Should Canada Dump Its Floating Regime?

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CANADA ADHERES TO THE FUNDAmental principle of free international movement of financial capital. In practice, this principle admits only two monetary regimes: a fixed exchange-rate system in which North American interest rates are set by the US Federal Reserve; or a flexible exchange-rate system in which Canadian monetary policy retains some independence in the management of domestic interest rates.

Why must this be so? Because every day between one and two trillion dollars move freely across currency markets in a search for the slightest speculative gain. For the Canada-US exchange rate to remain fixed, two conditions must be met. First, the owners of financial capital have to be absolutely convinced that the exchange rate will stay unchanged. That is, the fixed exchange rate must be perfectly credible. Second, interest rates on Canadian and US securities with identical characteristics have to be exactly equal. Any differential would immediately attract speculators and trigger a huge flow of capital that would modify the exchange-rate parity and thus put an end to the fixed regime. It follows that in a fixed exchange-rate system Canadian interest rates have to move in perfect harmony with US interest rates. An immediate corollary is that Canada can have an independent monetary policy only if it allows the Canadian dollar to float.

Since 1991, the goal of Canadian monetary policy has been to keep the national inflation rate within a target range of 1% to 3% per year. This objective is specific to Canada. US authorities also want to contain inflation, but have not committed themselves to achieving any precise official target or follow any precise operational rule. Consequently, the interest rates set by the Bank of Canada and those determined by the US Federal Reserve often follow different paths. This generates frequent and often important fluctuations in the exchange rate of the Canadian dollar. These movements in the Canada-US exchange rate constitute the price Canada has to pay in order to manage its interest, inflation, and unemployment rates with some degree of independence from the United States.

Current discussions about Canada's monetary regime focus on two questions. First, is it economically desirable for Canada to replace its current floating exchange-rate system with inflation targeting by a fixed exchange-rate system? Second, does there exist any type of fixed exchange-rate regime that would be not only economically desirable but also politically feasible? My answers are yes to the first question and no to the second. For the time being at least, Canada is stuck with its current floating regime.

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The Economic Case Against the Status Quo

Every floating exchange-rate system brings a benefit and a cost. The benefit is macroeconomic: it makes independent monetary policy possible. The cost is microeconomic: transactions induced by currency conversion are costly and, further, the exchange rate moves all the time. Important and often disorderly fluctuations in the exchange rate can destabilise business planning and international trade. Over time, this can hurt the incentive to do business in Canada and harm productivity and economic growth. The reason a rising number of Canadians severely criticise the current system is that, over the past decade, the perceived benefit of Canadian monetary independence has declined and the perceived cost of exchange transactions and exchange-rate instability has increased.

During the 1990s, the overall macroeconomic performance of Canada was dismal, and just about the worst among all industrial countries. Although the situation has improved significantly since 1997, the poor performance of Canadian monetary policy over that decade stands in sharp contrast with the resounding success of US monetary policy. But the good performance of the United States cannot be attributed only to the exceptional competence of Chairman Greenspan. Interest, inflation, and unemployment rates were lower in the United States than in Canada throughout the entire period from 1950 to 1990. Hence, to import US interest rates by fixing the Canada-US exchange rate does not entail any significant short- or long-term macroeconomic risks for Canada.

Meanwhile, the cost of foreign-exchange transactions and exchange-rate instability has increased sharply. The quarter century from 1950 to 1975 was a period of relative stability for the Canadian currency. The Canada-US exchange rate fluctuated within a moderately narrow band of ±6%. But since 1975 things have been very different. The Canadian dollar depreciated against the US dollar by 28% from 1975 to 1986, appreciated by 22% from 1986 to 1991, and depreciated again by 23% from 1991 to today. To make things worse, this greater medium-term volatility of the currency took place in an environment in which Canada's dependence on international trade increased from 25% of GDP in the old days to over 40% of GDP in the past five years. More foreign-exchange transac-

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tions are made in increasingly volatile currency markets.

