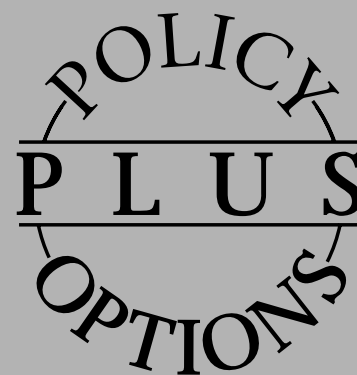


# SYMBOLISM VS. ECONOMICS: THE LOONIE VS. THE GREENBACK

Patrick Leblond

Canadians go up and down on the value of the loonie in terms of maintaining an independent currency. Americans, for their part, see the greenback, in addition to being the world's leading reserve and exchange currency, as an important symbolic element of their world hegemony. Neither country is likely to abandon its sovereign currency in favour of a North American monetary union anytime soon, argues IRPP Visiting Scholar Patrick Leblond. While Canadians can identify with North America because it reduces the importance of the United States, Americans cannot. For them, the US is North America. Even if economics argued clearly in favour of a monetary union, it's unlikely to happen as long as Canadians and Americans remain emotionally, and symbolically, attached to their own currencies.

L'avis des Canadiens sur l'opportunité de maintenir une monnaie indépendante fluctue au gré de la valeur du huard. De leur côté, les Américains voient dans leur dollar non seulement la première devise d'échange et de réserve au monde mais aussi un symbole fort de leur hégémonie mondiale. À brève échéance, aucun des deux pays n'est donc susceptible d'abandonner sa souveraine devise au profit d'une union monétaire nord-américaine, pronostique le chercheur invité de l'IRPP Patrick Leblond. Si les Canadiens s'identifient volontiers à l'Amérique du Nord pour y amoindrir l'importance des États-Unis, il en va tout autrement des Américains pour qui États-Unis et Amérique du Nord sont une seule et même chose. Même en supposant que l'économie s'en porte nettement mieux, l'union monétaire ne risque guère de se concrétiser tant que Canadiens et Américains resteront attachés à leur devise pour des raisons à la fois émotives et symboliques.



**I**n December 2002, in a report on advancing Canada's relations with the United States and Mexico, the House of Commons Standing Committee on Foreign Affairs and International Trade recommended against pursuing a North American currency union. It concluded that the Canadian government should pursue policies to "strengthen the Canadian dollar, not abandon it." In spite of this conclusion, calls continue for monetary integration between Canada and the United States (see Tom Courchene's article in the April 2003 issue of *Policy Options*). So who is right and who is wrong? The simple answer is no one. Both supporters and opponents of monetary integration have made valid points that tend to cancel each other out. This is probably why the standing committee opted for the status quo.

The debate on monetary integration has so far centred on economic arguments with the goal of determining what ought to be done. But what happens when the policy recommendations are ambiguous? How will the monetary issue be decided? Here, economics has limited predictive power. Indeed, it pre-

dicts that the status quo will prevail in the future; however, it does so only after the politics argues that we are unlikely to see a North American common currency, whether the US dollar or a North American dollar, in the foreseeable future. This is because the future of the monetary arrangement in North America will be decided by the value of the Canadian and American dollars as symbols of national identity. This would be so even if a compelling economic case could be made in favour of monetary integration, because in order for such a project to succeed, Canadians and Americans will have to support it. Currently, the symbolic value of the dollars is high in both countries, which suggests that no such support would be forthcoming. To make a common currency possible between Canada and the United States, this value would have to fall very significantly in both countries as a result of a terrible shock to their economies (e.g., a nuclear attack or major epidemic).

**E**ven if the debate on monetary integration in North America has been based solely on economic arguments,

no one denies that a national currency can be a symbol of national identity. Many, like Courchene, even acknowledge that the symbolic value of a currency is an important variable in the monetary integration equation. However, they treat it only superficially. For example, for advocates of monetary integration, it is an obstacle that can be easily circumvented. If they delved further into the subject, they would surely realize that the symbolic value of a national currency has greater policy ramifications than they generally assume. But this requires an understanding of what constitutes this value.

