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Canada's Monetary Choices in North America and Britain's in Europe - Economic Parallels and Political Differences *

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Abstract: There are strong economic arguments in favour of one money for one market, but multiple currencies continue to exist because of network externalities supported by national legal restrictions. The national currencies of Canada and Britain will not vanish spontaneously as the result of market forces, but they could be eliminated by acts of policy. Each country currently faces a choice between competing monetary orders, and in each of them the status quo, based on a national currency and inflation targeting, is working rather well; but the alternatives available are very different. Britain can join an already functioning European monetary order that is a component of a broader and still evolving political order, and its choice must ultimately depend upon its electorate's degree of trust in domestic versus European monetary institutions. The United States have no interest in sharing authority over their own monetary arrangements with Canada, let alone with a new supra-national central bank, so the choice facing the Canadian electorate is between the status quo and unilateral dollarization, a monetary order that is clearly inferior on both economic and political grounds.

***** This paper was presentated at a conference on *"Britain and Canada and their Large Neighbouring Monetary Unions"* to be held at the University of Victoria, Victoria BC, on October 17-18 2003. It draws heavily on the author's earlier work on proposals for North American monetary integration, much of which was carried out at the C. D. Howe Institute in collaboration with Bill Robson, Finn Poschmann and Shay Aba, who are nevertheless not to be blamed for any errors and omissions in what follows.

Basic Issues

At first sight the monetary choices now facing Canada and Britain have much in common. Each country has the option of abandoning its domestic currency for that of a larger neighbour, and for each the choice in question hinges on similar economic and political considerations. On the economic front for example, the cost reductions in trans-border transactions that a common currency would yield play off against the loss in flexibility in the face of shocks to the economy that giving up a separate currency with a flexible exchange rate is claimed to confer; and on the political front, questions of national sovereignty and the democratic accountability of policy makers attract attention.

Even so, the pros and cons of currency unification in particular, and monetary union more generally, play out very differently in the two cases. Their economic elements have points in common, as I shall show below, but their politics are fundamentally different, as I shall also argue. Should it adopt the Euro, Britain would become an equal partner in a monetary system that forms part of a supra-national political organisation of which it is already a full member. Monetary union in North America, on the other hand, would see the government of Canada yielding important policy powers to the Federal Reserve System, an agency of the United States government, which is now, and would remain, accountable solely to the people of the United States through the Congress. I shall conclude, therefore, that it is quite inappropriate to use blanket analogies with Britain's choice vis-a-vis the Euro in discussing the desirability of Canada seeking membership in an integrated North American monetary system. Each case must ultimately be judged on its local merits.

Some Economic Fundamentals

From the point of view of economic fundamentals, there is a strong case to be made that the right number of monies is one. What we call "the market" is a collection of institutions that establish property rights in goods and services, both currently available and promised for the future, and facilitate their exchange. For many purposes economists find it helpful to analyse market exchanges "as if" they take place on a multilateral basis, at prices which guarantee the continuous equality of supply and demand for all items, and costlessly into the bargain, but this is no more than a useful (often very useful) fiction. Trade is, typically, a series of bilateral acts, each involving the exchange of some specific item against one that is a commonly acceptable, to which we usually attach the label "money". It also takes place at prices set by market participants in terms of that means of exchange, which then becomes the economy's unit of account. To the extent that trade involves the exchange of currently available goods and services for claims to goods and services in the future, money usually functions as a standard of deferred payment too.[1]

In these roles, the use by all market participants of a commonly acceptable item reduces the cost of doing business. As far as actual transactions are concerned, if everyone stands ready to offer and accept the same single money, then partners for trade in any specific item are easier to find, and if all prices are stated in terms of that single money the structure of prices becomes more immediately transparent, computation costs are reduced, as is the scope for making errors. To take a market that is using a single money, and then to add a second, or a third, and so on, is simply to increase the number transactions and computations that need to be made to support a given volume of trade in goods and services, and hence to make their execution gratuitously more costly.

It is from considerations such as these that the well known slogan "one market - one money" derives its intellectual force, and they also pose a problem for monetary historians who need to explain how it is that the world we live in departs so far from this single money ideal. Two concepts that run through the academic discussion of these matters require our attention here: first, once established in circulation, any money is then supported by a *mutual trust* in the prospect that it will continue to be acceptable among the agents that use it; and second, particularly in the modern world, the effects of such trust are re-enforced by *legal restrictions* imposed by governments and the courts on what does and does not serve to discharge debts, not least tax-debts, and, closely related, on the way in which agents, particularly business enterprises, keep and report their accounts.[2] The extent to which legal restrictions have been responsible in and of themselves for the creation and maintenance of separate national currencies, as opposed to codifying arrangements based on trust that had already emerged among the inhabitants of particular regions, is much debated, but this debate does not matter for the issue at hand. What is important here is that both the Canadian dollar and the pound sterling are maintained in circulation by the *network externalities* that trust creates, and that these are

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[1]Textbook expositions usually stress money's function as a store of value. I here deliberately hark back to a pre-Keynesian way of thinking about money that focusses on its role in what Jevons (1875) called "the mechanism of exchange". Theories of money that treat it solely as an asset, such as the "over-lapping generations" model, are, from this standpoint, inherently defective. Nevertheless, as Benjamin Cohen has pointed out to me, in a store of value role, a single money is inferior to many because of the extra degree of portfolio diversification that the latter arrangement permits.

[2]Modern models of money that stress trust owe a great deal to Carl Menger (1892), while those that stress legal restrictions hark back to the Chartalism of Georg Friedrich Knapp (1921)

supported by local legal restrictions too.

