C.D. Howe Institute
Commentary

C.D. Howe Institute

No. 68, March 1995 ISSN 0824-8001

The Referendum Papers

Change for a Buck?

The Canadian Dollar after Quebec Secession

by

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Clause 6 of the Quebec government's draft sovereignty bill commits an independent Quebec to use the rest of Canada's currency. But behind this apparently straightforward statement lurks a formidable economic and political agenda.

Maintaining the currency union after secession would require many arrangements, ranging from infrastructure for a new cross-border banking system and financial reserves to backstop Quebec banks all the way to agreement on old federal debt and a sustainable balance-of-payments position for Quebec. Otherwise, the temptation for Quebec to issue its own currency will be strong. Fear that it will do so could, in turn, spark a flight of capital that would make the temptation overwhelming.

Awkwardly, however, meeting these requirements following a yes vote in a referendum on secession will be difficult. Both successor governments will face a crowded agenda in a short time-frame, amid considerable political turbulence. Unless work begins well before the referendum — a politically almost unthinkable move — it seems all but inevitable that an independent Quebec will end up with an independent currency.

Main Findings of the Commentary

- The draft bill on the sovereignty of Quebec contains a clause committing an independent Quebec to use the rest of Canada's (ROC) currency. Though clear as a statement of intent, the clause is less reliable as a forecast.
- Secession by Quebec would spark economic and political turbulence that would strain the currency union between the two new countries. If that strain raises fears of a separate Quebec currency, it could trigger a capital flight that would force the Quebec government to choose between a credit crunch and recession on the one hand, or the establishment of a new currency and devaluation on the other. Awareness that financial pressure is increasing the attractiveness of a new currency would, in turn, further damage confidence and accelerate the capital flight — a vicious circle that would doom the union.
- Making the currency union attractive and durable would require many or all of the following arrangements:
  - an integrated clearing system for financial institutions in the two countries;
  - lender-of-last-resort facilities for Quebec financial institutions;
  - Substantial ROC dollar reserves in the hands of the Quebec government;
  - a quick and successful agreement on division and servicing of old government of Canada debt;
  - a sustainable balance-of-payments position for Quebec; and
  - special measures, such as deposit insurance, to damp any initial movements of capital out of Quebec.
- This is a formidable list. It presents numerous technical challenges. Moreover, the negotiating period following a yes vote would be politically charged, and governments on both sides — especially the ROC — would face a crowded agenda and considerable political dissension. Under those circumstances, the list would be very difficult to fulfill.
- For these reasons, unless work begins well before a Quebec referendum — a highly awkward proposition, politically — it seems almost inevitable that an independent Quebec will end up with an independent currency.

"The legal currency of Quebec shall continue to be the Canadian dollar."[1] So says the one-sentence clause 6 of the draft bill on the sovereignty of Quebec now before the Quebec National Assembly. Read as a statement of intent, the clause is clear. For both economic and political reasons, Quebec separatists have elected to draw the line when it comes to money — separation from the existing Canadian currency union is not part of the package.

Read as a prediction, however, the clause deserves the critical attention owed to any forecast. If Quebec does secede, the maintenance of the currency union would offer important benefits to both the successor states, an independent Quebec and the rest of Canada (ROC). But there will be also be costs which many on either side of the new border will hesitate to pay. In particular, it is possible that the stresses of separation, both in the financial sector itself and in other areas that impinge on it, would lead to a crisis of confidence and a flight of capital, from both states but particularly from newly independent Quebec, that would drive Quebec to issue its own currency, thus bringing the currency union to an end.

This *Commentary* explores the strains that would afflict the currency union in the event of a secession by Quebec, and puts forward a list of institutions and arrangements that would help to preserve the union. The list is rather formidable. Financial regulations that permit an integrated financial system across the new border must be put in place. The financial resources must be found in Quebec, the rest of Canada, or both to cope with a difficult transition period. A swift, mutually agreeable conclusion to negotiations over the debt of the old federal government must be reached. And the long-term financial balance of an independent Quebec will need to be assured. Without progress in these areas, the sovereignty bill's commitment to use the rest of Canada's currency will likely prove empty.

What is awkward, however, is that progress on these matters will require a political commitment on both sides that is by no means assured. In addition, it will take time to meet these conditions: in the turbulent atmosphere that will follow a yes vote, overloaded political agendas and fast-breaking developments in financial markets will make it difficult to create the institutions and arrangements necessary for the currency union's survival. And at any point, the project could be aborted by a flight of capital. Unless work on these issues begins well before the referendum — a course of action that presents enormous practical and political problems — it is highly likely that an independent Quebec will end up with an independent currency.

Preparing the Ground

The question of whether or not the existing currency union would survive a secession by Quebec is inherently difficult because it has a circular element. A central theme in the pages that follow is that the ease with which the union can be maintained depends to a considerable extent on confidence, but that confidence will depend on how easy the task is. Since circular questions do not present any obvious point of entry, it is useful to start by trying to clear away some of the clutter that often surrounds the currency issue to get a clear view of the essential elements.

The Choice Is the Quebec Government's

To begin with, the choice whether to designate the currency of the rest of Canada (hereafter referred to as the ROC dollar) as Quebec's currency would be, at bottom, a choice for the Quebec government to make. Just as the Quebec government could choose the US dollar as its currency, passing legal-tender laws requiring that US dollars be accepted in discharge of debts and making US dollars the unit of account and payment in all dealings with the government, so it could choose the ROC dollar. In either case, the currency needed to carry on daily life is available on open markets.

To be sure, lack of cooperation from the ROC could condemn a Quebec using the ROC dollar to both a painful transition period and a much more primitive financial system than its citizens now enjoy. But the only way ROC could prevent Quebec from using its currency outright would be by stopping the trading of ROC dollars on world markets. In other words, it could make its currency nonconvertible and join the fast-shrinking camp of countries that have cut themselves off from the world economy. The resulting damage to ROC citizens' living standards, as well as the intense irritation that would be produced by foreign-exchange controls and the intrusive policing they require, would make this course deeply unattractive.[2]

Present Intentions Are Not an Issue

A second question that can be set aside for the moment is whether Quebec separatists are being honest in stating that an independent Quebec will use the ROC's money. For now, the draft bill's commitment can be taken at face value.

There are undoubtedly many in the separatist camp, as there are in the rest of Canada, who consider it unnecessary or undesirable to maintain the currency union. Indeed, although most authors who have examined this issue recently have concluded that, on balance, the continued existence of the currency union would benefit both sides, there is no reason separate currencies for the two countries, once established, would not prove workable.[3]

At the moment, however, the familiar currency is intensely attractive to Quebec's population. That is because a different one would be fraught with uncertainty. For example, the conversion of prices, contracts, and so on from old Canadian dollars into a different currency might lower the purchasing power of Quebec citizens. Or, if a new currency were introduced at one-to-one with the old Canadian dollar, there would be doubt as to whether it would keep that value. It is not difficult to imagine circumstances under which a currency introduced at par would, in the aftermath of separation, be worth less than the old Canadian dollar (and the new ROC dollar that will replace it).[4]

Any financial assets subject to redenomination into the new currency, such as bank accounts, pensions, and certain securities, would be in jeopardy. Economic issues may not top of the list of factors influencing sympathy for secession, but they matter. When Richard Le Hir, now the Quebec minister assigned to restructuring, speculated, while running as a Parti Québécois candidate in 1994, about a different currency for an independent Quebec, the resulting controversy showed how damaging this issue can be to the separatist cause. This damage alone is enough to make maintenance of the union an essential element in the separatist platform.

