A Canadian Perspective on North American Monetary Union

by

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I. Introduction

Over the decade following the Bank of Canada’s 1988 “conversion” to price stability and the subsequent volatility in the Canada-US exchange rate there have been intermittent calls for greater exchange-rate fixity or greater Canada-US currency integration, e.g., Mundell (1990), Courchene (1990), Harris (1993). However, it was the advent of the Euro in January 1999 that unleashed a veritable flood of interest, papers and conferences on the evolution of Canada-US and North America currency arrangements. As an important aside, the awarding of the 1999 Nobel Prize in Economic Sciences to Canadian Robert A. Mundell provided a further catalyst since Mundell has long been an advocate of some version of Canada-US currency integration.¹ Focussing only on the various symposiums or conferences, one would include Western Washington University’s conference Should Canada and the US Adopt a Common Currency (parts of the proceedings of which appeared in the North American Journal of Economics and Finance); special issues of Canadian Public Policy (fall 1999) and Canadian Business Economics (IV, 1999); the Montreal conference Vers une monnaie unique in April of 2000 sponsored indirectly by the Quebec government, the North-South Institute conference To Dollarize or Not To Dollarize (Ottawa, October 2000); and, most recently, the November, 2000 Bank of Canada conference Revisiting the Case for Flexible Exchange Rates (the papers are available at the Bank of Canada Website at www.bankofcanada.ca/conference2000/papers.htm).

Despite this flurry of activity and interest, it is perhaps not surprising that there is no support for currency integration from Canada’s macro authorities. More surprising perhaps is that the clear majority of academic and private sector economists and financial analysts remain staunch supporters of flexible rates. For some, the reasoning may be that fixed exchange rates are
unsustainable, dollarization is undesirable, and a currency union is unattainable, so that flexible rates win by default. For their part, the general public is more inclined to embrace a common currency, although a little probing reveals that they believe that a formal link to the US dollar is more inevitable than it is desirable.

With this as backdrop, the purpose of this paper is to articulate a case for a fixed exchange rate between the Canadian and US currencies, the optimal form of which would be a Canada-US or a North American monetary union (henceforth NAMU), largely designed along Euro lines. Of necessity, this will involve repeating aspects of the analyses that Richard Harris and I have published elsewhere (1999, 2000). However, emphasis will be on recent analytical, empirical and policy developments that complement selected features of these earlier analyses.

While this paper is part of a session dealing with Western Hemisphere currency integration, it is clear that the reasons why Mexico or other Latin and South American nations might opt for currency integration are likely to be very different from the reasons why Canada might wish to pursue this option. For example, for most of the 1990s Canadian inflation rates and interest rates have been below those in the United States, so that issues relating to monetary stability and central bank credibility are not relevant to the Canadian case for a common currency. Nonetheless, the Canadian-specific nature of the first half of the paper will have some resonance for the rest of the hemisphere. And Mexico’s currency choices will certainly have an impact on the Canadian debate if not on policy itself.

As a bridge between this introduction and the ensuing analysis, it is instructive to focus on a case for North American currency integration that is not readily amenable to analytical or empirical
verification. This is the recognition that the Euro represents a watershed in the annals of economic and monetary history in that it signals the “de-nationalization” of national currency regimes. Relatedly, the advent of the Euro also signals that currency arrangements are emerging as supersessional public goods. The fullest articulation of this potential is probably that by Zanny Minton Beddoes (from the Washington Bureau of The Economist) writing in Foreign Affairs (1999):

When tomorrow’s historians look back at the recent financial crises and subsequent efforts to reform global finance, they will reach two conclusions. First, the grand rhetoric of creating a new global architecture yielded few results. Second, we failed to foresee the most profound consequence of the turmoil: regional currency unions. By 2030 the world will have two major currency zones – one European and the other American. The Euro will be used from Brest to Bucharest, and the dollar from Alaska to Argentina – perhaps even in Asia. These currencies will form the bedrock of next century’s financial stability.

What this means is that the likely currency choice facing Canada will not be between flexible rates and some version of currency integration, but rather between dollarization (i.e. employing the US dollar domestically) and, say, a North American monetary union. Were this the real choice, then Canada’s macro officials, economists and the general public would clearly opt for a monetary union. More on this scenario in the later sections of the paper.

I now turn to a discussion of the Canadian case for exchange rate fixity, beginning with some rather traditional arguments.

