

North American Monetary Integration: Should Canada Join the Dollarization Bandwagon?

By Mario Seccareccia

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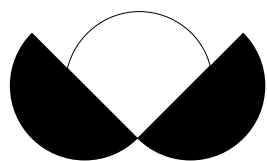
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Summary

Over the last few years, the issue of greater monetary integration and of an outright North American Monetary Union (NAMU) has scored high on the Canadian media's priority list. Much of this interest has been spurred by a plummeting Canadian dollar which has been subjected to strong speculative pressures during the last decade and which, in the opinion of many economists and politicians in Canada, remains significantly undervalued in the foreign exchange markets.

This desire to consider alternative monetary arrangements for North America has been strengthened by a number of events internationally, the most significant of which was the establishment of the European Economic and Monetary Union (EMU) and all the fanfare surrounding the launching of the electronic version of the new European common currency, the euro, in January 1999 and its *bona fide* version in January 2002 in the 12-member countries of the EMU. This event, perhaps more than the growing integration resulting from the original Canada-U.S. Free Trade Agreement and NAFTA, has done much to give legitimacy to the proposals of those in Canada pushing for further monetary integration with the United States.

As a growing number of academics, pundits, and politicians—especially those associated with the Canadian Alliance and the Bloc Québécois—have asked: if the Europeans and others have felt that greater monetary integration is indeed a desirable goal, should we not also embark on some

similar institutional harmonization with our NAFTA partners? In response to such questions, even the current Governor of the Bank of Canada, David Dodge, seems to have conceded that greater monetary integration with the U.S. may turn out to be a desirable goal to be realized when future conditions necessitate it. Hence, in this era of “de-nationalizing” money, there seems to be a growing opinion that the Canadian dollar might ultimately fall victim to what appears to be an unstoppable tendency towards monetary globalization and that, as pro-NAMU economists have advised, we should jump on the NAMU bandwagon and scrap the loonie.

Several alternatives to the *status quo* have been proposed over the last few years, including such measures as a hard peg to the U.S. dollar, a currency board arrangement (of the type that has proliferated in a number of “emerging” market economies of Eastern Europe, and in Latin America), the abandonment of our national currency in favour of the unilateral adoption of the U.S. dollar, as well as the institutional re-vamping of North American monetary institutions based on an EMU blueprint.

When compared to the current independent floating exchange rate, all these alternative schemes would lead Canada further down the path of what can be generically described as varying forms of “dollarization.” But the choice between pegging or floating, or between retaining or abandoning one's national currency, is not a matter of simply changing the colour

and design of the currency we carry in our wallets. The concern, rather, has to do with whether such major policy changes would actually be beneficial to most Canadians, and with whose wallets would be most affected, for good or ill, by a changeover to any new monetary regime.

The object of this report is to evaluate these various proposals and to see whether such alternative monetary arrangements would be at all helpful in solving the many problems facing Canadian society—problems which have to do primarily with the chronic underutilization of our human resources, the growing inequalities both among individuals and across regions, and most of all the chronic underfunding of our social safety net, especially education and health care.

In other words, will giving up more and more of our monetary sovereignty provide greater economic and social benefits directly to Canadians? Or, if not directly, will it do so indirectly by providing the state with better means than it has at present to address such problems and to achieve socially desirable goals?

My conclusion, which may be stated unequivocally from the outset, is that none of these proposed arrangements can solve any of these problems, and that Canada should continue to “go it alone” under a flexible exchange rate regime. As the recent experiences in both Europe and in our own hemisphere (Argentina and Ecuador) suggest, greater monetary integration neither alleviates social and economic problems nor does it provide policy-makers with the means to do so. At best, these arrangements may mitigate one social problem, such as high inflation, through monetary austerity, but only at the heavy cost of lower economic growth. This would ultimately mean higher unemployment, growing poverty,

and a slower growth or outright decline in a country’s living standard.

Moreover, unlike some Latin American countries, inflation is not even an issue in a low-inflation environment such as Canada’s. The various proposals in favour of greater monetary integration could therefore be considered as policy solutions in search of a non-existing problem.

Instead of greater monetary integration that further ties the hands of nation states, what is needed are obstacles to financial capital movements that prevent the needed flexibility in the exchange rate from becoming overly destabilizing and thereby frustrating policy-makers in pursuing policies of high growth and full employment. A Tobin tax may not be up to the task, even if one were able to succeed in getting the international coordination that such a transactions tax would require for effective implementation. The reason is obvious. A Tobin tax may be appropriate in preventing minor disturbances, but not the major speculative attacks of the type that practically crippled the ERM in 1992 or the wild foreign exchange-rate gyrations during the Mexican and Asian crises of the last decade.

It may be much preferable, therefore, to equip national governments with not only a Tobin tax (regardless of its form), but also a whole battery of regulatory controls on financial capital movement that were abandoned with the breakdown of the Bretton Woods system (from quantitative restrictions on financial capital movement to credit controls). Their effect would be to slow down significantly speculative financial movement and allow the exchange rate to fulfill its shock-absorbing role without the damaging effect of currency speculation.

The quality of such controls, of course, would depend essentially on the international coordination that is needed to make such controls fully effective, as were those in the Bretton Woods system that was put in place immediately after the Second World War.

Would such an international coordination be possible today? During the last year, there has been a strong show of political will and international solidarity in the wake of the September 11, 2001 terrorist

attacks in rooting out terrorist financing. Surely we can anticipate the same political will to control destabilizing capital flows whose impact can be as damaging (if not more so) to the world economy as any of the economic devastations caused recently by international terrorism. International economic insecurity tends to generate political instabilities, and it is only by dealing with the former that real peace and security can be achieved internationally.

Introduction

Over the last few years, the issue of greater monetary integration and of an outright North American monetary union (NAMU) has scored high on the Canadian media's priority list. Much of this interest has been spurred by the continuing spectacle of a plummeting Canadian dollar which has been subjected to strong speculative pressures during the last decade and which, in the opinion of many economists and politicians in Canada, remains significantly undervalued in the foreign exchange markets.

This desire to consider alternative monetary arrangements for North America has been strengthened by a number of events internationally, the most significant of which pertains to the establishment of the European Economic and Monetary Union (EMU) and all the fanfare surrounding the launching of the electronic version of the new European common currency, the euro, in January 1999 and its *bona fide* version in January 2002 in the twelve-member countries of the EMU. This event, perhaps more than the growing integration resulting from the original Canada-U.S. Free Trade Agreement and NAFTA, has done much to give legitimacy to the proposals of those in Canada pushing for further monetary integration with the United States.

As a growing number of academics, pundits, and politicians—especially those associated with the Canadian Alliance and the Bloc Québécois—have asked: if the Europeans and others have felt that greater monetary integration is indeed a desirable

goal, should we not also embark on some similar institutional harmonization with our NAFTA partners? In response to such questions, even the current Governor of the Bank of Canada, David Dodge, seems to have conceded that greater monetary integration with the U.S. may turn out to be a desirable goal to be realized when future conditions necessitate it. Hence, in this era of “de-nationalizing” money, there seems to be a growing opinion that the Canadian dollar might ultimately fall victim to what appears to be an unstoppable tendency towards monetary globalization and that, as Thomas Courchene and Richard Harris (1999a), Herbert Grubel (1999), and other pro-NAMU economists such as Sherry Cooper have advised, we should not miss the NAMU bandwagon and should scrap the loonie in a hurry.

Several alternatives to the *status quo* have been proposed over the last few years, including such measures as a hard peg to the U.S. dollar, a currency board arrangement (of the type that has proliferated in a number of “emerging” market economies of Eastern Europe, and in Latin America), the abandonment of our national currency in favour of the unilateral adoption of the U.S. dollar (commonly described as policy dollarization), as well as the institutional revamping of North American monetary institutions based on an EMU blueprint.

When compared to the current independent floating exchange rate, all these alternative schemes would lead Canada further down the path of what can be generi-

cally described as varying forms of “dollarization.” However, the choice between pegging or floating, or between retaining or abandoning one’s national currency, is not a matter of simply changing the colour and design of the currency we carry in our wallets. The concern, rather, has to do with whether such major policy changes would actually be beneficial to most Canadians, and with whose wallets would be most affected, for good or ill, by a changeover to any new monetary regime.

The object of this report is to evaluate these various proposals and to see whether such alternative monetary arrangements would be at all helpful in solving the many problems facing Canadian society—problems which have to do primarily with the chronic underutilization of our human resources, the growing inequalities both among individuals and across regions, and most of all the chronic underfunding of our social safety net, especially education and health care. In other words, will giving up more and more of our monetary sovereignty provide greater economic and social benefits directly to Canadians? Or, if not directly, will it do so indirectly by providing the state with better means than it has

at present to address such problems and to achieve socially desirable goals?

Our conclusion, which may be stated unequivocally from the outset, is that none of these proposed arrangements can solve any of these problems, and that Canada should continue “to go at it alone” under a flexible exchange rate regime. As the recent experiences in both Europe and in our own hemisphere (Argentina and Ecuador) suggest, greater monetary integration neither alleviates social and economic problems, nor does it provide policy-makers with the means to do so. At best, these arrangements may mitigate one social problem, such as high inflation, through monetary austerity, but only at the heavy cost of lower economic growth (see Edwards and Magendzo, 2001). This would ultimately mean higher unemployment, growing poverty, and a slower growth or outright decline in a country’s living standard. Moreover, unlike some Latin American countries, inflation is not even an issue in a low-inflation environment such as Canada’s. The various proposals in favour of greater monetary integration could therefore be considered as policy solutions in search of a non-existing problem in this country.

The Current Status Quo and Proposed Alternative Monetary Arrangements

In the wake of a series of currency crises in Asia and within our own hemisphere, contemporary international monetary arrangements remain in a state of continual flux. As identified by the International Monetary Fund in its annual reports on *Exchange Arrangements and Exchange Restrictions*, there exists at least a half-dozen distinct monetary arrangements internationally, beginning on one end of the spectrum with independent floating exchange rate regimes and going all the way to fully integrated monetary unions. In Table 1, we have classified these broad arrangements from left to right on the basis of their degree of monetary integration, as well as regrouped them dichotomously in the table as “nationalized/denationalized” monetary systems, i.e., we have classified them in accordance with the extent to which these arrangements are structurally accountable to their respective sovereign national authorities. It is important to note that these are the main prototypes, with hybrid versions being situated somewhere between them.

