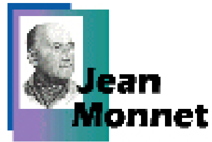

Robert Schuman

The Uses and Abuses of the Euro in the Canadian Currency Debate

-Paul Bowles, Osvaldo Croci, Brian MacLean

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The Uses and Abuses of the Euro in the Canadian Currency Debate

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THE USES AND ABUSES OF THE EURO IN THE CANADIAN CURRENCY DEBATE

Introduction

In the late 1990s, some prominent Canadian economists – notably Thomas Courchene, Herbert Grubel, Richard Harris, and Robert Mundell – began arguing that a North American common currency would solve the problems underlying the growing gap between U.S. and Canadian real GDP per capita.[1] They succeeded in provoking a lively economic policy debate that occurred in parallel with the launch of the euro. The purpose of this paper is to examine the uses – and abuses – of European parallels by both sides in the economic policy debate that peaked in the 1999-2001 period.

The body of the paper begins by providing an understanding of the European case. Hence, the second section outlines our interpretation of the major developments in the birth of the euro. The third section, the core of the paper, examines in detail the use of European parallels in the Canadian currency debate. We start by providing a brief overview of the protagonists in the debate. We then continue by arguing that the euro provided a "temporal spur" for the Canadian discussion but that it was only one among several important factors. We argue further that the proponents of a North American common currency relied very little on the European experience to support their case for the *need* for a common currency. Where they did use the European experience, however, was in their analysis of the institutional *form* that a common currency in North America might take. We argue that the opponents of a North American common currency were correct in viewing this as an abuse of the European parallel. In the concluding fourth section, we summarize our findings and argue that the most important parallel between the European and North American forces for a common currency is that both were driven primarily by politics.

The Road to European Monetary Union[2]

In Europe – or, more precisely, in twelve out of the fifteen countries forming the European Community (EC) – a common currency, the Euro, replaced national currencies on January 1, 2002. The process leading to the adoption of a common currency was long and complex. This section retraces its three most salient phases, each characterized by a distinct project, and analyses the reasons and driving forces behind each of these projects.

The EC did not devote much attention to monetary issues in its early years because the common market operated with practically fixed exchange rates, by virtue of its member states belonging to the Bretton Woods system. When this system began to unravel in the late 1960s, it

[1] Courchene and Harris are Past Presidents of the Canadian Economics Association. Mundell, the recipient of the Nobel Prize in Economics in 1999, resides in the United States but grew up in, and maintains ties with, Canada.

[2] This section is an expanded revision of a section in Bowles, Croci, and MacLean, "Globalization and Currency Convergence: What do the Regions Tell Us? In James Busumtwi-Sam and Laurent Dobuzinskis (eds.), *Turbulence and New Directions in Global Political Economy* (New York: Palgrave, 2003 [forthcoming]).

became evident that exchange rate fluctuations could pose a problem for the proper functioning of the common market, and would be particularly disruptive for the administration of the Common Agricultural Policy.[3] To remedy the problem, as well as to facilitate trade and promote further economic and political integration, the EC adopted in 1971 an ambitious plan (the Werner Report) for economic and monetary union to be achieved in stages by 1980. The first stage, a modest scheme known as the "snake" that limited the range of exchange rate fluctuations of the participating currencies, was launched in April 1972. To the objective difficulty of trying to establish a regional zone of stability in the midst of global monetary turbulence, member states added their pursuit of conflicting macroeconomic policy goals during an unprecedented period of stagflation. While Germany, for instance, pursued a restrictive monetary policy to control inflation, other member states implemented expansionary policies to try to encourage growth and employment. The result was that the "snake" ran immediately into trouble. A wave of currency speculation pushed half of the participating currencies outside the established exchange rate margins and by 1974, the "snake" was reduced to a limited Deutschmark zone. Consequently, the goal of achieving monetary union was abandoned, although not for long.

In April 1978, in fact, German Social-Democratic Chancellor Helmut Schmidt and French President Valéry Giscard D'Estaing resurrected the idea because both thought that adoption of a quasi-fixed European exchange rate system would help them attain preferred domestic economic policy objectives. Schmidt wished to adopt an expansionary policy with a view to the 1980 elections but had to overcome the doubts of some members of his coalition government and the Bundesbank's traditional commitment to price stability. As he saw it, German participation in a managed exchange rate system would slow the appreciation of the mark (and thus help German industry retain competitiveness) and act as a constraint on the Bundesbank, pushing it towards the adoption of a less restrictive monetary policy. For Giscard D'Estaing committing the franc to a managed exchange rate system was a way to enlist French industrialists in the struggle against inflation by convincing them that they could no longer hope to maintain international competitiveness by means of periodical de-valuations and, hence, encourage them to resist any wage increases not reflecting improvements in productivity.[4] The outcome of this Franco-German initiative was the European Monetary System (EMS) that began to operate in March 1979. Its central component was the Exchange Rate Mechanism, limiting the exchange rate fluctuations of most member currencies to plus or minus 2.25 per cent of predetermined parities. The EMS proved more successful than the 'snake', although some currencies were repeatedly obliged to leave it, and then devalue before rejoining.[5]

In 1987, EC member governments ratified the so-called Single European Act (SEA) that aimed at "completing" the common market by removing all remaining non-tariff barriers to the free movement of goods, people, services, and capital by the end of 1992. The success of this

