

FROM THE EDITOR'S DESKTOP/ LE MOT DU RÉDACTEUR

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Can the dollar be fixed?

What to do about the dollar continues to be a concern for Canadian policymakers. Although the C-dollar is officially “floating,” in recent years it has mainly sunk. Financial newsletters now regularly advise readers to maintain a good part of their portfolio in US dollars, in effect dismissing the C\$ as a wasting asset. Wasting assets do come back—witness the recent renaissance of the “old economy”—but even Bank of Canada Governor David Dodge seems willing to contemplate the possibility of the dollar’s demise. In 10 or 20 or 30 years, he told a parliamentary committee in April, the Canadian and American economies might be so similarly aligned that the Canada-US exchange rate could not perform its traditional function of absorbing differential economic shocks: There wouldn’t be differential shocks. If one industry or sector went into a downturn, that would have a more or less equal impact on both sides of the border, since whatever industry was in question would have equal weight in the two countries’ economies.

Mr. Dodge clearly intended his comments to dismiss talk that Canadian authorities were considering life without the dollar. And yet here was the unusual spectacle of a central bank governor granting the possibility that the currency he presides over might no longer be needed.

We are not there yet, however, so for the time being the shock absorber is still useful. With a separate currency we also get to choose our own inflation rate. Before 1990 or so we tended to favour slightly more inflation than in the United States, since then slightly less. A third benefit of a separate currency is, of course, national pride and a stronger sense of identity, although these virtues become less certain the farther the dollar falls. Beyond a certain point, revelling in past glories becomes mainly pathetic. (Acting on this principle, my two young sons have switched their allegiance from the Montreal Canadiens to the New Jersey Devils. Their father perseveres—in their eyes pathetically, no doubt.)

The customary requirement that significant nations each have their own currency will take a big hit if the United Kingdom abandons the pound—which, as this issue of *Policy Options* went to press, was thought to be the like-

ly eventual consequence should Tony Blair win a big majority in the June 7 election.

Against the benefits of a separate currency the principal cost is inconvenience in trade and investment. Economists often argue that this cost is low. The resources devoted to “hedging”—that is, protecting oneself against changes in currency values—invariably are found to be slight. It’s true that if exchange rates were done away with, everyone who toils in the foreign exchange markets could be sent off to do useful work, but, given their relatively small numbers, the social gain would not be that large.

Or would it? This spring Jeffrey Frankel of Harvard’s Kennedy School of Government and Andrew Rose of the University of California at Berkeley published a paper confirming their earlier results that countries that either use the same currency or are linked by a currency board trade with each other three times more on average than countries that use different currencies. (Under a currency board system, country A limits the amount of its currency in circulation to some fixed ratio of the amount of country B’s currency that it holds in its reserves.) Frankel and Rose also found that there is a strong link between how much a country trades and how high its GDP is. The rule of thumb emerging from their cross-country statistical comparisons is that one extra percentage point of trade means one-third of a per cent more GDP. Their point estimates for Canada are that a currency union with the United States would boost trade to 90 per cent of GDP and increase per capita output by an astounding 37 per cent.

There are good reasons to be skeptical of this result. Though more than 90 countries are involved in currency unions or use currency boards, none is very large. (Panama is probably the best known.) The first major experiment with big-country unions is currently taking place in Europe, and it’s still early days for the euro.

On the other hand, Frankel and Rose’s result shouldn’t be dismissed out of hand: An unexplained paradox of international trade is one that frequent *Policy Options* contributor and current Liberal MP John McCallum discovered in the mid-1990s, that Canadian provinces trade with each

other 12 to 20 times more than they “should,” given that most are closer to US states than they are to each other. One thing the provinces share, obviously, is a common currency.

If having the same currency really would bring such large income gains, why stop at the euro or western hemisphere “dollarization”? Why not have a world currency? In part, that’s what Robert Mundell, who favours such a currency, and Milton Friedman, who does not, discuss in the debate which leads off this issue. (In the paper he’s given us, James Tobin, a third Nobel Prize Winner—he won in 1981, Friedman in 1976, Mundell in 1999—doesn’t pronounce himself on this subject, but argues that, to succeed, currency unions require common fiscal institutions such as those possessed by the world’s most successful such union, the United States of America. Europe has them only on a modest scale and they do not seem likely for a long time yet at the world level.)