In sum, exchange-rate instability is vastly more important than in earlier times, and it affects an increasing portion of Canadian economic activity. If this greater volatility mirrored the evolution of economic fundamentals, there would be little room for complaint, since currency fluctuations would drive the economy toward the best possible allocation of resources. To stabilise the exchange rate in this context would only destabilise other prices without producing any net gain for the economy. But this ideal world is not real. On the contrary, examples of speculative bubbles, excess volatility and persistent currency misalignments have been frequent and well documented in the current economic literature. The greater instability of the Canadian-dollar exchange rate has become a drag on the good performance of the Canadian economy.

Arguments in Favour of the Status Quo

Supporters of the *status quo* typically counter with four arguments. First, they explain the bad macroeconomic performance of the 1990s as the price Canada had to pay in order to establish the credibility of its new "price stability" and inflation targeting regime. Now that the costs are behind us, international markets trust our central bank and reward Canada with real interest rates similar to US rates. Second, they claim that, two years ago, exchange-rate flexibility allowed Canadian monetary policy to shield the economy from the destabilising effect of the 1997-98 Asian crisis. In their view, our newly credible flexible regime passed this test with flying colours. Third, they point out there is little Canadian and international evidence that exchange-rate volatility hurts the expansion of trade. In particular, it does not seem to have prevented the surge of Canadian exports as a percentage of GDP over the last twenty years. Fourth, they argue that the transition to a fixed exchange-rate regime would be rocky. Since the Canadian dollar is currently undervalued, the Bank of Canada would have to raise interest rates in the short run to engineer a currency appreciation up to the level where parity would finally be established. This would likely generate a recession.

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What should we make of these arguments? First, it cannot be denied that the end of the fiscal and monetary turbulence of the 1990s brought Canadian interest rates closer to US interest rates in real terms, and even sometimes below (as between mid-1996 and late 1998). Canada is definitely not Argentina nor even Italy. It does not need the discipline of a fixed exchange rate or the euro to convince markets its central bank can be trusted. But the low interest rates seen in Canada during the long-awaited recovery of 1997-2000 do not destroy the record of 25 years of positive average real interest rate differentials between Canada and the United States. It is presumptuous to argue that the zero real differential observed since the end of 1998 will last indefinitely. Put another way, a zero interest rate differential with .the United States is a permanent characteristic of a fixed exchange rate system, but it is only the *best* that can be achieved under a flexible system.

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Second, the newly acquired credibility of the Canadian monetary regime has by no means done away with exchange-rate volatility. From the beginning to the end of the Asian crisis, the Canadian dollar depreciated by 12% and then rebounded by 6%, and the short-term interest rate increased by a full percentage point. It is a rash statement that this experience had any net stabilisation effect on the Canadian economy.

Third, the argument concerning the absence of evidence of a link between exchange-rate volatility and trade is also misleading for two reasons. First, that evidence relates to the effect of very-short-term volatility, and not with appreciations or depreciations of 25% lasting over periods of many years as observed in Canada since 1975. Second, the fact that Canadian trade increased from 25% of GDP to 40% of GDP over the past two decades logically constitutes no evidence at all against the view that exchange-rate instability hurts trade expansion, since no one knows what the increase in trade would have been in the absence of these wide fluctuations in the exchange rate.

Finally, a Canadian-dollar appreciation, say to 75 US cents from the current 68 cents, is not at all a prerequisite for the transition from the current flexible system to a fixed regime. Fixing the value of the Canadian dollar permanently at 68 cents is perfectly feasible even if the currency is in fact undervalued at this parity. What would happen then is that Canadian inflation would exceed US inflation for a while until some equilibrium level of relative competitiveness and purchasing power would be established between Canada and the United States. There is no need for painful appreciation and recession prior to fixing.

Should the Canadian Dollar Be Eliminated?