This conclusion enables us to dispose at the outset of this paper of an argument that is certainly sometimes heard in Canada, though I am not aware of its having figured in British debates; namely, that, as economies become more open and trading becomes more internationalised, minor currencies (such as the Canadian dollar) will simply disappear from use as individual agents come to recognise the transactions costs that can be saved by their adopting a more widely accepted and acceptable alternative.[3] It is true that there are example of economies that have spontaneously adopted a foreign currency for domestic use, experienced *market dollarization*, as the commonly used phrase would have it. Market dollarization, however, has never occurred as the outcome of competition between a large and a small currency *when the latter has been well managed.* It has invariable been the consequence of instability in the minor currency's domestic purchasing power brought about by high and unstable inflation, and what is surprising is how infrequent and incomplete market dollarization has been, even under such extreme circumstances.

In this context, it is interesting to note that anecdotal evidence of the onset of voluntary dollarization in Canada in the face of the Canadian dollar's sharp depreciation against its US counterpart in the late 1990s was sometimes cited to support the case for having the Canadian government move quickly to abandon its currency while conditions remained relatively favourable. This evidence, however, turns out to be have been anecdotal indeed, and grossly exaggerated by those who cited it, as recent research by the Bank of Canada has demonstrated.[4]

At the same time, however, though network externalities seem to be decisive in helping to keep an already existing national currency in place, provided it remains stable, they are not all powerful. Those who feared that a lack of trust on the part of the general public in the new and untried Euro might undermine its viability upon its launch in 1999 were proved wrong. The Euro's success has clearly established that network externalities can be overcome by a carefully designed change in the legal restrictions that impinge upon the monetary system, albeit particularly, one suspects, if that change is designed to preserve continuity with certain key features of the monetary system that went before it. It was surely, that is to say, a wise decision to make the European Central Bank look as much like the Bundesbank as was decently possible.

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[3]An extreme version of this view informs the analysis of Dr. Sherry Cooper (2001), and Richard Harris (2001) has also flirted with it.

[4]See for example Murray and Powell (2002)

The moral of all this for the monetary choices that currently face Canada and Britain is straightforward. There is no point in waiting for the Canadian dollar and the pound sterling to vanish of their own accords. Short of the implementation of domestic policies calculated to create hyper-inflation, that is not going to happen. On the other hand, there is no reason to believe that there are any obstacles, rooted in the nature of the monetary system, to the adoption by Canada of the US dollar, or by Britain of the Euro. Both currencies are already highly credible and well known to agents in the countries in question. Even so, choosing the time at which to join a larger monetary system, not to mention setting the exchange rate at which to convert the currency, do pose serious technical difficulties. East Germany's premature adoption of the Deutschmark at a grossly over-valued parity shows all too clearly how easy it is to make serious mistakes in managing these transitional matters. But transitional issues are just that, they can be resolved, and they should not weigh heavily, if at all, in the underlying choice.

Choosing a Monetary Order

The choices that face Canada and Britain need to be formulated properly if they are to be analysed usefully. I will let those who know more about the British debate speak for themselves on this matter, but in Canada the issue at stake is all too often stated dangerously narrowly, as involving the potential replacement of a flexible exchange rate regime with the limiting case of a fixed exchange rate on the US dollar, namely the adoption of that currency as Canada's own. Much more than the exchange rate regime is at stake in such a choice however. It is properly posed as lying between alternative *monetary orders*.[5]

By the phrase monetary order, I mean an arrangement that involves four sets of characteristics, namely: A goal or array of goals for monetary policy; an institutional and policy making framework which supports the achievement of those goals; the beliefs of the public at large about the capacity of the order to achieve its goals; and the political mechanisms through which the public is able both to influence the choice of goals, and to hold accountable for their performance those charged with the task of achieving them.

At present Canada and Britain possess national monetary orders that differ in many details, but are remarkably similar in broad outline. In each country, the goal of monetary policy is to achieve low and stable inflation. The central banks of both countries are, that is to say, formal inflation targeters. Each country has also conferred upon its central bank the necessary technical powers to implement monetary policy, each one also has in place a fiscal regime that puts no undue pressure on the central bank to monetise government debt, and crucially, each one

[5]The following few paragraphs draw heavily on Laidler (1999) and (forthcoming)

has in place a flexible exchange rate regime, which enables conflicts between the goal of monetary policy and anything that might be happening either to price level behaviour abroad, or that might effect the country's real exchange rate, to be absorbed by a movement in the nominal price of the domestic currency in terms of its foreign counterpart. Furthermore, because these arrangements are compatible with gearing monetary policy to the pursuit of low inflation, and because both central banks have by and large been successful in achieving their policy goal, the latter enjoys considerable credibility among the public at large.

When it comes to the political component of their monetary orders, however, some differences arise between the two countries. In Britain, the goal of policy, the inflation target, is set solely by the Chancellor of the Exchequer, who is accountable to Parliament for that choice, and through Parliament to the electorate. In Canada the target is set jointly by the Minister of Finance and the Governor of the Bank of Canada, and their discussions of this matter are subject to the local *dual responsibility* doctrine. Hence, though ultimate responsibility for the choice of the target lies with the Minister as it does in Britain, the Bank of Canada plays an active role in setting it, and a Governor who found himself in disagreement with the Minister over this matter would have the option of triggering a precise and public directive to follow the latter's orders, an event which would be followed by the Governor's resignation.