II. Traditional Pros and Cons of Exchange Rate Regimes

A: Falling Living Standards

As depicted by the dotted line in Figure 1, from a value of 104 US cents per Canadian dollar in 1974, the Canadian dollar now costs in the mid-60-cent range. (In terms of Canadian cents per US
dollar, the Canadian dollar depreciated from 96 cents per US dollar to roughly 150 cents of late). This represents an enormous fall in average Canadian living standards vis-à-vis those of Americans, especially since inflation and productivity were roughly similar in the two countries (although both were lower in Canada over the recent period, as will be elaborated later) and since traded goods loom so large for Canadians. Moreover, this depreciation of the Canadian dollar places our assets at bargain-basement levels for Americans. Even if one believes that ownership of assets, *per se*, should not be relevant, there are two reasons for concern here. First, some of these enterprises subject to takeover are fledgling knowledge-based and footloose enterprises where both people and technology are then transferred south of the border. Second, since part of the argument of those in favour of flexible rates is that monetary sovereignty (i.e. made-in-Canada interest rates and inflation rates) is important, then this sovereignty is rendered pyrrhic if at the same time it leads to much greater foreign control over Canadian assets.

Flexible rate advocates can counter aspects of this argument by noting that the general depreciation in the exchange rate was simply tracking fundamentals and, in particular, the recent sharp decline in commodity prices. Indeed, had the exchange rate not depreciated, the changes in fundamentals would have to be taken out internally. In the event, the depreciation not only accommodated falling commodity prices but did so in a manner that fully maintained Canada’s real growth over the period. This is the “exchange rate or buffer or safety valve” argument that looms so large for flexible rate proponents.

Intriguingly, the Bank of Canada has developed an exchange-rate forecasting equation that, in the Bank’s view, is characterized by “superior performance”. “It continues to track movements
in the Canadian dollar with surprising accuracy and has become an important part of the Bank of Canada’s internal forecasting exercise.” (Djoudad et al, 2000, 7). The forecasting equation explains the real value of the Canada-US exchange rate in terms of:

- the dependent variable, lagged one period;
- the non-energy commodity price index deflated by the US CPI;
- the energy-related commodities price index, similarly deflated;
- the Canada-US interest rate differential.

The second and fourth variables (non-energy commodity prices and the interest rate differential acquire positive coefficients (i.e., they cause the Canadian dollar to appreciate), while high real energy prices cause the Canadian dollar to weaken. Noting that this last result was “not expected”, given that Canada is a major energy producer, the Bank essentially rationalizes this in terms of our harsh climate and our energy-intensive production processes: Higher energy prices imply that “the Canadian dollar is forced to depreciate ... in response to the deterioration in our competitive position and the decline in our net worth” (Djoudad et al, 2000, 8). The solid line in Figure 1 presents the results of the Bank’s forecasting equation.²

The existence of this forecasting equation and the fact that any and all foreign exchange and currency analysts would surely be familiar with it, may actually create problems for the Bank and for the currency. At or near the depths of the summer 1998 Asian currency crisis, the Canadian finance minister took to the air waves to make the case that our currency should not be depreciating as much as it was since Canada was no longer as commodity intensive as it once was. But as long as the exchange rate is behaving along the lines of the forecasting equation, then the dollar is being driven by exchange rate “fundamentals” and, hence, all is OK. Or so it would appear if the Bank
indeed relies on this equation in terms of what is the “appropriate” exchange rate in light of the fundamentals. At times, therefore, the exchange-rate forecasting equation could well be driving the exchange rate!

**B: Volatility and Misalignment**

This caveat aside, much more difficult for the flexible-rate proponents to counter is the fact that the Canadian dollar has departed both upward and downward, and for substantial periods of time, from these underlying fundamentals (as is clear in Figure 1). In the literature, this is typically referred to as the “misalignment” problem or, in popular parlance, as the volatility issue. Again from Figure 1, the Canadian dollar went from 104 cents in 1974, to 71 cents in 1986, to 89 cents in 1991, to the low 70-cent range for most of the 1990s and then to 63.5 cents in summer of 1998 rebounding to upper 60-cent range for most of 1999 before falling back to mid-60-cent values. The problem here is that, within the integrating NAFTA context, “floating exchange rates provided inherently volatile and unpredictable cost structures” when what is really required are “stable and predictable rates of international exchange and cost calculations to support the volumes of trade and degree of specialization associated with [this trade]” (Harris, 1993, 40 and 39). This is especially the case as Canada moves from a resource-based economy to a human-capital-based economy, since this is a move away from organized commodity spot markets priced in US dollars and toward a regime where [generally unhedgeable] long-term bilateral contracts loom large within an economy with a substantial import competing manufacturing sector. On both these latter counts, exchange rate volatility is bound to be problematic.

In our earlier articles, Harris and I note that the asymmetric nature of these upside and
downside misalignments is economically very troubling. On the upside (a substantially overvalued currency), the degree of overvaluation swamps any possible role for productivity improvements to regain competitiveness. Hence, downsizing, outsourcing and exit become viable avenues for adjustment, especially if the overvaluation is deemed to be permanent. On the downside (i.e. substantial undervaluation) exports certainly do increase. However, other factors also come into play. First, undervaluation is a double-edge sword – productivity improvements (assuming that they are based on US imports or on intermediate goods priced in US dollars) become more expensive as the value of the Canadian dollar falls. (I shall deal with this important aspect in a later section). Second, the immediate impact of a depreciation is to shift relative incomes from wages to profits. Third, and relatedly, real wages in the US rise sharply relative to those in Canada and, as already noted, skilled labour begins to migrate in response to these higher paying jobs abroad. Thus, many firms will resist raising wages in the short run, and would rather use the depreciation to cut prices and build market share. If the low exchange rate persists, most firms will ultimately come to realize that longer term the situation is unsustainable – either they are going to have to raise real wages for their skilled workers or follow them to the U.S. Thus, the longer term legacy of repeated bouts of misalignment is likely to result in Canadian comparative advantage shifting toward industries that are resource-based and/or capital intensive, and with an employment base that is both less diversified and less-human-capital intensive than would be the case with exchange rate stability. This is not an appealing future in a world where economic growth is increasingly driven by knowledge and human capital formation.

