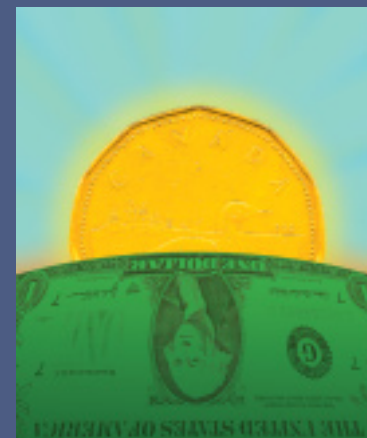


THE OTHER SIDE OF THE LOONIE: THE GREENBACK IN HISTORICAL PERSPECTIVE

Patrick Leblond

With the growth in the value of the Canadian dollar, there have been renewed calls for some kind of monetary integration with the United States. Although, as Patrick Leblond, assistant professor of international business at HEC Montréal, acknowledges, such a monetary union is unlikely in the foreseeable future, it is useful to assess what kind of monetary partner the United States would be should Canada ever opt for such a union. Here he looks at “the other side of the loonie’s exchange rate volatility, namely, the behaviour of the greenback.” Since the Second World War, he finds, the US dollar is no beacon of stability, and it bears its share of responsibility for the volatility of the exchange rate between the two North American dollars.



Au cours des derniers mois, l’essor du dollar canadien a renouvelé l’intérêt pour une union monétaire avec les États-Unis. Et, bien que la réalisation d’une telle union est peu probable dans un avenir prévisible, reconnaît Patrick Leblond, professeur adjoint en commerce international aux HEC, il est certainement utile de s’interroger sur le genre de partenaire monétaire que seraient les États-Unis. L’auteur examine donc « l’autre côté de la volatilité du huard », à savoir le comportement du billet vert depuis la Seconde Guerre mondiale. Il en conclut que celui-ci n’a rien d’un modèle de stabilité : « Le dollar américain porte aussi sa part de responsabilité dans la volatilité du taux de change entre les deux monnaies. »

Since the dollar surpassed parity with the US dollar in late October/early November of last year, there have been renewed calls from pundits for some kind of monetary integration of the two dollars. The justification is, as usual, that our dollar’s volatility is hurting the Canadian economy, mainly by negatively affecting international trade and investments.

Although the jury is still out with regards to whether exchange rate volatility has a significant impact on an advanced economy’s performance, the object of the present article is to examine the other side of the loonie’s exchange rate volatility, namely, the behaviour of the greenback. After all, it takes two to tango, and exchange rates are no different. Hence, the US dollar also bears its share of responsibility for the volatility of the exchange rate between the two North American dollars.

Supporters of integrating the Canadian dollar with its American counterpart would probably argue that it is irrelevant which currency is responsible for the volatility of the exchange rate; all that matters is that the exchange rate is volatile. Therefore, ways have to be found to reduce, if not eliminate, this volatility. The only way to do this is to adopt

a fixed-exchange-rate regime for the two currencies. Following the east Asian (1997-98) and Argentine (1999-2002) financial crises, many exchange rate specialists now believe that the best way to achieve exchange rate stability is through monetary union, where rates are irrevocably fixed.

Unilaterally, monetary union is commonly referred to as “dollarization,” and it involves one country adopting another’s currency. In Canada’s case, it would mean replacing the loonie with the greenback. Multilaterally, it means two or more countries getting together to create a new currency. The best example of this is the creation of the euro by a number of European Union member states back in 1999. Although a monetary union between Canada and the United States is unlikely in the foreseeable future (see my article in the November 2003 issue of *Policy Options*), it is nevertheless important to examine what kind of monetary partner the United States would be for Canada should we ever decide to form a monetary union with our southern neighbour.

In either the unilateral or the bilateral case, Canada would surely have little or no say in the union’s monetary policy.

Although our two economies are well integrated, they do not evolve exactly in sync. This means that if the union's monetary policy were set solely for the United States' economic situation, then it may not be appropriate for Canada (because it either fuels inflation or restrains economic growth unnecessarily). Unfortunately for Canada, contem-

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Before examining US macroeconomic and exchange rate policy-making since the Second World War, it is worth comparing the volatility of the Canadian dollar with that of the US dollar vis-à-vis major currencies. Listening to supporters of monetary integration, one often has the impression that it is only the loonie that is volatile. This line of argumentation gives the false impression that the greenback is a beacon of stability.