Threats to the Currency Union

To note that the decision is the Quebec government's and to acknowledge the sincerity of its intentions does not, however, establish the reliability of the statement made in the draft bill. The rapid collapse of the Czechoslovak currency union after the Czech and Slovak republics separated in 1991 is only the most recent example of a currency-sharing agreement that disintegrated after a political rupture.[5] While some such arrangements have lasted longer than others, it seems to be an almost universal pattern that secessions are followed, sooner or later, by separate currencies.[6]

To see why it would be difficult not to follow that pattern, it helps to review the possible actions and attitudes of four sets of players. The first is the maker of the crucial decision, that is, the Quebec government. The second is the ROC government (or, perhaps more accurately, governments), which will play a critical role in determining how attractive the union is to Quebec. The third is the individuals and businesses in the ROC — financial institutions, particularly. The fourth is Quebec's own citizens and businesses — for, whatever the Quebec government may choose, the ultimate fate of the currency union will rest largely in

their hands, and their confidence in its durability will be decisive. This section discusses the situation that will face each of these groups after a yes vote.

Advantages of a Separate Currency: The Perspective of an Independent Quebec

No matter what is said before the vote, once Quebec is independent, its commitment to use the ROC dollar would not and could not be unconditional. Statements such as Le Hir's are a useful reminder that governments of independent countries are free to choose the currency in which they will conduct their business. Regardless of prior promises, if it became attractive enough to use a different currency — probably its own newly created one — the Quebec government would not hesitate to do so.

Why might a separate currency appeal to the Quebec government? The short answer is that an independent currency gives a country more tools for dealing with various economic problems. Leaving the critical transitional issues for later discussion, consider the wider range of options open to a Quebec government armed with its own currency in dealing with potential imbalances in Quebec's dealings with the rest of the world.

Imbalances in a country's external accounts can have a variety of causes: changes in prices of exports and imports; ups and downs in the fortunes of important industries; changes in assessments of political and financial risks, and so on. What is generally needed in these cases is what economists call a change in a country's "real" exchange rate — that is, a shift in the prices of domestically produced goods and services and domestic assets in relation to their counterparts abroad.[7]

A country with its own currency can manage this shift by revaluing its nominal exchange rate up or down; that process occurs automatically when the exchange rate floats, and in discrete adjustments when it is pegged. A country with a pegged exchange rate that experiences a drop in export prices and finds, for example, that the resulting imbalance in its trade account is draining away its foreign exchange reserves can achieve the necessary lower real exchange rate by devaluing its currency. By instantly spreading the lower purchasing power in terms of foreign goods and services through the whole population — an effect that suggests the analogy of a "national wage cut" — the devaluation can lower the price of domestic assets enough to entice capital back in and improve the competitive position of producers of tradable goods and services.

A country without its own currency does not have this option. Its position is like that of countries that were on the gold standard a century ago. If export prices fell in a gold-standard country, the consequent trade imbalance would cause its monetary base, gold, to drain out of the country. The short-term result would be higher interest rates and a contraction of money and credit. In the longer term, the shrinking of the monetary base would produce a recession and, ultimately, a fall in the real exchange rate because of the drop in domestic prices compared to those of other countries. Unlike the instant "national wage cut" of a lower nominal exchange rate, this process at first affects incomes in some sectors and occupations more than others, depending on their sensitivity to reduced flows of credit and money and to measures such as wage and price controls that the government may impose to hurry the adjustment along (or impede it). The desire to avoid this painful process is a prime attraction of a currency issuable at will by a central bank, because its exchange rate, even if pegged from time to time, can always be adjusted.

The prospect, or experience, of such a process might make an adjustable exchange rate more appealing to the government of an independent Quebec. Canada's provinces are in a common currency area now, and to some extent they experience changes in their real exchange rates *vis-à-vis* each other similar to those undergone by gold-standard countries in an earlier time. But the effect of different economic cycles and shocks on provincial wages

and prices is buffered by fiscal transfers and mobility of labor. After separation, Quebec's internal economy will be more fully exposed.

To anticipate later arguments, moreover, separation will quite likely induce some movement of ROC dollars out of Quebec. If it does, Quebec will have two choices. Either it can live with the effects of a reduction in its monetary base on the domestic economy, wages and prices (which would be over and above other possible harmful effects of separation on the economy). Or it can allow it (and other negative factors) to push down the exchange rate of a new Quebec currency. The latter course will strike many as more attractive.

Advantages of a Separate Currency: The ROC's Perspective

What of the ROC? A recent poll by Léger and Léger found that almost six in ten Canadians outside Quebec were willing to maintain an economic association with a separate Quebec.[8] Presumably most of those respondents would consider a joint currency to be part of the package. But, as in Quebec, many in the ROC will argue that it is not in the ROC's interest to maintain the currency union.

This proposition draws much of its force from the observation that, if the union were maintained, the ROC central bank would be making monetary policy, not only for the ROC itself, but also for a separate country fully one-third its size whose economic development and government policies might be very different. Particularly during the transition period and immediately afterward, the ROC would be exposed to fluctuations in its exchange rate, its interest rates, and its money supply arising in Quebec. It would thus be more difficult to hit inflation targets or manage any other type of monetary policy.

Again like Quebec, the ROC's calculations on this point will be complicated by other results of separation. The disappearance of the buffering effects of cross-border fiscal flows will be a problem for the ROC. Other issues will loom larger. The ROC will be hampered in coping with separation-related pressure on its banking system and its economy by its exposure to disturbances originating in Quebec and by the demands made on its central bank by the need to maintain the currency union. Like their Quebec counterparts, many in the ROC will see a termination of the union as essential for a return to more normal economic conditions, particularly if the turbulence is due mostly to the fear that Quebec will abandon the union. Should these arguments carry the day, the ROC's subsequent failure to help nurture the currency union will make the ROC dollar much less attractive to Quebec.

A further complication is that the federal government is bound to be weakened, and even seriously crippled, by Quebec's departure.[9] If the ROC is busy sorting out other aspects of its postsecession structure, the provinces that oppose maintaining the currency union may be in a strong position to press their views. Many of the voices against the union will speak with considerable volume.

Transitional Turbulence

It may appear contentious to argue that Quebec's secession is almost certain to be accompanied by turbulence that might affect the views of each side about the merits of keeping the currency union. But no serious analysis of the consequences of a yes vote in a referendum on secession has concluded otherwise. Even the easiest transition imaginable would involve some awkward situations.

In the immediate aftermath of the vote there will be profound political uncertainty and perhaps temporary paralysis in the ROC, as the authority of the existing federal government to negotiate with Quebec, or to govern at all, is openly debated. This uncertainty will come at a bad time, since holders of Canadian dollars and Canadian dollar assets will badly want to hear reassuring words from voices of authority. The creditworthiness of governments, businesses, and individuals that are affected by the secession inevitably will be questioned.

Under these circumstances, one financial adjustment will be very hard to avoid. Banks, and their regulators, are sensitive to imbalances between assets and liabilities in foreign jurisdictions. Even in a foreign country where the economic and political climate is familiar, if a significant portion of a bank's loans, mortgages, and other credit is funded by deposits in Canada, rather than by deposits in that country, the bank is exposed to undesirable risks. However amicable the breakup, a newly independent Quebec will be an unknown quantity and these risks will loom large.