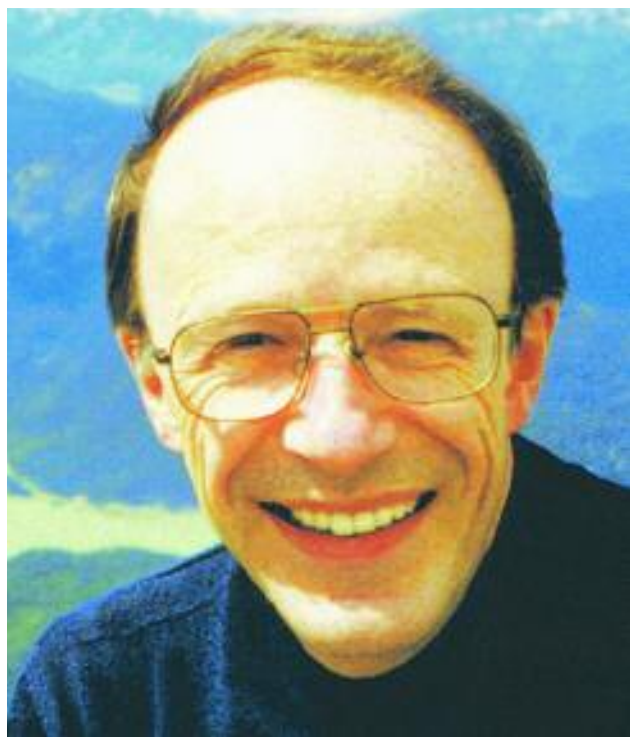
If it is agreed on economic grounds that the Canada-US exchange rate should be fixed, then the next question is: how should this be done? The cleanest solution would be to abolish the Canadian dollar and to have Canada form a monetary union with the United States. This could be implemented in one of two ways: unilateral dollarisation, or a formal monetary union. Dollarisation means the US dollar would replace the Canadian dollar as a unit of account and medium of payment in Canada. This would allow Canada to enter a monetary union with the United States without asking permission. Other countries, such as Panama and Liberia, have already

done it. A formal monetary union, on the other hand, means Canada and the United States (and perhaps Mexico and other Latin American countries) would agree by treaty to abolish all their individual currencies and replace them by a new common currency. This would exactly parallel the new common currency created by eleven European countries in 1999—the euro.

Under either unilateral dollarisation or a formal monetary union, the currency in use in Canada would always have exactly the same value as in the United States. At one point in time, all wages, goods and services prices, and asset prices in old Canadian dollars would suddenly be worth so many US dollars or so many units of the new common currency according to the Canada-US exchange rate of the day. From that point on, all transactions would take place in the new currency. Whither the Canadian dollar.

In either form of monetary union, the Canada-US exchange rate would by definition be rigidly fixed and equal to 1. No more speculation in favour of or against the Canadian dollar, no more exchange-rate fluctuations. Further, according to estimates based on research done by the European Economic Commission, Canadians could save up to $5 billion annually (0.5% of Canadian GDP) by economising on exchange-related transactions and conversion costs.

What would be the differences between the two types of monetary unions considered here? Essentially, a formal monetary union would have four advantages over unilateral dollarisation. First, the profits accruing to the new common central bank from issuing currency (the seigniorage rights) would be shared between union members according to some agreed-upon rule such as relative size of GDP. Canada's profit share would probably be worth about $1.5 billion annually. Second, common rules would be set for loans of last resort made by the new central bank to financial institutions in difficulty wherever they are in the new monetary area. Third, the board and monetary policy committee of the new central bank would include representatives from every member country. Fourth, a new symbol of international partnership would be created.



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Unilateral dollarisation would bring none of these advantages to Canada. Seigniorage rights from issuing US dollars for use by Canadians would all accrue to the US central bank. Canadian financial institutions would not have access to last resort lending by the US central bank. Canadian-US monetary policy would be under the sole responsibility of the US Federal Reserve. The currency in use in Canada would show the picture of George Washington. From a Canadian perspective, dollarisation would be a distinctly inferior form of monetary union.