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[3] Kathleen McNamara, *The Currency of Ideas: Monetary Politics in the European Union* (Ithaca: Cornell University Press, 1998), pp. 98-104.
[4] Thomas H. Oatley, *Monetary Politics: Exchange Rate Cooperation in the European Union* (Ann Arbor: University of Michigan Press, 1997), pp. 48-56.
[5] On these first two attempts at monetary integration in Europe, see Loukas Tsoukalis, *The Politics and Economics of European Monetary Integration* (London: George Allen and Unwin, 1977); D.C. Kruse, *Monetary Integration in Western Europe: EMU, EMS and Beyond* (London: Butterworth, 1980); and Peter Ludlow, *the Making of the European Monetary System: A Case Study of the Politics of the European Community* (London: Butterworth, 1982).

initiative gave new impetus to the integration process and enabled the European Commission to put again on the EC agenda the project of economic and monetary union (EMU) to be achieved in three stages. The official justification for the project was that monetary union was a natural and logical complement of a single European market. Once a single market was in place, EC member states would have to confront the dilemma of what Cohen called the "unholy trinity,"[6] i.e. the inability of governments to achieve simultaneously the objectives of capital mobility, exchange-rate stability, and monetary policy autonomy. After 1992, in fact, the EC would be an area characterized by complete freedom of capital movements and a system of quasi-fixed exchange rates (the EMS), deemed necessary to facilitate intra-Community trade and thereby promote greater economic efficiency. Hence, it was illusory for member states to believe that they could retain the ability to conduct autonomous national monetary policies. The inconsistency of these three elements had already manifested itself during the 1980s, when some member states had either opted for flexible exchange rates and withdrawn from the EMS (e.g. the U.K.) or had been occasionally obliged to resort to capital controls (e.g. France and Italy). After 1992, however, the instrument of capital controls would no longer be available. Hence, if governments wished to retain their ability to make autonomous national monetary policy, they had to return to flexible exchange rates. If, on the contrary, they were willing to relinquish whatever national autonomy they retained in monetary policy, then they might as well move from the EMS to full currency union.

Though a case could be made for returning to flexible exchange rates on the grounds that Europe did not appear to be an 'optimum currency area',[7] a number of factors combined to provide a favourable conjuncture for the re-launching of the currency union project.[8] First, and perhaps most importantly, currency union was the solution favoured by EC officials, especially within the Commission,[9] as well as by those political leaders who perceived the *telos* of the process of European integration to be the formation of a European federation. Officially, EMU was justified and sold by relying on the arguments that the single currency would lead to greater efficiency for the single market, eliminate transactions costs, and provide a stimulus to growth and employment.[10] The contention was also advanced that monetary union would solve the "unholy trinity" dilemma by transforming an already weak national monetary sovereignty into

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[6] Benjamin Cohen, "The Triad and the Unholy Trinity: Problems of International Monetary Cooperation," in R. Higgott, R. Leaver, J. Ravenhill (eds.), *Pacific Economic Relations in the 1990s: Cooperation or Conflict?* (London: Allen and Unwin, 1993), pp. 133-158.

[7] Barry Eichengreen, *European Monetary Unification: Theory, Practice, and Analysis* (Cambridge: The MIT Press, 1997).

[8] The most thorough analysis of the origins and developments of EMU can be found in Kenneth Dyson and Kevin Featherstone, *The Road to Maastricht: Negotiating Economic and Monetary Union in Europe* (Oxford: Oxford University Press, 1999).

[9] Amy Verdun, "The Role of the Delors Committee in the Creation of EMU: An Epistemic Community?" *Journal of European Public Policy* 6, 2: 1999, pp. 308-328.

[10] Tommaso Padoa-Schioppa, *The Road to Monetary Union in Europe: The Emperor, the Kings, and the Genies* (Oxford: Oxford University Press, 1987); Paolo Cecchini, *The European Challenge 1992: The Benefits of a Single Market* (Aldershot: Wildwood House, 1988); Commission of the European Communities, *From the Single Market to European Union* (Luxembourg: Office for Official Publications of the European Communities, 1992); Michael Emerson, *One Market, One Money: An Evaluation of the Potential Benefits and Costs of Forming an Economic and Monetary Union* (Oxford: Oxford University Press, 1992); Paul Temperton (ed.), *The Euro* (Chichester: J. Wiley, 1998).

"enhanced joint monetary sovereignty".[11] There is no doubt, however, that the view that the adoption of a common currency would promote a European identity, and thus contribute to the consolidation of the EC as a political union,[12] was paramount in the minds of the promoters of the project.[13] It was this realization, coupled with a divided public opinion, which led British and Danish politicians to opt out of EMU.[14]

A second and important factor was that throughout the 1980s European political elites, including social-democratic ones, had moved away from traditional Keynesian policies and converged towards neo-liberal ones. Their penchant for "minimum government" made agreement on a SEA built around deregulation and liberalization easier, while their preference for low inflation facilitated agreement on the structure of EMU, particularly on the choice of the status (independence) and main objective (price stability) of the European Central Bank. Even trade unions supported currency union, limiting themselves to argue that as a counterweight to the perceived deflationary bias of EMU, the EC should make an explicit commitment to promote employment. A specific title to this effect was introduced in the 1997 Treaty of Amsterdam.