I now turn in more detail to the exchange-rate/productivity linkage, with emphasis on some
novel analytical and empirical developments.

**III. Open Economy Endogenous Growth**

Consistent with the above reflections on the relationship between a weak currency and low productivity, is John McCallum’s “lazy dollar” hypothesis. For the record, one should probably note that McCallum (then the Chief Economist for the Royal Bank and now a member of Prime Minister Chrétien’s government) is one of the most ardent defenders of Canada’s floating rate. Writing in the *Current Analysis* series of the Royal Bank, he noted:

The idea that a weak currency induces “laziness” on the part of the manufacturing sector is not one that appeals to this author, but it seems to be broadly consistent with the data, [which] suggests a “double-dip” in Canada’s relative manufacturing productivity for the first half of the 1980s and then in the period 1994-97. Both of these periods correspond roughly to times of weak currency. Indeed, there is a positive and significant correlation (R=.45) between the Canada-minus-US productivity growth gap and the lagged value of Canadian unit labour costs in manufacturing relative to the United States (expressed in the same currency). So it may be that a weak currency has been a *cause* rather than a *consequence* of poor productivity growth in our manufacturing sector (1998, 3-4) [emphasis not in original].

In his more recent 1999 paper, McCallum quantifies this relationship – a 10 percent reduction in the Canadian currency is associated, two years later, with a 7 percent reduction in the ratio of Canadian to US productivity in manufacturing. Since Canada’s future living standards depend on productivity growth, this is an ominous finding indeed.

One way around this dilemma for flexible rate supporters was to point out that our productivity growth was essentially on par with that in the US, except for two sectors – machinery and equipment and computers and computer-related industries. But this is the new economy! – or more generally, this is the way in which the emerging GPT (general purpose technology) is working
its way through the system. A much more direct approach was the paper by Bank of Canada economists Lafrance and Schembria (2000) which argues and demonstrates that there is no link running from exchange rate depreciation to a widening productivity gap between Canada and the U.S. Indeed, they suggest that the reverse link is the more likely – higher productivity growth in the tradeables sector leads to a long run appreciation in the real exchange rate.

Two recent papers by Richard Harris make important further contributions to the analytical and empirical relationship between productivity and the exchange rate. The first of these (2001) borrows from the bourgeoning endogenous growth literature and treats productivity as endogenous within a macroeconomic framework with either fixed or floating exchange rates. This integration of the exchange-rate and endogenous-growth literature is long overdue. In the Harris model, there is an “old economy” (characterized by reduced growth opportunities and rigid labour markets) and a “new economy” (characterized by major growth opportunities and flexible labour markets). The drivers are a) the arrival of a new GPT (general purpose technology) that shifts these growth opportunities from the old to the new economies, and b) a price decline for the output produced in the old economy. In addition:

Labour market rigidities are present only in the Old Economy; these are modelled as a rigid nominal wage. Labour market equilibrium occurs in the Old Economy via changes in unemployment; these rigidities also serve as the rationale for the exchange rate to buffer Old Economy price declines – i.e. to prevent increases in unemployment. Nominal wages are fully flexible in the New Economy and adjust to equate labour demand to labour supply which is specific to each sector in the short run. In the short run labour supply is inelastic and specific to each sector. Over time labour is reallocated across sectors ... (Harris, 2001, 10).

The nature of the new equilibrium – arising from a) and b) above – depends critically on the
exchange rate regime. The intuition runs along the following lines. Under flexible exchange rates (where the exchange rate tracks or buffers the decline in commodity prices), output in the old economy is maintained, whereas under fixed exchange rates the price of output falls in the old economy and the excess workers transfer to the new economy. Moreover, under the flexible-rate buffering the domestic costs of innovation and technology rise (since they are assumed to be priced in foreign currency) which implies that the spread of the GPT is slowed down and, therefore, so is productivity growth. On both counts, therefore, buffering reduces productivity growth.