Under any circumstances, banks and their shareholders will worry about the risk of a new currency. Fewer than one-third of respondents to a 1992 survey of business economists outside Quebec were confident that an independent Quebec would remain in the currency union.[10] Even if the risk of redenomination appeared very small, other risks would make a significant preponderance of assets over deposits in Quebec imprudent. But at present there is a sizable imbalance. As of the third quarter of 1994, Canadian dollar assets — loans, mortgages, and so on (but not including corporate securities) — at Quebec branches of Canada's chartered banks totalled $73.8 billion, while Canadian-dollar deposits booked at Quebec branches totaled only $68.4 billion. Banks would seek to eliminate that $5.4 billion difference immediately before and after separation.[11]

The elimination of this mismatch need not be cataclysmic. Mortgages, term loans, and the like would be allowed to run their course. Other assets might be wound down more quickly, and new lending would be curtailed by individual institutions for as long as it took them to correct their own imbalances. Depending on political and economic circumstances, the banks might be prodded or restrained by the Office of the Superintendent of Financial Institutions (OSFI), the ROC central bank, or shareholders, an issue dealt with further below.[12] But a mismatch this big — an amount greater than all small business loans (under $500,000) outstanding from chartered banks in Quebec — could not be eliminated without producing a noticeable credit squeeze during the period surrounding secession.

Even if Quebec's economic prospects generally appeared good after secession, a squeeze caused by book squaring would most likely be accompanied by reduced credit to the sectors threatened by a slump in demand for their products. Quebec's dairy industry, a popular example, would lose its favored position in the ROC market and probably face new US competition as well, and thus be less able to get loans.[13] Other sectors, such as construction, and regions, such as the Outaouais, whose prospects were dimmed by secession would also have difficulty.

The Critical Role of Confidence

This partial survey is not inspired by a desire to paint a bleak picture of Quebec's financial prospects after secession. If secession proceeded smoothly and amicably, the disruptions could be temporary. In particular, short-term tightness of credit might be tolerable to a Quebec government (if not to all citizens) that was ready to invest some political capital in a durable currency union. The real significance of even temporary and small movements of capital lies in their possible influence on a much more volatile and absolutely crucial factor: confidence.

In a world where financial assets predominantly take the form of pieces of paper and electromagnetic codes, rather than commodities such as gold, expectations are critical. Paper money in a wallet is valuable because the holder knows that it will be accepted in exchange tomorrow; a bank balance is valuable because the holder knows that it can be withdrawn next week. Any question about value in the future can cause abrupt reactions today.[14]

The politics and economics surrounding secession matter for the effect they might have on expectations about the durability of the currency union, not only among ROC politicians and citizens, but among Quebec individuals and businesses. Despite the assurances

in the draft sovereignty bill, past and present documents of the Parti Québécois have put temporal and other conditions on the use of the dollar by an independent Quebec.[15] Divergences and changes in Quebec politicians' views about the ROC dollar matter because even if the stated intent of the Quebec government does not change, the tone of the debate might well make Quebec citizens suspect that there would be changes in future. Similarly, a fractious debate in the ROC about the currency union, particularly if accompanied by intransigence on, or inability to settle, the crucial issues could also shake the public's faith that the union would endure. And short-term volatility, or a noticeable credit crunch, along with their exacerbating effects on the political debate, would shake it further.

What if the fear that a new Quebec currency was on the way began to spread? In the face of a redenomination, holders of certain contracts or quasi-contracts, such as payments owing from the Quebec government or the Quebec Pension Plan, would be helpless to prevent their assets from a potential decline in value. The same is not true, however, of holders of bank accounts and other financial assets that can be liquidated and moved. Individuals and businesses that feared a revaluation would withdraw their deposits, sell their marketable assets, and call their loans, transforming them into physical currency or assets denominated in foreign currencies. Moreover, such measures could be taken without any announcement by the Quebec government that it intended to redenominate. They could be precipitated by other events that appeared to make redenomination more likely, including movements of assets by other people and a general loss of confidence in the ROC dollar and ROC-dollar assets.

Even if redenomination did not appear imminent, the threat of a flight of capital from Quebec — or, more precisely, the threat of capital controls that the Quebec government might impose to try to stop it — might lead banks, businesses, and individuals to move their assets out. The fear that such controls might lower the value of their assets, especially the possibility that controlled assets ultimately might be redenominated, would cause lenders to pull back immediately. Ironically, as with a redenomination, the actions of individuals and businesses might precipitate the very controls they feared.

In the light of that possibility, there is another serious drawback to Quebec's use of the ROC dollar that is critical. A country that, like Canada now or the ROC after secession, has a central bank that can issue currency at will has a ready response to a run on its banks when depositors line up to withdraw money from their accounts.[16] The central bank can act as lender of last resort, pumping newly created money into a bank whose deposits are being withdrawn.[17] With the central bank replenishing their funds, banks need not cease lending, start calling in old loans, or — in an extremity — close their doors. In fact, simply the knowledge that the central bank can provide unlimited support can stanch a run: depositors who know that money will still be available tomorrow do not have to dash to the bank today.

If a crisis catches a Quebec government unprepared during the transition to independence, it will threaten a contraction of money and credit in Quebec and subsequent economic slowdown and deflation. Under those circumstances, the pressure to introduce a separate Quebec currency and use it to prop up the financial system will grow overwhelming, and the Canadian-dollar union will not survive.

Maintaining the Union: A Checklist

The confidence felt by one person depends largely on the confidence of others — to stand still in a stampede is to be trampled. Still, though confidence is volatile, it does not appear and disappear randomly. The confidence of the citizens of the ROC and Quebec in the currency union will depend on whether they think it will last. And that assessment, in turn, will depend on whether governments create institutions and arrangements that bolster the

union before it comes under attack. The periodic collapses of currencies under speculative pressure show that no single bulwark, such as one central bank's war chest of foreign exchange, can hold back the tidal wave that would result from a collapse of confidence. But it is possible to imagine a set of arrangements that would give the currency union envisaged in the draft sovereignty bill a chance of survival.

Preserving an Integrated Banking System

A good starting place is the arrangements that would make the ROC dollar more than just a familiar bronze-plated coin in Quebec. At present, one of the main attractions of keeping the ROC dollar is its familiarity as a standard of value — which, for example, will assure pensioners that their cheques will be worth roughly what they expect. On a practical level, however, the attraction of using the ROC dollar after secession will be its usefulness as a medium of exchange — its ability to facilitate business. The ROC dollar's utility to Quebec citizens and businesses in this regard will depend especially on whether Quebec banks are part of the ROC payments system.

At least at the start, the ROC's system will closely resemble Canada's existing clearing system, which is operated by the Canadian Payments Association (CPA). The largest CPA members, such as the chartered banks and the Caisse centrale Desjardins, operate as "direct clearers"; that is, they use accounts they hold at the Bank of Canada to settle their claims on each other after each day's transactions. Other members, such as foreign banks and smaller trust companies, are "indirect clearers," which use direct clearers as agents.

The CPA is the heart of Canada's financial and payments system. If Quebec banks were not part of it, Quebec would find that its use of the ROC dollar condemned it to a rather primitive financial system. Unable to settle same-day interbank claims, Quebec banks would be prevented from offering many services nowadays taken for granted by Canadians, such as same-day credit for cheque deposits, or INTERAC transactions. Quebec banks would also be unable to carry out financial market transactions that have to be settled on the same day, such as money market activities. In important respects, then, the use of the ROC dollar would not ensure the continuity of daily financial life that the draft sovereignty bill appears to offer.

If Quebec banks are to participate in the ROC's clearing system, a number of legal and regulatory issues need attention. Initially, the ROC's regulations, like Canada's now, will require that financial institutions operating in the ROC be incorporated there. Banks headquartered in Quebec could establish ROC subsidiaries that, along with other activities in the ROC, would participate in the CPA on the same basis that subsidiaries of foreign banks do today. Since Quebec's legal system would start off substantially identical to Canada's, Quebec's regime presumably would be similar, and banks headquartered in the ROC would conduct business in Quebec through subsidiaries.

