

## Common currency with the United States It's not worth the risk

*Now that the dollar is worth more than the greenback, the argument for a monetary union with the two other NAFTA (North American Free Trade Agreement) partners has resurfaced. According to proponents, the loonie's volatility is very bad for the Canadian economy.*

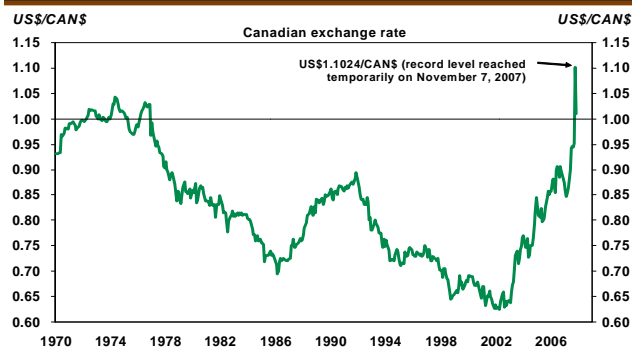
*Our dollar's strong appreciation since 2002 can be explained by a number of fundamental changes that have affected Canada and the United States differently, for example, the evolution of our public finances, the rise in commodity prices, and the broadbased weakness of the greenback. For the most part, the loonie seems to have played its role well by tempering some of the effects of upheavals on the Canadian economy. Had the dollar not risen, the Bank of Canada would have had to substantially raise interest rates to prevent an inflationary spiral, a move that would have been painful for both Canadian households and businesses.*

*The Canadian economy's robust performance since the adoption of an inflation target, which calls for a floating currency, leads us to believe that the loonie's fluctuations are not as harmful as proponents of a common currency would have us believe. Canada is fortunate to have a coherent monetary regime that has stood the test of time. Nothing currently justifies such a draconian change as abandoning the loonie and the inflation target. Moreover, North America, dominated by the United States, lends itself very poorly to a monetary union modelled after the euro zone.*

The idea of a common North American or even continental currency has resurfaced because the Canadian dollar has recently reached parity with the U.S. dollar for the first time in 30 years (Graph 1). This option is not at all farfetched given that we now live in an age of globalization where borders are being erased. It is also not new: this idea already made headlines at the turn of the century when the euro was introduced and the loonie hit an all-time low.

There is no denying that the Canadian dollar's surge to its recent high of US\$1.10 should give us pause. Even the Bank of Canada (BoC) admits it is perplexed about some of the movements. The Bank's Senior Deputy Governor Paul Jenkins recently stated that "the recent appreciation appears to be stronger than historical experience would have suggested." Moreover, from a practical viewpoint, it is true that adopting

**Graph 1 – The Canadian dollar is stronger than ever in relation to the greenback**



Sources: Global Financial Data, Datastream and Desjardins, Economic Studies

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the U.S. dollar would be easier today. Adjusting the price of assets would be simplified by the fact that the loonie's value is so close to the greenback's. However, monetary policy is one of the main pillars on which a modern economy like Canada's rests. Before resorting to a drastic change, the repercussions must be carefully weighed. A common currency means, among other things, that the BoC would have to abandon its inflation target and range. Moreover, unlike free trade, a common currency is not a plus-sum game. Everything depends on the situation and nothing ensures that a country will benefit from adopting a common currency. After an overview of the main issues involved in the debate, we will show that a major change in our monetary regime does not appear justified at this time.

#### **FIXED EXCHANGE RATE, DOLLARIZATION, MONETARY UNION...**

Canada has a number of options to eliminate its currency fluctuations against the greenback. First, the government could simply declare that as of a certain date the value of the loonie will henceforth be pegged at US\$1 or another rate. It would then ask the BoC or a currency board to intervene in the market to ensure the rate is maintained. The BoC would often have to adjust its rates to support the dollar. However, experience shows that such a regime is not always sustainable. Sometimes, the interventions required to support the currency can become very costly and even unsustainable for the monetary authorities. The fixed exchange rate regime therefore runs the risk of collapsing and causing major economic disruptions, as was the case in Argentina at the beginning of the decade. This type of regime is therefore not very appealing for a country like Canada, which already has an effective monetary framework.