1. The Status Quo: Independent Floating Exchange Rate

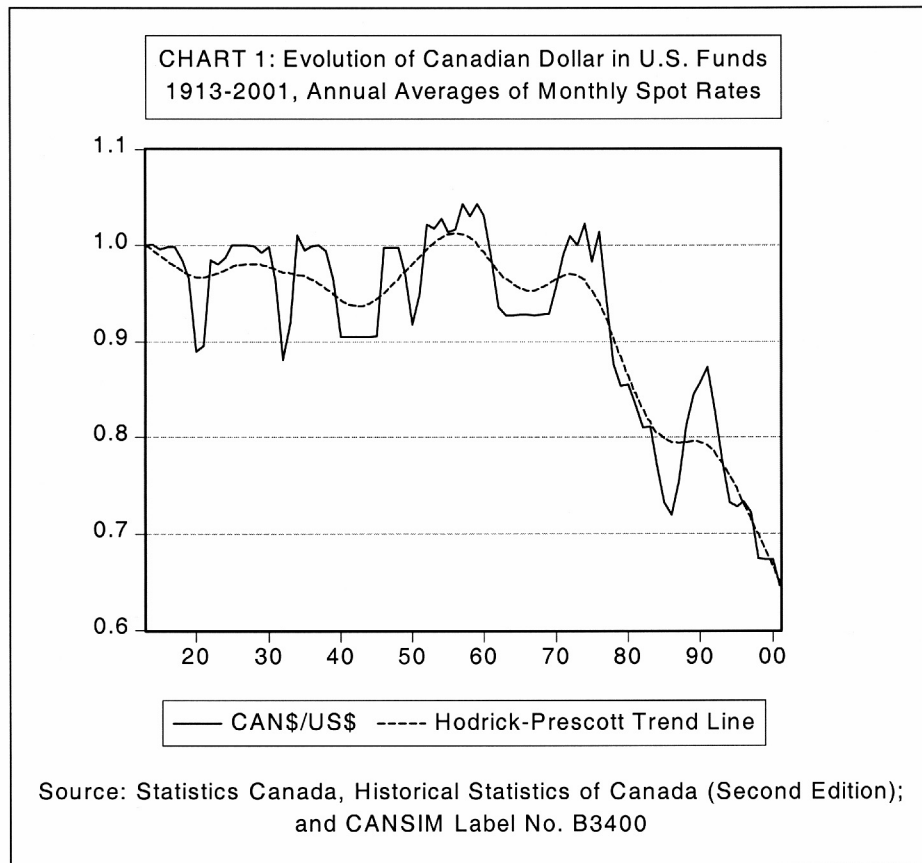
Ever since the breakdown of the Bretton Woods System at the beginning of the

1970s, a large number of countries, including Canada, opted for floating exchange rates. By a floating or flexible exchange rate we mean a system that allows the price of our domestic currency in relation to that of other countries to respond freely to demand/supply conditions internationally. These conditions are reflected in the overall value and volume of currency transactions measured in either the current account of Canada’s international balance of payments (because of changes, say, in our terms of trade with the rest of the world that impact on our exports/imports of goods and services) or the capital account (because of cross-border movement of funds).

As shown in Chart 1, except for a short episode between 1962 and 1970, during the last half-century the Canadian dollar has been floating in relation to the U.S. dollar, albeit primarily in the downward direction since 1976—an experience repeated by numerous other currencies internationally. Most of the short-term volatility around this downward trend cannot be explained easily by the movement of underlying “fundamentals” such as our terms-of-trade vis-a-vis the rest of the world. Many economists, regardless of their persuasion, would agree that it is short-term capital movement, driven by the herd behaviour of ei-

Table 1: Competing Monetary Arrangements

National Money			Denationalized Monetary Systems		
Independent Floating Exchange Rate	Floating Exchange Rate with Bands	Pegged Exchange Rate	Currency Board	Unilateral Policy Dollarization	Monetary Union



ther domestic or foreign speculators engaged in some form of currency arbitrage (with the latter being fueled by volatile expectations about the future course of the Canadian dollar) that would account for much of the “noise” around the trend-line of the average monthly observations of the Canada/U.S. spot rate in Chart 1. However, the sharp spike in the series during the late 1980s would suggest that monetary policy has clearly played a significant role in moving the underlying trend.

(a) Flexible Exchange Rate as Shock Absorber

Mainstream economists going back to Milton Friedman (1953), all the way to present-day economists at the Bank of Canada (see Murray, 1999), have always argued that, despite a susceptibility to speculative pressures generated in part by the highly deregulated financial markets,

flexible exchange rates have an important advantage because not only can they insulate a country from foreign inflation, but they can also smooth out adjustment to terms-of-trade shocks originating in the international market. According to these economists, this is especially important in a world in which domestic prices and wages may be highly “rigid” or unresponsive to pressures from export demand, in which case market-clearing adjustments must be fulfilled via the exchange rate.

Much of the research at the Bank of Canada has tried to show how our floating exchange rate has served as an important “shock absorber,” such as during the Asian crisis in 1997. For instance, in defense of Canada’s floating exchange rate, our former Bank of Canada Governor, Gordon Thiessen (1998-1999), argued that, without a downward adjustment in the value of the Canadian dollar that buffeted our economy

from the Asian shock, we would have suffered a serious slowdown in 1997-98.

Although there does exist a body of evidence—especially in the developing world (see, for instance, the respective performances of Brazil and Argentina in weathering the current world recession)—that partly confirms the shock-absorbing value of floating exchange rates (see Broda, 2001), the issue of “shock absorption” via the exchange rate may be considered of secondary importance. A falling Canadian dollar would not easily insulate us from the international transmission of a major recession afflicting the U.S. economy, with the latter now soaking up close to 90% of Canadian exports.

Moreover, this shock-absorbing effect of flexible exchange rates is further eroded because of the existence of financial capital mobility that often generates greater amplitudes in the movement of the exchange rate than would be desirable for the presumed shock absorption to take effect. Hence, the mix between flexible exchange rates and highly mobile financial markets may be an exceedingly explosive one, and would suggest that, contrary to the mainstream view, floating exchange rates would be most appropriate in a world in which financial capital markets are considerably regulated. This is why, in the 1970s, when floating exchange rate systems were proliferating in the world economy, Nobel Prize winner James Tobin advocated a tax on foreign exchange transactions as a way of slowing capital mobility, while still retaining the shock-absorbing property of a floating exchange rate system (Tobin, 1978). Although non-mainstream economists (see, for instance, Davidson, 1997) have argued that what is really needed are “boulders” rather than Tobin’s “grains of sand” to produce a truly significant slowdown of short-term capital move-

ments, an effective regulation of financial markets is the *sine qua non* to prevent some of the obvious negative externalities that currently afflict our current system of floating exchange rates.

(b) Policy Independence

However, there are far more important reasons for supporting floating rates than the traditional shock-absorbing feature of a flexible exchange rate system cited by economists at the Bank of Canada. The first of these additional features pertains to a country’s ability to conduct independent monetary policy under a floating rate system. An independent monetary policy traditionally enables our central bank to target short-term interest rates without necessarily seeking to satisfy any other formal constraint arising from a country’s commitment, say, to a fixed value of our currency in the foreign exchange markets.

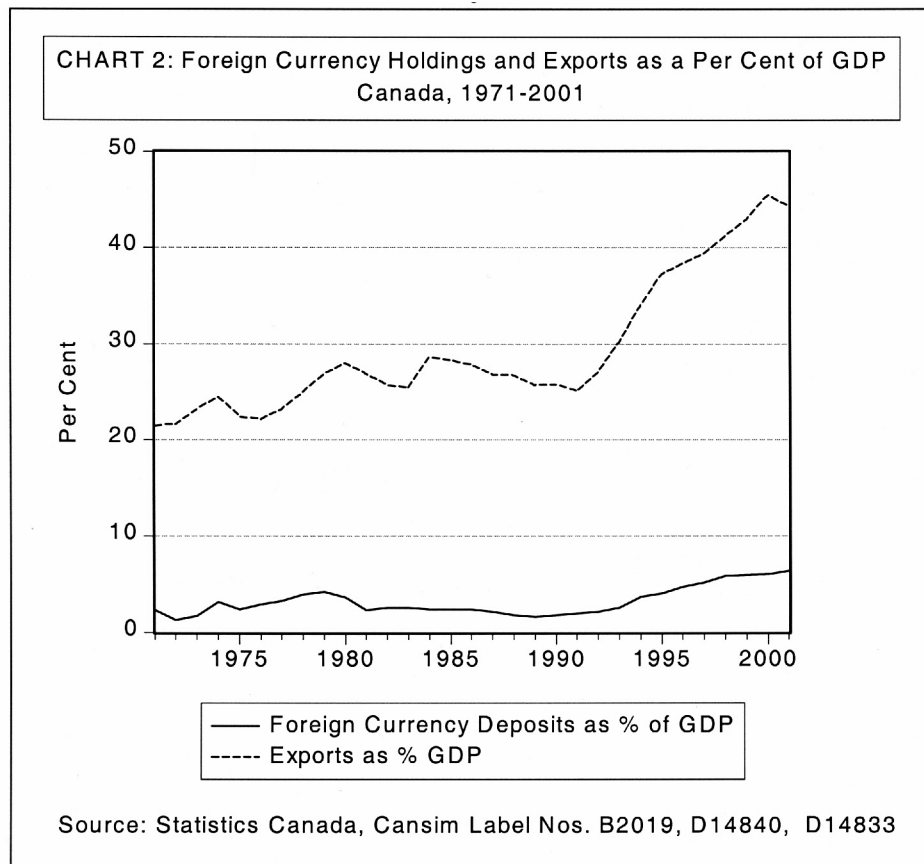
Admittedly, our experience with independent monetary policy has not been a particularly positive one, especially during the early 1990s under the governorship of John Crow, in the sense that Canada’s economic performance would probably have been much improved if we had implemented the less austere monetary policy pursued by the U.S. Federal Reserve during that time. This notwithstanding, under a floating exchange rate at least the Canadian monetary authorities, who in the final analysis are accountable to Parliament and not to the international financial community, would have the *choice* to pursue either good or bad interest rate policies. In the case of other monetary arrangements, such a choice would become progressively constrained or non-existent (see Smithin, 1999).

As will be further discussed below, any monetary arrangement to the right of the floating rate system in Table 1 above would

entail the loss of this important “monetary” instrument of government policy, either *de facto* (as in the case of national fixed exchange rate regimes) or *de jure* (for denationalized monetary arrangements such as currency boards, etc.). In fact, only under very strong political pressures, both domestically and internationally, because of problems of hyperinflation (as, for instance, was the case in Argentina in 1991 when it opted for a currency board arrangement), would a country seriously want to give up its monetary sovereignty, arguably as a pure act of desperation.

Consequently, most of the over 100 newly-emerging countries that acquired their political independence after World War II, including many of those that were part of the former Soviet Union prior to 1991, have historically chosen the route of floating exchange rates, justifiably in order to assert a certain element of monetary in-

dependence. Indeed, despite this supposed tendency towards monetary globalization, there are undoubtedly more currencies in existence today than, say, even a century ago. Unfortunately, in many of these small countries in which the state frequently holds little legitimacy, where there is no viable banking structure domestically, and where their citizens often choose to hold an important share of both their overall debts and deposits in foreign currencies, such monetary independence might be deemed as somewhat illusory. As is illustrated in Chart 2, this, however, is not the case for countries such as Canada where, despite the very sharp fall in the Canadian dollar during the last decade, one has not seen any dramatic shift in the holding of foreign currency-denominated deposits by Canadians over and above what one would normally expect from the growing share of foreign trade out of GDP (see Laidler and



Poschmann, 2000; and Murray and Powell, 2002).

(c) Foreign Currency Reserves and Liquidity Provision

One other important feature of floating exchange rate systems that critics of such regimes often neglect to mention is that, under a national system of flexible exchange rates, countries would not need to amass large buffer stocks of foreign currency reserves and/or rely perpetually on international lines of credit in order to protect one's currency from devaluation as, say, under a system of pegged exchange rate (except perhaps periodically to smooth out sharp fluctuations stemming from large international shocks). In the case of Canada, such central bank interventions have been very infrequent, and they have normally been intended to stave off serious speculative attacks against the Canadian dollar, as for example to prevent contagion during Mexico's "Tequila" crisis in 1994.

At the same time, however, the further one moves rightward in Table 1 towards dollarization, this difficulty of building up significant reserves quickly is transformed into an incapacity on the part of the domestic authorities to fulfill the crucial role as lender of last resort. For example, if a domestic liquidity crisis were to arise in a dollarized economy, the viability of the whole domestic financial structure would depend on the country's ability to borrow from the international financial community and/or from the International Monetary Fund (IMF) by soliciting Special Drawing Rights that would be tied to very stringent conditions to be met for the financial bailout. Under an independent floating exchange rate, this liquidity problem would not normally arise, unless the country is already faced with a high external debt, as

was the case during the Mexican financial crisis in 1994-95 where a dramatic depreciation of the Mexican peso had led to the massive failure of the then recently privatized commercial banks.

