Is the Loony Drowning?

Hemispheric integration is reducing the advantages of an independent currency

By Peter Diekmeyer

The recent Summit of the Americas meeting in Quebec City — part of a process leading to enhanced hemispheric economic integration — puts increased pressure on supporters of an independent Canadian monetary policy.

The loony's usefulness — particularly in light of its recent weakness — is increasingly being called into question. The *National Post* has been lavishing space on proponents of currency integration such as economist Robert Mundell. And both the Fraser and CD Howe Institutes have published papers advocating a North American monetary union.

More recently, CIBC World Markets chief economist Jeff Rubin made headlines when he warned about the likelihood of a 60 cent dollar. "Sixty cents is an extremely important psychological threshold," said Rubin in a telephone interview. "If it reaches that level, many people will lose confidence in the currency." Even many of those who oppose linking the Canadian and U.S. dollars, and possibly the Mexican peso, into a common North American currency acknowledge the proposal's potential benefits.

Canada has one of the most open economies in the world. Exports to the U.S. account for more than 35% of our GDP. According to Bank of Canada estimates, Canadians could save as much as $3 billion a year in transaction costs by adopting the American dollar, or by sharing a common currency with the U.S. Much of the impetus for North American monetary integration comes from the example set by the introduction of the Euro in January 1999. The fact that eleven different and often belligerent countries are working toward a common currency is leading many here to wonder why we can't do the same.

Frustration with the Canadian dollar's decline is easy to understand. One of a currency's principal functions is to act as a store of value. But the loony has been doing a poor job of it. As recently as 1992, the dollar was trading at close to $0.88 US, yet by mid March of 2001, it had dropped below $0.64 US, a decrease of more than 27%. In fact, the decline in the value of the dollar has wiped out virtually all the productivity gains that Canadians have made since the Chrétien administration took power in 1993.

Bank of Canada governor David Dodge has said that a weak dollar provides an impetus to growth by reducing the price of Canadian goods in overseas markets. It's an argument made by many of the currency's defenders. But there are two sides to this argument. A cheap dollar has long let exporters off the hook by shielding them from the restructuring they require to remain competitive on international markets.

Even more importantly, the cheap dollar amounts to an indirect subsidy to exporters, which is paid for by all Canadians. In essence, it is a hidden tax whose value is staggering.

Last year, Canada imported $363 billion worth of goods. Every penny the Canadian dollar drops costs importers $3.63 billion. If this hidden subsidy were replaced by a direct tax on imports that was paid out in transfers to exporters, Canadians would not stand for it. But since the subsidy is camouflaged in the form of a low dollar, it remains relatively unnoticed.

Another problem with a cheap dollar policy is that among the biggest winners are commodities exporters. A cheap dollar means that Canada, in effect, is selling off often non-renewable natural resources at cut-rate prices. This is being done to subsidize high-priced unionized workers in an old-economy industry. It's a short-term strategy that has severe long-term consequences.

Many wonder whether it is even possible for governments to maintain an independent monetary policy over the long term in a global economy. A graph of Canadian and U.S. interest rates over the past two decades shows that, with certain short-term exceptions, they move roughly in tandem.

Defenders of the Canadian dollar argue that it is those short-term exceptions that make having an independent currency so useful. For

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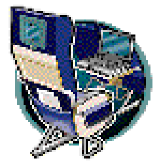

example, the Bank of Canada devalued the dollar to cushion commodities producers from the shock of the Asian economic crises. But stimulating exports through currency devaluation comes at a price. By definition, such a policy punishes companies that import. As matter of public policy, if the Canadian government were to support one group to the detriment of another, it would be better to do so through cash transfers rather than by playing around with the dollar. At least with cash transfers, who is getting what from whom becomes more transparent.

Another problem with the "short-term exceptions" argument is that if playing with a currency to favour one sector over another is a good idea, then every Canadian region should have its own currency so they could subsidize local industries. The real question is if the Bank of Canada more or less follows the interest rate policies of the U.S. Federal Reserve Board, then do we really need the Bank of Canada? Wouldn't a seat on the Federal Open Market Committee (FMOC), which sets U.S. short-term rates, give us more influence?

Bank of Canada officials downplay this argument by saying that having only one seat among 12 on the FOMC would leave us powerless. But that assumes that all U.S. regions have the same interests and that a Canadian could not make alliances with other FOMC members. Despite the questions surrounding it, there remains a considerable base of support for the loony. None of the major federal political parties have advocated currency integration. The governing Liberals (notably MP John McCallum, a former economist with the Royal Bank of Canada) are strongly against it.

"It is obvious to all but a few Canadians that the United States is not about to give up its dollar in favour of a new Euro-style NAFTA currency," wrote McCallum in a recent article. "Nor is the United States about to share control over monetary policy, which has been made abundantly clear by officials such as former treasury secretary Larry Summers."

But the pragmatic Liberals — who vociferously opposed free trade with the United States and NAFTA only to later support both agreements — can hardly be counted on as reliable defenders of any controversial policy, especially if the polls begin to swing against it.

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While they are unlikely to take any initiative on their own, Canada's natural governing party has an innate ability to reorient its priorities to shifting political winds. Prime Minster Jean Chrétien has demonstrated far less reluctance to engage in closer ties with the U.S. when arrangements can be made on a multilateral basis that includes other countries such as Mexico, who can act in concert as a check on U.S. dominance.

Another wild card to watch is the fact that Chrétien is notoriously short on accomplishments to define his legacy. And while it is by no means certain that his present term in office will be his last, leaving Canadians a strong North American currency would be a significant achievement.

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