Harris reflects on the potential policy implications of his model as follows:

In one sense this argument is just an extension of the ‘common shock’ case for currency unions. In this case a common GPT has hit both countries. With large trade volumes and substantial factor mobility between regions there is no particular case for using an exchange rate change to buffer adjustment in one country relative to another and moreover the consequences of attempting to do so could be harmful. In the Canada-U.S. context it would suggest yet another reason as to why Canada’s floating rate regime should be re-examined. The asymmetry in this case clearly works against Canada which is both small and well endowed with Old Economy natural resources. This is yet another argument which supports Robert Mundell’s contention that Canadian-U.S. living standards are unlikely to converge until Canada either fixes its exchange rate against the U.S. dollar or enters a monetary union with the United States.

In my view, this endogenizing of productivity in open-economy macro models will trigger a flurry of papers which will focus theorizing on the important relationship between exchange rate regimes and productivity which, in turn, will lead to hypotheses amenable to statistical testing.

Harris’ second paper *Is There a Case for Exchange Rate Induced Productivity Change?* (2000) begins the empirical testing of the implications of his theoretical model. His final paragraph runs as follows:

[The paper has focussed on] international industry productivity dynamics using a
conditional convergence framework in conjunction with a set of exchange rate misalignment measures. The results are consistent with a model in which, for highly open economies, exchange rate undervaluation carries short-term benefits in terms of productivity growth but long term costs in terms of productivity performance. The evidence is consistent with theories which suggest that sustained undervaluation appears to lead to deteriorating productivity growth. Whether this will hold up under other approaches and with other data sets should be an important item on the research agenda of both productivity researchers and international economists concerned with the exchange rate as a transmission mechanism in open economies (2000, 24).

Harris’s concluding section is also an appropriate conclusion for this section.

**IV. Flexible Rates and Asymmetric Shocks: A Fresh Perspective**

As noted, those who defend the floating Canadian dollar typically emphasize the potential safety-valve or buffer role of the exchange rate in terms of accommodating the asymmetric shocks that hit the Canadian economy. There is, of course, considerable merit to this argument. However, in the preceding section I attempted to make a case, based on recent research by the Richard Harris, that under certain circumstances the presumed advantages associated with exchange rate buffering may well be illusory. Admittedly, this analysis incorporated two types of shocks – a “common” shock (namely, the GPT) and an asymmetric shock (the fall in commodity prices). In this section I want to focus only on asymmetric shocks and to argue that the traditional approach to exchange rates and asymmetric shocks is off base in terms of the emerging geo-political realities and Canada-US economic integration.

Toward this end, Chart 2 presents the evolution of Ontario’s interprovincial and international exports over the last two decades or so. From a position in the early 1980’s where Ontario’s international and interprovincial exports were both running at $40 billion, by the late 1990s
Ontario’s international exports were running at nearly 3 times the level of its exports to other provinces. As a percent of Ontario’s GDP, the market value of Ontario’s international exports now exceeds 50%. Since just over 90% of Ontario’s international exports are to the US, the value of Ontario’s north-south exports is running at roughly 45% of its GDP.

This rapid shift from east-west to north-south trade applies to other provinces as well. Indeed, in 1996 all but two of Canada’s ten provinces exported more to the rest of the world (international exports) than they did to the rest of Canada (interprovincial exports). At the aggregate or all-province level, for each dollar of interprovincial exports in 1996, international exports were running at $1.83. In the early 1980's, the opposite was the case: interprovincial exports were running above international exports (Courchene and Telmer, 1998). Since over 80% of Canada’s international exports are destined to the US, it is clearly the case that, in the aggregate, north-south trade exceeds east-west trade.

Among the implications that can be drawn from this are the following. First, given that, on average, 63% of the exports of the 15 EU countries are to their sister EU countries, whereas well over 80% of Canada’s exports are to the US (Courchene, 1999), on economic integration grounds the argument for a common currency or for Canada-US currency integration is at least as compelling as that of the Euro for the average EU member state. Second, and much more important to the issue at hand, Canada is progressively less and less a single east-west economy, and progressively more and more a series of north-south (cross-border) economies. Third, these east-west series of cross-border economies are marching to quite different cyclical forces in terms of their business cycles.

This vision of the geo-economics of the upper half of North America leads to a fresh
perspective on the issue of external shocks that supposedly impact on Canada and the US asymmetrically. Consider the following thought experiment. British Columbia aligns its policies to become competitive in the American Northwest and the Pacific Rim. Likewise, support Alberta sets its domestic cost and tax parameters so that they are on par with its competitors in the Texas Gulf. And Ontario and Quebec gear their economic policies to match those of the US Great Lakes states. Ditto for the Canadian and American bread-baskets and also for Atlantic Canada as it pursues its more complicated economic future with respect to the New England states and the Atlantic rim. In any event, the scenario assumes that each province or region has aligned itself to be competitive with its cross-border counterpart.