The Canada-US Monetary Union: A Political Mirage?

But even if some kind of monetary union between Canada and the United States—unilateral dollarisation or a more formal union—is desirable economically, political obstacles make it highly unlikely to occur in the near future. Currently, the United States would draw no benefit from killing its dollar, replacing it by a new continental currency, and sharing its monetary sovereignty with Canada and other countries within a formal North American monetary union. The dollarisation alternative would mean using the US dollar as a unit of account and legal medium of exchange on Canadian territory. It would be seen as national humiliation by Canadians.

Even the more advantageous formal monetary union would be unacceptable to Canadians. The new central bank issuing the North American currency would be massively dominated by US representatives and could not be sufficiently accountable to the Canadian Parliament. This kind of transfer of power from Canada to the United States would have no political legitimacy in Ottawa. Canadians have historically been extremely sensitive to sovereignty issues, particularly in their relations with the United States. One needs only to remember the great reluctance with which Canadians finally accepted to proceed with the 1989 Free Trade Agreement with the United States. Yet, the FTA was merely a confirmation and mild extension of existing trade relations between the two countries. Accordingly, Canadian policy authorities, including Prime Minister Jean Chrétien, Finance Minister Paul Martin and Bank of Canada Governor Gordon Thiessen, have recently used strong terms to reject any idea of unilateral dollarisation or of a formal monetary union with the United States.

The lack of enthusiasm of the Bank of Canada for any form of monetary arrangement that would put the institution out of business is, of course, understandable. But the Governor's case against a monetary union with the United States must be considered for its own merits. What is his main argument? It is that exchange-rate flexibility helps stabilise the economy when world commodity prices fluctuate. Since Canada is a net exporter, and the United States a net importer, of natural resource products, it follows that a commodity price decline affects the Canadian economy negatively, and the US economy positively. The Bank of Canada would then compensate by allowing the Canadian dollar to depreciate.

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However, this traditional argument made by the Bank in favour of countercyclical exchange-rate movements is not very convincing, for three reasons. First, despite Canada's exposure to commodity price fluctuations, the country's terms of trade have been among the most stable across the industrial world over the last quarter century. In addition, the weight of Canadian exports of primary products in total Canadian exports has dropped markedly, to 35% in 1999 from 60% in 1973. The need for exchange-rate adjustment in the face of terms-of-trade changes is therefore small and declining.

Second, the fact that the Bank has always made clear its intention to allow the exchange rate to fluctuate in a stabilising way against terms-of-trade movements by itself constitutes an explicit invitation to speculate against the Canadian dollar at the slightest news of a commodity price decline. As reported above, during the recent Asian crisis and its aftermath, exactly this outcome was observed. The Canada-US exchange rate suffered gyrations that were of questionable usefulness for economic stabilisation.

Third, to allow the exchange rate to react systematically to commodity price variations amounts to letting the slightest price movement in the relatively small natural resource sector destabilize relative prices in the much larger remainder of the economy. This raises a serious problem of allocative efficiency.

Can the Canada-US Exchange Rate Be Credibly Fixed?

Be that as it may, political dynamics will likely prolong the life of the Canadian dollar for a while. This immediately raises the question whether the exchange rate of the separate Canadian dollar can be credibly fixed relative to the US dollar by some other means. Can a fixed Canada-US exchange rate be spared the kind of monstrous speculative attacks most currencies under a fixed regime have suffered over the last 25 years?

Perhaps, but nothing is less certain. In practice, two fixed exchange-rate systems could be envisaged by Canada: a soft fix and a hard fix. The soft fix would bring the country back to the pegged-but-adjustable exchange rate consistent with the Bretton Woods system that dominated the 1945-73 period. In this kind of regime, the Bank of Canada would normally be committed to manage Canadian interest rates to keep the exchange rate within a narrow range of perhaps ±1% around the official parity. But it would retain the option of adjusting the exchange rate at will in a situation of "fundamental disequilibrium"—as the Bretton Woods Agreement put it.