Both the Bank of England and the Bank of Canada are independent when it comes to the day by day conduct of monetary policy. Even so, in Britain, policy choices are made by a Monetary Policy Committee to which the Chancellor makes direct appointments, whereas in Canada they are made by an informal Governing Council of the Bank only two of whose members hold positions that are subject even to Cabinet ratification. This suggests that political oversight of the technical competence with which policy is executed might be a little more detailed and exacting in Britain, though the activities of both Banks are subject to scrutiny by Parliamentary committees and each has its own elaborate communications strategies to ensure that the electorate at large is kept well informed about monetary policy.

Over the last decade or so, The Canadian and British economies alike have performed well under their current monetary orders, which seem to be both coherent and compatible with the liberal political orders of which they form a part. This is true both by international standards, but particularly when the basis of comparison is these two countries' own earlier experience. These considerations have important implications for the way in which the pros and cons of monetary union are discussed in both cases.

To begin with, it is clear that in each country, exchange rate flexibility is a purely permissive device that enables a particular monetary policy goal to be pursued. Each of them became an inflation targeter in the early 1990s, having adopted flexible exchange rates much earlier, at the beginning of the 1970s. In the 1970s and '80s, furthermore, each of them sometimes pursued goals that were inappropriate for monetary policy, such as high real growth, or mutually inconsistent, such as unsustainably low unemployment along with low inflation, or sometimes simply unclear. Advocates of a supra-national monetary union (at least in Canada) sometimes cite this earlier experience as counting against the current monetary order, essentially branding it as guilty by association with earlier experience. Such a line of argument is clearly inappropriate. The monetary orders prevailing in Canada and Britain changed in the early 1990s, and should be judged on the basis of experience only since then, and both are entitled to have an "if it ain't broke don't fix it" defence mounted on their behalf as far as their economic outcomes are concerned.

To insist on looking at the overall monetary order, rather than international monetary arrangements *per se*, also forces us to pay attention to the political implications of the changes that are being suggested. It is a commonplace these days that monetary policy is the single most powerful component of macroeconomic policy more generally considered, and if it is not also a commonplace that, in a liberal democracy, policy makers should be answerable for their actions to the electorate that is affected by them, then it ought to be. This is not to argue for having day-to-day monetary policy made by a free vote of back benchers, or even by the Cabinet: we know enough about the incentives inherent in electoral politics to mount a strong case that monetary policy should be insulated from short-term pressures and treated similarly to the administration of justice, or the management of the news departments of public broadcasters. It is, however, to argue that arrangements which ensure the accountability of those who make monetary policy to those who are affected by it are an important element by which any monetary order should be judged.

The Economics of the Two Debates

Evidently, there must be a strong political element to any debate about alternative monetary orders, and one that is, in the last analysis, difficult, if not impossible, entirely to separate from economic questions. Even so, one cannot discuss everything at once, and it is helpful to divide the issues at stake between those that are predominantly economic in nature from those that are more political, and we begin here with the former.

Transactions Costs.

The strongest economic argument in favour of any monetary union has already been alluded to above: namely, that it leads to fewer costs in international transactions. These begin with the costs of buying and selling foreign exchange when goods, services and assets are traded across national borders, and in the Canada-US case seem to amount to somewhere in the region of a quarter of one per cent of gross domestic product.[6] These costs, it might be noted stem from the simple existence of a separate Canadian dollar, and would still be incurred under a fixed exchange rate regime of any degree of "hardness", including a currency board, and their existence and magnitude constitutes one of many arguments against settling for any such intermediate regime on anything but a transitional basis.

In the case of a separate currency whose exchange rate is also flexible, however, to these must be added the costs of hedging against future currency movements. Anyone engaged in regular cross border transactions in which the passage of time is important is going to want to undertake these, but I am unaware of any estimates of their costs, or of those incurred when less formal longer-term hedging takes place, as, for example when a Canadian exporter finds it prudent to undertake long-term borrowing abroad in order to finance the expansion of production facilities in Canada, or when a firm sacrifices economies of scale in order to diversify its production facilities across the boundaries of the currency areas in which it buys inputs and sells output. All of these costs, whose significance I do not wish to downplay, are manifestations of the simple point already made that, in one market, other things equal, the use of a single money enables economic activity to be carried on at a lower cost than the use of more than one money.

Trade and Output Growth

The potential economic gains from monetary integration do not stop with lower transactions costs, of course. Those costs inhibit trade, and their removal therefore encourages it. This observation, which ought to be uncontroversial, has formed the starting point of an important body of empirical work dealing with currency unions, to which the most visible contributor has been Andrew Rose, writing with a number of co-authors, most notably Jeffrey Frankel.[7] The essential message of this work is that, just as currency unification encourages trade, so does trade create higher income levels, and it appears to show that, on average, the income gains in

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[6]This estimate is drawn from Robson and Laidler (2002) It is small relative to estimates of the savings to be realised by the Euro because North American monetary integration would eliminate one currency, not nine. In this context it is worth noting that the creation of the Euro has presumably already created substantial cost-savings for British firms dealing with Europe.