Now comes a commodity price shock (say an increase in commodity prices). Such shocks are typically viewed as asymmetric since Canada is a larger commodity producer (as a share of GDP) than is the USA. \textit{Initially, however, this shock affects each side of every regional cross-border economy similarly, i.e. there is no regional cross-border asymmetry.} B.C. lumber is affected in the same way as north-west US lumber. Alberta oil faces the same price change as Texas Gulf oil. Oshawa/Windsor are still in step with Detroit in terms of autos, and so on. However, if the commodity shock is accommodated or “buffered” via an appreciation of the Canadian exchange rate (vis-à-vis the US dollar), \textit{then all of the Canadian provincial/regionaleconomies are now offside with respect to their American counterparts.} In my view, this is inappropriate policy, especially if this exchange rate “buffering” is also associated with exchange-rate overshooting or misalignment. Arguably, each Canadian trading region would prefer to maintain exchange-rate and transactions certainly with \textit{both} east-west and north-south trading partners. This necessarily implies exchange-
rate fixity relative to the U.S. dollar.\textsuperscript{5}

But this cannot be the end of the asymmetry story since the focus has thus far only been on what might be termed the “regional” component of a supply or demand shocks. Assuming that this shock is related to commodities or resources, there is also a “national” component to the shock since commodities/resources represent a much larger percentage of overall output in Canada than in the US. There are two components to this “national” asymmetry. One is a Canada-US component, since any change in, say, commodity prices will, as noted have a larger overall impact on Canada because commodity-based goods and services are a larger component of Canadian GDP than US GDP. The second component relates to “east-west” asymmetry since, along the lines of the original Mundell paper (1961) the really important asymmetries are east-west. Both require some “buffering”, to use the Bank’s term, but not necessarily of the exchange-rate variety. How is buffering accomplished with a fixed exchange rate?

The answer is at least three fold. The first mechanism is, of course, the internal adjustment of prices. Note that this is not as significant a challenge as might at first be imagined, because the terms-of-trade shocks affects both cross-border sides of the regional economies in a similar fashion, i.e., it is the exchange rate response, not the commodity price shocks, that triggers the cross-border disequilibrium for Canada’s regional economies. Phrased differently, we allow Canadian regions to adapt in the same way that their regional U.S. counterparts do.

Second, if there is a significant commodity price shock, fiscal stabilization will have to play a role. But this has always been an integral part of the philosophy underpinning fixed exchange rates. Moreover, it is probably important that individual provinces/regions become involved in the fiscal
stabilization of the exchange rate. In particular, and as argued in Courchene (1990), one would expect that economies that are beneficially affected by a favourable terms of trade shock to their own region would use their fiscal levers to temper their booms.

The third adjustment mechanism is arguably the most important, since it addresses the east-west or internal asymmetry within Canada. In the case of regional-specific shocks there are already national policy mechanisms to deal with this – the national tax-transfer system, unemployment insurance, federal-provincial equalization payments, internal migration, and the like. And apart from internal migration, all of the rest are triggered automatically, i.e., they operate as automatic stabilizers.

Hence, it is simply not the case that efficient adjustment to external price shocks requires a floating exchange rate. Indeed, the adjustment mechanisms underpinning exchange rate fixity are, arguably, more appropriate for an integrating North America. At the very least, this distinction between “regional” and “national” asymmetry merits further research.

V. McKinnon, Mundell and Demand-Side Buffering

In a paper celebrating Bob Mundell’s Nobel Prize, Ron McKinnon (2001), himself a pioneer of the optimal currency area literature, focusses on what is an intriguing paradox: while Mundell is frequently heralded as the “intellectual godfather of the Euro,” those economists opposed to the Euro also base most of their arguments on Mundell’s 1961 seminal article. McKinnon attempts to resolve this paradox by noting that there are really two Mundell models. The second is found in two papers prepared for a 1970 Madrid conference on optimal currency areas, but published only in 1973 and
then in a not-widely-accessible Conference volume. McKinnon notes that in these two papers (1973a and 1973b), Mundell “jettisons his earlier presumption of stationary expectations to focus on how future exchange rate uncertainty could disrupt the capital market by inhibiting international portfolio diversification and risk-sharing.” For present purposes the most important of these two papers is “Uncommon Arguments for Common Currencies” (1973a), on which McKinnon comments as follows:

[The emphasis on the forward-looking nature of the foreign exchange market] counters the idea that asymmetric shocks – i.e. those where an unexpected disturbance to national output affects one country differently from another – undermine the case for a common currency. Instead, Mundell showed how having a common currency across countries can mitigate such shocks by better reserve pooling and portfolio diversification. A country suffering an adverse shock can better share the loss with a trading partner because both countries hold claims on each other’s output in a common currency. Whereas, under a flexible exchange rate without such portfolio diversification, a country facing an adverse shock and devaluing finds that its domestic-currency assets buy less on world markets. The cost of the shock is now bottled up in the country where the shock originated.