Alternatively, the ROC and Quebec could amend their regulations to allow each other's banks to do business, including clearing payments, by establishing branches across the border, rather than subsidiaries. (At this point, an international angle intrudes. The Canadian government has been under pressure from the United States to allow US banks to open branches in Canada, and agreed to do so under the NAFTA, provided that the United States first liberalize some of its regulations that hamper the operation of foreign banks in the US market. If US regulatory reform proceeds, branch banking could begin to take place between the ROC and Quebec under the NAFTA's provisions, provided that an independent Quebec's accession to the NAFTA proceeds in a timely way.[18] If US regulatory reform stalls, it would still be possible for the ROC and Quebec to strike their own deal, but doing so would open the door to pressure from the United States and others for no less favorable treatment. And that might be an unwelcome addition to an international agenda that will already have been badly complicated by secession.)

In either case, a possible difficulty would be the sensitivity of each side to the extraterritorial reach of the other's regulations. The solvency and liquidity of all banks would be a major concern for regulators in the ROC, since the failure of one bank to honor an obligation in the clearing system can trigger a chain of defaults.[19] Quebec, on the other hand, might object to regulatory supervision of its banks by the ROC.[20] Not only will the additional layer of regulation on Quebec banks prove more irksome than the disentanglement that secession is said to promise, but the fact that the accounts of the Quebec government itself will be on deposit with banks regulated by the ROC will expose Quebec to unfriendly actions on the ROC's part.

A conceivable alternative would be mutual recognition of each other's regulatory regimes. However, since the provinces *inside* Confederation have failed to achieve mutual recognition in securities and trust company regulation, it is doubtful that the attempt would succeed *outside* Confederation, especially if the federal government is so weak that differences among the interests of the remaining provinces become more salient in the negotiations.

One way or another, mastering the mechanics of preserving an integrated clearing system is a large part of the task of preserving the currency union. Failure would make the currency union less attractive, especially to Quebec — and that, in turn, would raise fears about the durability of the union. If accommodation is to be reached in this area, it will require a governing structure and decision-making process in which each side has a voice. The magnitude of the task is attested to by the experience of Europe, which, after decades of work and with considerable political momentum toward greater *unity*, has yet to achieve a financial system integrated to nearly the extent that Canada's is. Moreover, in a pressure-filled postreferendum environment, the detailed and occasionally sensitive work needed for either type of arrangement will be much more difficult. Getting this bulwark for the currency union in place will require an early start.

Backstopping Quebec Banks

Another important element of the terms under which Quebec financial institutions might operate in the ROC would be the capacity of the ROC central bank to backstop the Quebec banking system. At present, Canadian financial institutions have access to the Bank of Canada as lender of last resort when they find themselves temporarily short of cash balances with which to settle interbank obligations or, less frequently, when they find themselves under pressure as a result of a draining away of their deposits.

In the normal course of business, the knowledge by a bank on one end of a transaction that the bank on the other end has access to a lender of last resort makes a major difference to the collateral or fees it may demand — or indeed to its willingness to enter into a transaction at all. When a bank does business with another bank inside Canada, it knows that the Bank of Canada stands ready to make good any temporary shortage of liquidity that the other party may experience, alleviating fear of a default. In dealing with, say, a US bank, a Canadian bank has a similar assurance that, if necessary, the US Federal Reserve will act as a lender of last resort to the US bank.

It is significant that Quebec financial institutions would not have such a lender of last resort in their own country, since a Quebec without its own currency would have no central bank with the power to create the necessary money. For that reason, a ROC direct clearer would hesitate to act as agent for a Quebec financial institution (unless the Quebec institution was a subsidiary or parent). Or it might do so only if sufficient collateral was put up or fees paid. Indeed, the ROC regulators might limit the discretion of ROC banks in this regard by imposing their own conditions. Like the clearing system, lender-of-last-resort facilities would be available, under existing legislation, only to financial institutions incorporated in the ROC. In fact, high counterparty risk would be such an obstacle to the operation of the clearing system that an agree-

ment on lender-of-last-resort facilities to Quebec financial institutions is a high priority if the Quebec government is to consider the currency union worth maintaining.

Normal business aside, a lender of last resort might be especially important during the transition period before and after secession, when lack of confidence in the currency union or other economic worries might cause deposits to begin flowing out of some or all Quebec financial institutions.[21] Even if the solvency of the institutions involved were not in doubt at first, a liquidity crisis could spread panic among depositors and heighten any reservations that other banks might already have about dealing with the institutions that were feeling the pressure. This threat would be alleviated by access to the ROC central bank as lender of last resort.

Clearly, however, to give the support of the ROC central bank to Quebec financial institutions is easier said than done. Two regulatory and legal issues stand in the way. First, the ROC central bank could not be expected to offer such facilities unless it had regulatory power over Quebec financial institutions or at least could obtain information about the solvency of the institution involved — information that the Quebec regulator, but perhaps not its ROC counterpart, would possess. Second, in the event of a default, the central bank's ability to realize on any collateral would depend on its legal standing in Quebec.[22] As with the measures needed to preserve a well-integrated financial system, creating a mechanism for backstopping Quebec financial institutions is complicated because it will entail issues of governance that are always awkward between partners of substantial but unequal size. This project would benefit from an early and energetic start.

Another useful backstopping measure would be an agreement to guarantee ROC dollar deposits in Quebec. At present, the Canada Deposit Insurance Corporation (CDIC) insures deposits in chartered banks in Quebec, and also backstops its Quebec counterpart, the Quebec Deposit Insurance Board (QDIB), which insures deposits at other financial institutions. The CDIC can borrow from the federal government and is thus ultimately backed by the Bank of Canada's money-creating powers. At present, however, the CDIC will provide the QDIB only fully secured loans repayable in a year or less — support that is probably not enough to offer reassurance that the Quebec banking system could withstand a major run.

But it would be difficult to make the CDIC's support more open-ended. The CDIC has no power over either the extent of the coverage provided by deposit insurance in Quebec or the fees that Quebec financial institutions pay for their coverage.[23] There is no easy solution to that problem, especially since giving the CDIC more of a say in the QDIB's activities is clearly not high on the separatist agenda right now, and it has scarcely occurred to anyone in the rest of Canada to formalize the CDIC's role in deposit insurance in an independent Quebec. An early start on discussions about a new agreement between the CDIC and the QDIB is also needed, then, if stronger deposit insurance is to help the currency union survive.

In view of the problems that a lender of last resort and deposit insurance are designed to address, it seems apt to remark that it will be considerably easier to agree on these matters if citizens and politicians alike on both sides of the border are confident that the currency union will last. Frustrating though these circular arguments are, the ROC's willingness to provide backstops for the Quebec banking system will be in direct proportion to the likelihood that those facilities will, in fact, not be used much, and either that any loans will be promptly repaid — in the same currency — or that collateral put up can be realized.[24]

ROC Dollar Reserves of the Quebec Government

Another possible source of support for the Quebec banking system would be a government reserve of ROC dollars on deposit with, say, the ROC central bank, or foreign exchange and liquid securities that could be sold for

ROC dollars. Such a reserve would enable the government to act as a lender of last resort to Quebec banks that were temporarily short of cash. A fund of this type would alleviate some concerns about counter-party risk that might otherwise gum up the clearing system. And a large enough buffer of ROC dollars that the Quebec government could use to prop up its banking system in the event of a run might prevent the process from beginning.