If we look at table 1, we observe that in fact the Canadian dollar has not been more volatile than the US dollar since 1973, when the post-Bretton Woods floating exchange rate regime effectively took root. Since 1973, the loonie's exchange rates vis-à-vis the French franc and the British pound have been slightly less volatile than the greenback's, while the reverse situation obtains in the case of the exchange rates with the yen and the Swiss franc. The loonie has been less volatile than the greenback in the last 10 years vis-à-

vis all the world's major currencies except for the yen. Based on these results, it is difficult to argue that the Canadian dollar is more volatile than the US dollar. Therefore, one cannot claim that the loonie is entirely responsible for the volatility of the exchange rate between the two North American dollars. As figure 1 shows graphically,

the greenback has hardly been a stable currency since the early 1970s. We will now examine why.

The US dollar's role as an international reserve and transactions currency began at the Bretton Woods Conference in 1944, which established the post-war monetary regime that lasted until 1973. The greenback formed the backbone of the Bretton Woods regime, whereby currencies had a

pegged or fixed exchange rate with the US dollar. In turn, the US currency was exchangeable into gold at the fixed price of US\$35 per ounce. To prevent a repetition of the competitive ("beggary-neighbour") devaluations and ensuing high inflation rates that took place during the interwar period, this regime aimed to ensure international monetary stability through the management of fixed exchange rates by the International Monetary Fund (IMF). Currencies' exchange rates were fixed to each other through the US dollar and, ultimately, gold. Currency devaluations and revaluations were allowed only with IMF approval. At any time, countries could ask the US Treasury to convert their US dollar holdings into gold at the above-mentioned fixed price.

The Bretton Woods regime worked well until the end of 1960s, but then the underlying asymmetries built up over time rose to the surface and eventually forced the United States to stop supporting international monetary stability. Throughout the 1950s and 1960s, the United States experienced

TABLE 1. EXCHANGE RATE VOLATILITY (STANDARD DEVIATIONS)¹

Currency and period covered	C\$	US\$
French franc ² (Jan. 1973-Dec. 1998)	0.86	1.27
German mark ² (Jan. 1973-Dec. 1998)	0.50	0.46
Euro (Jan. 1999-Dec. 2007)	0.05	0.14
Japanese yen (Jan. 1973-Dec. 2007) (Jan. 1998-Dec. 2007)	71.45 11.35	66.70 8.48
Swiss franc (Jan. 1973-Dec. 2007) (Jan. 1998-Dec. 2007)	0.60 0.09	0.52 0.17
British pound (Jan. 1973-Dec. 2007) (Jan. 1998-Dec. 2007)	0.05 0.03	0.09 0.06

¹ The standard deviations are calculated in the trading partner's currency, not the dollar.

² The French franc and the German mark were replaced by the euro on January 1, 1999.

Sources: IMF, *International Finance Statistics*; Bank of Canada; author's calculations.

trade and current account surpluses. However, these surpluses began to decline in the second half of the 1960s and fell into deficit in 1970. The key reason for this reversal is that the US government had begun running fiscal deficits as a result of the Vietnam War and President Johnson's Great Society program. These deficits were accompanied by rising inflation, which made US exports increasingly less competitive (as their prices rose), while imports became relatively cheaper. As such, given the fixed parities, the US dollar was becoming increasingly overvalued vis-à-vis other major currencies like the German mark and the yen (by 10 to 15 percent, according to the US Treasury's own estimates). To bring things back to equilibrium, the US dollar would have to be devalued or other currencies, such as the German mark, would have to be revalued.

Even more problematic, the US dollar had become overvalued vis-à-vis gold by 1960. By then, foreign dollar reserves had effectively exceeded US gold reserves. Therefore, if foreign governments had sought to convert their dollar reserves into gold at the fixed rate of US\$35 per ounce, as the Bretton Woods system allowed them to, then there would have been the equivalent of a bank run (an example is the recent case of Northern Rock in the UK), as governments would rush to convert their dollars at the above-mentioned price before gold ran out or the price was increased (i.e., the US dollar was devalued in terms of gold).