It is important to note that this argument for currency integration is largely absent from the Canadian debate and I suspect elsewhere as well. In particular, when flexible-rate enthusiasts wax eloquent about the buffering potential of a floating rate, there are focussing only suppliers and/or producers, i.e. a depreciating exchange rate can buffer a fall in commodity prices and benefit producers generally, although earlier I argued that buffering may well be a mixed blessing if it serves to reduce productivity growth. What McKinnon effectively points out, drawing from the 1973 Mundell contributions, is that there is also a “demand-side” effect of exchange rate buffering, and one that tends to offset the much-touted positive potential of exchange-rate flexibility. Moreover, policy measures that limit portfolio diversification across currencies (e.g. the foreign asset limitations
applicable to Canadian pension funds) enhance the role of this demand-side offset.

**VI. Recapitulation and Transition**

The intent of the analysis thus far has been to argue that the case for Canada-US currency integration is much stronger than is generally realized, even by those disposed toward a closer Canada-US exchange-rate link. Nonetheless, the debate continues to be waged in terms of a set of arguments that the march of events and theory are passing by. Hopefully, some of the newer approaches to exchange-rate regimes elaborated above will begin to inform the debate.

This aside, what has not as yet been broached is the nature of this currency integration. In our various papers, Harris and I express much more confidence than most economists in Canada’s ability to successfully maintain a sustainable fixed exchange rate, as, for example, the Dutch and the Austrians have been demonstrably able to do. And we certainly could guarantee a truly fixed link if we went to a currency board. However, given the “Currency Consolidation in the Western Hemisphere”, theme of this session, the focus of the rest of the paper will be on the manner in which North America and perhaps the Western Hemisphere might evolve into a currency union along the Euro lines. In the final sections of the paper, some attention will be directed to the various forces that might propel Canada and North America toward this end.

**VII. NAMU: North American Monetary Union**

A: The Nature of NAMU
NAMU would be, depending on one’s perspective, a Canada-US, or North American, or Western Hemispheric equivalent of the Euro and European monetary union. In its “steady-state” version, NAMU would have characteristics along the following lines (where, for illustrative purposes only, the focus is on Canada-US monetary union):

- The overarching institution would be the Federal Reserve Bank of North America (FABNA) or perhaps wording along the lines of the North American Monetary Authority or the Central Bank of the Americas;

- The Bank of Canada would have a seat on the board of directors of the FRBNA. The Americans would maintain voting control of FRBNA, since it is probably appropriate to assume that each of the 12 existing Federal Reserve Banks would also have a seat on the board. This approach to the board of directors of the FRBNA makes it much easier for the US to be interested in a supra-national central bank, since it would always retain majority control;

- The US dollar would continue to be the US currency. Since the US dollar is the world’s foremost currency, why would anyone want to suggest it ought to disappear? This would not make economic sense, nor would it make political sense, since Americans would never tolerate initiatives toward currency integration that would involve the undermining, let alone the demise, of their currency. Nor should they.

- Canada could retain currency symbolism, should it so wish. For example, one side of the new currency (say the $5 bill) would state that this is North American legal tender, fully and costlessly exchangeable with a US $5 bill, or some similar words to the same effect. The other side could be emblazoned with a prairies or rockies or maritime landscape. This was the original design for the Euro currency – a common side and a “landscape” side for each country. This approach was abandoned at the 11th hour, although the Euro 1 and 2
coins will differ by county on one side of each coin.

- The Bank of Canada would issue the new currency, at least for the smaller denominations, in the same way as the 12 Federal Reserve Banks currently issue the currency in their own jurisdictions. This automatically allocates seigniorage appropriately. If the larger bills are to be issued by the FRBNA, then provisions for allocating seigniorage will have to be negotiated.

- Canada would be free to maintain its policies and its regulatory approach toward financial institutions and to the financial sector. For example, the Bank of Canada could continue to conduct clearings on a national basis and then clear with the other members of NAMU.

- Even if, say, Canada, Mexico and the US agreed to establish a NAMU, the lead time would likely be in the nature of a decade, as it was in Europe.

- One of the roles of this lead time would be to enable countries to evolve toward an appropriate conversion rate for entering NAMU. It may also be appropriate on this side of the Atlantic to implement some version of the EMS in order that countries can iterate or grope their way toward an appropriate conversion or “entry” exchange rate;

- As an important aside, during this convergence period, Canada should work down its debt/GDP ratio to the US level in order to ensure that we have equivalent flexibility on the fiscal side to that of the Americans. This is a version of the Maastricht guidelines under the Euro.

- Finally, and by design, there would no longer be a Canada-US exchange rate.

While there presumably are many other visions of currency integration in the Americas, the above version will provide the benchmark for the remainder of the analysis.