In the case of Canada, none of these conditions have prevailed. Unlike, say, Mexico, our foreign debt is denominated mostly in Canadian dollars, and therefore we would face very little consequence if foreign investors were to decide suddenly to dump Canada's foreign debt. The Bank of Canada would be able immediately to step in to supply the needed liquidity. Indeed, although not related to an international crisis, the closest to facing a liquidity problem that required central bank intervention as lender of last resort took place when two Canadian chartered banks collapsed in 1985. At the time, the Bank of Canada quickly took up its role of lender of last resort by advancing liquidity to other domestic banks in order to limit the contagion arising from the two bank insolvencies. All of this was achieved in an orderly manner within a national floating exchange rate system that did not require an infusion of funds from abroad in order to meet chartered bank liquidity needs.

2. Alternative National Monetary Arrangements: Fixed Exchange Rates

Several monetary arrangements have been proposed as alternatives to the existing floating exchange rate system in Canada, all of which are listed in Table 1. Thus far, the term floating exchange rate has been used quite broadly to describe any system in which a country's exchange rate is employed as the primary mechanism of adjustment to external shocks; but there are various degrees of adjustments. In a freely

floating exchange rate of the type previously discussed, no predetermined limits to the adjustments in the exchange rate were considered. However, there have existed various constrained floating systems with a pre-set range within which the currency value is allowed to fluctuate before triggering a direct intervention from the monetary authorities to bring the currency value within its predetermined corridor.

In Table 1, we described such regimes as floating exchange rate systems *with bands*, with the latter being either narrow or wide in range. For instance, between 1962 and 1970, the Canadian monetary authorities had constrained the Canadian dollar to move within a very narrow band of plus or minus 1% around the fixed parity of 92.5 cents in U.S. funds. In much the same way, prior to the launching of the euro between 1979 and 1999, the Europeans worked within an Exchange Rate Mechanism (ERM) that would allow the varying exchange rates of the participating countries to fluctuate also between a fairly narrow corridor which, at the time, was described as the European “snake.” While, strictly speaking, such hybrid arrangements may still be considered as floating exchange rate systems because they do offer the monetary authorities some degree of freedom, in conventional discourse such regimes have been generally termed “fixed” exchange rate systems. Hence, although we have separated these two types of arrangements in Table 1, for the sake of

simplicity, one can justifiably regroup under the umbrella of fixed exchange rates a whole array of intermediate regimes going from a “hard fix” to adjustable or “crawling pegs”—all being mere variants of a generic archetype that we shall describe loosely as a system of fixed exchange rate. Table 2 lists these successive exchange rate regimes in Canada ever since the original adoption of the Canadian dollar as the official currency unit in the mid-19th century (see Powell, 1999).

As can be seen from this table, prior to 1914 Canada was locked into the prevailing gold standard—a peculiar fixed exchange rate system (somewhat akin to present-day currency board arrangements) that, at least according to conventional wisdom, tied the domestic stock of high-powered money to gold inflows/outflows and a country’s nominal exchange rate to the international market price of gold. Since then, Canada went through successive phases as the gold standard was put on hold during World War I, temporarily re-established after the war, and only to be abandoned definitively during the Great Depression. Since World War II, Canada has experimented with both fixed and flexible exchange rates, and in the 1950s it was one of the few Western countries that had *not* adopted a fixed exchange rate as prevailed under the Bretton Woods system. After a short episode during the 1960s of experimenting with a fixed exchange rate, Canada has been floating its currency ever

Table 2: Successive Canadian Foreign Exchange Rate Regimes Since before Confederation

Period	1854-1914	1914-1926	1926-1931	1931-1939	1939-1950	1950-1962	1962-1970	1970-present
Regime Type	Fixed (Gold Standard)	Flexible	Fixed (Gold Standard)	Flexible	Fixed with periodic adjustment	Flexible	Fixed	Flexible

since May 1970 when John Turner was still federal Minister of Finance in the first Trudeau government.

The dramatic shift during the 1990s in Canada's trade orientation in support of still closer integration with the U.S. has given impetus to those pushing for further North American monetary linkages that would both solidify and encourage greater expansion of Canada-U.S. trade. As a result, a number of economists have seen the floating loonie and its general volatility vis-a-vis the U.S. dollar during the 1990s as being highly detrimental to trade with our NAFTA neighbours. If greater trade is to be achieved, they argued, steps must thus be taken to peg the value of our currency to the U.S. dollar.

(a) Arguments in Favour of Fixed Exchange Rates: Elimination of Exchange Rate Risk

Support for fixed exchange rates rests on a few main arguments normally highlighted by those economists supporting greater monetary integration. The most obvious and least sophisticated of these arguments points to the detrimental effect of the high volatility in the exchange rate on Canada's economic performance. This is because sharp variations in the exchange value of our currency ultimately impose the cost of exchange-rate risk on those engaged in cross-border trade and investment (Van Audenrode, 1998: 127). Hence, stability in the exchange rate would create conditions more conducive to growth of output and investment in the export sector. Indeed, following Rose (2000) and others, it has been argued that growth in foreign trade is itself ultimately associated with the degree of monetary integration. As one moves progressively from fixed exchange rates towards monetary union, the "foreign exchange obstacle" is eliminated, with new

opportunities appearing in the export sector that stimulate the growth of overall trade and employment.

There is no question that exchange risk is a tangible cost to firms engaged in the export/import sectors. But while exchange rate exposure for firms is an obvious concern, exchange-rate risk-management strategies of corporations via exchange rate hedging are commonplace, especially among transnational corporations; and there is little evidence to suggest that they are unable to cope effectively with exchange rate risk—for instance, with the appropriate use of foreign exchange derivatives and, in the case of multinational corporations, with the adoption of cross-border strategies that are able to reduce foreign exchange needs altogether (Allayannis, Ihrig, and Weston, 2001). Moreover, if the volatility in the exchange rate were such a serious obstacle to Canadian foreign trade, it would be hard to infer that a floating rate was a significant factor holding up trade with the rest of the world, especially in light of the fact that the share of exports out of GDP reached unprecedented levels during the last half century, with most of this steep rise taking place during the era of floating rates.

Still more problematic to this argument, perhaps, is that, even if one were to accept the hypothesis that floating rates were of significance in preventing the growth of exports to our trading partners, it does not necessarily follow that the adoption of a hard fix with the American dollar would contribute any further in increasing our trade with our southern neighbour. Already more integrated than most of the countries of the EMU (see Courchene, 1998), with almost 90% of our trade being with the U.S., it would be difficult to envisage still further growth in a share that may already have reached its practical up-

per limit. It is true that one can always increase still further the volume of trade and commerce with the U.S., but this would not be possible without locking our trade share at levels that would even surpass the interstate trade shares within the United States itself.

(b) The Problem of Exchange Rate Misalignment and the Optimal Allocation of Resources

A second more sophisticated argument in favour of a fixed exchange rate is one based on a theory that is at the core of orthodox economics; it relates to the information-transmission role of the price mechanism as a market-signaling device that brings about the most efficient allocation of resources. It is argued that the tremendous short-term volatility in the exchange rate leads to chronic misalignment between the nominal exchange rate and the economic fundamentals that would supposedly be behind its long-term value: the “real” exchange rate. Acting on the distorted price signals engendered by the frequent exchange-rate misalignments, industries tend, as a result, to misdirect their investments in activities that would be unsustainable in the long run (Harris, 2000). Fixed exchange rates, according to this theory, would eliminate the volatility that generates the misalignments, and so their adoption would bring about a more appropriate allocation of both physical and human resources in Canada. Despite the lack of a formal consensus as to what are the underlying fundamentals and determinants of the “real” exchange rate, the general reaction of economists supporting floating rates, such as those at the Bank of Canada (Murray, 1999), is to argue that empirically the nominal exchange rate does closely track the real exchange rate, and therefore that the problem of exchange-rate

misalignments is not as severe as the critics make it out to be.

Whether the problem of “misalignments” is a serious one is clearly a highly debatable issue. In fact, some would argue that there are no immutable terms of trade, and that the real exchange rate is itself a variable that can be manipulated by government policy. Regardless of the relevance and significance of this misalignment, however, it is hard to understand why some economists would not consider other less drastic measures to deal with it. In particular, if behind the volatility in the “nominal” exchange rate is the behaviour of short-term speculative financial investment, why not seek to re-regulate short-term capital flows so as to put a cap on the deviations from the underlying fundamentals arising from changes in the terms of trade (Crotty and Epstein, 1996)? As the dictum goes, why throw away the baby with the bath water?

Even if the evidence, both during the early post-war period and during recent times (in countries such as Chile), suggests that capital controls can work in slowing down the cross-border movement of “hot money” and thus stem the tide of currency speculation, the usual reply is that such regulations would be wasteful of resources. While undoubtedly capital controls are resource using, a policy of a fixed exchange rate is not without costs. The latter would not only include the tangible costs of building up significant foreign reserves to intervene continually in the foreign exchange markets (Mosler, 1998), but, most importantly, there is the loss of monetary policy as an instrument to achieve other socially desirable objectives. Indeed, such objectives are listed in the preamble to the Bank of Canada Act of 1934, and include strong economic growth, price stability, high em-

ployment, and a favourable balance of international payments.

(c) Optimal Currency Area Argument

A third argument in favour of fixed exchange rates, going back to the work of Robert Mundell during the early 1960s, has to do with what has come to be described as the “optimum currency area” problem. The idea is quite simple. If a country is regionally differentiated, as is Canada, the use of exchange rate adjustments when its regions are subjected to asymmetric external shocks can exacerbate regional imbalances. For instance, let us assume that there was a sharp hike in the international price of oil, as occurred during the 1970s, thereby favouring the Western oil producers, while central Canadian industries were still suffering from a North American recession. Because of the stabilizing role of the floating regime, the impact of that oil price shock would be to put upward pressure on the Canadian dollar. The higher exchange rate would somewhat suppress inflationary demand pressures in the oil-producing regions but, at the same time, it would make central Canadian producers less competitive in the export market and thus deepen the recession in central Canada. Under fixed exchange rates, the adjustment to asymmetries just described would not arise. The burden of the adjustment would fall on regional prices (and output), rather than macro-economically via the exchange rate.

From this analysis, it is commonly concluded that the use of the exchange rate as a shock absorber in the presence of strong industrial/regional diversity is inappropriate, since it can exacerbate regional tensions. Consequently, a fixed exchange rate, or even monetary union, would be desirable for the central Canadian regions most

hurt by the floating exchange rate (Beine and Coulombe, 2001).

There are, however, serious problems with this argument. If Canada is, in fact, *not* an optimal currency area, it is hard to comprehend why we should join a broader continental monetary arrangement that would be even less “optimal.” Moreover, although the previous example of a positive, yet asymmetric, regional demand shock would advise in favour of a fixed exchange rate system, this would certainly not be appropriate for all seasons. For instance, let us suppose that there is a negative demand shock afflicting primary producing regions in Canada, as occurred during the Asian crisis of the late 1990s. In that case, as demand for primary resources from Asia collapsed in 1997, the Canadian dollar fell and amortized the negative shock on the resource sector, primarily in British Columbia. At the same time, it also meant a windfall gain for central Canadian exporters of manufactured goods, who were able to capitalize on the falling Canadian dollar.

In this example, a floating exchange rate benefited Canadian exports in general. In all cases, therefore, a floating exchange rate would engender these positive or negative side-effects (or externalities) arising from international shocks. The externality would certainly not be normally in one direction. It would all depend on the precise nature of the shocks impacting on the Canadian economy.

However, the alternative of a fixed exchange rate regime would certainly be no more appealing than the current *status quo* of floating rate. As an example, let us take the present case of an international shock arising from the recent slowdown of Canadian exports because of a major recession in the United States. Under a floating system, the Canadian dollar would be try-

ing to play its role as “shock absorber” by mitigating the impact of the U.S. recession on Canadian exports. In what way would a pegged exchange rate protect us from this negative international shock? The answer, it would seem, is that, under normal conditions, it could actually make matters worse. Since, with a pegged exchange rate exports in real Canadian dollars would fall even more sharply than under a floating rate regime, there would be greater pressure on both domestic wages and prices to deflate (Robson, 2001: 47). For familiar Keynesian reasons, this would result in negative consequences on consumption demand and employment, particularly on the non-tradeable goods sector as domestic incomes are squeezed.