A number of more circumstantial variables also played a significant role in the choice of currency union.[15] For example, the fall of the Berlin wall, and the consequent prospect of German reunification, led some member states to regard reinforcement of EC institutions as the best way to avoid an institutionally weak EC being dominated by a bigger Germany. The solution of a currency union was particularly appealing since Germany (or, more precisely, the Bundesbank) was already perceived as playing a hegemonic role in the EMS.[16] Germany, for its part, traded its initial reluctance to adhere to EMU, and thus relinquish the mark, in exchange for unqualified support of reunification on the part of its EC partners. The adoption of a single currency was also regarded as necessary if the EC wished to be able to compete with the United States as an equal on the world stage. It was, after all, the perception that Europe was increasingly lagging behind the United States in economic growth that had led to the adoption of the SEA. Finally, and perhaps most importantly, domestic political and economic considerations also played a significant role. In Italy, for instance, EMU, and particularly the need to meet the criteria for admission to its third stage, was regarded as an 'external constraint' that would help

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[11] Commission of the European Communities, *First Report on the Consideration of Cultural Aspects in European Community Action* (Brussels: European Commission, 1996), pp. 12-15.

[12] Although this contention is difficult to evaluate at this early stage, it is unlikely that the Euro will make a great contribution to the formation of a European-wide national identity. At best, having replaced national currencies, it will contribute marginally to the erosion of national identities. On the role of currencies in the promotion of national identities, see Eric Helleiner, "One Money, One People? Political Identity and the Euro," TIPEC Working Paper 01/6, http://www.trentu.ca/tipec/helleiner6.pdf (2001).

[13] Chris Shore, *Building Europe: The Cultural Politics of European Integration* (London: Routledge, 2000), pp. 87-122.

[14] In Sweden EMU was rejected by Parliament, while Greece did not meet the convergence criteria for entry into the third stage.

[15] The role of serendipity, as it were, is recognized by one of the participants in the process: "Even those of us who laboured to complement the single market with a monetary union and to embody such a transformation into a treaty held only that such a transformation was desirable and feasible, not that it was probable, or much less, inevitable. …. Thus we might speak of a benevolent historical conspiracy, but certainly not of inevitability" Padoa-Schioppa, "The Road to Monetary Union in Europe," p. 9.

[16] Francesco Giavazzi and Alberto Giovannini, *Limiting Exchange Rate Flexibility: The European Monetary System* (Cambridge: MIT Press, 1989).

Italy bring its public finances under control by supplying clear objectives for fiscal policy and a supranational surveillance upon progress to attain them.[17]

To conclude, EMU was officially justified as a logical next step after the completion of the common market, a step that would reduce transaction costs and thus increase trade, and stimulate economic growth. These arguments, however, would have been not as successful -- after all, good economic counter-arguments also existed, most importantly that EMU would deprive national governments of their ability to use interest and exchange rates as instruments of economic policy – had it not been for the fact that EMU was also, and primarily, a *politically* driven process. First, there was the desire on the part of EC officials to make another significant step forward in the process of integration, a step that arguably had the potential to increase Europe's role and visibility on the world stage as well as contribute to the formation of a European-wide 'imagined community'. Second, and most important, national leaders that could have blocked the project did not because they saw EMU as an external factor that would help them attain domestic objectives (e.g. fiscal restraint in Italy, political reunification in Germany).

The Canadian Currency Debate and the Euro

The Protagonists

Before analysing the details of the Canadian currency debate, it is useful to provide some brief background information on the "players" in the debate. The euro was, as indicated above, a central political issue in Europe in the 1990s. The debate over the euro was informed by "expert opinion" - typically economists – but involved also political parties, pressure groups, and even the public at large since, at least in some cases, its adoption was the subject of popular referenda. The scope and intensity of the debate in Canada instead has been of a much lower order. In Canada, the debate has mainly been between a relatively small group of economists either working in academia or for major financial institutions. The currency debate has been a long way down the political agenda although it has made sporadic appearances, largely at the behest of the Parti Québécois and the Canadian Alliance, and has reached the public mainly because of press coverage, especially by the *National Post*.

As noted in the introduction, the leading proponents of a common currency have been Thomas Courchene, Herbert Grubel, Richard Harris, and Robert Mundell, all prominent academic economists. The proposals for a common currency were made by Courchene and Harris[18] in a jointly authored work produced for the C.D. Howe Institute and Grubel's proposal[19] was published by the Fraser Institute, both leading right-wing "think tanks". The leading proponents are associated with the conservative end of Canada's public policy spectrum. This is especially true of Grubel, a former Reform M.P., and Mundell, a long-time supply-side

[17] Osvaldo Croci and Lucio Picci, "European Monetary Integration and Integration Theory: Insights from the Italian Case," in A. Verdun (ed.), *The Euro: European Integration Theory and Economic and Monetary Union* (Lanham, MD: Rowman & Littlefield, 2002), pp. 215-240.
[18] Thomas Courchene and Richard Harris, "From Fixing to Monetary Union: Options for North American Currency Integration," *C.D. Howe Institute Commentary*, No. 127, (Toronto: June 1999).
[19] Herbert Grubel, "The Case for the Amero: The Economics and Politics of a North American Monetary Union," *Critical Issues Bulletin* (Vancouver: The Fraser Institute, September 1999).

economist who publicly endorsed the economic program of the conservative Canadian Alliance in the 2000 federal election.[20] They have been joined in their support for a common currency with the United States by some private sector economists, most notably, Sherry Cooper, a strongly pro-United States, pro-business economist at BMO Nesbitt Burns and a regular commentator in the financial press.