[7]See in particular Frankel and Rose (2000, 2001)

question are large. Indeed, extrapolating from Rose's results, it has been suggested that the creation of a Canada-US currency union might lead to as much as a thirty per cent rise in Canadian living standards over a ten year period. Qualitatively similar claims have also been made about the benefits for Britain of adopting the Euro, though, quantitatively speaking, on a rather more modest level.[8]

Now empirical work in economics is inherently controversial, and not all well informed commentators have found these estimates convincing. This is not the place to go into the details of the debate. Suffice it to note that there are two links in the causative chain at work here, that between currency unification and trade, and that between trade and output, and that the second of these is particularly problematic in the current context. No one would deny that, when heavily protected, even essentially autarchic, economies have opened up to trade, spectacular gains to living standards have followed. The example of the Asian "tigers" is well known. But there are good reasons to believe that here, as in many other places in economic life, diminishing returns are eventually to be expected. Canada and Britain are already extremely open to trade, and if the transactions costs associated with maintaining separate currencies are indeed preventing its further expansion, that must be in areas where the potential gains are small, for the simple reason that the transactions costs inhibiting their exploitation are also small.

Only if there are significant external economies of scale in the sectors affected, whose exploitation cannot be ensured by the pursuit of private profit would this not be the case, and this seems unlikely in the light of the available evidence. The NAFTA and its predecessor agreement have now been in place for more than a decade and have generated a dramatic increase in Canada-US trade, particularly in manufacturing. A recent study be Dan Trefler (2002) estimates that the NAFTA has been responsible for productivity gains in the order of 6 per cent. in this sector, though it also reveals significantly greater improvements in the sub-sectors most affected by it. Improvements in economic performance of this magnitude have certainly been well worth having, but it is hard to believe that further gains of four or five times their size are there for the taking, particularly since Trefler finds little evidence of economies of scale having been responsible for them. In any event, Europe is now in the process of generating as close as economics usually gets to a controlled experiment on the benefits of monetary integration, because three members of the EU have yet (and may never) adopt the Euro. Though it is early days as yet, it is hard, even after four years, to discern any marked divergence in economic

[8]See House of Commons (UK) (2003) for a discussion of a range of estimates and the arguments for taking a cautious view of them in the UK case.

performance between the “Euro ins” and the “Euro outs”.[9]

All in all then, though it would be ridiculous to deny that economic benefits would arise for both Britain and Canada from the lower transactions costs associated with monetary integration, and misleading not to point out explicitly that estimates of the direct element of those costs associated with the foreign exchange market per se put a rock bottom lower bound on them, it would also pay to be cautious about their overall magnitude. No doubt the economic gains from monetary integration are big enough to matter on an “other things equal” basis, but other things are not always equal, and there are potentially offsetting losses that must also be taken into consideration.

The Question of “Flexibility”

Just as fundamental as the proposition that one is the right number of monies, is the observation that there would be no point in international trade, or inter-regional trade within a country for that matter, if all areas produced and consumed a similar bundle of goods and services. The productivity of trade derives precisely from the fact that there are differences among these, particularly, perhaps, among production bundles.

It is in this context that issues having to do with the extra flexibility conferred upon a country by a flexible exchange rate arise. They do because the so-called “law of one price”, which says that - making due allowance for transportation costs and taxation differences - the same good cannot trade at a different price in two parts of the same market, does *not* also say that, where different regions produce different bundles of goods, the relative prices of these bundles will not vary over time. On the contrary as tastes and technology, not to mention the state of the business cycle, change, so will those relative prices, and so, therefore must the real incomes in terms of consumption goods of the people who produce them.

Within a monetary union, and on the assumptions (made at this point for the sake of simplicity) that the consumption bundle is more or less standard across regions and dominated by goods that are easily traded, these real income changes must be brought about to an important extent by variations in money wages. If these are flexible, all well and good, but if there is any

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[9]A recent time series study of the Irish economy by Thom and Walsh (2002) finds essentially no effects on output growth associated with the break-up of the Anglo-Irish monetary union. Note also that the start of the more Irish “economic miracle” antedates the launch of the Euro and seems to be associated with Ireland’s membership in the EU as well as with the adoption of an investment-friendly tax regime.

stickiness to them, particularly downward stickiness, then, in areas where incomes must fall, these changes will be accompanied by increases in unemployment which, though transitional, will not necessarily be either small or short-lived. Now if the monetary union is also a fiscal union, the tax-transfer system will work automatically to mitigate these effects, and if labour mobility is relatively easy within it, so will movements of workers away from depressed and towards buoyant regions. These conditions, roughly speaking, characterise monetary unions whose borders are co-terminus with those of a country, but more often than not, fiscal transfers and labour mobility stop at the national boundary.

How important all this might be for any country considering entry to a supra-national monetary union depends, of course, upon the extent to which it is likely to be hit by shocks, particularly adverse shocks, that are specific to the mix of traded goods that it produces. It is by now reasonably well understood that Canada's status as a major producer and exporter of primary commodities, coupled with that of the United States as a significant importer thereof, makes the country particularly vulnerable to such problems (and similar considerations seem to arise in Britain from differences between its output mix and that of the major European economies). It is also understood that a nominal exchange rate adjustment is one way of dealing with them, not as a permanent fix that avoids real income adjustments, but as a means of bringing those adjustments about without putting more transitional downward pressures on money wages than they can comfortable bear. In the Canadian case, an adverse shock to commodity prices must reduce real wages in the sector that produces them, but also in other sectors of the economy if they are to absorb the resources released from commodity production. It must do this in any circumstances, but under a flexible exchange rate, part of the adjustment can, and so it seems does, occur by way of a currency depreciation.[10]

The Role of Labour Market Integration

The economic significance of the flexibility that Canada would sacrifice by joining a North

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[10]Chen and Rogoff (2002) document the influence of commodity prices on the Australian, Canadian and New Zealand exchange rates. Note that, since early 2003, the well known Bank of Canada equation (Amano and Van Norden 1995), which has performed well since the early 1990s in predicting the real Canadian-U.S dollar exchange rate as a function energy prices, non-energy commodity prices, and the short term interest differential between the two countries, has been seriously under-predicting this variable. It is too early as yet to say whether this is a temporary aberration, a signal that some newly important fundamental variable is missing from it, or evidence that the foreign exchange market is itself prone to generate exchange rate misalignments for non-fundamental reasons.

