

No Small Change: The Awkward Economics and Politics of North American Monetary Integration

C.D. Howe Institute Roundtable
Toronto: 19 September 2002

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William Robson
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The plug...



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The Economics and Politics of North
American Monetary Integration

- Framing the issues: the current order and its critics
- Three insights about money, exchange rates, and accountability
- Impacts of different US\$-based monetary orders on Canada
- Issues in Canada-US monetary negotiations

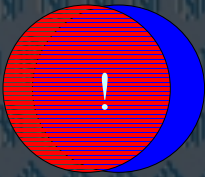
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The key question:
Do the sets of economically attractive and
politically feasible options intersect?



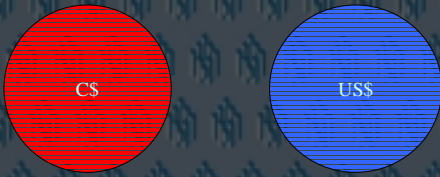
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If they do, North American monetary
integration might make sense for Canada



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If they do not, Canada should keep an
independent currency and monetary order



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The Current Monetary Order (1)

- Money-creating central bank
 - ▶ Provides liquidity to financial system
 - ▶ Influences money and credit growth, interest rates, output and inflation

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The Current Monetary Order (2)

- Floating exchange rate
 - ▶ Has floated since 1950, except for peg from 1962-70
 - ▶ Can support many policy targets

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The Current Monetary Order (3)

- Inflation targets
 - ▶ Established 1991
 - ▶ 1-to-3 percent since 1992

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The Current Monetary Order (4)

- Political accountability
 - ▶ For use of seigniorage
 - ▶ For inflation targets
 - ▶ For institutions (OSFI, CDIC, FSA, MOF) governing financial system

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Motives for Change

- Coming to terms with the inevitable
- Reducing transaction costs
- Preventing further C\$ declines
- Giving lazy managers a salutary jolt
- Giving bad policymakers a salutary jolt

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The Alternatives

- Market dollarization
- A peg
- A currency board
- Unilateral dollarization
- Negotiated dollarization/union

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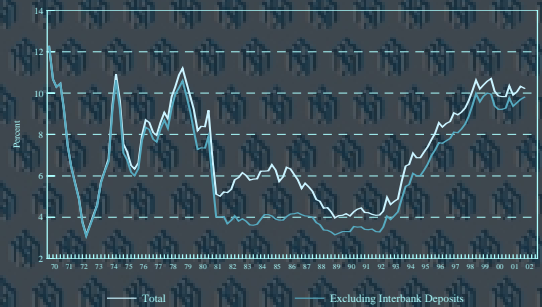
First Insight: Well Managed Currencies are Durable

- Monetary systems have network externalities
- Large-scale substitution is a collective choice
- Individuals and firms use US\$ if they wish
- But the C\$ is unlikely to vanish spontaneously
- And no disaster looms if it does

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Foreign Currency Deposits in Canadian Banks (% of total)



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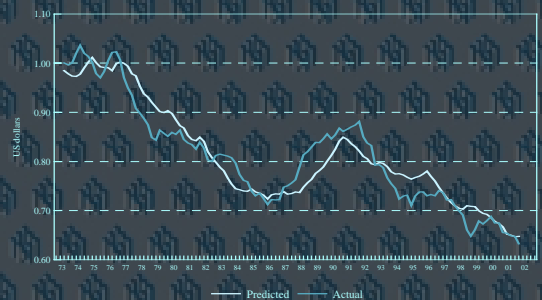
Second Insight: Real Exchange Rates are Key

- Would fixing change US\$/C\$ RER moves?
- Simple models “explain” the US\$/C\$ RER with
 - ▶ Non-energy commodity prices
 - ▶ Energy commodity prices
 - ▶ Short-term interest-rate differentials

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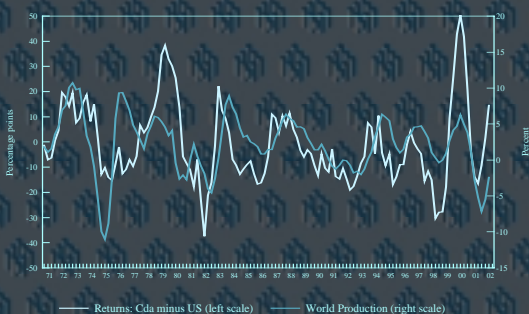
US\$/C\$: Predicted and Actual