The leading opponents of a common currency have been economists with Canada's banks, most notably John McCallum when he was chief economist with the Royal Bank,[21] and economists with the (central) Bank of Canada, such as John Murray and Lawrence Schembri, all with strong academic credentials.[22] Successive Governors at the Bank of Canada, Gordon Theissen and David Dodge have also periodically entered the debate by affirming their belief that Canada's flexible exchange rate system has served the country well. Other opponents can be found on different ends of the ideological/political spectrum. Among them one should mention Mario Seccareccia, an economist at the University of Ottawa, whose work was published by the left-leaning think tank, the Canadian Centre for Policy Alternatives, and David Laidler, an internationally-known monetary economist with the University of Western Ontario, and a Canadian Bankers Association Scholar and Fellow-in-Residence with the C.D. Howe Institute. The range of political opinion found among the opponents should not be surprising because, although Courchene, Grubel, Harris and Mundell are prominent academic economists, their proposals are not particularly in keeping with mainstream academic opinion, which leans strongly towards flexible exchange rates for all but the smallest of the high-income countries.[23]

The Context

The Canadian currency debate of the late 1990s owed a good deal to the impending birth of the euro. The decision of the EU to proceed with the launch of the euro focussed attention in many parts of the world on exchange rate and currency arrangements. Canada was no exception. The euro project has had a profound influence on the credibility of common currency arrangements and has acted as a catalyst for, and has provided credence to, proponents of common currency arrangements for North America. The advent of the euro has led many to speculate that the world is inevitably moving towards the use of fewer currencies.[24] Even opponents of monetary integration, such as John McCallum, conceded that if the world moved towards the use of three key currencies, an independent Canadian dollar would not survive as a fourth. The EU example shaped the intellectual agenda and made common currency arrangements the intellectual fad of the late 1990s even though, as Pomfret has pointed out, the collapse of the rouble zone meant

[20] Even Harris, the least conservative of the four, is sufficiently conservative to serve on the *Financial Post* board of economists.

[21] John McCallum was a distinguished academic economist at McGill University before joining the Royal Bank, which he subsequently left to become a Liberal Cabinet Minister.

[22] John Murray has held academic appointments at the University of British Columbia and Princeton University, while Lawrence Schembri was economics professor at Carleton University before being hired away by the Bank of Canada, and he maintains a connection with Carleton as an adjunct research professor.

[23] See, for example, Robert Frank, Ben Bernanke, Lars Osberg, Melvin Cross, and Brian MacLean, *Principles of Macroeconomics*, 1st Canadian edition (Toronto: McGraw-Hill Ryerson, 2002), pp. 494-495.

[24] See Bowles, Croci and MacLean, "Globalization and Currency Convergence" for more details and a critique of this hypothesis.

that Europe as a whole "had more independent currencies in 2002 than it had in 1991."[25] This, plus the Canadian origins of Nobel Laureate Robert Mundell, widely described as the intellectual father of the euro and regularly featured in the news because of his Nobel Prize award, served to raise the issue of monetary integration to a higher level of public debate than might otherwise have been expected. The "temporal spur" given by the euro to the Canadian debate was explicitly recognised by many of the participants in the debate. For example, Courchene notes that "it was the advent of the Euro in January 1999 that unleashed a veritable flood of interest, papers and conferences on the evolution of Canada-US and North American currency arrangements."[26] The birth of the euro was therefore important in focussing attention on monetary unions and provided a trigger for the Canadian currency debate. However, it was by no means the only factor that was important in this context and there were at least four other factors that played a role in placing currency arrangements on the public agenda.

The first of these was that the debate took place in a political environment where the Canada-U.S. exchange rate had fallen sharply since 1991, which was often portrayed as being just before the Liberals took power at the federal level in 1993. Pro-business think tanks and political forces in Canada, including numerous business columnists, moreover, had repeatedly used drops in the value of the Canadian dollar as opportunities to criticize the status quo under the federal Liberals and to argue for more business-friendly policies.[27] Before Finance Minister Paul Martin's February 1995 federal budget, drops in the Canadian dollar were met with calls for social program spending cuts to eliminate the federal deficit, bring down federal government debt, and prevent Canada from supposedly hitting the "debt wall" and experiencing currency collapse.[28] Later in the decade, after substantial cuts to social program spending had been achieved, the focus shifted to using drops in the Canadian dollar to call attention to the desirability of corporate and personal income tax cuts to make Canada more "competitive" with the U.S.[29] In this political environment proposals for a common currency with the United States

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[25] Richard Pomfret, "Monetary Integration in East Asia: Lessons from Europe," paper presented at the 8th Convention of the East Asian Economic Association, Kuala Lampur, November 4-5, 2002, p. 2.

[26] Thomas Courchene, "A Canadian Perspective on North American Monetary Union," paper presented to NAEFA/ASSA session on "Currency Consolidation in the Western Hemisphere," New Orleans, January 5, 2001, p. 1.