If Canada decides to fix its currency, it should choose a more lasting solution. One option would be to replace the loonie with the U.S. dollar, sometimes referred to as dollarization. This could be done officially, in the form of a government decree, or *de facto* if our economic agents began increasingly using the greenback on their own initiative. Given that dollarization does not require the agreement of the United States, Canada could make a unilateral decision in this regard. Some small countries, for example, Ecuador and Panama, have a dollarized system.

Another option is to negotiate a monetary union with the United States and perhaps other countries. In this case as well, the Canadian dollar would be eliminated and replaced by the greenback or another currency. A monetary union would offer a few additional advantages but would entail long and complex negotiations. Unlike dollarization, a monetary union could allow Canada to continue collecting seignorage revenue, i.e., revenue associated with producing

currency, based, for example, on its economic weight. We estimate that the Canadian government earns some \$2 billion per year from the production of banknotes and coins. However, given the economic dominance of the United States, we feel that a North American monetary union would not be much different from dollarization. Monetary policy would be controlled by Washington, and Canada would have very limited influence.

#### **WHY SOME PEOPLE WANT A COMMON CURRENCY?**

Some arguments in favour of a common North American currency have unquestionable merit. Given that the Canadian and U.S. economies are highly integrated, it would certainly be practical for businesses and consumers to always transact in the same currency. A few years ago, the annual cost associated with US\$/CAN\$ transactions was estimated at \$2.9 billion.<sup>1</sup> Eliminating foreign exchange risks and the costs companies incur to protect themselves against dollar fluctuations would also make their lives easier. While substantial, these savings alone do not justify abandoning our floating exchange rate and inflation target regime. It would be irresponsible to jeopardize the macroeconomic stability of our economy just to save a few billion dollars in transaction costs.

However, a stronger but harder to quantify argument used to promote a common currency is that the tremendous volatility of the loonie has very negative effects on the Canadian economy and can no longer be tolerated. At US\$0.65, the dollar was said to make businesses lazy and unproductive. Today, at above parity, the dollar is said to undermine the international competitiveness of our exporters and jeopardize important sectors of our economy. Some also say that the volatility of our currency discourages foreign investment. These arguments must be examined more closely. It is true that our dollar has been on a roller coaster for a few years now, ranging from US\$0.62 in the early 2000s to the recent high of US\$1.10. Such changes certainly have a big impact on the Canadian economy. If these movements were completely unjustified, for example, if they were simply due to speculation, it is true they could seriously harm our economy and perhaps even justify the adoption of a common currency.

#### **REASONS FOR AND CONSEQUENCES OF THE LOONIE'S VOLATILITY**

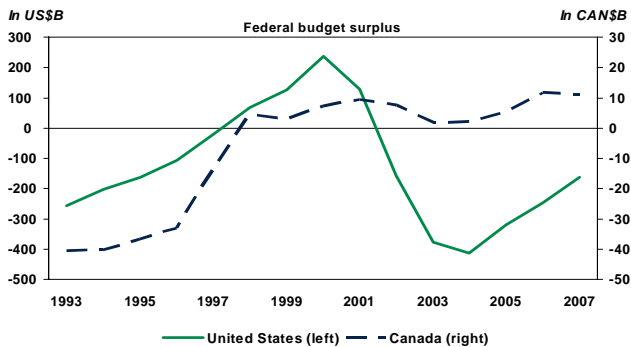
By definition, it is normal for a currency to fluctuate in a floating exchange rate regime. It is important to understand that regardless of the monetary regime, if an economic shock

<sup>1</sup> William B. P. ROBSON and David LAIDLER, "No Small Change: The Awkward Economics and Politics of North American Monetary Integration," C.D. Howe Institute, 2002.