With foreign demand for US gold potentially greater than its supply, there were two options to restore the monetary system's equilibrium. These options became known as the Triffin dilemma, named after the late Robert Triffin, a Belgian economist who was a professor at Yale University.

The first option was to devalue the US dollar vis-à-vis gold, whereby the price of gold in dollars would have to increase beyond US\$35 per ounce. Such an option, however, would undermine one of the cornerstones of the Bretton

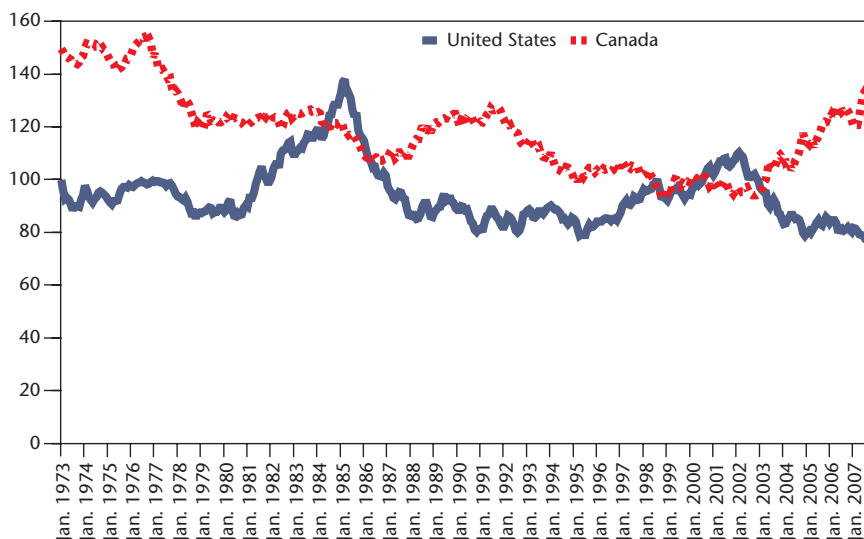
Woods regime's stability. Moreover, any discussion of a possible devaluation would surely provoke a rush by foreigners to convert their US dollar reserves into gold before a new, higher price was established. The second option for putting US gold demand and supply back in equilibrium — as well as maintaining the parity of US\$35 per ounce — was for the US to adopt deflationary policies, the effect of which would be to starve the world of liquidity in the form of US dollars and dollar-denominated assets. The fear associated with this latter option was that it would set off a deflationary spiral like the one experienced during the Great Depression.

In any event, neither option was pursued, at least throughout the 1960s. Allowing domestic considerations to prevail over the restoration of the Bretton Woods regime's return to some form of equilibrium, the US continued to pursue inflationary macroeconomic policies that further enhanced monetary imbalances in the system. To keep the regime going, the US and its European allies created the Gold Pool, whereby member states agreed not to convert their dollar

reserves into gold. However, the US continued to subordinate the defence of the dollar-price of gold to its domestic interests. Understandably, this made European countries less keen to shoulder an increasingly greater share of the responsibility to prevent the system from breaking down.

France was first to throw in the towel and it withdrew from the Gold Pool in June 1967. A little less than one year later, other countries followed suit, and the arrangement was terminated. To prevent the drainage of US gold, the dollar-price for private transactions (i.e., involving individuals and companies) was allowed to increase, while the price for official transactions (i.e., involving central banks) remained at US\$35 per ounce. This created a nice arbitrage opportunity for foreign central banks, buying gold from the US Treasury at \$35 per ounce and selling it on the private market for a little less than \$40 per ounce. To limit gold outflows and additional increases in the dollar-price of gold, the US government introduced a series of controls on private transactions involving gold. These

FIGURE 1. NOMINAL EFFECTIVE EXCHANGE RATE INDEX FOR THE US AND CANADIAN DOLLARS, 1973-2007



Note: A nominal effective exchange rate index represents the ratio (expressed on the base 2000 = 100) of an index of a currency's average exchange rate to a weighted geometric average of exchange rates for the currencies of selected countries and the euro area. For the nominal effective exchange rate index, weights are derived from trade in manufactured goods among industrial countries over the period 1999–01. Source: IMF, *International Financial Statistics* (series code 111.NEUZF).

measures just postponed the regime's day of reckoning.