Although the government of Quebec already controls substantial reserves of currency and deposits — its own cash and that of its auto insurance and workers' compensation plans — this cash is only useful to the extent that it is initially deposited *outside* Quebec. *New* deposits in branches in Quebec would be needed if one or more financial institutions came under pressure. If a government has a fiscal surplus, it can build up such a reserve fund simply by waiting. But a government like Quebec that is running deficits has to borrow. Since the borrowing terms available immediately before and after secession will likely be poor, if a referendum on independence is to be held this year, it would be prudent for Quebec to begin building up such a reserve immediately.[25]

If the government of Quebec is unable or unwilling to build up an adequate reserve in advance, the source of ROC dollars, the ROC itself, might be willing to help through loans or loan guarantees. The involvement of the ROC might, in turn, make additional lines of credit available from elsewhere. But this possibility raises the same uncertainties familiar from the previous discussion of backstopping banks. If deploying the money, alongside other measures to strengthen the union, appeared likely to succeed, the ROC might treat the effort as a worthwhile investment in monetary stability. The greater the doubts on this score, however, the greater the likelihood of losses, and the greater the ROC's reluctance. Like the other matters discussed so far, this is an area where discussions launched only after a yes vote are unlikely to succeed.

Smooth Negotiations over the Debt

Among all transitional issues, few would be as devastating for confidence in Canada's financial system generally as a breakdown in negotiations over dividing and servicing pre-existing debt of the government of Canada. Anything that shakes investors' faith in the security of their holdings will force interest rates up, push the exchange rate down, shake the banking system, and give domestic and foreign investors alike a bad case of the jitters.

The difficulties that will plague negotiations over the debt are too numerous to list here.[26] On the three big issues — how much of the debt is to be attributed to Quebec, whether Quebec should repay its share of the principal, and whether Quebec's share should stay on Ottawa's books or be transferred outright — there is not only no guarantee of agreement between the ROC and Quebec, but there are strongly divergent views within each camp.[27] Further complicating the issue is the threat that the collapse of the currency union would pose to any arrangement that is concluded over the debt.[28]

An additional question of confidence, at the political level this time, adds another circular element here as well. The prospects for the currency union's survival will affect the negotiations over Quebec's share of the debt.[29] A small portion (currently less than $25 billion) of existing government of Canada debt is effectively interest-free, since it has been bought by the Bank of Canada as a counterpart to its issue of currency and other liabilities to the banking system, and the interest paid on this debt is returned to the Bank's owner, the federal government, as profit. The holders of the Bank of Canada's liabilities (principally banknotes) are forgoing the interest that they would have earned by holding government debt. This forgone income — the counterpart of the profits the Bank remits to the government — is known as seigniorage.

If Quebec is to continue using the ROC dollar, its negotiators will argue, it is only fair to adjust Quebec's share of the debt downward

in recognition of the fact that its citizens will continue to pay seigniorage by holding ROC dollars.[30] Asking them to pay interest on the corresponding debt held by the Bank of Canada would be to ask them to pay twice.[31] If there are no doubts that Quebec's leaders both intend to maintain the currency union and are able to do so, the ROC might well agree to this arrangement.[32] If, however, the union's chances look poor, ROC negotiators will balk at compensating Quebec up front for seigniorage that its citizens will never actually pay. Disagreement on this front is significant not only because it will be another bone of contention, but also because failure of the politicians to settle this point quickly and amicably would signal clearly to the public that the survival of the currency union cannot be taken for granted.

If acrimonious debt negotiations negatively affect the dollar and interest rates, the union will be less attractive to the Quebec government: after all, the argument that the ROC dollar must continue to be used to avoid financial volatility will lack force in the midst of a financial crisis. Moreover, the knowledge that the Quebec government might be changing its views on the benefits of the union will, in turn, make a redenomination seem more likely in the minds of individuals and business, further eroding confidence. What is worse, rising interest rates will make the burden of the existing federal debt even heavier, and thus further damage the chances of an amicable settlement.

In summary, a good outcome on the debt front would be enormously helpful to the currency union's chances of survival. A breakdown in negotiations, by contrast, would strike a heavy blow against the confidence that the union needs if it is to endure. The apparently rudimentary current state of official thinking about this issue on each side of the border is not promising.

Quebec's External Financial Balance

Lurking in the background, during any temporary turbulence surrounding secession, will be concern about Quebec's external balance of payments once the first adjustments are out of the way. For the reasons outlined earlier, persistent deficits in Quebec's external balance would produce a strong incentive for its government to introduce its own currency, in order to avoid the deflationary effects of the deficits on its monetary base of ROC dollars. If Quebec is able to meet its public and private borrowing needs from internally generated saving, thus achieving external balance, any initial shift of capital should be followed by a period of relative calm. Put another way, if Quebec's consumption and investment appear, together, likely to be in line with its production over the long haul, the balance of payments of the new country will cause no worries.[33]

At the moment, Quebec appears heavily dependent on external saving. Partly estimated figures drawn from the 1993 provincial economic accounts suggest that Quebec generated some \$12½ billion in private saving that year (see Table 1). After financing roughly \$10½ billion of net investment in housing by households and in plant and equipment by businesses, Quebec's private sector produced a financial surplus of around \$2 billion. The operations of all levels of government in Quebec, not surprisingly, generated a huge financial requirement: \$12½ billion.[34] With government requirements exceeding the private sector's surplus by that much, Quebec's overall saving shortfall — a current account deficit, financed by inflows of saving from outside the province — would have been in the neighborhood of \$10½ billion. At 6.6 percent of gross provincial product, this deficit is larger, relative to Quebec's economy, than the deficit of any OECD country, except crisis-ridden Mexico, has been in the 1990s.

An alternative approach (also illustrated in Table 1) takes the "net exports plus statistical discrepancy" component of expenditure in the provincial economic accounts, a bit less than \$5½ billion in 1993, and adds to it a share of Canada's net payments of investment income abroad (prorated by Quebec's share of national gross domestic product [GDP]), which is also somewhat less than \$5½ billion. Given the

Table 1: *Calculation of Quebec's External Financial Balance*

	($ billions)
A. *The sources-and-uses-of-saving approach*	
Private sources of saving	
Household saving	11.1[a]
Corporate retained earnings	1.4[b]
Total private sources	*12.5*
Private uses of saving	
Gross business investment	25.4[a]
Less capital consumption allowances	– 15.0[c]
Net private uses	*10.3*
Private sector financial balance	2.2[d]
Government sector financial balance	– 12.7[e]
External (current account) balance	– 10.6[f]
B. *The balance-of-payments approach*	
Net exports plus statistical discrepancy	– 5.3[a]
Quebec's share of foreign debt service	– 5.4[g]
External (current account) balance	– 10.7

Notes: All data are from the Provincial Economic Accounts (PEA) or the National Income and Expenditure Accounts (NIEA); some data for 1993 are estimates. Numbers may not sum exactly due to rounding.

[a] PEA data.

[b] Pretax profits (PEA) minus estimated direct taxes (PEA and NIEA, assuming direct taxes in Quebec grew in line with the national total in 1993) and estimated dividends (NIEA, assuming a distribution rate in Quebec similar to that elsewhere).

[c] Total capital consumption allowances (PEA) minus estimated government share.

[d] Private sources minus private uses.

[e] Government saving (estimated from PEA and NIEA) plus CCA (PEA) minus government investment (PEA).

[f] Private financial balance plus government financial balance.

[g] Net interest and dividend payments abroad prorated by Quebec's share of Canadian GDP.

uncertainties associated with these data, not too much should be made of the fact that this method yields an almost identical figure for Quebec's 1993 current account deficit. Nevertheless, it appears that, for 1993, $10½ billion was in the right neighborhood.