affects two economies differently (asymmetrical shocks), the relative prices of the two economies will have to adjust to reflect the new reality. For example, to re-establish its competitiveness after the introduction of the euro, Germany suffered a number of years of weak economic growth, which held back wage and price growth. In a floating exchange regime, some of the adjustment is made through foreign exchange rates, which cushion the effect of asymmetrical shocks. Given that prices and wages tend to adjust less quickly than exchange rates, some economists believe that a floating exchange rate is better because it allows for a faster and less painful transition.<sup>2</sup>

In our view, the dollar's strong appreciation in the last few years is largely justified by several fundamental changes. First, public finances have taken a very different direction north and south of the border. The Canadian government, which appeared to be headed for bankruptcy in the 1990s, is awash with surplus cash, while the war on terrorism and generous tax cuts have taken a toll on the U.S. budget (Graph 2). The positive effects of restored public finances on the Canadian economy and on the loonie highlight the importance of choosing the right policies. If the various levels of government continue to manage Canada responsibly and avoid budget deficits, it would have the added benefit of helping to stabilize our currency.

**Graph 2 – Unlike Canada, the budget situation in the United States has significantly deteriorated**

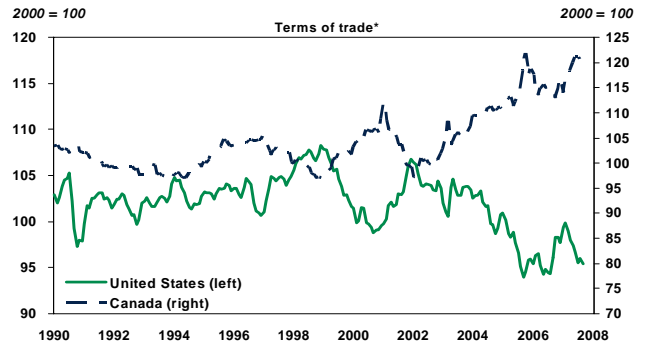


Sources: Statistics Canada, Bureau of Economic Analysis and Desjardins, Economic Studies

Moreover, the rise in commodity prices has been to the decided advantage of Canada and to the detriment of the United States. This is because their industrial structures differ, i.e., Canada is a major exporter of commodities whereas the United States is a net importer. The exploitation of the Alberta tar sands has made this difference even more pronounced. The change in terms of trade (export/import prices) over the

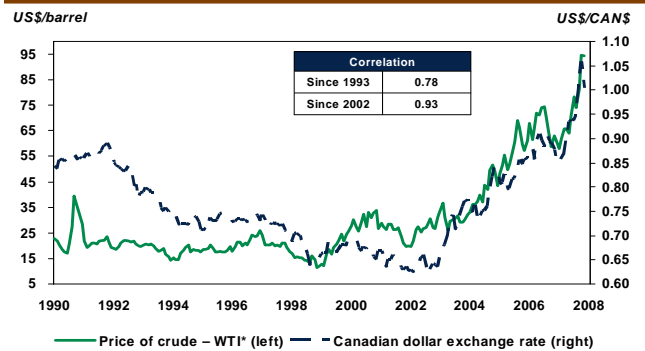
<sup>2</sup> John MURRAY, "Why Canada Needs a Flexible Exchange Rate," working paper of the Bank of Canada, 1999.

**Graph 3 – Canadian and American terms of trade have gone in opposite directions**



\* Ratio of export to import prices.  
Sources: Statistics Canada, Bureau of Labor Statistics and Desjardins, Economic Studies

**Graph 4 – The vitality of the loonie reflects high oil prices**

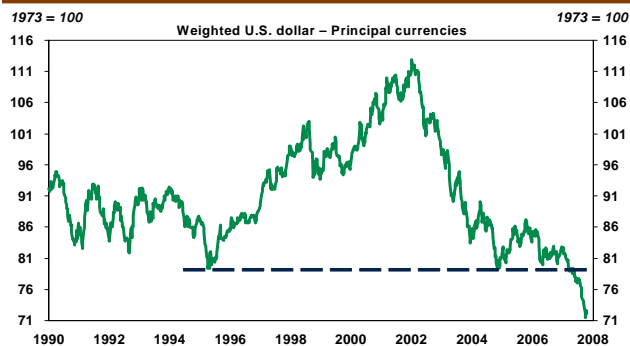


\* West Texas Intermediate.  
Sources: Statistics Canada and Desjardins, Economic Studies