One of the typical responses to this approach to NAMU is that it essentially involves adopting the US dollar as our currency. This being the case, why do we not simply declare the dollar as legal tender in Canada and do away with the various embellishments elaborated above? The answer is not only that NAMU and dollarization are very different, but that NAMU is much the preferred alternative as the next section attempts to detail.
B: Dollarization

In our 1999 article, Harris and I addressed two conceptions of dollarization. The first of these we termed “policy dollarization,” defined to refer to an official decision by the policy authorities to proclaim the US dollar as legal tender. While this is what Ecuador recently did and perhaps what Mexico has been thinking about, it is highly unlikely that Canada would ever go this route. To be sure, policy dollarization would, in a sense, be the ultimate exchange-rate “fix” or the ultimate in currency integration. And it could be done unilaterally whereas NAMU would require US cooperation. But the downsides are very significant. Canada would lose its existing seigniorage. (As an aside, Senator Mack of Florida has tabled a bill that would return some of the seigniorage back to the countries that formally dollarized. This bill is very unlikely to see the light of legislated day). Canadians would also lose currency symbolism, since the Canadian dollar would cease to exist.

As worrisome, many of our institutions would likely begin to operate north-south, away from the current national (east-west) mode. For example, it is likely that the clearings system under dollarization would progressively operate north-south (or cross-border) by region. Under a NAMU framework, Canadian clearings would occur under the purview of the Bank of Canada and, therefore, would continue to clear nationally before internationally. Moreover, our financial institution regulation would, under dollarization, begin to fall into the US orbit and ambit. Finally, but not exhaustively, there would be no rationale for the Bank of Canada so that it would presumably disappear. One implication of this is that dollarization would be very difficult to reverse, since we would have to begin everything anew.

While “policy dollarization” is very unlikely, let alone on the radar screen, what we term
“market dollarization” is nonetheless proceeding rather quickly in Canada – market dollarization is a scenario in which Canadian private sector agents progressively conduct their affairs in US dollars. On-going examples include a) the increased tendency, especially for high-tech firms, to prepare their books in US dollars, among other reasons for listing on US exchanges or for raising capital; b) remuneration of senior employees being set in US dollars; c) the move by the Montreal Stock Exchange to establish a NASDAQ satellite which will trade in Canada in US dollars, etc. If this proceeds unabated, there will come a point where the march of market dollarization begins to seriously affect the ability of the Bank of Canada to conduct monetary policy, since so much of domestic economic activity would be in the US currency area. While Canada is not yet at this threshold, it is unclear just how far away we are from it.

My view is that both external events (e.g., further Canada-US and North American trade integration, moves by Latin and South America to forge closer currency links with the dollar) and domestic developments (beyond those listed above, one might expect increased market dollarization if the Canadian dollar continues to exhibit its recent volatility), will propel Canada in the direction of market dollarization and which, in turn, will generate increasing interest in some version of NAMU as a way to fend off using the US dollar as our domestic currency. One obvious implication is that a move now toward fixed exchange rates might stave off some of the trend toward market dollarization, since exchange rate fixity would address most of the concerns highlighted in the earlier parts of this paper.

C: Would the Americans Ever Embrace NAMU?

The prevailing view among Canadians is that the US would never accede to the requisites of
NAMU. This may well be true. Even so, it is instructive to delve a little deeper here. Assuming that the Euro rebounds from its mid-80 cent range and that in tandem with the advent of Euro currency and the deepening of Euro short-term markets this serves to make the Euro a meaningful competitor to the US dollar in global portfolios. And soon it will become either the effective circulating currency in more than a score of countries and de facto in several more (via currency boards or fixed exchange rates). It will be interesting indeed to watch what the Russians do when the Euro currency finally comes into existence. At any rate, the issue here is that the Americans, in the wake of a growing Euro currency area and a growing Euro influence, may well be in favour of having a larger formal US dollar area, especially given the US proclivity to run huge current account deficits. To this one should add that repeated currency implosions in Latin and South America cannot be in the economic or geo-political interest of the US. Presumably it is reasons such as these that have triggered suggestions from various quarters (e.g., Robert Barro, 1999) to the effect that the US should encourage dollarization, Likewise, such rationales no doubt underpin the Connie Mack Senate bill referred to earlier.

While the US may well be sympathetic to this line of reasoning, a generous approach to encouraging dollarization might meet its objectives. Why would it go the further route of effectively opening up the Federal Reserve Board to “districts” comprised of foreign central banks, even under the earlier-elaborated rules where the Americans would clearly maintain majority control of and FRBN? . My hunch is that they would not do this as an opening gambit. Rather, the evolution toward an FRBNA and a NAMU may well be along the following lines:

· Several larger countries opt to use the US dollar (i.e. opt to dollarize), perhaps as
a parallel currency;

· As the currency becomes entrenched and mechanisms are developed for clearing and seigniorage, the stage will be set for those countries to also establish some mechanisms for informal consultations with the US Federal Reserve;

· As more countries use the dollar, some effective power begins to shift to these dollarized countries. Phrased differently, the US Fed will want to manage some of these “externalities” (e.g. a large country abandoning dollarization, and throwing excess dollars on the market), so that it too, will want to engage in informal discussions;

· Such informal discussions would represent, to my mind, the beginnings of a shared input to US monetary policy. Over time, the informal arrangements would extend to other areas and, in some areas, would become more formalized.

· With this as the evolutionary path, the eventual embracing of some version of NAMU would not be the revolutionary step that it is always made out to be.