Getting a handle on what this balance might look like after secession involves considerable guesswork. Investors will, at least initially, focus on the government sector's financial requirement. There are a number of estimates of the impact of separation on the budgetary balance of Quebec's public sector. They differ in matters such as how Ottawa's spending by province should be allocated under the federal system, what arrangements will be struck regarding old federal debt, and what assumptions are made about the economic climate after secession. The estimates they yield of the increase in the new Quebec government's deficit, compared with the combined deficits of its federal and provincial predecessors, vary from almost nothing to over $10 billion.[35]

Such numbers exaggerate the change in the financial requirement of the Quebec public sector as it affects Quebec's external balance, however, since the excess of federal government expenditure in Quebec over revenue raised there is *already* reflected in the all-government financial requirement and in the inflows of external saving to Quebec. Among factors that would affect the all-government financial requirement, estimates made by Pierre Fortin as to the effects of independence on interest costs for Quebec, start-up costs for the new government, and the impact of a transitional economic slowdown on the economy suggest that these elements might add some $2.2 billion to public sector borrowing following independence.[36]

By 1996, the earliest date that secession is likely to occur, however, the fiscal plans of the federal and Quebec governments suggest that the 1993 consolidated federal-provincial deficit in Quebec will have been reduced by almost 5½ billion. Allowing for, say, $1 billion of slippage in these deficit reduction targets related to the turbulence of secession, the initial requirement of the government sector after secession might be around $10½ billion, down from 1993's $12½ billion figure.[37] If the private sector's financial balance were unchanged from 1993, this would imply that the Quebec current account deficit would also be reduced by an equivalent amount, from about $10½ billion to some 8½ billion.

At over 5 percent of provincial GDP, a current account deficit of this size would probably be seen as insupportable. Moreover, the implications of a budget deficit of more than $10 billion — around $1 billion annually in new taxes just to keep pace with interest payments; and deteriorating ratios of interest payments and debt to provincial GDP — would be so ugly as to call the financial stability of the new government immediately into question. Substantial cuts in government borrowing beyond what is already envisaged in federal and provincial plans would be needed.

What if the Quebec government made spending cuts and tax increases that pushed its borrowing down into the $7 billion range? A fiscal contraction of close to $3½ billion (just over 2 percent of GDP) would be arduous for those on the wrong end of the changes but by no means off the scale by comparison with fiscal consolidations that other countries have undertaken under less pressing conditions. An unchanged private sector financial surplus of $2 billion would still imply a $5 billion current account deficit. But the private sector's financial surplus might well increase since the disruption of, and uncertainty over, commercial links will almost certainly lead to a period of lower business spending on plant and equipment. Moreover, as argued earlier, even a minimally disruptive transition is likely to involve rises in interest rates and tightness of credit sufficient to depress interest-sensitive investment and consumer spending. A decline in gross business investment and a rise in household saving (that is, a fall in consumption) of, say, $2½ billion apiece would generate a financial surplus equal to the government's financial deficit — and thus produce overall external balance for Quebec.[38] To summarize, then, Quebec would need sizable reductions in government borrowing and comparably large increases in the private sector's financial surplus to achieve the external balance that would be essential to the survival of the currency union.

As to the private sector's financial balance, lower consumption and the loss of jobs and future wealth entailed by lower investment would obviously be unpleasant. Insofar as reduced demand for saving from the private sector alleviated fears about Quebec's current account, however, it would enhance the prospects for the currency union's survival.

It is worth emphasizing that, on the government borrowing side, the numbers used here involve a number of optimistic assumptions — in particular that the bulk of the deficit cuts already envisaged in both federal and provincial fiscal plans will actually be made. Recent developments in the Quebec budget cast doubt on the assumption regarding fiscal plans, however, which can only hurt confidence in the currency union. Political circumstances after secession might make a tighter fiscal stance easier; economic circumstances, on the other hand, will make things more difficult. But if progress were made on this front, the commitment to use the ROC dollar would be more credible.

Muting the Effect of Capital Outflows from Quebec

To recap a point made at the outset, none of the arrangements or institutions in this list will be able to withstand a massive flight of capital. Even if they are in place, moreover, it appears certain that secession will be accompanied by *some* movements of capital out of Quebec.[39] So the ROC and Quebec might want to put some special measures in place to reduce the chance that the initial shifts of credit and deposits will snowball into a panic that buries the union.

As noted, the chartered banks will seek to eliminate the imbalance between credit extended and deposits booked in Quebec. Presumably the regional mismatches of assets and liabilities on the part of other financial institutions, whose assets are dominated by residential mortgages, is less than that of the chartered banks with their greater size and more national scope. For that reason, the $5½ billion excess of chartered bank assets over chartered bank liabilities booked in Que-

bec might represent the bulk of capital subject to movement on book-squaring grounds alone.[40] A central element in preserving the union could be to spread this book squaring over time so that it produces no fallout that might cause a run on deposits.

One step that the ROC might take to that end would be to instruct its regulatory authority, OSFI, to refrain from any action that would accelerate the book squaring, essentially by turning a blind eye to the risks posed by the imbalance. This action would be a great deal more palatable if there were some reciprocal move on Quebec's part — perhaps a limited (in time or scope) guarantee of bank assets in Quebec. Whether steps of this type would be politically acceptable on either side or would be consistent with other imperatives, such as sound fiscal policy, is of course an awkward question. They would, however, probably help to strengthen the currency union.

What is far more important is to prevent an initial shift of deposits from becoming a flood. A $5½ billion drawdown of credit is nothing next to the possible consequences of a run on deposits. In addition to almost $65 billion in Canadian dollar deposits at Quebec branches of chartered banks, individuals and businesses hold around $50 billion of Canadian dollar deposits at the Quebec branches of other financial institutions.[41] Given the uncertain influence of confidence on how much of this amount might be moved by its holders, it is arbitrary to pick a figure. But, if 10 percent appears reasonable, the pressure on the chartered banks to shift $5½ billion in assets out of Quebec might be accompanied by pressure on all financial institutions to shift an additional amount approximately twice that size as their ROC dollar deposits in Quebec shrank. As with the book squaring, it will be crucial to prevent any shift along these lines from precipitating a credit crunch that would shake confidence in the union.

Whatever the magnitude of the shift, it will be more easily coped with, whether through new deposits from the ROC central bank or from the Quebec government's reserve fund, if the movement is slow. Since coercive measures to slow it, such as temporarily freezing deposits in Quebec banks, would guarantee a panic, the best measure might be a temporary special guarantee of deposits in Quebec. Even if regular deposit insurance has already been established by a new CDIC-QDIB agreement, there will be nervousness about deposits of the type and size that are not covered. Some sort of special arrangement, preferably by the Quebec and ROC governments in concert, would be an added bulwark against a flight of capital. Again, whether such a step will be compatible with other imperatives is an open question. But if preserving the currency union is a priority, special temporary deposit insurance could help.

Political Commitment and Time

Finally, the survival of the currency union seems much likelier if each side is playing by rules recognized by the other, and if the mutual pursuit of arrangements that will bolster the union is not hampered by bad temper, mistrust, and disagreements within each camp about whether the project is worth attempting at all.

Persuasive voices in both camps will argue against preserving the union. Regardless of the warm reception that bad temper and mistrust may get during separation, and regardless of the merits of the arguments themselves, the simple fact is that these forces will need to be held in check by firm political leadership if the union is to survive. On Quebec's side, one option would be a constitutional or quasi-constitutional provision that, for example, a decision to abandon the union could only be made by a specified super-majority vote in the National Assembly, perhaps ratified in a referendum. One of the most solid assurances Quebec could give along these lines would be to include such a provision in the sovereignty bill itself, or make it part of a referendum question, before the vote on independence takes place. Unfortunately, however, the ROC's influence over the attractiveness of its currency to an

independent Quebec makes it difficult for Quebec to make such a commitment without convincing evidence that the ROC would do what it could to make the system work.

Political direction matters from start to finish. The regulatory and institutional framework for an integrated banking system will not be achieved without political enthusiasm sufficient to overcome the bickering and mistrust that will be sparked by the separation and the fear that the currency union may collapse. It will take time to amass the reserve fund or arrange the borrowing facilities needed for Quebec to weather any initial outflow of funds, and it will be immensely easier if the ROC cooperates. A successful conclusion to the negotiations over old federal debt will require considerable political commitment. Even the pursuit of a sustainable external balance for Quebec — which will be a matter of concern for the ROC government as it contemplates its options, as well as for Quebec citizens — will be aided immeasurably if the government's necessary tight fiscal policy is not impeded by other conflicts.

