Is North America Ready for Monetary Union?

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NINETEEN NINETY-NINE SAW THE successful launch of the euro, the EU's new currency. The North American Free Trade Agreement (NAFTA) is the world's second biggest trading block after the EU, and yet from an integration perspective the bloc has yet to fully develop beyond a free-trade zone, let alone start to seriously consider a single currency. Countries like Canada and Mexico depend heavily on their trade with the United States for export markets and import sources, and yet there is no formal exchange rate or macroeconomic policy co-ordination between the three countries. From a European integrationist perspective, the lack of effort to develop NAFTA beyond a free-trade area would appear a puzzling oversight, but the lack of co-ordination mechanisms within North America would strike them as simply foolhardy.

North America is Not Europe

The economic rationale for the use of a single currency stems from the European logic of "one market, one money", whereby the full potential benefits of operating a single market will only be apparent once the costs of converting currency have been eliminated. Many economists have jumped on this fact to argue for a single currency for North America. But is the North American situation similar to that in Europe? First, NAFTA is not yet a single market. The EU single market is a single market in all goods and services and factors of production (and even then there are institutional barriers still in place), whereas in NAFTA there are still trade barriers both within and between member countries. In addition, there is never likely to be a single market in all types of labour. So the "one market, one money" argument does not yet (and may never) apply to North America.

The economic integration of Europe has been a very long process which dates back to the 1950s in its origins but only received significant impetus in 1979 and then subsequently during the Delors era. Particularly important here was the date when the European Monetary System (EMS) was created—most Europeans acknowledge that without the EMS, European Monetary Union (EMU) would simply not have occurred. So North American economists who talk of a rapid changeover to a single currency conveniently ignore the fact that the move from a free-trade area to a monetary union could pose problems in that a whole series of steps in the integration process would be missing.

The EMS had as its major component the exchange-rate mechanism (ERM), which was an adjustable-peg exchange-rate system with specified margins of fluctuation on either side of a central rate. When a currency approached the edge of its fluctuation band, the monetary authority could either raise interest rates, intervene, "talk" the currency up or down, request a change in the central rate (realignment), or widen the fluctuation bands. The exchange-rate mechanism of the EMS was in operation from 1979 until 1999, when the euro was launched. It still continues to this day, albeit in a revised (and voluntary) format for currencies yet to take the plunge into EMU (notably Greece, Sweden, Denmark and the United Kingdom).

From a European perspective, the lack of co-ordination mechanisms within North America appears foolhardy.

The Case For North American ERM

What arguments are there in favour of a North American ERM (or NAERM)? One of the arguments *against* any interventionist scheme to promote greater exchange-rate stability is that there is no strong evidence that exchange-rate volatility affects trade flows. Why? Because even though the prices of goods and services are affected by exchange rates, companies can always purchase "insurance" through exchange-rate derivatives. But recent research has shown that exchange-rate volatility and exchange-rate derivative activity are not related, eliminating that explanation. So what is left to explain the apparent inability to find any relationship? At present no other explanations are on the table—in fact, other research on the impact of exchange-rate volatility on the level of investment does suggest that there are significant effects. I would propose that profit-margin adjustment is probably the most likely way in which exchange-rate volatility affects economic activity. If companies view a trading relationship as a long-term commitment that should not be affected by exchange-rate volatility, then they will allow profit margins to fluctuate. No research has yet been done to explore this explanation so we are still "in the dark". But is being "in the dark" reason enough to ignore the fact that there is likely to be a relationship (given strong anecdotal evidence in the media)? Obviously not.

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The second part of the case for a NAERM is that it has some potential benefits if judiciously used. Paul Krugman has constructed a theoretical model suggesting that if a central bank is credible, exchange-rate volatility will be lower than if the exchange rate were allowed to freely fluctuate. Empirical findings on whether such credibility effects exist are mixed, however.

Third, an ERM is flexible enough so that if for some reason resisting a change in the central parity is deemed to be undesirable, then realignments can occur which do not (as the EU experience has shown us) lead to discrete jumps in the exchange rate.