American Monetary union, or Britain by adopting the Euro for that matter, is a legitimate matter for debate, not least because this will vary depending upon what other measures, if any, are simultaneously put in place. The root of the problem under discussion lies after all, not with the monetary order, but with a lack of labour market flexibility. Perhaps it should be treated as a labour market problem in the first place, and perhaps indeed it would be so treated in the absence of the buffer provided by a flexible exchange rate.

Though this argument deserves respectful attention it also needs to be treated with care. One benefit that was supposed to flow from the adoption of the Euro by such economies as France and Germany was the imposition upon them of the discipline needed to bring extra flexibility to their labour markets. Now, after four years, we can see that this is beginning to happen, but no one would deny that much still remains to be done. Though argument by analogy with French and German experience suggests that accession to a monetary union might encourage greater flexibility in the Canadian labour market, and in the British market too, to the extent that there are still problems there, it also suggests that it would be unwise to expect too much too quickly in this regard.

In Europe, we know that the Euro is part of a drive towards the eventual creation of a single market in goods, services, labour and capital, but the case for North American Monetary Union has not usually been stated in such terms, or at least not yet. Nevertheless, arguments for moving the NAFTA in the direction of a fully fledged Customs Union, and for creating greater labour mobility within North America, along with harmonised immigration and refugee policies, are now beginning to be heard in Canada, and the removal of restrictions on the free movement of labour across the Canada-US border would surely remove an important element of the case for exchange rate flexibility.[11]

One reason why exchange rate flexibility is important for Canada is that shocks emanating from commodity price fluctuations must be absorbed within the domestic labour market, because there are significant legal barriers to international labour mobility in North America. Though linguistic and cultural barriers to labour mobility also exist in North America, they seem, to casual observation at least, to be much less significant there than they are in Europe, where the legal barriers to international labour mobility are smaller. The removal of legal barriers to North American labour market integration would thus remove an important

[11]A wide range of possibilities for further Canada-U.S economic integration exists. Some of them are discussed in the C.D. Howe Institute's recent *Border Papers* series. See in particular Wendy Dobson (2002) and Danielle Goldfarb (2003)

drawback to North American monetary integration, and there seems to exist no similar opportunity in the case of Britain and the Euro. There are two ways of stating the implications of this conclusion. The first is to note that advocates of North American monetary integration would probably be wise to argue for North American labour market integration as well. The second is to suggest that those who are skeptical about the desirability of a more general move towards North American economic integration should probably be wary of supporting monetary union as a stand alone goal, for the simple reason that the disappearance of exchange rate flexibility would create a situation in which pressures towards labour market integration would significantly increase.

Currency Depreciation as a Factor in the Canadian Debate

Canada and the UK are currently operating under broadly similar monetary orders, and from a purely domestic perspective, outcomes in both countries have been satisfactory. There has been, however, at least until recently, one salient difference between them. In the 1990s, under inflation targeting Sterling has been a strong currency internationally, while the Canadian dollar has depreciated, particularly against the US dollar. In the absence of this latter phenomenon, it is doubtful that there would now be so much Canadian interest in North American monetary integration, and certainly it has figured strongly in its proponents' case.

The first thing to be noted here is that the Canadian dollar's nominal depreciation began not in 1991, but in 1976, and that some commentators are inclined to view the currency's performance over this period as evidence of a fundamental and long-standing economic malaise.[12] Here, their presentation of the facts is open to question. To begin with, the Canadian dollar's nominal depreciation between the mid-1970s and later 1980s is easily accounted for by the fact that, over those years, the Canadian inflation rate was systematically higher than that of the US. After its recent rise against the US dollar, moreover, which, at the time of writing, is beginning to look like more than a temporary aberration, the currency is back at levels that are actually a little above the lows that it touched in the mid-1980s. It may well turn out, then, that experience which until recently could be presented as stemming from a serious long-term problem with the exchange rate that had gotten worse in the 1990s, is better interpreted as an inflation-induced depreciation that came to an end in the mid-1980s, only to be followed by a short-lived and unsustainable appreciation that peaked in 1992, after which the currency took another decade to find its mid-1980s level again.

[12]This seems to be the view, among others, of Courchene and Harris (1999) Cooper (2001) and Grubel (1998)

But whatever the appearances will turn out to be in the future, by the end of the 1990s, the dollar's weakness was being blamed for a variety of factors affecting the real economy, and these matters played a major role in the case that began to be made at that time for North American Monetary Union. Managerial laziness induced by a weak currency was said to be inhibiting productivity growth, and undisciplined politicians were said to be putting off hard decisions because the exchange rate was enabling them to hide the consequences of their procrastination from the electorate. Neither argument, however, was particularly convincing.[13]

There is no doubt that, relative to the US, Canada has, overall experienced a shortfall in its productivity performance since the early 1990s, but it is now well known that the aggregate statistics hide the vital detail that significant differences here have been concentrated almost solely in the "high-tech" sector, which is also a good deal smaller in Canada than in the US. The exchange rate is a significant variable right across the economy, and it is simply implausible to attribute so narrowly focussed an effect to its behaviour. As to the resolve of Canadian politicians during the 1990s, the NAFTA was negotiated and kept in place, inflation was brought down and kept down, the federal government's finances were put in order, and those of some provinces too, a highly unpopular reform of indirect taxation was begun, and a significant reform of the Employment Insurance was also undertaken. Though there has certainly been back-sliding on some of these fronts, by international standards, or by those that they themselves set in the 1970s and 1980s, Canadian politicians do not have to apologise for any overall lack of discipline in the 1990s.