A good example of this is the recent experience in Argentina, where deflationary pressures originating in the export sector, because of their hard peg, impacted negatively on overall domestic income and employment. On the other hand, the above-mentioned strong deflationary consequences, with negative spillover effects on the domestic sector, would not commonly be a characteristic feature of a floating regime. In the case of a floating rate, the effect of a falling Canadian dollar would be to lessen the decline in exports and discourage imports (thereby siphoning off domestic demand from imported goods towards domestic consumption), but this would take place without the same negative deflationary consequences on domestic nominal incomes. Hence, to conclude, negative and positive externalities arising from asymmetric shocks is a problem with any monetary arrangement and is in no way peculiar to a floating rate system, as most advocates of fixed exchange rates seem to argue.

The only question is whether one prefers as the primary mechanism of adjust-

ment the exchange rate or changes in domestic wages and prices (in the case of fixed exchange rates). The problem with the latter mechanism, not usually recognized by advocates of fixed exchange rates in Canada, is a simple Keynesian one. Under a pegged exchange rate, once domestic wages are affected because of negative pressures from the export sector, these external demand pressures are, in turn, also transmitted to the domestic sector. In this case, the domestic sector would no longer be sufficiently insulated from the external shock, since it would also suffer greatly because of falling domestic consumption demand—an outcome that would be far more effectively mitigated under a floating rate system.

3. Denationalizing Money: From Currency Boards to Policy Dollarization

For most advocates of monetary integration, fixed exchange rates are usually conceived as a temporary halfway house on the road towards some form of monetary union. For example, the Europeans first adopted, between 1979 and 1999, a fixed exchange rate system that was supposed to allow the economies within the ERM to converge sufficiently until full-fledged monetary union would be achieved with the creation of a single currency in 1999. A similar process is being proposed by advocates of North American monetary integration. For instance, Courchene and Harris (1999b) have argued that in Canada the long-term objective of exchange rate fixity ought ultimately to be a NAMU based on some variant of the EMU structure. Other types of arrangements, such as currency boards or even unilateral dollarization, have sometimes been sug-

gested (as one moves rightward in Table 1), but the preferred institutional structure for those partial to greater North American integration remains overwhelmingly the EMU.

(a) Currency Boards

Before discussing why the EMU is the model of choice for those supporting greater monetary integration for Canada, let us first briefly analyze some of the competing models which have been sometimes referred to but which have rarely been advocated as viable institutional alternatives that Canada ought to emulate.

The first of these structures that has recently acquired a degree of notoriety is a currency board arrangement. During the 1990s, currency boards became fashionable in a number of “emerging” market economies of Eastern Europe, as well as in certain developing countries. Largely because of its spectacular default on its foreign debt that led to the unravelling of its currency board arrangement, the most well-known of the now remaining seven other surviving currency boards in the world today is the Argentine currency board, which was first established in 1991.

There are two key characteristics of a currency board that need highlighting: (i) much like “hard-fix” exchange rate systems, under a currency board arrangement the exchange rate is set by law (for example, in the Argentine case it was pegged at a conversion rate of one Argentine peso to the U.S. dollar); and (ii) the currency board can only issue its own domestic currency if the latter is backed by foreign currency (for example, in the case of Argentina and Hong Kong, by U.S. dollars) at the conversion rate as set out in (i) above. Hence, in order to issue domestic currency (such as the Argentine peso) as its liability, the currency board would first have to receive U.S.

dollars of an equivalent amount, from which ensues that, on the asset side of its balance sheet, it would essentially be holding U.S. dollar-denominated liquid assets, such as U.S. Treasury bills. This latter fact would thus also highlight the importance of the fiscal policy of the issuing government of the currency to which the country is pegged.

Typically, countries that adopt such a monetary straightjacket do so only under enormous political pressures, so as to re-establish confidence in their currency by financial markets after facing some severe monetary problem, as in the case of Argentina, relating to a persistent hyperinflation. However, once in place, such rigid monetary structures rarely last very long, because of the very reason for their existence, i.e., to inspire confidence in the currency by taking away from the domestic monetary authorities any discretionary powers, particularly the power to create liquidity. During times of crisis, the authorities’ lack of power to create liquidity for domestic banking institutions means that they must abandon the currency board arrangement to prevent the domestic banking system from complete collapse.

Let us look at the recent experience in Argentina. During the period of relative growth in the world economy of the 1990s, when the country was able to rely on growing exports to meet domestic liquidity needs, the currency board structure remained intact. However, as the U.S. dollar (to which the Argentine peso was pegged) continued to soar and the world economy slowed down during 2001, net exports fell sharply and the currency board could no longer meet the country’s liquidity needs, thereby ensuring its eventual collapse. This is why we have seen the proliferation of “near-currencies” such as the *patacones* that were issued by cash-strapped provincial

governments in Argentina (see Sourbeck and Wray, 2002).

Unless one is a tiny protectorate (as, for instance, Hong Kong is to China and Bosnia is to the EMU) so that there is a “big brother” who can satisfy one’s short-term liquidity needs in times of financial crisis, or unless one is endowed with large foreign reserves, the loss of monetary policy and the inability of the national monetary authorities to serve as lender of last resort are too constraining for any independent national government to continue to sustain a currency board arrangement for any appreciable length of time.

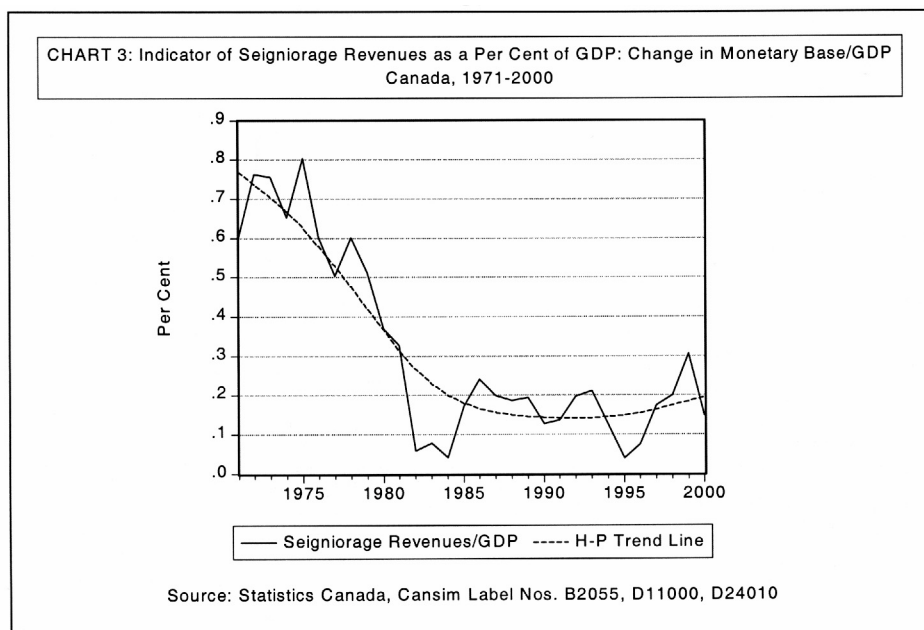
Under a currency board system, a country loses its monetary sovereignty, both because it gives up control of monetary policy and because it forfeits its power to issue liquidity on demand in order to meet domestic needs. But the national authorities still retain the privilege of extracting what is sometimes referred to as “seigniorage” revenues. Seigniorage revenues accrue to the issuer of currency and they arise from the fact that holders of money first had to give up real resources to acquire these relatively costless pieces of IOUs from the

monetary authorities. Hence, in our example of Argentina, one simple measure of this annual flow of seigniorage revenues, frequently referred to by traditional economists, is that represented by the annual net addition of Argentine pesos in circulation. Such seigniorage revenues are not large when compared to a country’s GDP, but, when calculated in present value terms (over an indefinite horizon), they would hardly be insignificant.

As can be seen from Chart 3, an indicator of these seigniorage revenues for Canada (calculated as the annual change in base money as a percentage of Canadian GDP) is displayed. Since the 1970s, these annual seigniorage revenues have declined as a result of changes in the public’s portfolio holdings, especially as payment in cash has been replaced by the use of credit and debit cards and because banks are no longer required to hold cash reserves. Currently, such revenues hover around a mere 0.2% of GDP for Canada.

(b) Policy Dollarization

As an alternative to a currency board “hard fix” which allows a country to retain



seigniorage, a number of countries have opted historically for a policy of complete "dollarization." Such a country gives up its domestic currency, as well as the accompanying seigniorage revenues, and unilaterally adopts the currency of another country. While countries choose the route of unilateral dollarization for reasons at times similar to why countries may opt for a currency board structure (see, for instance, Ecuador in this hemisphere), historically countries which remain dollarized are countries that are essentially vassal states of some larger political entity.

Perhaps the best example of a dollarized country in this hemisphere is Panama, which adopted the American dollar almost a century ago when it was taken over militarily by the United States. There are literally dozens of such dollarized states in the world today, and the vast majority of them reflect an incapacity on the part of the local authorities to issue a generally accepted currency in which their populations have confidence. This incapacity occurs either because the country is so small and weak that it cannot enforce even the payment of taxes in its own currency (such as with, say, Liechtenstein, the Republic of San Marino, or more recently the Republic of Montenegro), or because of a former, and persistent, colonial relation (as with Panama, Puerto Rico, and the Virgin Islands in relation to the United States) (see Bogetic, 2000). All other examples of dollarized countries, such as Ecuador, confirm that a dollarized structure cannot persist for any lengthy period without succumbing ultimately to serious liquidity problems.

Despite the unhealthy track record of such dollarized regimes in terms of general economic performance (Edwards and Magendzo, 2001), owing to their chronic balance of payments problems, there is

enormous pressure on numerous countries to choose dollarization as a quick-fix solution. Because of the difficulty of obtaining IMF support, because of the political stigma attached to that support, and because of the humiliating conditions that are often imposed on countries under IMF "structural adjustment" programs, certain countries have opted for dollarization as the lesser of two evils.

At the same time, for self-interest reasons, this process of dollarization is being fed by some very strong signals coming from the U.S. under the belief that the latter would benefit politically and economically, not only from the direct seigniorage revenues that it would secure, but also from the widening of U.S. exports to these newly dollarized regimes. Indeed, a country that adopts unilaterally the U.S. dollar would relinquish all seigniorage revenues to the U.S., and the latter would assume none of the responsibilities, especially in terms of lender of last resort.

In part as a reaction to the growing opportunities in Latin America for dollarization, in the last few years there has been an attempt by some U.S. politicians, led by Senator Connie Mack, to provide further impetus to the dollarization drive by offering to share a portion of these seigniorage revenues in exchange for extra-territorial regulatory control of a dollarized country's banking and financial system. The intent and purpose of the "Mack proposal" [see the "International Monetary Stability Act of 2001" which was introduced at the 107th U.S. Congress on July 24, 2001] is to provide greater incentives to countries that would dollarize and to offer the facade of greater security against financial crisis, but without the critical lender-of-last-resort provision that would ensure the longer-term viability of the dollarized structure. As can be seen from the recent

experience of Ecuador, this asymmetrical relation between the issuer and the user of the currency makes dollarization a highly unattractive arrangement for any country seeking a stable long-term solution to its short-term liquidity problems.

Indeed, as highlighted in Table 1, it may be affirmed that, whether it be dollarization or a currency board structure, all these arrangements entail in essence what we have described as the denationalization of money. This is because all of these arrangements drive a wedge between the domestic state authority and the ultimate issuer of money. Hence, policy dollarization entails that the national government of a dollarized country accepts payment of taxes and services, not in tokens that it had previously issued, but in the legal tender of another national government. The consequence is that the state finds itself at the mercy of the now dollarized financial markets to engage in activist fiscal policy and, even more importantly, it can no longer be the ultimate purveyor of liquidity during times of financial crisis.