past few years clearly shows the contrasting reaction of both economies (Graph 3). It is perfectly normal for the currency of resource-based countries such as Canada and Australia to appreciate in relation to others when commodity prices go up (Graph 4). The opposite happened in 1997 when the Asian crisis drove commodity prices and the Canadian dollar down. Lastly, it bears mentioning that a number of factors, including the ballooning U.S. trade deficit, have been dragging down the greenback in the last few years (Graph 5). It is also perfectly normal that the Canadian dollar benefit from this depreciation.

In our opinion, the Canadian dollar has been an effective shock absorber for the Canadian economy. Try to imagine what would have happened if the dollar had held steady at around US\$0.70 in the last five years. Initially, the rise in commodity prices would have created an even bigger boom in Western Canada as international investors would have been able to invest in the tar sands at a lower cost. The economies of the other provinces would also have grown more quickly, because U.S.-bound exports would not have been held back. However, such frenetic economic activity would have quickly fuelled inflation, and the BoC would have

**Graph 5 – The U.S. dollar index fell to a historic low**



Sources: Federal Reserve Board, Datastream and Desjardins, Economic Studies

had to raise interest rates by several percentage points to rein in the economy. At best, we would be in a situation, not unlike today, where high interest rates would have effectively slowed down the economy but pummelled businesses. At worst, inflation would have spiralled upward, causing the economy to overheat and subsequently plunging us into a recession. Note that had we adopted a common currency at the beginning of the decade, we would not even have been able to raise rates, and the risk of overheating would have been even greater.

While we find the dollar's general trend justified, we admit that not all of its movements can be easily explained. The dollar has at times been excessively volatile, particularly when it jumped to US\$1.10. Just as in other financial markets, there is speculation on the foreign exchange market, which tends to increase volatility and directional movement, i.e., overshooting. This reality is one of the disadvantages of a floating currency, which can cause major headaches, especially for exporters. In addition, like interest rates, a floating currency is an instrument that affects all sectors of the economy and can seem inaccurate and unfair. However, in a modern, free economy, this is the only type of instrument that is really effective and acceptable. Without denying the occasional inconveniences of a floating exchange rate, it is an acceptable price to pay for a monetary regime that plays a big role in the stability and success of our economy.

**WHY FIX WHAT'S NOT BROKEN?**

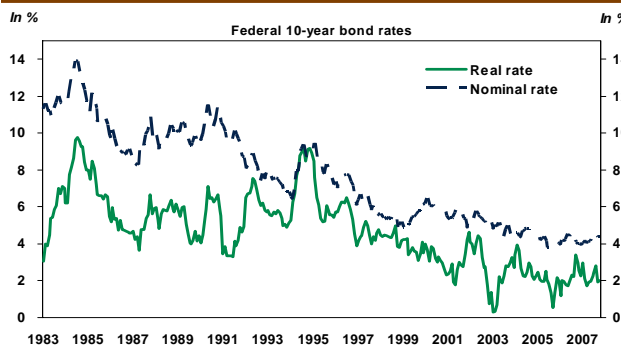
It would be unfair to judge our monetary system by looking only at the evolution of the loonie. The purpose of monetary policy is not to keep the dollar stable but "...to enhance the well-being of Canadians by contributing to sustained economic growth, rising levels of employment and improved living standards."<sup>3</sup> According to modern economics, the best

<sup>3</sup> www.bankofcanada.ca.

way to do to achieve this goal is to ensure that inflation remains low, stable and predictable. This is why in the early 1990s the BoC set a single objective: to keep inflation at 2%, i.e., the midpoint of its 1% to 3% target range. A floating exchange rate regime is necessary to pursue such an objective.