One element in the critics' commentary on the effects of exchange rate depreciation nevertheless needs to be taken seriously: the dollar's decline did make imported investment goods more expensive, this did inhibit capital accumulation, and this probably did hold back the growth of productivity in Canada, particularly labour productivity.[14] The fundamental force at work here was, of course, the real exchange rate depreciation that underlay the dollar's nominal decline, and how much significance one attaches to it in making the case for the desirability of monetary integration depends upon the factors to which the nominal and real exchange rate depreciations in question are attributed. Those who believe that movements in the nominal exchange rate are largely the consequence of fundamentals that would force the real exchange

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[13]Grubel (1998) in particular made a great deal of these matters. Courchene and Harris (1999) were careful to refer to the potential effects of the exchange rate regime on business decision-making as a "conjecture".

[14]Harris (2000) includes a well argued account of this hypothesis.

rate to adjust through movements in domestic wages and prices in the absence of exchange rate flexibility regard this argument as irrelevant to the monetary integration debate, since these forces would be at work under any monetary regime. Those who believe that the workings of the foreign exchange market itself can lead to serious and persistent misalignments of the real exchange rate, on the other hand, regard it as highly pertinent. This is not the place to try to settle this issue. Suffice it to say, first that disagreement about it is a major factor dividing those who are skeptical about the likely productivity enhancing effects on Canada of a common North American currency, from their opponents; and second that it is at heart an empirical issue on which the evidence is by no means all in.[15]

Political and Institutional Questions

The economic factors discussed so far in this paper do not seem to me to be decisive, one way or another, to either Canada's or Britain's choice of future monetary arrangements. On the one hand, inflation targeting has worked well in both countries since the early 1990s, and there has been nothing about its performance to make a compelling case for either country to give it up. On the other hand, there are some striking examples of monetary unions among diverse economic regions that have also worked well for a long time - the United States or indeed Canada itself - so the advantages of joining such an arrangement cannot be dismissed out of hand either. For each country, the balance between costs and benefits discussed so far is a fine one, about which reasonable people can disagree.

The choice in question should, in any event, be posed as one between monetary orders, and there is a great deal more to a monetary union than the use of a common currency, which is the characteristic on which the discussion has focussed so far. Any monetary order also involves, among other things, a regulatory and supervisory framework for the banking system and other financial institutions, a set of institutional arrangements within which monetary policy is conducted on a day to day basis, not to mention the political mechanisms through which the goals of monetary policy are chosen, the relationship between fiscal and monetary policy is managed, and the accountability of policy makers to the public at large is defined and enforced. When these factors are brought into the picture, it becomes apparent that the nature of the

[15]Laidler (forthcoming), which was completed in late 2002, argued that the good performance of the Bank of Canada equation (See above) in the 1990s put the burden of proof on squarely on those who denied the importance of economic fundamentals. Since the beginning of 2003, the question has become more open.

choices facing Britain and Canada are very different.

The European Union, the Euro and Britain's Choice

The development of the European Union has been driven from the outset by memories of the two devastating wars that were fought on continental European soil in the first half of the twentieth century. Though its earliest stages were dominated by the creation of economic ties among its members - the Coal and Steel Community, and after the signing of the Treaty of Rome, a Common Agricultural Policy - European integration has been at heart a political project from the outset, and the Union's institutions are those of an embryonic federal (or confederal) state, albeit not one for which one can find any obvious prototype in previous history. Europe has a well developed bureaucracy in the shape of the Commission, the electorates of member states are indirectly represented through the Council, and those electorates also send members to a European Parliament, albeit one of very limited authority. There is a European Court to which national courts and legislatures are subservient in a range of areas, while in certain areas, notably agriculture, international trade, and regional development, policy is made on a European rather than a national level.

There is also a common currency for those who want to adopt it, and with it comes a common monetary policy, set by a European Central Bank, and implemented through a European System of Central Banks. The ECB derives its political legitimacy from the Maastricht Treaty, which, while giving it an unusually high degree of independence - the choice of inflation targets for Europe is a matter for the Bank, not for politicians - , also requires its Governor to account for his actions on a regular basis to the European Parliament. At the same time, the all-important interface between fiscal and monetary policy is dealt with, at least in principle, by a supplementary treaty - the Growth and Stability Pact - which seeks to limit the ability of member governments to run deficits, and provides for penalties for those who violate them.

The significance of all this for the question at hand is that Britain faces an extremely clearcut choice in deciding whether or not to adopt the Euro as its currency, because the Euro is underpinned by an already well defined and fully functioning monetary order. Moreover, the European Union is a going concern, both economically and politically, and, the currency question aside, Britain is already fully committed to it and represented within its decision making bodies on exactly the same terms as any other member nation. Should the Bank of England become a member of the European System of Central Banks, the interests of the British public would be taken into account, to exactly the same extent as those of the population of any other member nation, in monetary policy decisions, and that public would have exactly the same ability to hold the European Central Bank accountable for its decisions as any other within the system. Furthermore, the European Monetary union was designed on the assumption that Britain would eventually become a member, and, always presuming that it fulfills the well defined criteria for accession, there would be no question but that Britain would receive the full co-operation of its European partners in managing the transition.