As a corollary, it follows that any “denationalized” monetary structure can only be a temporary arrangement, which would soon unravel once sufficient pressure comes to bear. Hence, dollarized countries have never been a permanent fixture of the international monetary landscape, with the exception of countries that have been politically dependent or *de facto* colonies of a larger “metropole,” such as Puerto Rico and Panama vis-à-vis the U.S. in our hemisphere. Other nations, such as Argentina over the last decade and Liberia before 1980, have set up denationalized structures that have eventually succumbed to political pressures that necessitated their dismantling. Because of this, there are few serious commentators in Canada who have pointed to dollarization as a viable alter-

native to the *status quo*, with the possible exception of Marcil and Beaulieu (2002). It is because of the perils of dollarization that most advocates of greater monetary integration have advocated an institutional restructuring of the NAFTA monetary landscape along the lines of the EMU. Within many political circles, such as in the federal caucuses of the Canadian Alliance and the Bloc Québécois, the EMU framework is often pointed to as the ideal type that we should ultimately strive for in North America.

4. North American Monetary Union (NAMU): The Myth of a New Stateless Money That Would Not Jeopardize Canada’s Political Sovereignty

Given the immediate pressures of dollarization and the spread of regional currency blocs, it has been argued by advocates of a NAMU that Canada should act preemptively. It should try to negotiate a monetary union with the U.S. on more advantageous terms than the less appealing ones that would eventually be imposed on Canada and its other NAFTA partner, Mexico, by way of either market developments or unilateral policy dollarization along the lines of, say, the Mack proposed legal framework. Just to quote the well-known paper by Courchene and Harris (1999):

“While a NAMU is not on the immediate horizon, there is nonetheless an urgent need to place the currency union issue on the public policy agenda. Policy developments within the NAFTA and elsewhere in the Americas appear to be moving quickly in the direction of

dollarization. Since widespread dollarization could preclude the emergence of a NAMU by reducing the advantages the United States would garner from it and since...a NAMU would be preferable to dollarization from a Canadian perspective, Canada must become engaged on this issue with its NAFTA and hemispheric partners—and sooner rather than later.” (Courchene and Harris, 1999a: 3-4)

Much like the debate over the original Canada-U.S. Free Trade Agreement during the 1980s, the argument in favour of monetary union nowadays is not dissimilar. Since Canada must eventually acquiesce to the logic of monetary globalization, we are told that it would be best to seek to negotiate *immediately* a more favourable monetary arrangement within a regional currency bloc that would put Canada on a better footing vis-a-vis the U.S. than to be forced *later* to beg from outside the regional currency bloc under the pressure of unilateral dollarization.

We are told that the model which would best benefit Canada in the North American context is the EMU structure of monetary integration, which would remove one of the last important barriers to trade with the U.S., while still guaranteeing Canada’s political sovereignty. For instance, in extolling the virtues of the EMU, Grubel (1999) imagines:

“On the day the North American Monetary Union is created—perhaps on January 1, 2010—Canada, the United States, and Mexico will replace their national currencies with the amero ...In all three countries, the prices of goods and services, wages, assets, and liabilities will be simultaneously converted into ameros at the

rates at which currency notes are exchanged.

“At the same time, the national central banks of the three countries will be replaced by the North American Central Bank. The operations of that bank will be governed by a constitution like that of the European Central Bank, which makes it responsible solely to maintain price stability. It is not required to pursue full employment or maintain exchange rates. Its personnel policies would be free from political influences, in particular those arising out of partisan national politics in member countries. ... As in Europe, membership in the union will require that countries do not incur persistent budget deficits.

“The amero notes and coins will have in common abstract designs on one side. Notes and coins will be produced in each of the three countries according to their own demand and show national symbols on the other side...” (Grubel, 1999: 5).

This long quotation from Grubel spelling out the basic institutional structure of the proposed NAMU is also highly representative of what is widely held by most other partisans of monetary union in Canada. For instance, Courchene (1999) and Courchene and Harris (1999) view the NAMU as “the North American equivalent of the European Monetary Union (EMU) and, by extension, the euro” (Courchene and Harris, 1999a: 22). Much like the EMU blueprint, a first phase of this process would be the setting-up of a fixed exchange system modelled on the European Monetary System (EMS) that existed in Europe between 1979 and 1999. With time, this fixed exchange rate system would evolve into a common currency arrangement.

Eventually, a North American central bank ought to be set up that would be independent of each national government and that would be solely committed to the goal of price stability. At the same time, the NAMU would also bind each national government to strict rules of “sound finance” such as those that were spelled out under the 1991 Maastricht Treaty and the 1997 Stability and Growth Pact in Europe.

Indeed, we are told that an EMU institutional arrangement would protect Canada (and Mexico) from the obvious abuses that would arise from unilateral dollarization. Firstly, unlike dollarization, the three NAFTA countries would be giving up their respective national currencies not merely to adopt the currency of some other country, but rather to create a new single currency for North America—the “amero” (as Grubel (1999) has dubbed it), or the “neuro” (as some have more facetiously described it). Consequently, instead of subordinating itself to someone else’s stronger currency (as under dollarization), Canada would be abandoning its national currency while simultaneously creating a supranational or “stateless” money (see Corbridge, 1994) that would be free from political control of any one national government within the NAMU. Hence, political sovereignty supposedly would not be threatened, and at the same time each member country would be reaping the rewards of greater monetary integration. Secondly, unlike unilateral dollarization which snatches from the dollarized countries seigniorage revenues, under an EMU structure seigniorage would be shared by the participating members in proportion to each country’s base money requirements. We are told that monetary union would not be as costly as any of the two other alternative arrangements of “denationalized” money listed in Table 1 since, at least with

monetary union, seigniorage benefits would be retained.

Although seigniorage revenues would indeed be shared, it is difficult to understand how some in, say, the Canadian Alliance and the Bloc Québécois, could hold the view that more than a mere semblance of political sovereignty could be retained under an EMU arrangement in North America. First of all, as discussed elsewhere (see Parguez, Seccareccia and Gnos, 2002), the current EMU structure is simply one major stage in a long-term process of historical development in post-war Europe towards *political* unification. Hence, monetary union is seen as an important prerequisite to eventual political union. For this reason, the twelve member countries of the EMU have not only given up their monetary sovereignty, but are also slowly relinquishing part of their political sovereignty in terms of powers to tax and spend, to pursue social policy, etc.

However, within the current interim structure of the EMU, each current national government is in a similar position vis-à-vis the European Central Bank (ECB) as the Canadian provinces are to the Bank of Canada; yet there is no federal government that holds the ultimate monetary authority and that is accountable to the citizens of Europe. For this reason, some have pointed to the obvious weakness of the present system, which resembles much more a medieval-style structure under the supreme stewardship of an unaccountable ECB than the modern constitution of a democratic state (Moss, 1998: 24).

This is perhaps most visible with the pursuit of a single macroeconomic objective—price stability—by the sole reliance on monetary policy pursued by a technocratic élite within the ECB and by the almost complete suppression of discretionary fiscal policy (see Parguez, 2000). The

subordination of fiscal policy has been achieved through the adoption of a cacophony of fiscal rules, which set binding constraints on member states to engage in deficit spending and which prohibit central bank financing of budget deficits. The obvious objective of the Maastricht rules and the logic of the Stability and Growth Pact has been to suppress the authority of the current national governments on matters pertaining to money and the macroeconomy, but without a central state yet filling the political vacuum. Unfortunately for the Europeans, the long history of integrated monetary space teaches us that “stateless” monies will quickly unravel unless there is ultimately some state backing (see Goodhart, 1998; and Wray, 1998).

From this it would seem to ensure that the modern world’s first stateless money, founded on an independent central bank serving as the supreme guardian of the single currency without a significant central state with its own power to tax and spend, must ultimately give way either to a federal structure or possibly collapse under the pressure of its own political contradictions. In much the same way, as Buitter (1999) has argued, without some form of political union to ensure an acceptable degree of accountability of a North American central bank, a NAMU would also lack political legitimacy.

On the basis of what is the visible constitution of the EMU, it is a wonder that anyone would want to emulate such a structure in North America. Unlike dollarization or a currency board arrangement, and more like the FTA and NAFTA, once an EMU-type structure is negotiated and put in place, it would not be easily reversible politically without some agreement among all the member states. In reality, however, it is Americans themselves who might probably save Canadians and

Mexicans from an EMU-based NAMU. This is because Americans would hardly wish to give up the U.S. dollar for any supranational currency, so the prospect of a *new* single currency would be completely unacceptable politically to Americans.

The only viable alternative would be to adopt the U.S. dollar in Canada, with the hope that, in dismantling the Bank of Canada, we would also be able to negotiate a seat at the Federal Open-Market Committee (FOMC) by entering as a 13th district of the Federal Reserve System. This, together with the extension of U.S. banking regulations to Canada, thereby hopefully widening the lender-of-last-resort provision to Canadian banking and financial institutions, may be the best that would be imaginable by those partial to greater monetary integration in Canada—that is to say, a hybrid EMU/dollarized North American monetary landscape.

Other Maastricht rules, such as the strict prohibition of central bank financing of government expenditures, would probably face a strong veto from the U.S. government because of the fear of having its ability to undertake military spending severely hampered. The North American equivalent could therefore hardly resemble the EMU constitution (based on the symmetrical treatment of the member countries) that numerous Canadian advocates of a NAMU would want to import to North America.

Despite the formidable political problems that would be faced by any country wishing to implement such an EMU set-up in North America, this has not stopped a number of economists and politicians in both Canada and Mexico from pushing the political agenda along the route of greater monetary integration and monetary union structured on the EMU model.

There are a few key economic arguments that have been repeatedly advanced

in support of monetary union that have not entered our previous discussion and which now need further analysis. Given the importance of these presumed economic benefits in the current political discourse of

those favouring monetary integration, it would perhaps be best to focus one by one on each of these supposed economic advantages in the following section.

What Would Be the Supposed Benefits of Greater Monetary Integration? A Critical Assessment

The advent of the euro in 1999 has been followed by a proliferation of papers extolling the virtues of the EMU and its institutional adaptation to the North American continent. In Canada, we have been told by its most ardent supporters, such as Courchene (1998), Courchene and Harris (1999) and Grubel (1999), that Canada is no longer a viable optimal currency area and that the economic benefits of greater monetary integration on the basis of the EMU blueprint are many and the costs few, the latter usually being associated with the presumed negligible (and mostly intangible) political costs pertaining to the loss of national sovereignty.

We have seen, on the contrary, that those costs are very real and mainly relate to the potential policy straightjacket that would result from the adoption of a hybrid EMU structure in North America. Hence, much like under dollarization which would largely take away the national authority's capacity to pursue activist monetary and fiscal policies, an EMU-structured economy would face the same consequences, i.e., we would face slower economic performance than if governments were not institutionally prevented from better fine-tuning and moving the economy closer to its potential growth path. However, while these political costs are important and would probably vary in accordance with whether one believes in the positive impact on growth of activist Keynesian policies, the question that needs to be better addressed is what exactly are these presumed benefits of a NAMU.

1. Lower Transactions Costs

The first of these supposed benefits pertains to what traditionally has been the central proposition of those defending monetary integration. In the language of mainstream economists, this has to do with the existence of "static gains" accruing to economic agents from minimizing transactions costs because of the elimination of currency transactions between two countries. Many of the studies in support of European monetary unification made much of these potential gains, and the argument may be dubbed the "tourist" perspective on monetary union, as it was perhaps most dramatized by Emerson *et al.* (1992: 66) when calculating the currency transaction losses in a hypothetical round-trip through ten countries in Europe.