The symbolic value of a currency has two components: scope and scale. First, to give a currency any symbolic value, a person must identify with it. This means that a person must identify with the geographical region (e.g., a continent, a country, a state or a province) that a currency represents. The stronger this geographical identification, the stronger will be the scope of a currency's symbolic value. Second, the degree to which a currency reinforces a person's identification with a given region defines the scale of a currency's value. This task is usually performed by the exchange rate. Both scope and scale are necessary for a currency to have symbolic value.

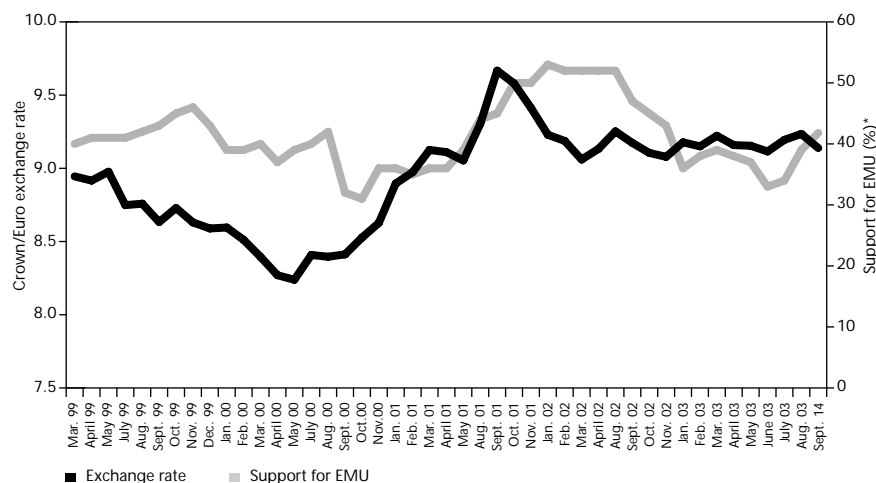
For the Canadian dollar, this means that its future will depend on two factors: 1) the exchange rate between the Canadian and the US dollars, and 2) Canadians' and Americans' respective degree of identification with available currency options. Regarding the first factor, the expectation is that support for a common currency with the United States will move in tandem with the exchange rate. This happened in Europe. In the period preceding the start of the European Monetary Union (EMU), the Italians were more willing to give up their national currency for the euro than were the Germans. Italian support for EMU averaged 80 percent of the population, according to Eurobarometer surveys between 1997 and 1999, while German support hovered around 50 percent. This is

largely because the lira was considered a weak currency, owing to Italy's longstanding inability to bring inflation under control, while the deutschemark was the anchor currency of Europe from the 1970s onward, because of Germany's low inflation record in the post-World War Two period.

Similarly, in Sweden, popular support for EMU has moved (with a lag) with the exchange rate between the Swedish crown and the euro (see figure 1). When the crown appreciated, support subsequently declined and vice versa when it depreciated. In the September 14 referendum on joining the euro zone, 56.1 percent of participating Swedes voted against replacing the crown with the euro while 41.8 percent voted in favour. This result is in line with recent opinion polls if one looks at figure 1, in spite of the horrific assassination of the foreign minister, Anna Lindh, who was a prominent pro-EMU figure. If one compares the percentage of no-voters in the referendum with nay-sayers in opinion polls before the referendum, one can see that the great majority of the 15 percent of Swedes who were still undecided at the end of August voted against EMU on referendum day.

The exchange rate also seems to affect Canadians' opinion regarding the adoption of a common currency with the United States. According to the Centre for Research and Information on Canada (CRIC), Canadian support for a common currency with the US was only 43 percent in February 1992, but it had jumped to 53 percent by October 2002. During this period, the Canadian dollar depreciated from US\$0.86 to US\$0.63 (see figure 2). This suggests that it takes a dollar close to US\$0.60 or below to convince the majority of Canadians to abandon it. However, since market fundamentals support an exchange rate of close to US\$0.75 (i.e. where the Canadian dollar is neither under- nor overvalued), it is doubtful that Canadian policy makers would decide to adopt a common currency based on a temporary undervaluation, as was the case between the beginning of 1998 until last spring, when the Canadian dollar climbed to its equilibrium rate against the US dollar (see figure 3). Furthermore, given the independence of the Bank of Canada and its ability to keep inflation under control, it is highly unlikely that the Canadian dollar would start on a path of irreversible decline vis-à-vis the US dollar.

