidler put it in the *National Post* last month: "Canada's current choice is between the status quo — stable domestic inflation supported by a floating exchange rate — and a pegged rate accompanied by greater domestic instability that would itself tend to undermine the very regime producing it." In other words, without a floating rate the Bank of Canada's response to rising energy prices would have to be to create Canadian dollars to hold down the rate. This would lead to upward wage and price pressures and may eventually make

FIGURE 2. INDEX OF US DOLLAR MANFACTURING UNIT LABOUR COSTS, CANADA AND THE US, 1980-2005 (1992 = 100)



Source: Calculations by the author based on US Bureau of Labor Statistics data.

the fixed rate difficult to hold, so that the dollar may well appreciate in any event. So why not let it float right away and temper the domestic impact.

Now one cannot rule out this scenario, but there are some important caveats that need mentioning. By far the most important of these is that Canada has had a successful experience with fixed exchange rates (1962-70) which included the 1963-68 Lester Pearson era. This is the period when we Canadians created or reworked much of our social envelope (Canada-Quebec Pension Plans, medicare, making equalization comprehensive, and funding of post-secondary education). Moreover, we did not follow the US into Vietnam. On the economic front, our productivity growth increased relative to that in the US. Hence, the fixed-rate regime and, therefore, our reliance on US monetary policy did not affect our performance on the economic front and certainly did not prevent us from creating our own social vision for the upper half of North America.

Among other counterpoints, one would note that wages and prices have become much more flexible across Canada's regions, so that some of the aggregate demand pressures will be taken out regionally rather than nationally. Second, labour is also much more mobile across regions than we anticipated it to be. Moreover, booming provinces like Alberta are also actively accessing temporary foreign workers on a significant scale. Third, under fixed exchange rates, similar firms on different sides of the border will be facing similar cost and price structures. This will temper some of the pressure for wages to rise. Relatedly, given that outsourcing and offshoring have become real options, they, too, will also temper wage increases. Fourth, prices of traded goods are being held in check by China and India and other low-wage countries. And above and beyond all of this there still remains the old chestnut — fiscal policy or stabilization policy. Canada has the tools and the financial flexibility to bring fiscal policy to the task of ensuring that the overall macro environment is consistent with holding the exchange rate. Overall, therefore, I am convinced that we are significantly underplaying the role and stabilizing influence that fixed rates can play in the current environment.

In a different vein, it should be noted that Norway handles the Dutch disease in part by placing some of its foreign exchange inflows back into international capital markets. Provincial ownership of energy makes this more difficult in Canada, but it remains an option that may be worth pursuing. For example, were Alberta to do some of this, it would lessen the appreciation of the loonie, thereby increasing the Canadian-dollar value of any energy exports. The final counterpoint is that floating rates, as noted, have a demonstrated tendency to overshoot their PPP equilibrium and to remain there for considerable periods of time. Hence, one may obtain an exaggerated view of the aggregate demand pressures under fixed rates from looking at the pressures arising under flexible rates. For example, the cost deterioration shown in figure 2 is a result of exchange rate overshooting or "over-appreciation." One notes in this context that both Holland and Austria maintained their fixed exchange rates with Germany, even throughout the unification of the two Germanys which, by any standards, was a major macro shock.

Nonetheless, if energy prices spike to $150 per barrel, then we are in trouble under either exchange rate regime. My preference would be to tolerate a bit more inflation rather than tolerating a bit more industrial hollowing out, especially if the energy spike turns out to be temporary. Others will clearly choose differently.

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I now turn to alternative versions of exchange rate fixing. One obvious approach is a "currency board" (CB), anchored on the US dollar, where the exchange rate is precisely fixed and the CB stands ready to buy and sell US dollars at this rate. There is little or no scope for domestic monetary policy because a CB is not a central bank. Received wisdom points to Argentina as a case study of why currency boards do not work. This too has to be put in perspective on two counts. The first is that during Argentina's economic troubles, the CB continued to hold so well that Argentina had to legislate it out of existence. Second, Argentina anchored its CB to the US dollar, but the US was not one of its major trading partners. During the 1990s high-tech boom in the US, the American dollar appreciated against many currencies and certainly against the Brazilian real. Beyond this, Brazil actually devalued its currency. For both reasons Argentina's currency (effectively the US dollar) became way offside vis-à-vis that of Brazil, its major trading partner, with admittedly devastating results. The key point here is that if we were to have a CB, we would be anchoring it against the currency of our dominant trading partner.