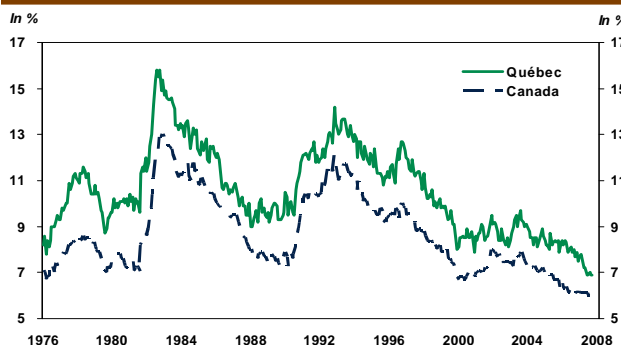
The Canadian economy has performed very well since a credible inflation target was introduced. Inflation has remained under control without the BoC having to raise rates to highly constraining levels (Graph 6), and the economy has been firing on all cylinders. As a result, unemployment has fallen to a historic low, even in Québec (Graph 7). In fact, we have not had a recession in more than 15 years despite many changes in the global economy, bursting economic bubbles, and a volatile loonie. The credit does not only go to the BoC; the provincial and federal governments also opted for better public policies and, like everything else, good fortune has certainly played a role in Canada's excellent performance. Still, the fact is that these solid results came about under our current monetary regime, once inflation targets were adopted. The devastating consequences of the loonie's fluctuations pointed out by common currency proponents are hard to discern when you look at the performance of the Canadian economy overall.

**Graph 6 – Nominal and real interest rates have been very low in Canada in recent years**



Sources: Statistics Canada and Desjardins, Economic Studies

**Graph 7 – Unemployment is at a 30-year low**



Sources: Statistics Canada and Desjardins, Economic Studies

The one negative thing you can say about the Canadian economy is that productivity growth has lagged behind the United States in recent years. Is it because of the floating dollar? Not likely. Productivity is a very complex topic and although studies abound, there are no clear cut answers. However, some authors have shown that Canada's weaker productivity growth is only concentrated in a few sectors, which would seem to suggest that the problem does not stem from our currency, which affects the entire economy.<sup>4</sup> In our opinion, a common currency is not the answer to Canada's productivity problems. What we need, among other things, are government policies that promote flexibility, competitiveness, accessible quality education and innovation, along with a tax regime that encourages success and risk-taking.

The Canadian monetary regime is also accused of causing wide regional disparities. For example, the West is booming while Québec and Ontario are struggling. These disparities stem from structural differences within Canada. As such, according to economic theory, Canada is not an optimal monetary zone due to the vast differences between East and West, which result in asymmetrical shocks. A monetary union would not resolve this problem because North America is also not an optimal monetary zone. The advantage of the current system is that Canada has a number of mechanisms to soften the effect of asymmetrical shocks, for example, the weaker provinces benefit from the West's robust growth through equalization and federal transfer payments, allowing them to use fiscal policies to absorb negative shocks. It should be noted that had the provinces not racked up such massive debts, they could have channelled more of these funds to shore up struggling sectors. Reproducing such fiscal transfer mechanisms within a North American monetary union would be a major challenge. The free flow of labour in Canada also gives the opportunity to workers from the rest of the country to move to Western Canada.

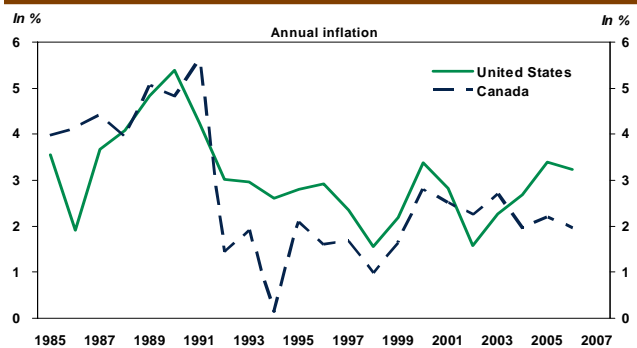
#### COULD A MONETARY UNION BECOME A VIABLE OPTION IN THE FUTURE?