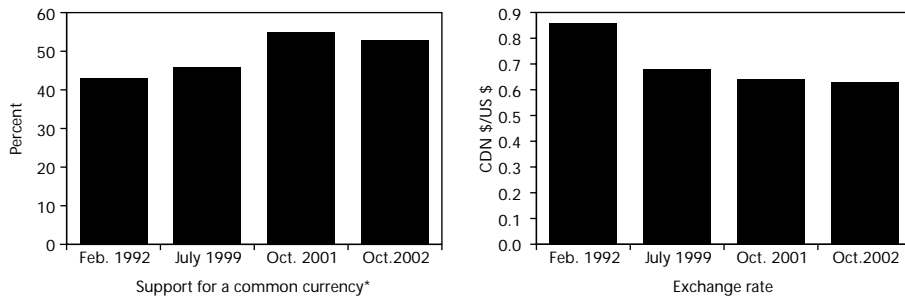
FIGURE 1. EVOLUTION OF THE SUPPORT FOR EUROPEAN MONETARY UNION (EMU) IN SWEDEN AND THE SWEDISH CROWN/EURO EXCHANGE RATE



\* Percentage of people surveyed who indicated that they would vote yes in a referendum on Sweden joining the EMU.

Sources: Demoskop; Riksbank

FIGURE 2. EVOLUTION OF THE SUPPORT FOR A COMMON CURRENCY IN CANADA AND THE CANADIAN/US DOLLAR EXCHANGE RATES



\* Percentage of Canadians surveyed who think it is a good idea for Canada and the United States to have a common currency.

Sources: Centre for Research and Information on Canada (CRIC); Bank of Canada

Canadians' and Americans' respective degrees of identification with available currency options are the second factor affecting the future of the Canadian dollar. If the majority of Canadians seems ready to accept a common currency with the United States when the exchange rate approaches US\$0.60, we need to ask ourselves what kind of common currency it has in mind. Does it mean a "new" common North American currency à la the euro, or a common US dollar? According to CRIC, in spite of a common currency receiving the support of 55 percent of respondents in 2001, 60 percent of Canadians interviewed were opposed to Canada adopting the US dollar as its currency. This is because the US dollar would provide Canadians with a new national identity: as America's inferior neighbours. For a people whose national identity is in good part defined as not being American, adopting the US dollar as Canada's currency would be a serious blow to our pride. Furthermore, by dollarizing its economy, Canada would join Andorra, Ecuador, El Salvador, Kiribati, Liechtenstein, the Marshall Islands, Micronesia, Monaco, Palau, Panama, San Marino and the Vatican in the group of countries that use a foreign currency as legal tender. Except perhaps for the Holy See, this is hardly a select grouping. It is far from the G8, G10, NATO and the OECD.

So it appears that a majority of Canadians would accept to form a monetary union with the United

States when the Canadian dollar is hovering at 60 cents US or lower, but only if a new currency is created for both countries. What about the Americans? Would they accept such a union? Although monetary union with Canada would not provide much economic gain for the US (trade with Canada represents only 4 percent of America's GDP), Americans would refuse such a proposal because it would mean abandoning the US dollar. As the world's reserve and invoicing currency, the US dollar is an important symbol of US hegemony. Americans take tremendous pride in this hegemony. This is why in a poll conducted in April 2002 by NFO WorldGroup, 84 percent of Americans interviewed rejected the idea of a common North American currency between Canada, Mexico and the United States. Canadians can identify with the notion of North America as a region because it minimizes the importance of the United States. However, Americans cannot. For them, the United States is North America.