One can imagine mechanisms that would strengthen a fixed rate without going the full route to a CB. For example, were the US Fed to agree to support one side of the exchange rate (i.e., agree to buy Canadian dollars in the foreign exchange market when the Canadian dollar is tending to fall), then the fixed rate regime would become much more robust.

The longer-term goal of a fixed rate regime would be a common currency or a North American monetary

union (NAMU). Quoting Laidler again, "A full North American monetary union supported by a high degree of goods and labour market integration would mitigate many of these problems" (problems that he associates with fixed exchange rates but I would not). The features of a NAMU might be as follows. It would be modelled along euro lines, with a supranational central bank, say the International Reserve Bank of North America (IRBNA), composed of the 12 existing Federal Reserve Banks and the Bank of Canada. Acceptability on Canada's part would probably require that we be on any executive committee of the board. The US would maintain its currency (why unwind what is still the world's foremost currency?). Canada would issue a new currency that would trade one for one with the US dollar. Suppose the chosen conversion rate was C$1.10 for each US dollar or roughly US90 cents per Canadian dollar. Then 100 of the new Canadian dollars would exchange for 110 of the old Canadian dollars and items that used to cost 110 old dollars would now cost 100 new dollars. Thus we maintain the existing purchasing power differences between the two currencies. And, as noted, the new Canadian dollars will be perfect substitutes for US dollars. While this may seem complicated, this is identical to the process that all European countries went through en route to the euro.

Obviously the process would be much easier and much more transparent if the conversion rate was one for one (parity). Indeed, the concept of a NAMU may well become much more acceptable to Canadians now that parity is in the choice set for the conversion rate.

One side of the new Canadian currency (say, the $5 bill) would say (bilingually) that this is a North American $5 bill, issued by the IRBNA, and identical to US$5, or some comparable message. The other side could have a picture of the Rockies, for example. Hence, Canadian symbolism could remain.

The Bank of Canada would issue the new currency, in the same way that the 12 Federal Reserve Banks used to issue US currency, and would do so under the overall surveillance of the IRBNA to ensure inflation control. Thus we would keep the seigniorage. Among other issues, we would want to maintain control over financial regulation, and bank clearings would occur within Canada before settling with the US. Finally, and this is the whole point of the exercise, there would be no exchange rate.

I agree with Laidler that NAMU is not on the near-term horizon, neither for the US nor for us. However, the US currency has been having a hard time of late. As it puts its fiscal house in order and rethinks/reworks its role in the community of nations, the US will probably be interested in expanding its formal currency area, especially if the euro begins to make meaningful headway in South and Central America. Stay tuned.

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The final alternative is dollarization: using the US dollar for our currency. We could do this unilaterally, whereas NAMU requires US cooperation. And dollarization does eliminate the exchange rate and deliver many of the benefits of NAMU. However, we would lose seigniorage and currency symbolism. Beyond this, the nightly clearings would probably go north-south (cross-border) by region, and our financial institutions and financial regulatory system would likely be drawn into the US ambit and orbit. There would be no rationale for the continued existence of the Bank of Canada, so that it would become difficult to withdraw from dollarization. All in all, dollarization would work well on the economic front, but would not rank high with most Canadians because it would begin a process of Americanization across a wide swath of sectors. But it does represent a way for Canadians to opt out of their current exchange rate arrangements.

By way of concluding, the Canadian currency area is too small to accommodate a world-class energy sector and a world-class manufacturing/services sector. Hence, volatile energy prices and floating exchange rates are pitting the energy sector against manufacturing. And it certainly does not help that there is a regional nature to this tug-of-war. It need not be this way: under fixed rates the recent increase in energy prices would have allowed both sectors to be better off than they currently are. The reality is that the exchange rate is the most important price in Canada. It does not need to be left to the overshooting tendencies of the inflation-targeting monetary strategy. Finally, I recognize that is was not until business supported the FTA that it came to fruition. The same will be true for fixed exchange rates. But business is not yet onside. Nonetheless, my view remains that Canada's floating exchange rate needs fixing.

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