Now, to be sure, there are legitimate concerns about the differences between the European monetary order and the one currently in place in Britain: both are based on inflation targets, but in Europe, these are set by central bankers, not elected politicians, and at a significantly lower level too; monetary policy decisions are taken with much more transparency in Britain than in Europe; the interaction between fiscal and monetary policy in Britain is managed continuously and at the discretion of politicians, but in Europe, it is subject to constraints embedded in a treaty that might well turn out in practice to be too rigid to be enforceable; to name but three of them.[16] But with the worrying exception of the Growth and Stability Pact, which large countries seem to be finding easier to circumvent than small ones, the rules of the game are the same for all who use the Euro.

Like that recently made by Sweden, Britain's choice hinges, as Lars Jonung (2002) has put it, on the relative amount of trust that the British electorate are willing to invest in the alternative monetary orders on offer. For Britain to adopt the Euro as its currency would involve a surrender of national sovereignty in monetary policy, but, subject to the serious *caveats* just mentioned, which presumably influenced the outcome of Sweden's choice, a degree of fundamental accountability on the part of monetary policy makers to the British electorate would be preserved, albeit in a form likely to reduce the responsiveness of policy to their wishes. And in this matter, they would be treated in exactly the same way as the electorates of any other country using the Euro.

The United States, the United States Dollar and Canada's Choice

The choice between monetary orders that Canada faces is very different, because, although it is known what is currently in place, it is not clear what form of North American monetary

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[16]Issing et al. (2001) provide an accessible and comprehensive survey of the workings of the new European monetary system. To say that this system is well defined is not to say that it is necessarily satisfactory in every respect from a British point of view. There is for example concern in Britain that the ECB has too much goal independence, and it has been suggested that responsibility for setting inflation targets should be transferred to ECOFIN, a committee of the Council made up of the finance and economics ministers of member states. The Growth and Stability Pact has also been criticised for imposing too much rigidity on fiscal policy. See House of Commons (2003)

integration is available as an alternative. Other countries have dollarized, some quite recently, on an essentially unilateral basis, and Canada could, presumably do the same. There already exists a clear record of the United States attitude towards such measures. It occurs in statements made by then Deputy Secretary of the Treasure Laurence Summers in response to monetary developments in Latin America (Summers 1999a and b), but it uses quite general language, nor has any element of it been repudiated since.[17]

> "While there are many issues, possibilities and approaches, as these are considered it would not, in our judgement, by appropriate for United States authorities to adjust their bank supervisory responsibilities, access to the Federal Reserve discount window, or the procedures or orientation of U.S. monetary policy in light of another country's decision to dollarize its monetary system. Any country contemplating dollarization will have to weigh carefully these considerations and many others. It will surely be appropriate and welcome that its representatives do so in consultation with the United States authorities so that we can jointly think through the implications for both of our economies." (1999a, final page, un-numbered)

Applied to Canada, this statement suggests that the United States would like to be consulted if dollarization is contemplated, and would not necessarily oppose or obstruct such a step. But crucially, it also says that the United States authorities would not be willing to make any changes in either the style or substance of their domestic monetary order in order to accommodate Canadian interests. It is, then, instructive to consider the salient features of a North American monetary order designed to accommodate such constraints.[18]

To establish such an order, Canada would have to purchase US currency to replace the existing stock of Canadian notes and coin in circulation. In round numbers the amount involved here is about $40 billion, and the interest on the loan needed to raise these funds would eat up around half of the savings in foreign exchange market transactions costs that dollarization is expected to realize. The current Canadian regulatory and supervisory framework would presumably remain in place, and so, therefore would the many incongruities between it and the

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[17]The remarks in question were immediately prompted by the possibility of Argentina dollarizing, but simultaneously seeking access to the Federal Reserve discount window for its banking system. The wording differs between the two statements in inessential ways.

[18]The following few paragraphs draw heavily on Robson and Laidler (2002) where their arguments are developed in more detail.

United States regime. Thus, the integration of the North American monetary system beyond the adoption of a common currency would be inhibited, and the cost savings inherent in the creation of an integrated financial system would not be fully realised.

The efficiency of the Canadian financial system would also be impaired under unilateral dollarization. That is because the Bank of Canada's ability to create domestically acceptable money in unlimited amounts in times of emergency would be given up with the abandonment of the domestic currency, along with the capacity that this gives the Bank to act as the ultimate guarantor of the stability of such specific institutions as the Clearing and Settlement system, the Canadian Deposit Insurance Corporation, and of the financial system more generally. Substitute arrangements would be available under dollarization: the Bank of Canada could, and presumable would, begin to hold reserves of liquid US dollar assets against its own liabilities, and it would arrange lines of credit too, probably with the Federal Reserve system itself but also with large US banks; and financial institutions in Canada's private sector would do the same. But such a system would not provide quite as much stability as the one currently in place, and it would be more costly to operate into the bargain. Canadian based banks would see whatever competitive edge they now have diminished. There would be an incentive for them to decamp to the US, where they could avail themselves of the central banking services of the Federal Reserve system on the same terms as their American competitors, leaving local branches or subsidiaries to service those among their Canadian clients who for one reason or another could not conveniently take their own business to the U.S.