The only reason why Americans would accept to adopt a new common North American currency would be if the euro (or some other currency) became the world's leading currency and the US dollar depreciated steadfastly against it. This would happen only if economic management in the US became very poor and irresponsible, or if there was a terrible shock to the US economy.

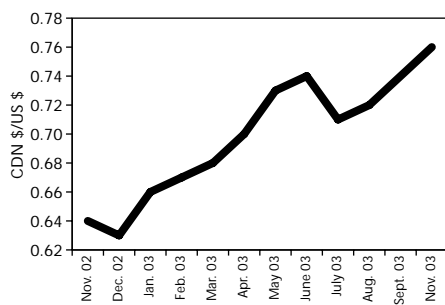
If the fall of the US dollar was due to economic mismanagement, then

the Canadian dollar would surely appreciate against its southern counterpart, assuming that Canada continued with the current wave of responsible economic management. This would lower popular support for a common currency, while tipping the economic argument against monetary union. So the only scenario in which Canada could envisage forming a monetary union with the United States is if the greenback's decline were due to a disaster of epic proportions. In such a case, Canada's policy response and popular support for monetary integration would depend on the degree to which it was affected by those shocks.

The improbability of a monetary union and the lack of interest in dollarization in Canada leave Canadian policy makers with two exchange-rate regime options in addition to the status quo: a currency board and a peg. The currency board is a legal mechanism in which the Canadian money supply would be directly tied to the amount of US dollars held in reserve by the Bank of Canada. The peg is a fixed exchange rate between the Canadian and American dollars that the Canadian government announces it will maintain for the foreseeable future. These two arrangements would allow Canada to maintain its dollar as a symbol of its sovereignty, while eliminating the exchange rate volatility that is said to have a negative impact on the Canadian economy.

Like monetary unification and dollarization, a currency board is a fixed exchange-rate arrangement considered to be "hard," while the announced peg is considered to be "soft." In the world of highly mobile capital that we know today, many economists argue that countries should avoid soft-peg arrangements, which are seen as unsustainable and leading to financial crises, as exemplified by the Asian debacle of 1997. The argument is that a country on a soft-peg arrangement can easily devalue its currency because there is no commitment mechanism other than the government's reputation and willingness to maintain the exchange rate fixed. This is why investors

FIGURE 3. THE CANADIAN/US DOLLAR EXCHANGE RATES, PAST YEAR



Source: Bank of Canada

do not hesitate to remove their funds from a given country if they fear a devaluation of the currency as a result of economic imbalances, thereby creating a self-fulfilling prophecy. Speculators will also test a government's commitment to an announced pegged exchange rate, as the renowned George Soros and his Quantum Fund did against many countries in the European Monetary System back in 1992-93.

This is why the International Monetary Fund and many economists now recommend that countries wishing to fix their exchange rate should, at a minimum, adopt a currency board. In this case there is a legal commitment to the pegged exchange rate and a legal mechanism by which the money supply is directly linked to the amount of the anchor currency held in reserve. This way the home country loses all control over its monetary policy, adopting instead that of the country to which it is pegging its currency. However, there remains a risk of currency devaluation associated with a currency board if a government under crisis decides to change the law to either abandon the currency board or just set a new exchange rate. The Argentinean crisis in 2001-02 is a prime example of the fallibility of currency boards.

These arguments and examples do not mean that currency boards or soft pegs never work in a world of high capital mobility. Hong Kong and Estonia are examples of successful currency boards. Denmark is a good example of a

country that has successfully managed to peg its exchange rate to another currency (the deutschemark and the euro). However, to be successful, these exchange rate arrangements must be accompanied by a sound fiscal policy (i.e. a budget balance over the economic cycle), an independent central bank whose goal is to keep the exchange rate fixed, a solid and well-regulated financial system, and an optimal currency area with the anchor country (i.e. the country whose currency one pegs to).