While this is entirely speculative, its possibility may well serve as a catalyst for some countries to dollarize, since their hope is that this may lead to a common currency. Presumably, this is behind Vicente Fox’s proposals for an eventual broadening and deepening of NAFTA, including the adoption of a common North American currency. Were Mexico to receive some positive feedback from its NAFTA partners on this proposal (which have not been forthcoming), the very eventuality of a deeper integration could serve as a catalyst for making the $US dollar a parallel currency, since this would set the above (speculative) process in motion.

At this juncture one should note that a decision on the part of Mexico to dollarize could have quite dramatic implications for Canada. Already there is concern about our shrinking North American share of inward foreign direct investment. Were Mexico to embed its existing wage advantage within the context of a stable currency regime, its attractiveness as a North American business location would be much enhanced. My hunch is that Canadian businesses would begin to
exert greater pressure on our policy authorities for granting currency integration a more sympathetic hearing.

**D: Sovereignty**

The issue of sovereignty is never far from the surface in terms of any discussion of NAMU or a common currency. One of the key messages that I take from the advent of the Euro is that 21\textsuperscript{st} century sovereignty will have much less to do with having one’s own currency than had heretofore been appreciated. As noted in the introduction, currency arrangements are clearly moving in the direction of being viewed as a supra-national public good. But this does not end the sovereignty concern. In Canada, for example, there is a widespread view that a move to a common currency will be tantamount to becoming more “Americanized” across a broad range of policy areas. In our earlier writings (1999, 2000) Harris and I respond to this by noting that Canada’s heyday in terms of charting a direction different from the Americans on social policy was the decade of the 1960s. Yet this was the very decade when we had fixed exchange rates. Hence, buying into US monetary policy in the 1960s did not mean that we bought into US social policy. Indeed, the opposite was the case.

There is another aspect to the sovereignty issue. In his reflections on North American currency integration, Willem Buiter (1999) concludes as follows:

While the economic pros and cons of NAMU are rather finely balanced, the political arguments against it appear to be overwhelming. The absence of effective North America-wide political institutions means that there could be no effective political accountability of the NAMU Fed. The surrender of political sovereignty inherent in NAMU would therefore not be perceived as legitimate by a sophisticated citizenry, used to accountability as a right not as an optional extra.
Critics of EMU have pointed out that the EMU is a small, flightless bird, surviving precariously in arid surroundings. I actually believe that the EMU will fly, and that it will prosper, because it is part of an ongoing process of political unification in Europe. NAMU, however, will not fly, except as part of a wider political movement toward far-reaching political integration, a United States of North America. And there is no sign of that (Buiter, 1999, 302).

I agree that political accountability is important: this is among the reasons why I am placing so much emphasis on NAMU and little if any on dollarization. In this sense, therefore, I am also placing emphasis on the likelihood that the US will open up the management of the FRBNA to voting representation from Canada (and Mexico ...). That this might only be one seat on the board compared to, say, 12 for the US Reserve Banks is not all that problematical, since if Britain joins the Euro it will only be 1 of 12 members (and soon more like one of 20).

If we cannot get acceptable access to the governance of NAMU, then one alternative would be a currency board arrangement which would follow the broad lines of the NAMU arrangement (e.g. issuing a new Canadian currency, etc.). This would satisfy any and all political accountability issues. This, not flexible exchange rates, may be the fallback option.

Relatedly, thus far, all of the above discussion of sovereignty assumes that the choice facing Canada and Canadians is between flexible rates and NAMU. Reality might be different: the choice could well be between dollarization and NAMU. Here, any recourse to sovereignty issues would clearly favour NAMU.

Nonetheless Buiter’s point remains important: because NAFTA is not intended to evolve in the direction of a political union, we will have to become quite creative in finding approaches to the governance of a common currency that can accommodate some degree of political accountability
for all parties.


Endnotes

1. Included among Mundell’s many activities and appearances in Canada over the past year was a week-long debate in the pages of the National Post with Milton Friedman on alternative currency regimes in North America and elsewhere. The full e-mail interchange is at www.nationalpost.com/currency.

2. The forecast values in Figure 1 are derived from what the Bank calls a “dynamic simulation”. Specifically: “The simulation begins with the actual value of the exchange rate, but in all subsequent periods, its level is determined solely by the estimated parameters and the values of the independent variables. No updating of the dependent variable is allowed, (Djoudad et al, op. cit., 8). This makes the forecasting performance in Figure 1 very impressive indeed.

3. Actually, the following exchange rate values are month-end values, while the data in Figure 1 are quarterly data, so that there may be slight differences.

4. The remainder of this paragraph is essentially a direct quotation from Harris and Courchene (2000, 6).

5. Readers will recognize that this is a variant of the argument in the original (1961) paper by Mundell – the asymmetries are east-west, not north-south.

6. While Grubel (1999) also argues in favour of a North American currency union, he envisions the creation of an Amero which would replace all the existing currencies, including the US dollar.