Some authors have concluded, in part just because the alternatives are so bleak, that the goodwill to arrive at cooperative solutions will *have* to be found.[42] The problem, however, is that, even with goodwill, many of these arrangements will take time. If the experience of other countries can be relied on, separations, once set in motion, tend to be quick, and the list of matters dealt with in the negotiations over the split tends to be short.[43] There may be little time for the negotiations, legal drafting, and legislation needed to set up the arrangements for a smooth, reassuring transition. Again, if maintaining the currency union is to be more than an idle wish, one would want to start now.

Unfortunately, however, it is not clear that the draft sovereignty bill envisages such negotiations, at least before a vote.[44] And from the point of view of those who seek to hold Canada together, it is imperative not to engage in discussions designed to make separation easier. Unless the separatists can convince Ottawa that their success is inevitable, such discussions are very unlikely to take place until the consequences of a yes vote become known. And at that point, the agendas of both governments will fill rapidly with other issues, sharply lowering the chances of reaching agreement on measures to preserve the currency union before a collapse of confidence destroys it.

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$6.00; ISBN 0-88806-374-1

Conclusion

It is difficult to avoid the conclusion that, if Quebec votes yes in a referendum on separation, and the economic environment surrounding secession is roughly as presented here, a lot of work will be needed if the currency union is to survive. The Quebec government's intentions, as laid out in the draft sovereignty bill, are clear. But many things are needed for those intentions to become reality: arrangements for a new cross-border banking system; support for Quebec banks from either the ROC central bank or a Quebec government reserve fund or both; agreement on the debt; a large reduction in Quebec's fiscal and current account deficits;

and political determination along with a coherent negotiating environment on both sides.

In other words, behind the briefly worded commitment in clause 6 of the draft bill lurks a daunting agenda. To put the various pieces in place in time to deal with the turbulence that will surround separation would be difficult. To attempt to cobble them together after a yes vote, when the political and economic storm has already broken, would be all but impossible. The flight of capital triggered by a collapse of confidence will almost certainly doom the attempt. Therefore, unless both Quebec separatists and governments in the rest of Canada immediately turn their attention to the preservation of the currency union in the event that Quebec secedes, it seems highly unlikely that the union will survive — and an independent Quebec will mean an independent currency.

Notes

I am grateful to David Laidler for his collaboration in previous work on this issue; to him, John Chant, Marcel Côté, Angela Ferrante, Pat Grady, John Grant, Tom Kierans, John McCallum, Ed Neufeld, Daniel Schwanen, and a number of other knowledgeable individuals for valuable comments and discussion; and to Susan Knapp for timely tracking down of sources. Responsibility for the remaining analytical and factual errors, as well as for the opinions expressed here, is mine alone.

1 Quebec, "Draft Bill on the Sovereignty of Quebec" (Quebec City: Québec Official Publisher, 1994), p. 6.

2 See David Laidler and William B.P. Robson, *Two Nations, One Money? Canada's Monetary System Following a Quebec Secession*, The Canada Round 3 (Toronto: C.D. Howe Institute, 1991), pp. 27–29.

3 Studies that have highlighted the benefits of a common currency include Laidler and Robson, *Two Nations, One Money?* and Bernard Fortin, "Les options monétaires d'un Québec souverain," in Commission on the Political and Constitutional Future of Quebec [Bélanger-Campeau Commission], *Élements d'analyse économique pertinents à la révision du statut politique et constitutionnel du Québec*, vol. 1 of background papers (Quebec City, 1991). However, the factor weighing most heavily in favor of the union, particularly when its links with other matters such as debt and commercial relations are added to the calculation, is the transitional cost of dissolving it.

4 Not to mention the loss of purchasing power *vis-à-vis* other currencies such as the US dollar.

5 In some respects, the Czechoslovak situation might appear to have been more conducive to a durable currency union than the Canadian one. The separation was amicable, there were two coherent political entities involved, agreement had been reached on joint jurisdiction over a single central bank, the current deficit and accumulated debt of the previous central government were relatively small, and the population, which was financially unsophisticated and living in a relatively primitive financial environment, did not move its money as Canadians might in a comparable situation. Yet the union collapsed after only six weeks.

6 In the past half-century, Malaysia and Singapore seem to have set the record for durability of a shared currency following secession, with an arrangement that lasted eight years. For most of that time, however, the shared currency coexisted with the earlier Malay dollar, which traded at a different value, causing considerable confusion and discontent.

7 A real exchange rate is usually calculated by multiplying the nominal exchange rate by the ratio of domestic prices (as measured by, say, the implicit price index for gross domestic product or the consumer price index) to their foreign counterparts.

8 Rhéal Séguin and Richard Mackie, "PQ prods outsiders to join debate," *Globe and Mail* (Toronto), February 8, 1995.

9 This essential point has been made by many astute observers. See, particularly, Gordon Gibson, *Plan B: The Future of the Rest of Canada* (Vancouver: Fraser Institute, 1994); Patrick Monahan, *Cooler Heads Shall Prevail: Assessing the Costs and Consequences of Quebec Separation*, C.D. Howe Institute Commentary 65 (Toronto: C.D. Howe Institute, January 1995); and Alan Cairns, "The Quebec Referendum: The Long View," *Canada Watch* 3 (1995), nos. 4 and 5 (January/February and March/April).

10 To the question "Would there be a separate currency?" 42 percent said "yes," 28 percent said "maybe," and 30 percent said "no." *CABE News*, Spring 1992, p. 11.

11 *Bank of Canada Review*, Winter 1994–1995, tables C5 and C6. Since there are substantial "residual" assets and liabilities that, for both conceptual and practical reasons, are difficult to allocate by province, these figures present some problems of interpretation when it comes to defining the role of the banks in distributing credit around the country. As indicators of the assets and liabilities that might be subject to redenomination, however, they seem reasonably reliable.

12 If, as is argued below, the regulatory structure adopted by the ROC and Quebec requires banks to incorporate separately in the two jurisdictions, the distinct corporate structures will make the mismatches more visible.

13 Daniel Schwanen, *Break Up to Make Up: Can Trade Relations Be Maintained after a Quebec Declaration of Sovereignty?* C.D. Howe Institute Commentary (Toronto: C.D. Howe Institute, forthcoming).

14 In fact, just as during previous periods when secession was in the air, deposits are *already* being moved out of Quebec. See Richard Mackie, "Referendum jitters spark savings shifts," *Globe and Mail* (Toronto), January 27, 1995.

15 For a summary of past views of Jacques Parizeau and others on the desirability of a separate Quebec currency or use of the US dollar by an independent Quebec, see Martin Masse, "Jacques Parizeau et les billets verts," *Le Devoir* (Montreal), August 31, 1994. Alan Freeman and Patrick Grady, *Dividing the House* (Toronto: HarperCollins, 1995), p. 126, provide further documentation of this point.

16 For the sake of simplicity, the term "bank" is used in this *Commentary* as short-hand for all deposit-taking financial institutions.

17 The central bank does this by making collateralized loans, or "advances," to the banks, or by buying government securities from them. Any excessive amount of cash in the system that results from advances to, or purchases of securities from, one institution can be mopped up with offsetting reductions in advances, or sales of securities, to others. Whether or not neutralization is needed depends on whether the money withdrawn by depositors is held in currency or is deposited in other banks.

18 For more discussion of this and other aspects of post-secession commercial relations between the ROC and Quebec, see Schwanen, *Break Up to Make Up*.