We believe the current monetary regime is very well suited to the Canadian economy. We have the good fortune of having a credible and coherent monetary regime that has stood the test of time. The BoC has a sole objective, i.e., to control inflation, which it does by using a single instrument, the key rate. This is a simple, winning recipe. However, things do change over time and it is therefore conceivable that one day a common currency will become more appealing.

<sup>4</sup> David LAIDLER and Shay ABA, "Productivity and the Dollar: Commodities and the Exchange Rate Connection," C. D. Howe Institute, 2002.

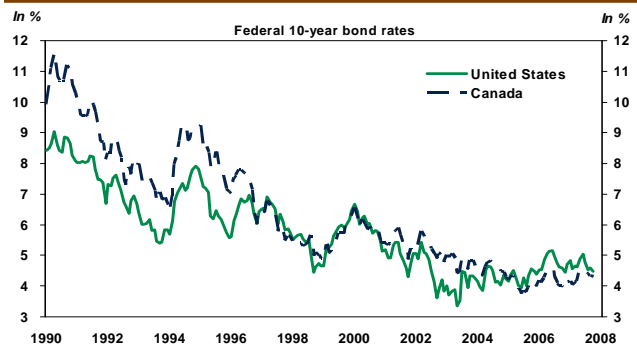
First, if the Canadian monetary authorities were to lose their credibility and no longer be able to adequately control inflation, it might be a wise move to adopt a common currency to benefit from the U.S. Federal Reserve's (Fed) credibility. In fact, it was often this need to tame inflation and put an end to a chaotic period that prompted other countries to peg their currency or to dollarize. However, this situation is rather difficult to envision given that in recent years, the BoC has performed at least as well as the Fed on the inflation front (Graph 8). This has had a tremendous impact on Canadian interest rates, which have fallen below their U.S. counterparts' after being well above them in the 1990s (Graph 9).

**Graph 8 – Inflation has been lower in Canada than in the United States in the last few years...**



Sources: Statistics Canada, Bureau of Labor Statistics and Desjardins, Economic Studies

**Graph 9 – ... which has driven Canadian bond rates below their U.S. counterparts**



Sources: Datastream and Desjardins, Economic Studies

A more realistic scenario is that somewhere further down the road, the Canadian and U.S. economies will increasingly converge and end up with similar industrial structures. This would result in less asymmetrical shocks, which would make our currency less useful as a shock absorber. The option of a common currency would then become more appealing, but before that point, a genuine common North American market would have to be created where, as it's the case in the capital market, the free flow of goods and labour would be total. Ideally, we would even set up a fiscal transfer system, much

like the Canadian equalization system. As in Europe, a common North American currency should be the last step in a long integration process. Compared to the euro zone, North America, with its free trade agreement, is only at the cusp of a true common market. Given the major legal and illegal immigration problems between the United States and Mexico, it would be difficult to include the latter in such a project. A monetary union should not be built by erecting border barriers.

With or without Mexico, a North American monetary union will always have to contend with the handicap of being dominated by the United States, whose economy is about eleven times bigger than Canada's. This would require tremendous humility and possibly a loss of autonomy by the other participants. The European monetary union is based on a central bank where each country has the same representation. In a union with the United States, Canada would probably become the thirteenth district of the Fed. The non-existent balance of power in North America is one of the main obstacles to a monetary union fashioned after the euro model.

In closing, a few words about the amero, i.e., a common currency for the three Americas. This arrangement would have the advantage of reducing the dominance of the United States. This project, however, does not appear even remotely feasible for many years to come given the economic and political context. The emerging economies of Central and South America are too different from the rich, developed economies of the United States and Canada. Moreover, it is difficult to imagine South American countries accepting a monetary union when the current trend is to elect socialist governments that are hostile to the United States. Similarly to what transpired in Europe, where the economic union was initially sparked by a desire to put an end to the terrible wars ravaging the continent, only political motivations could allow such a project to see the light of day. This could be the case if the United States felt it was becoming a marginal economic and political power and was prepared to make major sacrifices to convince the other countries in the Americas to adopt a common currency.

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