The Case Against North American ERM

Turning to the first alleged disadvantage, a member country would not have as much latitude in running its monetary policy, because inflation targeting (or whatever monetary policy was in place) would also have to take into account exchange-rate movements. But loss of autonomy will not be complete and, depending on the width of the fluctuation bands, the central bank can still conduct an appropriate monetary policy to maintain domestic price stability. I propose 3% fluctuation bands, so that if the central parity for the Canadian dollar, for example, were set at C$1.48, the fluctuation margin would be C$1.5244 to C$1.4356 per US dollar. This is wider than the standard European ERM band width of 2.25%, but would also probably allow for Krugman's credibility effects. Obviously a 15% band width would not give such credibility effects, whereas a 1% fluctuation band would probably limit the central bank's monetary policy independence too much. But if price stability were really threatened, the central bank could always realign the exchange rate band as well—if inflation differentials were too large, then this would be the most appropriate course of action.

Second, most of the critics of this type of exchange-rate arrangement cite the European experience with the speculative attacks of 1992-93 that eventually caused a widening of the fluctuation bands of the ERM to 15% in August 1993. But all of the research that has been done on these exchange-rate crises point to the fact that the ERM was no longer *just* an exchange-rate arrangement—it was explicit in the Maastricht Treaty of 1991 that the ERM was one of the economic criteria that had to be met before being eligible for EMU. In addition, several of the EU central banks and governments had resisted realignments (because of the political capital that could be gained by reminding the electorate that the EMU criteria were being met), even though economic fundamentals strongly suggested a realignment. Clearly, such an exchange-rate policy should be made independent of government policy, so having the central bank implement the policy along with monetary policy would seem to be logical. Given a reasonable amount of central bank independence and credibility, as long as the NAERM is not incorporated as conditions in any future NAFTA treaties, then its operation will not likely be politicised as the ERM was in 1992-93 in the EU.

Third, some critics will say that the EU has institutional arrangements already established for the EMS, which also included some borrowing facilities to permit market intervention beyond the level of reserves immediately available to a central bank. This is indeed a problem, not just because there is virtually no institutional structure in NAFTA, but also because NAFTA has largely operated through bilateral consultation and arbitration panels, which can be costly in terms of time and resources.

Two Options for a NAERM

There are clearly two options for institutional arrangements—either unilateral operation of such an exchange-rate regime (as in Sweden in the 1980s and early 1990s), or some agreement on a NAERM among the three NAFTA partners. I think the latter is the more desirable. The agreement I propose would mimic the original blueprint for the ERM, in that the onus to intervene should be on both the depreciating and appreciating currency, and if a realignment was necessary, the realigning currency should consult all members of the ERM to gain agreement on the new parities.

How would such an agreement be monitored? NAFTA members would establish a North American ERM with a monitoring agency similar to the European Monetary Institute. The monitoring agency would manage short-term borrowings between the NAFTA countries, monitor economic developments, conduct research and call upon the signatories to act or negotiate whenever appropriate. For example, the agreement on the ERM would stipulate that the Fed would join the Bank of Canada in intervening to support whichever currency had weakened, if it was agreed that other actions should be resisted. The monitoring agency would also be able to call a meeting if it thought that a currency needed to be devalued within the system. This additional autonomy granted to a supra-national institution in NAFTA, if applied to the EU's ERM, would correct one of its major flaws—the inability of EU institutions to call on member states to devalue, even if not doing so threatened the long-term stability of the system. In addition, having a new institution that mirrors the current arbitration process for trade disputes would also resolve any conflicts that appeared in operating such a system. What happens if the United States refuses to co-operate? There is nothing to prevent Canada or Mexico going ahead and introducing a NAERM unilaterally, as long as it announces how the system will work so that the general public and the foreign-exchange market understands the policy—the rules just become one-sided instead.

The NAERM proposal represents the "third way" for NAFTA monetary arrangements in that North America would gain the benefits of more stable exchange rates while maintaining the ability to pursue largely independent monetary policies. In this sense, a NAERM would automatically allow for policy co-ordination while monetary policy autonomy would not be significantly curtailed over the short run, and would be completely intact over the longer term. The danger would be if the NAERM became politicised, in that NAFTA members decided to adopt plans to move toward deeper levels of economic integration using the NAERM. In this case history has shown that an ERM can invite speculative attacks. But this situation is unlikely given the current attitude of the US Congress toward more integration with present NAFTA members. ◆