19 Complicating things greatly is the coming switch to the CPA's "Large Value Transfer System," which will alter the terms — particularly the requirements for collateral — on which direct and indirect clearers participate in the system.

20 Although CPA bylaws and regulations are applied mainly to direct clearers, these requirements tend to "cascade" onto their correspondents, since no direct clearer wishes to be exposed to problems arising in a less prudently managed correspondent.

21 This problem would not apply to financial institutions operating on both sides of the border where clients simply transferred their deposits from Quebec to ROC branches.

22 This is a specific manifestation of a problem that would plague all sorts of commercial relations across the new border. See Stanley Hartt, "Sovereignty and the Economic Union," in Hartt et al., *Tangled Web: Legal Aspects of Deconfederation*, The Canada Round 15 (Toronto: C.D. Howe Institute, 1992).

23 At present, fees charged to institutions covered by the QDIB are much lower than those charged for CDIC insurance because of the much better record of financial institution failures in Quebec.

24 The breakdown of the currency union between the Czech and Slovak republics showed how quickly the Czech side's enthusiasm for supporting Slovak banks dissipated as the amounts involved grew and the prospects of repayment dwindled. In that situation, despite initial cooperation, the Czechs cut the support off, and the loans made to the Slovak banks have yet, in fact, to be repaid.

25 Further complicating the picture is the fact that the Quebec government, in addition to funding its post-secession borrowing requirement and (the ROC would hope) servicing the maturing portion of its share of old federal debt, has to roll over some $7 billion in maturing bonds during the next three years.

26 This issue is dealt with in E.P. Neufeld, *Quebec Separation and the National Debt*, C.D. Howe Institute Commentary (Toronto: C.D. Howe Institute, forthcoming).

27 See, for example, the comment of the Quebec Finance Minister Jean Campeau that an independent Quebec "would assume its share of the debt to the extent that its portion...would not affect out economic development." (See Kevin Dougherty, "Campeau's Debt-Payment Statement 'A Scary Scenario'," *Financial Post*, February 8, 1995.)

28 Suppose, for example, that while the currency union is intact, a deal is struck by which Quebec agrees to service a portion of the debt by sending monthly interest payments, in ROC dollars, to Ottawa. Later, however, following failure to agree on any number of the institutions presented in this *Commentary*'s checklist, the currency union collapses. Quebec introduces a separate currency that, though introduced at par with the ROC dollar, subsequently trades at a discount of, say, 20 percent. Quebec might well decide that its debt-service payments to Ottawa would henceforth be in Quebec currency. Given the likelihood that the ROC would have proved intransigent (or incompetent) on several of the checklist issues, the Quebec government would be able to make a convincing case that the resulting financial shortfall to the ROC is the ROC's just desserts for the lack of cooperation that led to the collapse of the union. ROC taxpayers would obviously take a different view.

29 As well as the negotiations over how it will service its share.

30 See, for example, the discussion in Pierre Fortin, "The Impact of Sovereignty on Quebec's Budgetary Deficit," Centre de recherche sur les politiques économiques, Université du Québec à Montréal, 1992, pp. 5–7. The alternative would be for Quebec to receive a share of the annual profits of the Bank of Canada. The implication that Quebec might be involved in managing the Bank of Canada may make this a nonstarter in the ROC; in any event, compensation up front for the Bank of Canada's debt holdings has become a standard feature of debt-division calculations in Quebec.

31 The foreign exchange reserves of the federal government do not present a problem in this regard, since they are financial assets of the federal government and

are already subtracted in calculations of the net debt that would be divided between the two parties.

32 Although there will be no shortage of arguments to the effect that, if Panama is not compensated by the United States for the seigniorage it forgoes by using the US dollar, Quebec should not be treated any differently.

33 For Quebec to import the currency needed to supply the needs of a growing economy actually implies that Quebec needs to run a small current account surplus, assuming a balance on flows of long-term investment capital. Given the uncertainty about the numbers used in the discussion below, however, it seems safe to ignore this consideration.

34 The calculation of government budget balances for an independent Quebec has become something of a cottage industry. It worth stressing, therefore, that this figure is an estimate of consolidated government financial requirements on a National Accounts basis, which is the relevant basis for calculating the effects of domestic generation and absorption of saving on a country's external balance, for all levels of government related to their operations in Quebec. The more familiar Public Accounts figures for government deficits would show a bigger number, principally because they also include the increase in the (to all intents and purposes) unfunded liabilities of public employees' pension plans.

35 Pierre Fortin, "The Impact of Sovereignty," especially p. 28, provides a useful comparison of estimates from a variety of sources, including his own calculations.

36 Using a fiscal year 1990/91 base, Fortin estimated these figures at 0.3 billion, 0.3 billion, and 1.3 billion, respectively (pp. 8–9, 12–14). Updating the figures to 1996/97 yields 0.4 billion (reflecting the larger debt), 0.3 billion (no change), and 1.5 billion (scaled up in line with growth in government revenue and spending). This figure assumes that Quebec is compensated for seigniorage paid by its citizens for their use of the ROC dollar. Without this adjustment, the total might be some $0.5 billion higher.

37 That is, $12.7 billion (the 1993 figure) plus $2.2 billion (impact of secession) minus $4.5 billion (partial achievement of deficit-reduction plans) equals $10.4 billion. The economic consequences of separation would likely have an adverse impact on the finances of local governments and the Quebec Pension Plan. The implications of this for Quebec's annual financial balance in the short run, especially if the prospect of an emergency hike in the QPP payroll tax is allowed for, are probably small enough to be ignored.

38 A 10 percent decline from $25.4 billion to, say, $22.9 billion in gross private investment, and a 2½ percent fall in private consumption, from $100 billion to $97½ billion, are within the range of recent business cycles. In 1981/82, gross business investment in Quebec fell in real terms by 11½ percent, and the 1993 figure was 7½ percent below its 1989 counterpart. For its part, consumer expenditure fell 3.7 percent in 1982 and 2.2 percent in 1991. The hardship involved would be greater than suggested by these figures, however, to the extent that the changes involved would be long-lasting responses to a structural imbalance in the Quebec economy, and to the extent that falls in income made the declines in investment and consumption needed for a given private sector financial surplus larger.

39 To repeat, deposits are already moving.

40 It is possible that some non-chartered-bank financial institutions based in Quebec have an excess of assets over liabilities elsewhere in Canada, and that for these institutions prudential or regulatory pressures could lead to a net inflow to Quebec. Compared with the imbalance of the chartered banks in the other direction, however, this mismatch would be quite small.

41 Fifty billion dollars is 22.5 percent (Quebec's share of national GDP) of the difference between M2+, a monetary aggregate that includes deposits held at all financial intermediaries, and M2, which includes deposits at chartered banks alone.

42 For example, Robert A. Young, *The Secession of Quebec and the Future of Canada* (Kingston, Ont.: Queen's University, Institute of Intergovernmental Relations, 1995), pp. 237–239 predicts that, of the three arrangements that would provide a definitive solution to the currency question — a separate floating Quebec currency, use of the US dollar by Quebec, and maintenance of the current union with full Quebec participation in policymaking — the two sides will choose the last. He envisages Quebec representation on the board of the Bank of Canada, sharing of seigniorage, agreement about the goals of monetary policy, and regular meetings between ministers of finance about fiscal and monetary issues. Although it is possible to imagine such an outcome, the complexity of negotiating a durable arrangement along these lines should not be underestimated.

43 See ibid., pp. 137–138 and 139–140 for evidence from other secessions on these respective points.

44 For a discussion of similar problems in the context of commercial relations between an independent Quebec and the rest of Canada, on which subject the draft bill clearly stipulates that negotiations will occur *after* a vote on secession, see Schwanen, *Break Up to Make Up.*