[27] On an annual basis, the Canadian dollar has fallen from U.S.$0.87 in 1991 to U.S.$0.65 in 2001. The Canadian dollar was at a peak in 1991 associated with the unusually high interest rates the Bank of Canada had implemented to achieve its low inflation target, and 1991 therefore makes for a misleading starting date for calculations of the trends in Canada-U.S. dollar exchange rate (though not as misleading as using the highest daily rate from 1991). Over the period 1984-1987, for example, the Canadian dollar averaged about $U.S.0.74, which is not much different from the average value of the Canadian dollar ($U.S.0.73) over the 1994-1997 period.

[28] For a critical analysis of the tactics employed in the campaign for social program cuts, see Linda McQuaig, *Shooting the Hippo: Death by Deficit and Other Canadian Myths* (Toronto: Penguin, 1995).

[29] See Brian MacLean, "A Sherry Cooper Budget," *Policy Options/Options Politiques* (April 2000), pp. 21-24. The explanation for the decline in the Canadian dollar relative to the U.S. dollar during the 1997-2001 period seems quite simple: the U.S. dollar had become overvalued relative to most other currencies, a fact that is widely recognized outside of Canada. For example, the latest version of the "Big Mac Index" published by *The Economist* (27 April 2002), has the subtitle: "In the history of the Big Mac index, the [U.S.] dollar has never been more overvalued." To illustrate with a couple of specific examples, from January 1997 to April 2002 the Canadian dollar depreciated against the U.S. dollar by less than 14 percent, which is not much different from the 12 percent depreciation of the British pound over the same period, and is far less than the 31 percent depreciation of the Australian dollar. As 2002 unfolded, the U.S. dollar began to slide against a number of currencies, most notably the euro.

were naturally given a high level of news media attention because they fit in with the long-standing news media theme of treating the depreciation of the Canadian dollar as a very serious Canadian public policy problem.[30] The fallout from the Asian financial crisis, which saw the Canadian dollar hit an all-time low against the U.S. dollar in 1998 (although it fell to further lows in 2001 and 2002), added more grist to the mill.[31]

A second factor behind the Canadian currency debate was the emergence of the public perception in Canada that the United States was once again home to a highly dynamic economy. From the mid-1990s, when the Federal Reserve Board under Alan Greenspan decided to put to the test the hypothesis that the U.S. unemployment rate could not be allowed to fall below 6 percent or so without triggering a surge in the inflation rate, until 2000, the United States enjoyed exceptionally rapid employment, productivity, and output growth.[32] The economic dynamism that the United States exhibited in the late 1990s, and the way that rapid U.S. economic growth translated into rapid expansion of Canada's net exports to the United States during the same period, added appeal to claims that Canada should strive to be "competitive" with the United States, and that the two countries should become more highly integrated. Towards the end of the 1990s greater integration with the United States sounded much more attractive to the Canadian public than it did as late as 1993 when the United States was seen as experiencing a "jobless recovery" and as declining in economic power relative to Japan. At that time, many Canadians attributed Canada's economic ills to the Canada-U.S. Free Trade Agreement (FTA), and even the federal Liberals campaigned against the proposed North American Free Trade Agreement (NAFTA).

A third factor behind the Canadian currency debate was the perception that the Canadian economy had become substantially dollarized, a perception which permitted some observers to argue that Canada might as well adopt a common currency with the United States because powerful market forces were driving Canada towards full dollarization anyhow. The perception depended on anecdotal evidence such as news stories about certain corporate CEOs as well as players for Canadian professional sports teams being paid in U.S. dollars. In the absence of solid statistical studies, however, it was plausible for observers to assume, for example, that the strong upward trend in Canada's trade with the United States since the signing of the Canada-U.S. Free Trade Agreement would have prompted Canada's trading firms to increase their trade-related U.S. dollar holdings.[33]

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[30] Both the tax cuts theme and common currency arguments received special prominence in the pages of the *National Post,* established in 1998 by newspaper baron Conrad Black.

[31] For many Canadians, each new low for the Canadian dollar invited envious comparison with the strength of the U.S. dollar. They sensed that the depreciation of the Canadian dollar meant that their relative standard of living was in decline, and that it would be restored if the Canadian dollar were to trade at par with the U.S. dollar.

[32] Dean Baker, "NAIRU: Dangerous Dogma at the Fed," *Financial Markets and Society,* Financial Markets Center (December 2000), pp. 1-16.

[33] More careful empirical analysis has since put a damper on this line of argument. In particular, in a paper which constitutes a major advance in the measurement of "dollarization" in Canada, argue that "existing data suggest that informal dollarization is proceeding at a very slow (to non-existent) pace. Indeed, by many measures, Canada is less dollarized now than it was twenty years ago, and bears little resemblance to those economies that are typically regarded as truly dollarized." John Murray and James Powell, "Dollarization in Canada (The Buck Stops There)," paper presented at conference on Exchange Rates, Economic Integration and the International economy, Ryerson University, Toronto, May 17-19, 2002. See also Mario Seccareccia, "North American Monetary Integration: Should Canada Join the Dollarization Bandwagon? University of Ottawa (February 2002).