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Canadian vs. US Equity Returns (in US\$) & World Industrial Production



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Third Insight: Voters Have Legitimate Interest in

- Seigniorage
- Goals of monetary policy
- Financial backstopping and regulation

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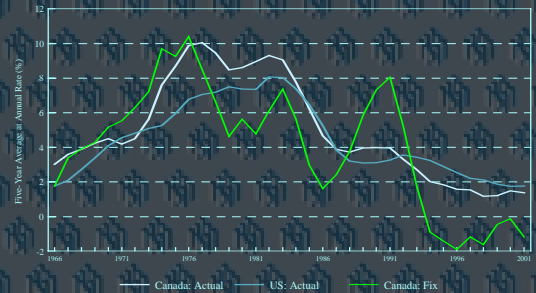
Macro Impacts of a Fix (1)

- If fundamentals affecting the US\$/C\$ RER do not change with a fix
 - ▶ They will affect relative prices and costs
 - ▶ Less credible regimes (peg, currency board) will amplify the resulting stresses

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Canadian Inflation with a Fix



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Macro Impacts of a Fix (2)

- Seigniorage: the \$40 billion question
 - ▶ Peg or currency board do not require replacing monetary base
 - ▶ Dollarization without US help is expensive

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Macro Impacts of a Fix (3)

- To ease stresses, Canada would want
 - ▶ Full dollarization
 - ▶ Help with seigniorage — if negotiable
 - ▶ Canadian voice at FOMC — if negotiable
 - ▶ Fuller economic integration — if negotiable

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Financial Sector Impacts of a Fix (1)

- Peg/currency board preserve some features of system
 - ▶ Allow (very) limited fiat-money support
 - ▶ Maintain some OSFI, CDIC, MOF roles
- Dollarization eliminates many features of system
 - ▶ No fiat-money support: alternative (likely inferior) reserves and lines of credit needed
 - ▶ Existing institutions would disappear or lose key functions

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Financial Sector Impacts of a Fix (2)

- Canada would want
 - ▶ Access to liquidity support from Fed — if negotiable
 - ▶ Congenial regulatory environment — if negotiable

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Non-Financial Impacts of a Fix (1)

- Transactions costs could fall, depending on regime
- Would bad managers and policymakers improve?
 - Maybe not
 - Logic of most arguments is weak
 - Evidence is patchy at best, but...
- For “cold shower” to work, regime must be credible

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Non-Financial Impacts of a Fix

- Peg/currency board is:
 - No help with transaction costs
 - Less credible
 - Less likely to affect behaviour
- Full dollarization/union is:
 - Helpful with transaction costs
 - More credible
 - Likelier to affect behaviour

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Economic Attractiveness: Reviewing the Options

- Peg or currency board
 - Unchanged transaction costs; not credible
 - Economic stress
- Unilateral dollarization
 - Lower transaction costs; credible
 - Up-front cost, handicapped financial sector, economic stress
- Negotiated dollarization or union
 - Lower transaction costs; credible
 - Less cost; competitive financial sector; less stress?

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Things Canada would want in negotiated dollarization or union

- Help with seigniorage
- Voice at FOMC
- Liquidity support with congenial regulation
- Further liberalization of cross-border flows

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How might the US respond?

- US\$ 26 billion?!
- How could BOC fit into the Fed?
- Welcome to our banking regulation!
- Why should we liberalize border for your monetary convenience?

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The economically attractive and politically feasible options may not intersect...

Things
Canada would
want

Things
the US would
grant

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...unless Canada brings something non-monetary to the table

- What might that be?
- Why would we use it to “buy” the US\$?

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The Good News

Inflation targeting is a proven success!

Since the benefits of “easy” alternatives are not compelling and the costs of “hard” alternatives are high...

We should tackle the roots of our economic underperformance directly, not chase a monetary will-o-the-wisp.

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