Until the euro was created 18 months ago, Austria, Luxembourg and the Netherlands had experienced mass popular support for a fixed exchange-rate regime and had been able to manage a Bretton Woods-type system without any major turbulence for two decades. But their success was the exception, not the rule. At the very least, it is hard to disagree with those who question the capacity of a fixed Canadian dollar to stand up to speculative attacks, given the continuing growth and volatility of international short-term capital markets, the lasting perception of Canada as vulnerable to commodity price fluctuations, and the weak domestic political support for a fixed exchange rate. Many observers have pointed out that a Bretton Woods system is a high-risk option that not one OECD country enforces anymore.

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The other option is the hard fix. This kind of regime would be managed by a currency board. In this case, the official exchange-rate parity could not be changed at will by the central bank. A law of parliament would be required. In addition, the monetary base of the financial system would be 100% supported by US treasury bill assets. The credibility of this regime could also be made much stronger if an agreement was reached with the US Federal Reserve whereby the latter would commit itself to back the Canadian currency board in its efforts to defend the established parity, and would agree to act as lender of last resort in case of a financial crisis in Canada. This type of commitment on the part of US authorities would be motivated by the benefit of monetary and financial stability accruing to US firms doing business with Canadians.

There is little question that a hard fix would have more chances of surviving than a Bretton Woods-type soft fix. Argentina and Hong Kong have been operating under a currency board for 10 and 25 years, respectively. However, the case for the currency board is not airtight. First, the recent experience of these two countries has shown that speculative raids remain a possibility even under very solid currency boards. Damaging increases in interest rates are the consequence. Second, contrary to the situation in Argentina and Hong Kong, it is doubtful whether Canadian opinion would stand very solidly behind the hard fix. The political credibility of the regime would be fragile. Third, the United States would likely require a *quid pro quo* from Canada in exchange for its commitment to support the exchange-rate parity and its willingness to act as a lender of last resort. For example, Canada could be asked to sur-

render its sovereignty over financial regulation. These imposed conditions would probably be too much for Canadians to swallow politically.

A hard fix managed by a currency board is certainly a worthwhile option to be considered by Canada. But it is not a riskless option either—especially from a political perspective.

Conclusion

The reasons for questioning Canada's current flexible exchange-rate system with inflation targeting are clear enough. Put simply, during the 1990s the perceived benefit from conducting an independent monetary policy declined, and the perceived cost of exchange transactions and medium-term exchange-rate instability increased. In my opinion, the ideal *economic* solution would be to abolish the Canadian dollar and start the process of creating a formal monetary union in North America (with Mexico and other Latin American countries eventually included) much like the new European Monetary Union. The problem is that, from a Canadian perspective, this economic solution fails elementary tests of political legitimacy and parliamentary accountability.

Monetary union, from a Canadian perspective, fails elementary tests of political legitimacy and parliamentary accountability.

An interesting alternative would allow Canadians to keep their dollar, but would fix its US-dollar parity firmly under the surveillance of a Canadian currency board with the full backing of the US Federal Reserve—thus making it a kind of *armoured* currency board. However, nothing guarantees that this sort of monetary arrangement would be exempt from global speculative attacks, and everything guarantees that important political obstacles would have to be cleared before Canadians would agree to support it.

An increasing number of Canadians rightly complain about the small benefits and large costs of our current floating exchange-rate system. It is a bad system. But political realities must force everyone to recognise that for the time being it is still, as the saying goes, the only one-eyed regime eligible for king in the country of the blind. For the far future, alternatives that are both economically and politically feasible need to be developed and analysed. But for the near future, Canada is stuck with its current floating regime. Our criticism and suggestions will continue to be needed to help the Bank of Canada improve its management of the present system. ◆