A fourth factor is that the Canadian debate over a common currency with the United States took place during a period in which the sovereignist movement in Quebec came to see greater Canadian economic integration with the United States as a means of easing the transition costs of a move to a separate (or at least decidedly more sovereign) Quebec (Parizeau 1999: 8).[34] Proposals for Quebec sovereignty have always raised difficult issues of what currency would be used post-independence and how continued use of the Canadian dollar could be negotiated with the rest of Canada in that event. With the adoption of a common North American currency, the sovereignists believed that this source of uncertainty would be removed, facilitating the re-drawing of political boundaries within a larger economic unit. The sovereignist Bloc Québécois introduced a motion in the House of Commons to study a common currency for the Americas in March 1999, a motion which was defeated by 175 votes to 67 but, much to the chagrin of the Liberal government, the Banking Committee of the Senate did discuss the issue one week later. The Canadian Alliance (the successor to the Reform Party of which Grubel was a member) also supported the study of a North American common currency but support for such a study by sovereignist parties made its discussion a low priority for other mainstream federal parties.

The birth of the euro, therefore, although instrumental in promoting the Canadian currency debate was only one among many, perhaps equally important, factors. We now turn to the use of the euro in the substance of the debate.

The Economic Arguments

Despite the relatively small number of participants in the currency debate, summarising the debate is no easy task because of the range of arguments that have been used, especially by the proponents of a common currency who have on occasion adopted an "everything but the kitchen sink" approach. Here, we focus on what we take to be the substantive parts of the debate.

The economic arguments of the proponents of monetary union are largely the same as those which would be advanced in favor of a fixed exchange rate, a currency board, dollarization (i.e. the unilateral adoption of the U.S. dollar by Canada), or a common currency. The proponents recognize this but argue that of these four options, the common currency option is the most attractive. It is preferred economically to a fixed exchange rate since the increase in capital mobility over the past decade has made fixed exchange rate regimes more difficult to sustain, an argument which can also be extended to the case of currency boards, and only a common currency or dollarization offer an economically sustainable "superhard" currency fix. A common currency is politically preferred to dollarization because it offers the possibility of Canada retaining some voice in continental monetary policy making.

There are four central economic arguments made by the proponents of monetary union.[35] The first is that the volatility of Canada-U.S. exchange rates has inhibited cross border investment and trade, and therefore reduced economic growth. Faced with exchange rate

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[34] Jacques Parizeau, "Globalization and National Interests: The Adventure of Liberalization," in Brain MacLean (ed.), *Out of Control: Canada in an Unstable Financial World* (Toronto: James Lorimer and CCPA, 1999), p. 8.

[35] In our summary of the arguments for monetary union we rely mainly on the analyses presented in Courchene and Harris, "From Fixing to Monetary Union," and Grubel "The Case for the Amero."

uncertainty, firms plan conservatively and therefore investment is lower than it would be in an environment of greater certainty. Thus, the argument runs that further integration requires a more stable currency regime.[36]

The second main argument used by proponents of a common currency relates to the effects of the secular decline of the Canadian dollar against the U.S. dollar over the past 25 years or so.[37] Specifically, the argument is that the flexible exchange rate regime has served Canada badly, allowing its staple producers and manufacturers to seek solace in a depreciating exchange rate rather than in making the productivity-improving investments that Canada is deemed to need.[38] That is, a depreciating exchange rate is argued to have insulated Canada's manufacturing and resource sectors from competitive pressures enabling them to minimize productivity-enhancing investments and slowing down the structural transformation of the Canadian economy. In short, a depreciating dollar had cushioned "lazy manufacturers" in Canada.[39] This argument has some parallels – although Canadian proponents did not draw on them – to the reasons which led Giscard D'Estaing to launch the EMS proposal in 1978. It will be recalled that then it was argued that a fixed exchange rate system would force French industrialists to pay more attention to the curtailment of wage inflation. For Courchene and Harris, a fixed exchange rate system would force Canadian industrialists to pay more attention to productivity-enhancing investment.

The third argument was a more general version of the productivity argument and was based on the view that monetary union would not only change the investment behaviour of Canadian industry but would also have wider impacts on Canada's institutional structure making it more 'flexible' and 'efficient'. A common conservative critique of the Canadian institutional framework has been that, in comparison to the United States, Canada is less flexible, less dynamic and more "welfarist" (to both firms and workers). Implicitly, the argument is that Canadian economic institutions and policy had 'failed' with the result that Canada had a persistently higher level of unemployment, and a lower productivity growth rate, than the United States. It is this more generalized failure that the proponents of a common currency sought to address. If adjustments to differential economic performance by the United States and Canada could no longer be channelled through the exchange rate, then they would have to be addressed by greater flexibility in other markets such as the labour market. Tying in with the U.S. monetary order would therefore force Canadian institutions to adapt and to become more like those in the United States: labour markets would need to become more flexible (read trade union power

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[36] Courchene and Harris, "From Fixing to Monetary Union."

[37] In recent academic analyses, it has been usual to take 1977 or so as the starting point for analysing the secular decline of the Canadian dollar on the grounds that during the six-year period of 1971-1976 the Canadian dollar had traded roughly at par with the U.S. dollar. This is certainly more sensible than taking the early 1990s as the starting point for analysis, as many media pundits have done. Canada had pegged to the U.S. dollar at U.S.$0.925 in the spring of 1962, however, and maintained the peg until mid-1970, when the Canadian dollar was allowed to appreciate. In looking at long-run trends in the Canada-U.S. dollar exchange rate, then, while a starting point of 1977 or so is customary, it is also inherently arbitrary. It establishes a period of unusually high commodity prices and hence a strong Canadian dollar as the norm against which subsequent exchange rate performance is judged.