If, with a common currency, one were to eliminate all the foreign exchange dealings between Canada and the United States, the economic gain would comprise the direct savings to the public engaged in cross-border transactions. These savings would represent essentially the loss of net financial revenues of banks and other foreign exchange dealers pertaining to the elimination of the bid-ask spread of the pre-NAMU partner's foreign currency. Because of the expected net revenue loss for these agents, the savings to the public could be measured by the proportion that the foreign exchange departments of banks and other firms would shrink owing to the elimination of a large portion of the public's foreign exchange needs. For instance,

Grubel (1999) provides a casual estimate of the annual efficiency gains for the NAMU countries as a whole at about 0.1% of national income—a figure which seemed perhaps more reasonable than the estimate of 0.4% of GDP found in European studies following the Delors Report (Grubel 1999: 9).

Given the weight that reduced transactions costs hold in the arsenal of arguments in favour of greater monetary integration, it is somewhat surprising that we are only talking about a 0.1% (or even a 0.4%) average annual efficiency gain from dollarization for Canada. While such welfare gain may not appear to be that substantial in size, in present value terms it would loom much larger. But, regardless of its estimated magnitude, such postulated gain is in fact highly illusive. Firstly, as pointed out by Arestis and Sawyer (1999) with respect to the euro, when these presumed welfare benefits are balanced against the costs of transition to a single currency, in present value terms the estimated *net* benefits tend largely to disappear. For instance, in referring to these estimated benefits, even in official reports such as that of Currie (1997), it is stated quite candidly:

“The likely amounts [of the estimated benefits] are not however very large, and once the one-off costs of converting to the euro are taken into account as well, the net transactions savings do not provide a strong reason for moving to the euro.” (Currie, 1997: 6)

Secondly, included in these estimated transactions costs, there are both the direct transaction fees as covered by the bid-ask spread as well as the added cost of having to maintain additional reserves of foreign currency for precautionary purposes, as

reflected in the moderate growth of foreign currency holdings in Canada that are somewhat correlated with the increased growth of foreign trade (see Chart 2). While these types of savings would be meaningful for, say, Canada’s elderly “snow birds” heading to Florida during the winter months, such savings would be insignificant to the bulk of cross-border transactions done *en bloc* by large transnational corporations that can internalize many of these transactions and that would require very limited foreign exchange. As Carr (2000: 98) rightly points out, for many multinational firms, foreign exchange transactions are merely a bookkeeping exercise and do not entail actual currency conversion. Hence, what we have described as the “tourist” perspective on monetary union is highly misleading for Canada in which a large portion of cross-border transactions are done by transnational firms which do not face as significant transactions costs.

Thirdly, and perhaps most importantly, when a new common currency is adopted (as was the case with the euro in January of 1999), naturally the effect would be to wipe out the bid-ask spread from which financial institutions can make a profit and, therefore, as the “tourist” perspective would predict, to reduce the direct cost for those engaged in such foreign exchange transactions. But this ought not mean that these financial institutions would naively sit back to see their net revenues fall. Indeed, much of the pro-NAMU approach is based on a view of the monetary system that largely abstracts from an analysis of the role of commercial banks. As profit-maximizing institutions holding a certain local monopoly, it would be much more realistic to assume that they would attempt to maintain their overall bank revenues, for example, by charging services fees for related activities.

This is basically what happened in Europe as of January 1999, when, in order to recoup some of their losses arising from the elimination of the foreign exchange rate spread, banks began opportunistically to charge user fees to citizens of the EMU countries seeking, for instance, to cash their travellers' cheques. It is most probably for this reason that the European Commission (1999: 3) kept warning the public after the launching of the euro that banks could not take advantage of the transition by charging the public for even the conversion of their national currencies into the euro. Hence the disappearance of one type of transactions cost seems merely to have triggered a compensating increase of alternative bank charges faced by the European public under a common currency arrangement.

Unless one can show why the share of net revenues of financial institutions ought to fall under a NAMU, the argument in favour of efficiency gains because of reduced transactions cost is terribly misleading. If the share of net bank revenues out of GDP would essentially remain unchanged between the pre- and post-NAMU period, this would result in a possible redistribution among economic agents of the burden of transacting within the enlarged currency space, but *not* necessarily in a reduction of overall transactions cost to the community at large.

2. Productivity Gains

A second argument that has been peddled extensively by those in favour of alternative currency arrangements for North America focuses, in this case, not on the presumed efficiency gains pertaining to lower transactions costs, but on the enhanced economic efficiency or increased

productivity that would be forthcoming from greater monetary integration. Following the research findings of McCallum (1998a, 1999) who had looked at productivity growth in the Canadian manufacturing sector since 1977, there was found to be a strong statistical correlation between the Canada/U.S. exchange rate (lagged two years) and manufacturing productivity growth. From these findings, which have been further reinforced by anecdotal evidence in the Canadian media about the "lazy" manufacturing sector being favoured by the declining exchange rate, advocates of greater monetary integration with the United States have suggested that there is a causal link between the falling Canadian dollar and low productivity growth.

The idea is quite simple. It is based on the premise that a floating Canadian dollar since the 1970s has had a long-term negative effect on Canada's competitiveness. While there is a short-term gain associated with a floating exchange rate in amortizing external shocks to the Canadian economy, the long-term impact of a falling dollar on productivity growth in the export sector would supposedly be negative. The argument is appealing and has been marketed a great deal by advocates of pegged exchange rates and greater monetary integration, such as Courchene (1998) and Courchene and Harris (1999). As Laidler (1999a: 8) notes, however, the evidence is highly circumstantial.

As is displayed in Chart 1, it is true that, when the Canadian dollar was pegged to the U.S. dollar between 1962 and 1970 (and even during the 1950s and the early 1970s under a floating regime—an era in which the Canadian dollar generally showed much greater stability), this was indeed associated with a period of somewhat higher productivity growth, both for the

manufacturing sector and for the business sector as a whole. However, as Table 3 shows, when looking at output per person employed since 1960, Canada showed a mild decline *comparable* to that of the U.S. and the U.K. between the 1960-79 period and the 1980-98 period—thus questioning the significance of the depreciating Canadian dollar in impacting on overall productivity growth.

During the post-1970s, productivity growth decelerated in all countries, regard-

less of whether their exchange rate rose or declined. In fact, further econometric work undertaken by Dupuis and Tessier (2000) at the Bank of Canada found that McCallum's (1998, 1999) original analysis was highly problematic and discovered, instead, that manufacturing productivity growth and the Canada-U.S. exchange rate were statistically unrelated variables. Therefore, the cause could just as easily have been, say, the slowdown in real wage growth, which could also have impacted

Table 3: Real GDP Per Capita and Per Employed Person, and Output Per Hour in the Manufacturing Sector (Average Annual Percentage Change, 1960-1998)

Country	1960-1979	1980-1998	Percentage Fall in Growth Rate
Real Gross Domestic Product per Capita			
Canada	3.1	1.6	-48.4
Japan	6.1	2.6	-42.1
Austria	3.8	2.2	-42.1
Belgium	3.7	2.1	-43.2
France	3.6	1.4	-61.1
Former W. Germany	3.1	1.8	-41.9
Italy	3.9	1.9	-51.3
United Kingdom	2.2	2.1	-4.5
United States	2.7	2.2	-18.5
Real Gross Domestic Product per Employed Person			
Canada	1.8	1.4	-22.2
Japan	6.1	2.2	-63.9
Austria	4.1	2.4	-41.5
Belgium	3.7	2.1	-43.2
France	3.9	1.7	-56.4
Former W. Germany	3.5	2.1	-40.0
Italy	-	2.2	-
United Kingdom	2.4	1.9	-20.8
United States	1.8	1.6	-11.1
Output per Hour in Manufacturing Sector			
Canada	3.7	2.5	-32.4
Japan	7.9	3.8	-51.9
Austria	-	-	-
Belgium	6.5	3.9	-40.0
France	5.9	3.6	-39.0
Former W. Germany	5.2	2.7	-48.1
Italy	6.0	2.6	-56.7
United Kingdom	3.2	3.7	+15.6
United States	-	3.2	-

Source: U.S. Bureau of Labour Statistics and Statistics Canada

negatively on productivity growth since the 1970s. It is ironic, too, that the focus of the analysis has been solely on the impact that the falling exchange rate has had on the competitiveness position of firms selling Canadian goods abroad, which has supposedly relaxed the pressures on productivity growth in the manufacturing sector. However, this is a highly one-sided view of the effect of the exchange rate. It is quite obvious that the plummeting Canadian dollar has also had the effect of raising the price of imported goods, which, for the Canadian manufacturing sector, as is well known, means a rising price of imported machinery and equipment. Why did these rising import costs of capital goods not squeeze profitability and spur on productivity growth in the manufacturing sector?

Perhaps, to the further annoyance to those supportive of the “lazy manufacturer” hypothesis: if exchange rate fixity is of such crucial importance to productivity growth, why is it that the European countries who joined the EMS and subsequently the EMU during the post-1979 period faced an even sharper drop in productivity growth? Indeed (as shown in Table 3), even in such small open economies as Austria and Belgium—which are probably in a similar relation vis-a-vis the core countries of the EMU (France and Germany) as Canada is with the U.S.—their growth rates of average labour productivity (as measured by real GDP per employed person and output per hour in the manufacturing sector) and growth in their standards of living (as measured by real GDP per capita) all plummeted during the post-1979 period, even though, unlike Canada, they had been pegging their exchange rates within the EMS throughout this period. Stability in the exchange rate did not seem to provide much protection against an even sharper

drop in productivity growth for all those European countries that joined the EMS since 1979.

In much the same way, one could legitimately argue that greater monetary integration, in the form of a pegged exchange rate or monetary union with the other NAFTA partners, could hardly be expected to be a significant factor in speeding up productivity growth in Canada. Regardless of the exchange rate arrangement, all countries suffered a decline in productivity growth.

3. Lower Real Interest Rates

A third argument in support of greater monetary integration has to do with the dampening effect that monetary unification would have on the level of interest rates in Canada. Once again the hypothesis put forth is a very simple one. While sovereign or default risk has never been a visible concern for foreign holders of Canadian securities, exchange rate risk ought to be a very real concern, especially for long-term bond holders, because of the risk of exchange rate depreciation. It would ensue, therefore, that, because of the weight of risk-averse bond holders, the greater the volatility in the exchange rate, the higher ought to be the real interest rate spread between Canada and the U.S. Moreover, as has been argued by many EMU observers, since greater monetary integration leads to the further deepening of financial markets (see, among others, Eichengreen, 2000), this would probably have a further desirable negative impact on domestic interest rates in both countries. Consequently, if these factors are at all important in the determination of interest rates, one ought to find a significant long-term association between exchange rate stability/volatility and the

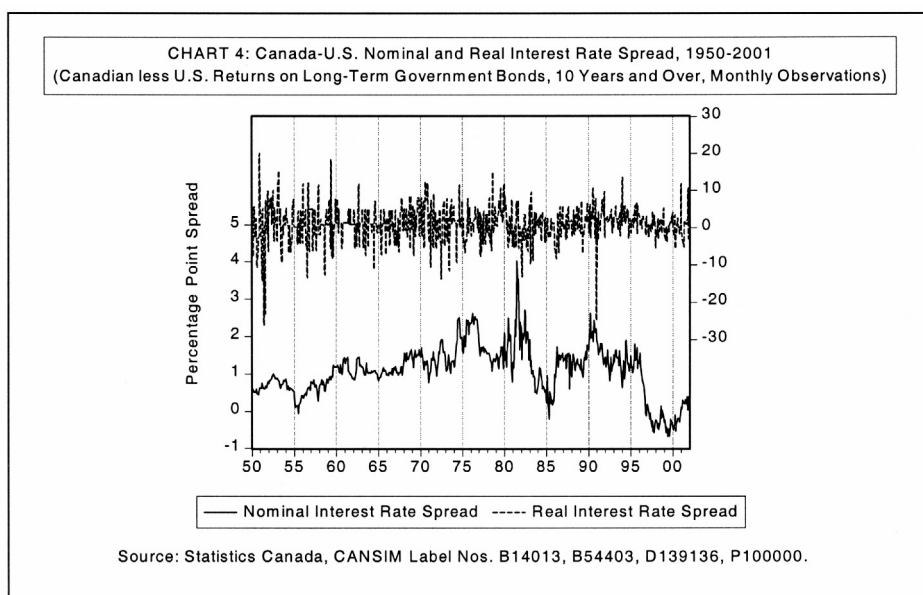
real interest rate spread on long-term bonds across countries.