The Friedman-Mundell debate reproduced here first appeared in the *Financial Post* section of the *National Post* in December 2000. *Financial Post* editor-in-chief Terence Corcoran, who commissioned and refereed the debate, has kindly agreed to describe how it came about and what it was like to run. Last month a debate on western alienation from the CBC. This month a debate from the *National Post*.

We cover the spectrum at *Policy Options*—or try to at least.

In addition to the three Nobelists, five other economists—Richard Harris, William Robson, Kevin Dowd, Christopher Ragan and Jean-Luc Migué—provide their views on various aspects of Canada’s monetary future. Not to forget fiscal policy, political scientist Geoffrey Hale gives us his evaluation of Paul Martin’s record as Mr. Martin passes one milestone and approaches three others. On May 26, he became the fifth-longest serving federal finance minister in Canada’s history. On August 12, unless there is a cabinet shuffle before then, he passes Samuel Tilley; on August 27, William Thomas White; and on December 5, George Foster, who was Canada’s second-longest-serving finance minister. The all-time record is held by William Fielding, who served almost 19 years, under Sir Wilfrid Laurier from 1896 to 1911 and Mackenzie King from 1921 to 1925. Mr. Martin presumably wants the current Liberal reign to continue at least 19 years. His thoughts on whether he wishes to challenge Mr. Fielding’s record can only be imagined.

I do realize (despite all appearances to the contrary) that not everyone loves economics. The next couple of issues of *Policy Options* will therefore discuss such things as voting, privacy, dissent, and forest management. The dollar will be entirely absent—a state of affairs we may eventually have to get used to.

Peut-on sauver le dollar ?

Que faire du dollar ? La question continue de tourmenter les décideurs canadiens. Car notre monnaie, officiellement qualifiée de « flottante », aura plutôt sombré au cours des dernières années. Périodiquement, les bulletins financiers nous conseillent d’ailleurs de conserver en dollars américains une bonne partie de nos portefeuilles, reléguant de fait notre dollar au rang d’actif sujet à épuisement. Et bien que ces actifs aient la faculté de rebondir, comme en témoigne le récent soubresaut de l’« ancienne économie », même le gouverneur de la Banque du Canada semble disposé à envisager l’éventuelle disparition du dollar canadien. Dans 10, 20 ou 30 ans, expliquait David Dodge devant un comité parlementaire réuni en avril dernier, les économies canadienne et américaine pourraient s’aligner si étroitement l’une sur l’autre que le taux de change cesserait de jouer son rôle traditionnel d’amortisseur de chocs économiques différentiels. Car on ne trouverait plus trace de tels chocs. L’érosion d’un secteur aurait alors un impact analogue des deux côtés de la frontière puisqu’il pèserait au départ d’un poids égal sur l’économie de chaque pays.

Visiblement, M. Dodge souhaitait démentir les rumeurs voulant que les autorités songent déjà à l’agonie du dollar. Or, on a plutôt assisté au spectacle inusité d’un gouverneur

de banque centrale concédant que la monnaie dont il est responsable puisse tomber en désuétude. Mais nous n’en sommes pas encore là, si bien que cette fonction d’amortisseur conserve pour l’instant toute son utilité.

Notre monnaie nous offre en outre l’avantage de fixer notre propre taux d’inflation. Jusqu’au tournant des années 1990, nous avons ainsi privilégié une inflation légèrement supérieure à celle des États-Unis, pour favoriser depuis une inflation légèrement moindre. Le troisième avantage d’une monnaie distincte consiste évidemment à raffermir notre identité et notre fierté nationales, deux vertus qui se fragilisent hélas au gré du fléchissement de cette monnaie. Et au-dessous d’un certain seuil, il devient affligeant d’invoquer ses succès d’antan. (Forts de ce principe, mes deux jeunes fils ont retiré leur confiance au Canadien de Montréal, auquel leur père reste à leurs yeux piteusement fidèle, pour faire allégeance au Devils du New Jersey.) Quant à la règle voulant que toute nation d’importance possède sa propre monnaie, elle risque d’être battue en brèche si le Royaume-Uni renonce à la livre, un scénario qui, au moment de mettre sous presse, était perçu comme fort probable advenant la réélection de Tony Blair à la tête d’un gouvernement fortement majoritaire, le 7 juin prochain.