[38] For more details of this argument, see Richard Harris, "Is there a Case for Exchange-Rate-Induced Productivity Changes?" in *Revisiting the Case for Flexible Exchange Rates*, proceedings of a conference held at the Bank of Canada, November 2000, pp. 277-309.

[39] The argument is suspect from a standard, pro-market neoclassical perspective because by the same logic manufacturers should be spurred to increased productivity if unions impose strong wage increases upon them.

reduced), firms to be more innovative, structural change to occur more quickly and for the government to be generally less interventionist. It is for these reasons that the currency debate found a wider resonance in the conservative media, especially the *National Post*, which has been at the forefront of the arguments for pro-business policies over the past decade such as lower government spending and lower taxes.

The fourth economic argument was that patterns of resource endowment and industrial activities had already resulted in the emergence of significant cross-border regional economies. Thus, Courchene and Harris, for example, argued that the similarities of regional economies across the Canadian-U.S. border, rather than East-West economic similarities, indicated that Canadian regions had at least as much interest in a stable exchange rate with neighbouring U.S. regions as with other Canadian provinces.[40]

The economic arguments presented by the proponents of monetary union did not therefore appeal to European experience, even where parallels were available. The focus was very much on a common currency as a way of addressing the perceived dynamism and superior performance of the U.S. economy relative to the Canadian economy; it was the Canada-U.S. comparison rather than any analysis of the European case, which drove the argument.

The opponents of monetary union were similarly focussed although they did make marginally more use of the European example in their arguments. Firstly, to counter the view that a flexible exchange rate had inhibited Canada-U.S. trade, opponents pointed out that there had in fact been a substantial increase in trade between Canada and the United States during the 1990s. In 1989, when the NAFTA was signed, Canadian exports to the United States totalled US$108 billion and accounted for 73.5 per cent of Canada's total exports. By 2000, however, exports to the United States had risen to US$360 billion and accounted for 85 per cent of Canada's exports.[41] The fact that exports to the United States had surged under a flexible exchange rate regime was used by opponents to argue that common currencies were *not* required to spur trade integration.[42] That is, it was argued that the European model of monetary integration was not necessary to reap the benefits of increased trade and investment integration.

With respect to the "lazy manufacturers" hypothesis, this was rejected at the theoretical and empirical levels. At the level of theory, the hypothesis implied that Canadian firms were not profit maximisers, and therefore inconsistent with one of the basic tenets of neoclassical economics. Empirically, it was argued that Canada's inferior productivity performance was due to performance in just two sectors of the economy and could not, therefore, be generalised to an argument about Canadian industry as a whole.[43] The argument of a wider institutional failure in Canada was countered by the argument that, whatever institutional failings there might be, they were not to be found in the monetary sphere. Canada had, as Laidler pointed out, a stable

[40] Courchene and Harris, "From Fixing to Monetary Union," p. 16.

[41] See Statistics Canada – Cat. No. 11-210-XPB, 2000/2001, p. 59.

[42] As Seccareccia notes "already more integrated than most of the countries of the EMU, with almost 90 per cent of our trade being with the U.S., it would be difficult to envisage still further growth in what is a share that have practically reached its upper limit!". Seccareccia, "North American Monetary Integration," p. 9.

[43] The two sectors were "industrial machinery and equipment" and "electronic and other electronic equipment". John McCallum, "Engaging the Debate: Costs and Benefits of a North American Common Currency," *Current Analysis* Royal Bank of Canada (April 2000), p. 7.

"monetary order" and had lower inflation rates than the U.S. for much of the past decade.[44] The monetary regime should therefore be left well alone.

The most prominent argument used by the opponents, however, was that it was precisely Canada's position as a staple producer that justified the continued use of a national currency and a flexible exchange rate. That is, it is because Canada relied, relatively speaking, more heavily on commodity exports that its currency depreciated in times of global economic slowdowns as commodity prices weakened. The Bank of Canada, in its analysis, pointed out that it is this feature of the Canadian economy which distinguishes it from the U.S. economy and why a flexible exchange rate serves as a useful adjustment mechanism in the face of external shocks.[45] Furthermore, adopting a common currency would not remove the need for adjustments to be made; it would merely move them to areas other than the exchange rate, such as nominal wage flexibility or labour mobility, where there are likely to be, at least in the short run until labour is sufficiently weakened, more protracted struggles and higher output costs. The fact that the United States and Canada did not meet some of the central criteria for an optimal currency area, added weight to the argument that independent national currencies and a flexible exchange rate were more appropriate.[46] These arguments, concerning the asymmetries of external shocks and the degrees to which labour markets adjust to shocks, can of course be found in European debates on the effects of a common currency. This, however, represents the application of common methodologies and theories by economists on both sides of the Atlantic rather than any particular borrowing from, or influence of, the European debate.