Chart 4 presents data on both the nominal and real interest rate spread on long-term government bonds (10 years and over) between Canada and the U.S. Casual observation surely would not lead one to conclude any significant decline for the 1962-1970 period during which Canada had fixed its currency exchange to the U.S. dollar. Indeed, while the real interest rate spread was volatile with a moderate *upward* movement during the latter half of the 1960s (yet following a trend stationary path, throughout the complete period since the 1950s around a mean of 0.97%), the nominal interest rate spread moved significantly *upward* throughout the 1960s. Moreover, evidence from our charts does not suggest that lower spreads are associated with greater exchange rate stability. As can be inferred from Chart 1, even during the decades when Canada floated its exchange rate (as during the 1950s and 1970s), the Canada-U.S. exchange rate showed a high degree of stability (when compared to the decades of the 1980s and 1990s).

For instance, when measuring the variability in terms of standard deviation,

monthly observations for the 1980-2001 sub-period exhibit a standard deviation of over twelve times that for the period from 1950-1979. Did this greater volatility lead to a steep rise in the real interest spread between Canada and the United States for the post-1980 period? The data from Chart 4 show no such increase, on average. For instance, the mean value in the real interest rate spread for the period 1950-1979 went from a 0.99% point spread to 0.93% for the 1980-2001 period. Much like the tightening in the nominal spread, this was a *decline* in the real interest rate spread that would hardly be accounted for by the *greater* volatility in the exchange rate.

It is all the more surprising that this mild decline took place during a period when the Bank of Canada was following a very restrictive monetary policy in fighting inflation during the 1980s and the first half of the 1990s (see Seccareccia, 1998). Indeed, empirical evidence in a related study explaining long-term interest rates in Canada (see Seccareccia and Lavoie, 2001) found that, rather than market-related factors, movements in the central bank-controlled variables, such as the overnight rate, were of crucial importance in ex-

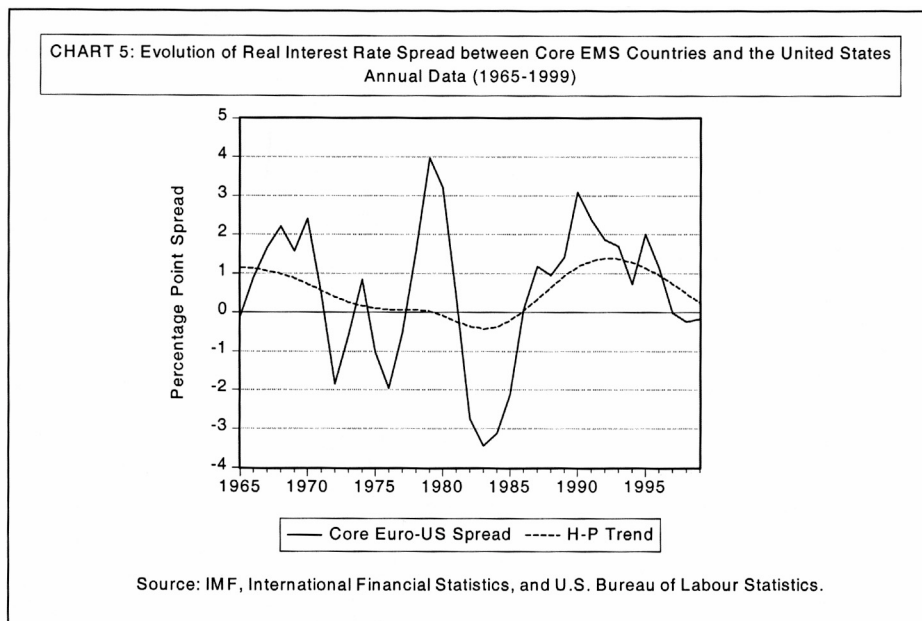


plaining the movement of long-term interest rates in Canada. In a sense, what our chart indicates is that exchange rate stability may lead to greater interest rate volatility and a widening interest rate spread and not the reverse as defended by conventional wisdom.

A similar argument can be made with respect to the European experience with monetary integration. With the breakdown of the Bretton Woods system during the early 1970s, European countries did attempt, under follow-up agreements to the Werner Report of 1970, to establish a structure of exchange rates—the so-called European “snake” previously mentioned—but which led to extremely loose and fluid relations during the 1970s until the creation of the EMS in 1979 (see Apel, 1998: chapter 1). Thus, the 1970s was a decade during which some of the major players of what ultimately has become the EMU, such as Italy and even France, experimented with much greater flexibility in their exchange rate system, especially subsequent to the first oil price shock in 1973. Theory would thus suggest that elimination of some of the exchange rate volatility would have led to lower interest rates in Europe

with respect to some benchmark interest rate.

To evaluate whether this led to a widening of interest rate spreads, a comparison was done by looking at the difference between, on the one hand, the average real rates of the original core countries of the EMS (France, Italy, the Federal Republic of Germany, and the Benelux countries) and the benchmark U.S. real rates on the other. The data displayed in Chart 5 was based on a simple averaging of the real rates of the five core countries (with the exclusion of Luxembourg) for the period between 1965 and 1999. While undoubtedly many factors would have impacted on the interest rate spread, it would be difficult to conclude from the chart that greater monetary integration in Europe led to a narrowing of the interest rate spread vis-a-vis the United States. For instance, the chart shows that the spread fell significantly during a good portion of the 1970s, only to rise during the late '70s and then fall sharply and rise again from the early 1980s to the mid-1990s. Interestingly, when comparing the evolution for the European countries (in Chart 5) to the Canada-U.S. real interest rate spread (previously in Chart 4), a close



analysis would confirm that their pattern is conspicuously similar (even though these countries were under very different exchange rate regimes).

Once again, one can infer from this that, at least from simple graphical illustration, evidence to support the views of Grubel (1999) and others as to the beneficial effects of eliminating nominal exchange rate variability on long-term interest rates is extremely weak, if not non-existent. This is not to argue that exchange risk is of little importance to long-term bond holders. Rather, as also emphasized by Seccareccia and Lavoie (2001), market forces are perhaps less important than the policy actions of the monetary authorities in determining the level of both short and long-term interest rates and, thus, the interest rate spread between Canada and the U.S.

In an ironic twist, in recent times some have argued (see Mosler, 2001, Bell, 2002) that, if anything, the current structure of the EMU, which is so idealized by orthodox economists because of the clear separation of money from the state, may have probably created problems of default risk for the member countries of the EMU. This is because of the lack of liquidity provisions in the Maastricht Treaty, which currently prohibits national governments from borrowing from the ECB even in times of financial crisis. Therefore, in contrast with Carmichael (2002: 2) and unlike the customary view that default risk and exchange rate risk are complementary (see Rojas-Suarez, 2000), some have argued that, while exchange rate risk would *de facto* be eliminated under monetary union, the peculiar type of supra-national monetary arrangement along the lines of those now existing in Euroland may have created more serious problems of default risk. This would be so particularly if a banking crisis were

to erupt in any one of the EMU member countries.

4. Fiscal Austerity

In addition to these three important arguments in favour of greater North American monetary integration, there exists a plethora of other arguments that have traditionally been called upon to support greater monetary integration in North America. Among the other arguments that proponents such as Grubel (1999) have identified traditionally, there is at least one that merits mention here because of its important policy ramifications. We are told that greater monetary integration in the form of a pegged exchange rate or outright monetary union will impose the needed discipline on the fiscal authority as exemplified by the current experience of the EMU (see Courchene, 1998: 18; and Grubel, 1999: 15). While the theoretical underpinnings of this point of view are quite fluid and founded on questionable economic logic (to be discussed below), where is the evidence that a floating exchange rate leads to fiscal “indiscipline?”

To paraphrase McCallum (2000: 8), how can we explain the fact that, despite its floating currency, over a good number of years during the 1990s Canada was running primary surpluses [measured as the difference between the actual budget balances and the interest payments on the public debt—frequently used by the federal Department of Finance as a measure of fiscal impulses] and is essentially meeting all of the Maastricht criteria? Moreover, as displayed in Chart 6, for the period between 1978 and 2000 the evolution of primary balances (as a percentage of GDP) under fixed exchange rates in Europe has not been very different from that under a flex-

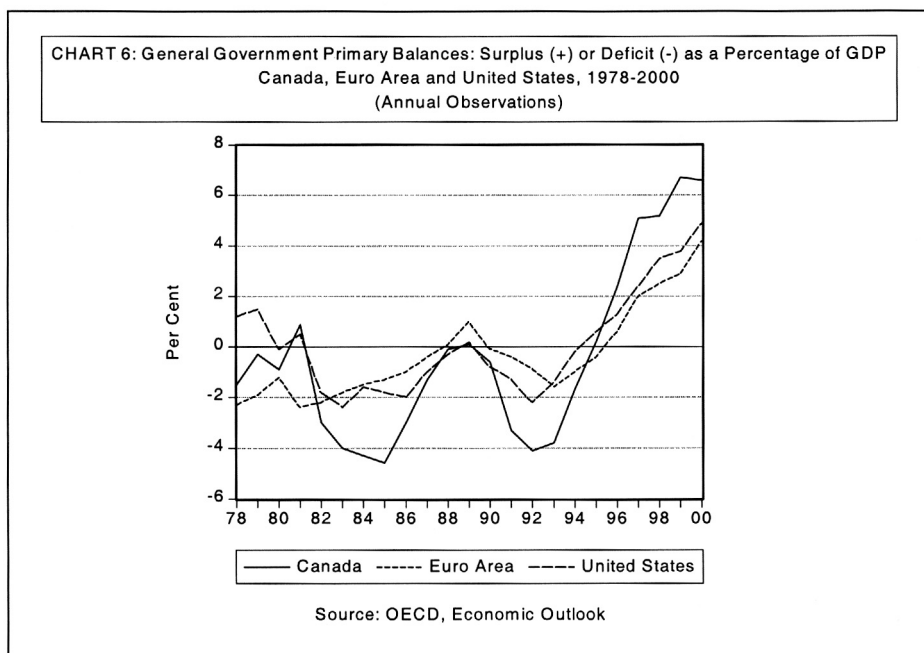
ible exchange rate regime in Canada. Unlike Europe, this was achieved in Canada without a major constitutional change to enforce quasi-balanced budgets.

Why, then, all this concern with fiscal discipline? The reason has to do with the orthodox underpinnings of the theory of monetary union to which the vast majority of the supporters of a NAMU subscribe. Under monetary union, conventional theory suggests that an expansionary fiscal policy, say, to combat unemployment in Canada, is widely postulated to have negative externalities on its NAMU partner, the United States (see Carlberg, 1999). This is because, while a fiscal expansion in Canada would raise Canadian domestic income through the usual Keynesian multiplier effect, the upward pressure that the expansionary fiscal action would exert on overall NAMU interest rates would lead to an appreciation of the NAMU dollar and thus to a fall in net exports in both countries.

The final outcome of the Canadian fiscal expansion is assumed to be a *relative* rise in Canadian income that would largely be done at the expense of a fall in U.S. income.