President Nixon finally put an end to the Bretton Woods regime when he announced on August 15, 1971, that the US was suspending the convertibility of the dollar into gold at US\$35 per ounce. The value of gold in US dollar terms was effectively allowed to fluctuate, thereby elimi-

In fact the Canadian dollar has not been more volatile than the US dollar since 1973, when the post-Bretton Woods floating exchange rate regime effectively took root. Since 1973, the loonie's exchange rates vis-à-vis the French franc and the British pound have been slightly less volatile than the greenback's, while the reverse situation obtains in the case of the exchange rates with the yen and the Swiss franc. The loonie has been less volatile than the greenback in the last 10 years vis-à-vis all the world's major currencies except for the yen.

nating one of the essential components of the post Second World War international monetary regime. Attempts to reform the system in the following months were fruitless. By March 1973, however, the US dollar was floating freely against all major currencies. A new era of floating exchange rates had begun.

In the years that followed, the Nixon and Ford administrations adopted a laissez-faire attitude vis-à-vis the US dollar, as the world economy was reeling from the first oil shock. When economic conditions began to improve, the newly installed Carter administration decided that a fiscal stimulus in the form of a US\$31-billion tax cut was necessary to ensure that the US's economic recovery was sustained. Predictably, this policy led to a depreciation of the dollar vis-à-vis major currencies (see figure 1). Toward the end of 1978, however, the Carter administration began intervening in currency markets to prevent the dollar from depreciating further and stoking inflation. This interventionist exchange rate policy ended with the arrival of President Reagan in the White House in January 1981.

With the arrival of Paul Volcker at the helm of the Federal Reserve in late summer 1979, American monetary policy began to tighten in order to bring inflation down. This new policy regime combined with the Reagan administration's penchant for large budget deficits to push interest rates to record levels. High real interest rates attracted large sums of foreign capital

into the US, which pressured the US dollar to appreciate. President Reagan and senior treasury officials were little concerned with the dollar's rise. As a result, the dollar climbed to new heights against the currencies of its major trading partners (see figure 1). This remarkable appreciation made US exports more expensive, while imports became cheaper. Seeing their competitiveness and jobs at stake, business and labour in manufacturing sectors lobbied the administration and Congress for a reversal of this situation. Following threats from Congress, the Reagan administration finally took action in the summer of 1985. The result was the Plaza Accord of September 1985, where G5 (France, Germany, Japan, the UK, and the US) finance ministers and central bank governors decided to cooperate to encourage the US dollar to depreciate. Shortly thereafter, the Federal Reserve began loosening its monetary policy. The ensuing reduction in interest rates contributed to the dollar's depreciation. By 1987, the dollar's effective exchange rate was back to its 1980 level.

In order to stabilize the dollar's exchange rate vis-à-vis the currencies of the United States' main trading

partners, the Reagan administration negotiated the Louvre Accord with its G5 partners plus Canada (Italy did not take part in the final deal) in February 1987. This agreement committed its signatories to intervene in currency markets in order to keep exchange rates within a certain (secret) range (supposedly set at ± 5 percent). Over time, the level of com-

mitment to the accord waned. For example, German reunification forced the Bundesbank to raise interest rates to contain inflationary pressures arising from the 1:1 conversion of the ostmark into the German mark. The US Fed refused to raise its own interest rates to maintain the mark/US dollar exchange rate within

the range prescribed by the Louvre Accord. This was politically unfeasible at a time when the US economy was slowing down and there was no room for a fiscal stimulus, since the federal budget continued to be in heavy deficit (remember President George H.W. Bush's famous "Read my lips, no new taxes"). In fact, the Fed decided to lower interest rates over the next couple of years in order to give a boost to a stagnating American economy.

During the rest of the 1990s, with Bill Clinton in the White House, the policy vis-à-vis the dollar was one of benign neglect. The federal budget deficit finally receded under the Clinton administration and the US economy experienced rapid economic growth, fuelled by gains in productivity owing to investments in information technology (which eventually turned into a speculative bubble). The dollar embarked on a renewed path of appreciation against the currencies of its main trading partners (see figure 1). The dollar also gained as a result of financial turmoil in emerging markets (e.g., the Asian financial crisis in 1997 and the Russian debt default in 1998),

whereby international investors sought refuge in dollar-denominated assets.