There is also the matter of monetary policy itself. It is often suggested that dollarization of the Canadian economy would lead to Canada importing the inflation rate ruling in the United States, but that is not true. Rather, in the absence of variations in a nominal exchange rate, the Canadian price level would have to make whatever moves were needed to bring about any adjustments in the Canada - US real exchange rate that shifts in market fundamentals dictated. The extent to which Canada's vulnerability to such fluctuations could be reduced by measures designed to promote North American labour market integration has already been discussed, but at this point, it is worth noting explicitly that even such a development would not be sufficient to make the price level consequences of unilateral dollarization on Canada's part similar to those that would arise for Britain from adopting the Euro. With Britain inside the European monetary system, the performance of the British economy would become a matter of concern to the European Central Bank and would be weighed in its policy decisions, for which the Bank would be accountable through the European Parliament to, among others, the British public. Under unilateral dollarization on Canada's part, monetary policy would be made by a Federal Reserve system concerned solely with the performance of the U.S. economy, and accountable only to the

U.S. electorate.

These drawbacks to unilateral dollarization explain why it has been resorted to only by countries whose own domestic monetary orders have already collapsed, and imply that it is an extremely unattractive option for a country such as Canada that has a well established and credible monetary order in place, not to mention an efficient and well functioning financial system.[19] Any North American monetary order that Canada could conceivably find attractive would, that is to say, have to be a negotiated one, and the preceding discussion provides a shopping list of what might be sought in such negotiations. Clearly, and as Herbert Grubel (1998) argued at the very outset of the current debate about Canada's monetary future, a North American Monetary Union, overseen by supra-national institutions designed along European lines could fill the bill here, but equally clearly this option is not available. Not only did Secretary Summers' statements exclude this possibility, but so did later remarks by the current administration's Ambassador to Canada, Mr. Paul Cellucci. Specifically, though the ambassador has often expressed support for closer economic integration in North America, he has never, to the best of my knowledge, mentioned monetary arrangements in this context, and he has also explicitly denied any interest on the part of the United States in the creation of supra-national institutions of the European type in any area.[20]

Thus, the best that Canada could hope for on the monetary front would be some sort of integration of the Canadian monetary system into the Federal Reserve system. Any such integration, however, were it to be anything other than purely symbolic, would require legislation on both sides of the border. On the U.S. side, there is indirect evidence that Congress might be willing to help Canada in the matter of covering the costs of currency replacement, though I suspect that a gift in excess of US$25 billion to Canada would be a hard sell in the current political climate.[21] It is, however, difficult to see any concessions being made that would

[19]In this context it is worth stressing that Canada has a well developed bond market where local firms can borrow long-term in local currency. This feature is not always present even in reasonably advanced economies, for example Spain, Portugal or Greece before their adoption of the Euro, and can pose a serious obstacle to their smooth functioning under a completely flexible exchange rate.

[20]See for example the important interview with Mr. Cellucci reported in Fife and Toulin (2001)

[21]A report of the Joint Economic Committee of the US Congress dealing with Latin America (United States 1999) suggested that such aid could be extended to dollarizing countries.

give Canadian representatives a meaningful say in the regulation and oversight of the financial system or in the conduct of monetary policy, or that would lead to Congress sharing its oversight of Federal Reserve behaviour with the Parliament of Canada, let alone accepting any limitations on its powers over the United States budget in the interests of ensuring that the stability of the North American monetary system be protected from fiscal irresponsibility. There are no United States interests that would be promoted by any such measures, and some that would be compromised.

Nor would the integration of Canada's monetary system into that of the U.S. be plain political sailing on the Canadian side of the border. To begin with, the prospect of Canada becoming exposed to the monetary consequences of U.S. fiscal policy, given its current trend, would cause considerable concern. Furthermore, some very difficult institutional adjustments are implicit in such a move. To give but one example: in the unlikely event that Congress would accede to the measure, the conversion of the Bank of Canada into a thirteenth District Bank of the Federal Reserve System would require, among other measures, that it be privatized, with its stock being sold to the chartered banks. These institutions would thus acquire the power to appoint a majority of the Bank's directors, who in turn would share the responsibility for appointing its President (formally the Governor) with the authorities in Washington. And this newly constituted District Bank would also acquire extensive regulatory and supervisory powers over the Canadian chartered banks which the Bank of Canada does not now possess, these being exercised at present by the Office of the Superintendent of Financial Institutions (OSFI) and the Canadian Deposit Insurance Corporation (CDIC) both of which are creatures of the Department of Finance, not to mention by the Minister of Finance himself. Simply to spell out conditions such as these is to make a compelling case against their political acceptability in Canada.

In short, the form that North American monetary integration might realistically be expected to take would differ very little from the unilateral version, unless of course it took place as a component of an altogether broader movement towards North American economic and political integration that seems to be on no-one's political agenda.

Conclusion

The monetary arrangements currently in place in Canada and Britain are reasonably alike, and are working well, but the alternatives on offer to the two countries are quite different, particularly in their political aspects. The monetary integration of Britain into Europe would involve it in becoming an equal partner in a supra-national monetary order, designed as a component of a broader supra-national political order of which it is already a member, and which is configured (imperfectly no doubt) to treat all of its members on an equal basis, and to ensure all of them a voice in its current functioning and future evolution. Were Britain to make this choice, it would surrender national sovereignty in monetary affairs, but it would preserve some accountability of monetary policy makers to its electorate, albeit less than that electorate is used to. Monetary integration into North America, on the other hand, would involve Canada giving up both national sovereignty and every shred of political accountability on the part of policy makers to its electorate. In seeking such a change, Canada would in effect be offering hegemony over the most important single component of its domestic macroeconomic policy to the government of the United States. To the best of my knowledge, the United States have neither the ambition to establish such hegemony, nor any interest in having it thrust upon them, and Canadians would be wise to take such schemes off their agenda. There are many more important and pressing matters to which the country's scarce political energy could better be devoted.

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