However, the overall effect on the monetary union would be negative, since it would be associated with higher interest rates (with its usual investment crowding-out implications) in both countries, a higher common currency exchange rate, and lower net exports of each member country vis-a-vis the rest of the world. Given this perceived problem pertaining to the behaviour of any member country of a monetary union, strict constitutional rules must be put in place to guarantee fiscal discipline, such as those that have been imposed on the member states of the EMU. Hence, any attempt by one jurisdiction to escape neo-classical fiscal austerity can now be enforced by a supra-national arrangement. Naturally, this economic logic would also fit well the political ideology of those firmly entrenched pro-market policy-makers who are committed to reducing the role of the state in economic matters.

Unfortunately for the member states of the EMU, the imposition of strict rules of fiscal austerity (in accordance with the criteria of the Stability and Growth Pact) has been premised on a highly questionable orthodox theory of money that sees higher



interest rates as the unavoidable consequence of a fiscal expansion. If one were to espouse a competing Keynesian framework, these negative implications of an activist fiscal policy cannot be inferred (see Seccareccia and Sharpe, 1994; Parguez and Seccareccia, 2000; and Seccareccia and Sood, 2000). On the contrary, within this latter analytical framework, fiscal policy would be a necessary tool to achieve greater economic welfare. As argued by Arestis, McCauley and Sawyer (2001), the arbitrary 3%-of-GDP limit on budget deficits seriously impairs the EMU members' ability to absorb macroeconomic shocks and condemns them to rely on the limited monetary policy actions of a highly undemocratic and unrepresentative ECB, whose sole responsibility is price stability.

Why would the member states of the EMU want to abandon such an important

instrument of macroeconomic policy on the basis of a questionable theory of money, and to accept as a consequence higher long-term rates of unemployment? If the structure of the EMU will lead to increasing problems of unemployment—as predicted, for instance, by Feldstein (1997)—how long would national governments last in imposing fiscal austerity domestically? Recently, even some of the strongest supporters of the EMU system (see Fitoussi, 2000: 20) are beginning to question the current policy mix of the EMU that (a) has given prominence to orthodox monetary policy in favour of price stability, (b) has led to the complete abandonment of fiscal policy as a macroeconomic tool, and (c) has imposed a deflationary bias on the complete EMU structure and, by implication, on the world economy.

What Would Be a Socially Desirable International Monetary Arrangement for Canada of the 21st Century?

The growing trade and financial liberalization that followed the demise of the Bretton Woods system during the early 1970s, coupled with a strong commitment by national governments to fiscal and monetary restraint in the developed world, has spawned deflationary tendencies in the world economy that moved it away from a virtuous cycle of growth and prosperity of the pre-1970 “Golden Age” to a vicious cycle of economic stagnation and retrenchment of the post-1970 “Leaden Age” (Pollin, 1998:433). This shift away from pro-growth commitments towards stag-nationist policies has created an economic environment characterized by a burgeoning Keynesian problem of declining effective demand in the Western countries and has led to the development of a fragile international financial structure that is ever more prone to financial crises.

The proliferation of these recessionary tendencies in the developed world has had devastating repercussions on the developing world, as the latter countries have struggled to keep aloof from a long-term relative decline in global effective demand and deterioration in their terms of trade, with alarming consequences for these countries’ liquidity position. It is primarily as a result of these outstanding liquidity problems faced by numerous developing countries that, for instance, the question of dollarization has been advanced as a possible way out of their financial quagmire. As previously discussed, however, these quick monetary fixes—such as currency board arrangements and policy dollarization—that have as a long-term ob-

jective the subordination of national economic policy solely to the needs of the purveyors of international finance, do not work.

What is needed are neither international financial arrangements that suppress global effective demand by imposing further constraints on domestic macroeconomic policies, nor IMF-style policies whose ultimate objective is to drain reserves further from the very countries facing the liquidity problem. As Keynes made it very clear at the time of the Bretton Woods negotiations in the 1940s, what is necessary is a system that places the major burden of payments adjustment on the surplus countries and issuers of international liquidity, and not primarily on the nations facing the liquidity constraint. Hence, in a sense, what may be desirable are IMF-type structural adjustment policies *in reverse* that would impose constraints on the surplus nations to expand domestic demand and create the needed liquidity.

The purpose of such “reverse” IMF structural adjustment would be to build sufficient global effective demand to gradually carry the debtor nation out of its liquidity crisis. Unfortunately, current IMF arrangements tend to do the exact opposite by misplacing the onus of adjustment. In particular, the IMF tradition has been to attack severely the country facing the financial constraint by imposing harsh economic austerity in the hope of squeezing liquidity out of the debtor nation. When that inevitably fails, the debtor nation seeks to redefine the problem—as we have seen, for instance, with Argentina and Ecuador in

this hemisphere— by seeking some remedial arrangement that locks the country within a tight monetary confinement that will have the same inescapable negative consequences on both domestic and global effective demand.

What is essential for the further growth of the world economy is not any of the quick monetary fixes that spread recessionary pressures internationally, but a greater respect of national sovereignty coupled with a complete reform of the international monetary institutions and clearing system by grafting them more closely, perhaps, on the Keynes plan of the 1940s (see Davidson, 1997).

Instead, all current attempts at redefining alternative international monetary arrangements focus on establishing a rigid exchange-rate structure to which domestic macroeconomic policies must become enslaved. In the process, we are merely seeking to recreate the same conditions and thereby condemning ourselves to the same mistaken outcomes of the Gold Bloc of the late 1920s and early 1930s. As was mentioned previously, the gold standard of international payments was a particular type of fixed exchange rate system that, instead of setting a hard fix between the Argentine peso and the U.S. dollar or between the Canadian and U.S. dollar, established a hard fix in relation to the price of gold. Hence, whenever there was a negative external demand shock on a member of the Gold Bloc, that country would have to defend its gold parity by deflating the domestic economy. That is to say, in order to maintain the stability of the country's exchange rate, the domestic economy would have to be destabilized by means of wage and price deflation.

Paraphrasing Keynes, Davidson (1992) describes the gold standard as “the barbarous relic for enforcing coordinated inter-

national incomes policies” and, whenever faced with a negative demand shock, its effect was indiscriminately to deflate national income. As long as these shocks were not too serious, the gold standard mechanism of adjustment survived the ensuing recession. Historically, however, once the shocks became more serious, as in 1929, the maintenance of this particular fixed exchange rate system merely unleashed a vicious cycle of deflation and depression that could not withstand the public outcry.

Whether it is the gold standard, a system of fixed exchange rates (with or without a currency board), or policy dollarization, all these institutional arrangements transmit a similar deflationary bias to the national and international economy. Hence, as was previously discussed, in addition to further constraining the monetary and fiscal authorities in pursuing traditional Keynesian stabilization policies, these various arrangements also greatly magnify the shocks to the national economy and therefore make matters worse for everyone in the international community.

Large monetary unions would have similar consequences for member countries as do pegged exchange rates. This is because any asymmetric shocks on demand across, say, a three-country NAMU would mean that the burden of the adjustment would fall on local wages and other incomes. As pointed out by Tobin (2001) and as advocates of monetary union have themselves sometimes recognized, so long as there is in place politically-acceptable inter-country transfer mechanisms to offset the negative effects of the asymmetric shocks, and as long as there are no legal obstacles to labour mobility (as is normally the case, say, in a modern federal state such as Canada), no serious difficulties would arise domestically in addressing the insta-

bilities (other than a lack of political will on the part of the domestic authorities).

On the other hand, without such inter-country transfers, the monetary structure would gradually unravel because of the growing NAMU disparities that would likely ensue. However, the problem with all of this discussion is that no such NAFTA federal state is being proposed, even for the very distant future, by any of the advocates of monetary union. Although not without criticism in communicating with their own citizens, European governments at least have been far less ambiguous as to the ultimate implication of a monetary union: a political union of the member countries. In the case of North America, we are being asked to adopt an EMU structure whose final outcome will be a political union without telling anyone that the NAMU ought to follow a similar historical logic. If the ultimate goal is indeed a sort of United States of North America, why then have the defenders of NAMU not simply stated their underlying agenda for what it really is? It is obvious that, if the question were to be posed in this way, few Canadians would want to give up their national sovereignty under the false pretense of presupposed "efficiency gains" from monetary integration.

Is the current *status quo* of a floating rate system any more desirable? As was previously argued, a system of floating rates does have the important shock-absorbing feature of stabilizing domestic income that other proposed monetary arrangements do not have. The problem, however, is that, since the demise of the Bretton Woods system, the current regime of floating rates has nurtured the development of a sort of international casino economy (analogous to Stanford's (1999) "paper economy") fuelled by the animal spirits of financial speculators. This is not because intrinsically a float-

ing system must generate the kind of destabilizing speculation that has been associated historically with a growing number of very serious currency crises, particularly during the last decade, which can literally cripple domestic economies. The problem is that the worldwide financial deregulation that followed the collapse of the Bretton Woods system has made such speculation more lucrative than productive investment. Hence, the concern that Keynes well recognized very long ago is with the disabling effect of what he termed "capital flight" (see Crotty, 1983), which not only can generate some mild disturbances around an underlying trend (as displayed in Chart 1), but can also practically derail the trend itself because of the long-term ramifications that the ensuing currency crisis can have on the real domestic economy.

Instead of greater monetary integration that further ties the hands of nation states, what is needed are obstacles to financial capital movements that prevent the needed flexibility in the exchange rate from becoming overly destabilizing and thereby frustrating policy-makers in pursuing policies of high growth and full employment. We have already alluded previously to the fact that a Tobin tax may not be up to the task, even if one were able to succeed in getting the international coordination that such a transactions tax would require for effective implementation. The reason is obvious. A Tobin tax may be appropriate in preventing minor disturbances, but not the major speculative attacks of the type that practically crippled the ERM in 1992 or the wild foreign exchange-rate gyrations during the Mexican and Asian crises of the last decade.

During a speculative outburst, one observes wide swings in the exchange rate within a very short time horizon. For instance, Davidson (1997: 678) estimates that,

when the Mexican peso fell by 60% to the U.S. dollar in the winter of 1994-95, it would have taken at least a 23% Tobin tax to quell the speculative surge and not the proposed 0.5-to-1.25% tax that is normally envisaged. Hence, unless one is considering a variable Tobin tax rate that would be quickly and sharply adjusted upwards on the basis of the realized gains from a currency transaction (much like a progressive income tax), such a small flat rate would not make any significant dent on destabilizing currency speculation.

This is why it may be much preferred to equip national governments with not only a Tobin tax (regardless of its form), but also a whole battery of regulatory controls on financial capital movement that were abandoned with the breakdown of the Bretton Woods system. Crotty and Epstein (1996) and Nembhard (1996), among others, provide a list of such regulatory controls (from quantitative restrictions on financial capital movement to credit controls), whose effect would be to slow down significantly speculative financial movement and allow the exchange rate to fulfill its shock-absorbing role without the damaging effect of currency speculation. This is a position that has been widely defended by a good number of economists outside of the mainstream, such as Palley (1998) and Smithin (2001).

The existence and extent of such controls is important in narrowing the domestic space within which such speculative dis-

turbances may originate. However, the quality of such controls would depend essentially on the international coordination that is needed to make such controls fully effective, especially against circumventing financial innovations. Moreover, much like the Tobin tax, a country like Canada may not want to go it alone, since the policy might quickly backfire as our country would be singled out as the pariah of international finance. While still defending our sovereignty, what is needed is a coordinated international commitment of the type that put in place the Bretton Woods international regulatory system immediately after the Second World War.

Would such an international coordination be possible today? During the last year, there has been a strong show of political will and international solidarity in the wake of the September 11, 2001 terrorist attacks in rooting out terrorist financing. Surely we can anticipate the same political will to control in a more effective way destabilizing capital flows whose impact can be as damaging (if not more so) to the world economy as any of the economic devastations caused recently by international terrorism. As alluded to recently by Prime Minister Jean Chrétien himself, international economic insecurity tends to generate political instabilities, and it is only by dealing with the former that real peace and security can be achieved internationally.

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