Canada satisfies all these conditions except the last one. In its report, the Standing Committee on Foreign Affairs and International Trade justified its recommendation for maintaining the Canadian dollar on the grounds that North America does not represent an optimal currency area. It argues that shocks affect the area's economies asymmetrically (i.e. they tend to be country-specific), and labour is not mobile enough across the borders to compensate for these shocks. In concrete terms, this means that a common monetary policy — either that of the United States in the case of a peg, a currency board or

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dollarization; or led by the US in the case of a North American Central Bank (since Canada would most probably get many less seats than the US) — would not be appropriate for the Canadian economy since economic cycles in Canada and the United States do not move in sync. Thus, monetary policy in Canada would be either too tight or too loose, leading to either low economic growth or inflation, respectively.

It is true that regions inside Canada or inside the US also face asymmetric shocks; however, there are fiscal transfers from the federal governments to compensate regions adversely affected by a shock. However, such a fiscal-transfer mechanism between Canada

and the US would require political integration to accompany monetary integration. If adopting the US dollar is unpopular with Canadians, a political union with the United States is even more so. According to a survey conducted by the CRIC in 2001, 81 percent of Canadians interviewed were opposed to a political union with the United States. The absence of cross-national fiscal transfers was an additional factor leading the Standing Committee on Foreign Affairs and International Trade to recommend keeping the Canadian dollar.

What about the benefits of fixing the exchange rate between the Canadian and the American dollars? Do they compensate for the loss of a monetary policy geared to the Canadian economy? If monetary integration, with its added benefits arising from a common currency and integrated financial system, is deemed insufficient to compensate for Canada's loss of monetary independence, then simply fixing the exchange rate should fare even worse. This is because the two arguments in favour of fixing the dollar to its US counterpart do not measure up.

With 80 percent of our trade being with our southern neighbour, one would expect a stable exchange rate to provide a significant reduction in hedging costs or currency exchange risk for Canadian enterprises selling to and buying from the US. However, the reality appears to be otherwise. In a 2002 C.D. Howe Institute *Commentary*, William Robson and David Laidler estimate that the transaction-cost savings to form a common currency with the United States would amount to \$2.9 billion annually, or 0.26 percent of our GDP. For a currency board or a soft peg the savings would be even lower, as the costs of converting one currency for another would remain. Thus, although not insignificant, a couple of billions of dollars are unlikely to

compensate for the cost of being unable to deal with shocks specific to the Canadian economy.

The second argument in support of a stable exchange rate between Canada and the US is the elimination of the "lazy manager" problem. This problem is said to arise, first, because an undervalued Canadian dollar leads our exporters to delay productivity-enhancing investments in machinery and equipment as they gain a competitive edge vis-à-vis their American counterparts. Second, it arises because a low dollar raises the cost of imports from the US, and thus lowers the incentive for Canadian businesses to invest in state-of-the-art machinery and equipment, which are most often produced south of the border. As a result, lazy Canadian managers keep our productivity and economic welfare from reaching US levels.

The problem with this argument is that it has nothing to do with the

volatility of the exchange rate, as John McCallum, current defence minister and former chief economist at the Royal Bank Financial Group, has pointed out. It has to do with the strength of the Canadian dollar. Now that the loonie has appreciated against the greenback, Canadian business managers should start taking advantage of the situation to improve their productivity. This would have been impossible if the Canadian dollar had been fixed at the low rate of, let's say, US\$0.62. But what about fixing the exchange rate now that the dollar is trading at above US\$0.70? Although it might lock in Canadian manufacturers' ability to enhance their productivity in the future, it will take away the boost to economic growth that a cheaper Canadian dollar will provide (in terms of enhanced exports) next time the US dollar becomes overvalued.

In conclusion, even if economic arguments were clearly in favour of a

monetary union between Canada and the United States, it is unlikely to happen as long as the symbolic values of the Canadian and American dollars remain high. As for dollarization, it is a non-starter since Canadians do not want to adopt the US dollar. This leaves the future open to either the status quo or a fixed exchange-rate arrangement such as a currency board or a soft peg. Since a fixed exchange rate would provide no net economic benefits to Canadians, we are better to focus our attention and energies on lowering remaining barriers to trade with the US (and the rest of the world), while ensuring that we maintain the current macroeconomic policies of low inflation and balanced budgets.

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