This review of the economic arguments has illustrated the limited role that the European experience has played in debating the need for a common currency in North America. The arguments of the proponents were not based on a superior performance of Europe, a performance which might be attributable to its exchange rate regime. Rather, the argument in Canada was that Canada had performed poorly relative to the United States; it is here that the comparisons were made. The United States was seen as having a more dynamic economy, out-performing Canada in terms of job creation, productivity growth, and economic growth. However, while the economic case for the *need* to change the exchange rate regime was based on comparisons with U.S. economic performance rather than with Europe, the *form* that it should take, and its political governance structure, drew heavily on the European experience.

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[44] The issue of the performance of the Bank of Canada relative to the US Federal Reserve was debated, however, by Mundell and Friedman with the former particularly critical of the Bank's record particularly under the disastrous "zero inflation" policy implemented under former Governor John Crow. Robert Mundell and Milton Friedman, "One World, One Money? Symposium," *Policy Options?options Politiques* (May): 10-30.

[45] See John Murray, Larry Schembri and Pierre St.-Amant, "Revisiting the Case for Flexible Exchange Rates in North America," paper presented at conference on Exchange Rates, Economic Integration and the International Economy, Ryerson University, Toronto, May 17-19, 2002.

[46] See Murray, Schembri and St.-Amant, "Revisiting the Case for Flexible Exchange Rates in North America," for tests of the asymmetric responses by Canada, the United States and Mexico to exogenous shocks. See also Jack Carr and John Floyd, "Real and Monetary Shocks to the Canadian Dollar: Do Canada and the U.S Form an Optimal Currency Area?" Department of Economics, University of Toronto, *Working Paper UT-ECIPA-Floyd-01-02*.

The Governance Structure

In advancing their arguments for a common currency, Courchene and Harris proposed a new common currency, the North American Monetary Unit (NAMU),[47] while Grubel suggested the 'Amero'.[48] In arguing for such a currency, they were clearly suggesting that Canada might be able to enter into a new currency regime with the United States on the basis of some presumed national equality and shared sovereignty. Courchene and Harris drew explicit parallels with the European model and argued that "the easiest way to broach the notion of a NAMU is to view it as the North American equivalent of the European Monetary Union and, by extension, the euro. This would mean a supranational central bank with a board of directors drawn in part from the central banks of the participating nations."[49] Grubel, in discussing the governance structure for the Amero, proposed that the three NAFTA signatories adopt a common currency with each member country appointing members to a North American central bank "governed by a constitution like that of the European Central Bank."[50]

In making these proposals, the attempt was made to sell North America as if it was comparable to Europe and to suggest that joint sovereignty over monetary policy was possible in the same way that it was (imperfectly) exercised through the European Central Bank. To suggest that the regional political superstructures for European monetary governance were capable of being applied to the North American case was, however, an abuse of the euro example, as opponents were quick to point out. For example, McCallum (2000: 2) argued that "the European Union model, in which independent states share decision-making and sovereignty, is alien to American thinking and American history" and he described the United States as being "light years" away from allowing any other country a formal role in formulating U.S. monetary policy.[51] The absence of any discussion in the United States about sharing a new common currency with Canada (or anyone else) is also telling.

Conclusion

The argument of this paper has been that the euro was important in acting as a temporal spur for the Canadian debate on currency regimes. However, the European experience of exchange rate management under the ERM and the economic performance under fixed exchange rates played very little part in explaining why proponents of North American currency union viewed this as a desirable policy option. Rather it was the comparison of Canada with the United States that played the central role in the debate. If anything, it was opponents which used the European experience in a negative way by illustrating that the trade growth between Canada and the United States in the 1990s did not require a European style fixed exchange rate regime. Where the euro did play a prominent role in the Canadian debate was as a model for North America, although we have argued that this was an abuse of the euro example given the vastly different capacities and desires to construct regional political institutions in Europe and North America.

[47] Courchene and Harris, "From Fixing to Monetary Union."
[48] Grubel, "The Case for the Amero."
[49] Courchene and Harris, "From Fixing to Monetary Union," p. 22.
[50] Grubel, "The Case for the Amero," p. 5.
[51] McCallum, "Engaging the Debate," p. 2.

Our discussion has also highlighted the way in which the temporal spur given by the euro was important in the period 1999-2001. However, other important factors were also identified to explain the reasons for the timing of the debate. The changes in these factors, and especially the end of the U.S. boom of the 1990s, have led to a considerable dampening of the public debate in Canada over North American currency arrangements. Writing in early 2003, the Canadian dollar has strengthened against a now weakening U.S. dollar, U.S. growth rates have fallen, and Canada has been outperforming its southern neighbour. In 1999-2001, when most of the literature which we have surveyed was produced, there was a widespread perception of Canadian economic performance relative to the U.S. that still reflected Canada's "Great Stagnation" of 1990-1996 and the U.S. boom of 1996-2000. This, however, has changed and the arguments for a euro-style common currency for North America which, as we have seen, rested heavily on the Canada – U.S. comparison, have become much less prominent in the public domain as a result.

This should not, however, be interpreted to mean that the issue of North American currency union will remain off the table for an indefinite period. In the European case, we argued that the issue continued to resurface despite numerous interludes and setbacks caused by economic events. It kept resurfacing because it was driven essentially by political motives. For the same reason, the issue of a common currency in North America is quite capable of resurfacing at future points since it too is tied to a political agenda of achieving a more integrated continental economy and of promoting a convergence of Canadian economic institutions to those found in the United States.