The dollar's ascent stopped when the information technology bubble burst at the end of the 1990s. With the arrival of the George W. Bush administration and its Reagan-inspired fiscal policy based on tax cuts to stimulate the economy, the dollar once again appreciated. Unlike in the 1980s, it was not relatively high real interest rates that attracted foreign capital but rapidly accumulating foreign exchange reserves in east Asia. Thus, capital inflows into the US economy came from Asian central banks that were investing their reserves in US Treasury bonds. These flows allowed US interest rates to remain very low, in spite of the fact that the US current account deficit and consumer indebtedness were reaching levels considered unsustainable. As a result, domestic consumption and the real estate market flourished. Downward pressures on the current account were only made worse as the federal budget surpluses achieved during the Clinton years turned (again) to deficits in 2002, as a result of increased spending on the military and homeland security.

By 2003, the US dollar stopped defying gravity and began depreciating against the currencies of its major trading partners (see figure 1). As the US current account deficit continued to grow, foreign investors realized that it was only a question of time before the dollar's relative value would head downwards. After all, the only way to reduce the current account deficit to more sustainable levels was to make exports cheaper and imports more expensive. Only a depreciated dollar could achieve this. The alternative — turning budget deficits back into surpluses and raising interest rates significantly to stimulate domestic savings and reduce consumption — was not politically appealing given the “war on terror,” the war in Iraq, high levels of consumer

indebtedness (including subprime mortgages) and, most importantly, the 2004 elections coming up.

Thus, the US dollar has depreciated by 37 percent against the Canadian dollar since the heights reached in 2002. Vis-à-vis the euro, the Swiss franc, the British pound and the Japanese yen, the US dollar's depreciation has been, respectively, 40 percent, 33 percent, 29 percent and 14 percent over the same period. Therefore, it seems difficult to argue that the loonie's side of the exchange rate equation with the greenback is solely responsible for the fact that the Canadian dollar is now trading

One cannot deny the impact that the demand for Canadian natural resources has had on the loonie's rise: oil, gas and mining extraction represented 12 percent of total Canadian exports in 2002; this percentage was 19.2 percent in 2006. But clearly the greenback's sustained depreciation against other major currencies over the same period suggests that a not insignificant portion of the rise in the Canadian dollar's value since 2002 is a result of what's happening south of the border.

around parity with its southern neighbour, whereas it was worth only US\$0.64 at the end of 2002. One cannot deny the impact that the demand for Canadian natural resources has had on the loonie's rise: oil, gas and mineral extraction represented 12 percent of total Canadian exports in 2002; this figure was 19.2 percent in 2006. But clearly the greenback's sustained depreciation against other major currencies over the same period suggests that a not insignificant portion of the rise in the Canadian dollar's value since 2002 is a result of what is happening south of the border.

This short history of the US dollar since the 1950s indicates that the US has a strong tendency to adopt an attitude of *laissez faire vis-à-vis* its currency's exchange rate, unless there are domestic political pressures to do otherwise. Even when US agrees to international monetary commitments, it is clear that American domestic interests will always prevail. Given the size of the US market and the international status of the greenback, there is no doubt that any form of North American monetary integration, should it ever happen, will be done on US terms. This means that a common monetary policy for North America would be geared toward US domestic political and economic priorities, which are likely at times to differ significantly from Canadian ones.

As for the loonie's supposed volatility, it is clear that it has not been worse than that of the greenback. In fact, its performance vis-à-vis other major currencies has generally been superior to that of the US dollar in the last decade, possibly as a result of Canada's exemplary macroeconomic management since the mid-1990s. If a significant part of the loonie's volatility vis-à-vis the greenback comes from the United States, which has a less

than stellar record of macroeconomic management, it is hard to see why we should let our southern neighbour take over our currency and monetary policy. Therefore, only a monetary union along the European model with a common currency (e.g., an “amero”) and an independent supranational central bank should be acceptable to Canadians. Unfortunately, history shows that Americans are unlikely to accept such a constraining monetary arrangement.

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