North American Monetary Union (NAMU)—A Critical Assessment

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Background and Introduction:

The free trade-driven integration of the Canadian economy with the US has spawned proposals for a North American Monetary Union (NAMU) that would replace the current system of national currencies and floating exchange rates. Exchange rates of the NAFTA countries would be permanently fused in a single North American currency. (Monetary union is an extreme version of a fixed exchange rate system). NAMU, once thought to be far fetched, has gained further credibility with the establishment of the European Monetary Union (EMU) in 1999.

The proposal for monetary union has come from several prominent conservative academics (Harris and Courchene 1999; Grubel 1999). It also has some support within the business community. Politically, both the Bloc Quebecois and the Conservative party (both wings), have publicly supported the concept.

The policy establishment as well as most economists—conservative and progressive—support the existing independent floating exchange rate system and do not favour NAMU. Although supporters of both views can be found within the business community, the major Canadian business lobby groups: the Chamber of Commerce, the Alliance of Manufacturers and Exporters, the Conference Board, and the Canadian Council of Chief Executives, also currently prefer the floating exchange rate system. Notably, the Bank of Canada governor, David Dodge, has left open the door to the possibility of a NAMU at some future point *if* there is sufficient convergence of the two economies.

What is being proposed*:*

Proponents of a North American Monetary Union argue that the logic of globalization is intensifying pressure for dollarization—greater use of the US dollar in international business transactions, and the formal adoption of the US dollar by several developing countries. Moreover, they say, the logic of globalization is moving eventually towards the creation of (three) regional currency blocs and Canada should act now to negotiate monetary union on more favourable terms than would be available when imposed on Canada down the line.

The proposed NAMU would be similar to the European Monetary Union. At an agreed upon date (and transition period), the three NAFTA countries would replace their currencies with a new currency unit at an agreed upon rate of exchange. At the same time the central banks of all three countries would be replaced by a North American Central Bank. New notes and coins would be produced for the North American monetary unit, replacing the notes and coins of each country.

As occurred in the European case, the first phase of the transition to NAMU would be to set up a system of fixed exchange rates between the three countries. NAMU would also, like the EMU, be accompanied by binding fiscal rules adopted by the three countries—for example rules limiting the size of deficits and debt.

According to proponents, the new North American Central Bank would be beyond the political control of any one government. How each country would be represented on the governing NAMU bank board is not clear, but in the decision making structure of European Central Bank each government has an equal voice.

Some NAMU proponents concede that the idea of a NAMU might be a difficult sell in the US. They suggest that while the US dollar would likely become the single North American currency, Canada (and Mexico) would negotiate a place within the US Federal Reserve System as the 13th Reserve District, where it would have influence over North American monetary policy comparable to that of member countries of the European Central Bank.

<u>The existing system—independent floating exchange rate:</u>

Canada, like many countries, has an independent flexible, or floating, exchange rate system. This means that the price of our currency in relation to other currencies--the exchange rate--is allowed to move freely according to demand and supply (with rare interventions by the Bank of Canada). For example, when demand for Canadian dollars by holders of US dollars to pay for Canadian exports (or to make investments in Canada), exceeds the supply of Canadian dollars, the Canadian dollar rises in relation to the US dollar. Conversely, when demand for US dollars to pay for imports from the US (or to withdraw investments from Canada), exceeds supply, the Canadian dollar falls in relation to the US dollar.

Since the 1930s, Canada has maintained a floating exchange rate system, except for two brief periods—1962 to 1970 and 1939 to 1950--when the price of the dollar was fixed in relation to the American dollar.

<u>Key Issues and Arguments:</u>

<u>Claimed costs of the floating exchange rate system:</u>

In order to make their case for NAMU, proponents argue that the existing floating exchange rate system has a number of costs or weaknesses that the NAMU would eliminate. They also claim that NAMU would have additional benefits over the existing system. We examine these claims and then present counter arguments. We also outline several key advantages of the floating exchange rate system.

1. *Under the floating exchange rate system*

4. *It would eliminate the cost of currency transactions between the two countries—a saving to people and business engaged in cross-border transactions. Grubel (1999) estimates this "efficiency gain" at 0.1% of the National Income.*

<u>Counter-argument:</u> Transaction costs are very small and have not been a source of complaint from Canadian business generally. They can easily protect themselves through currency hedging instruments-swaps, futures, etc.

Transaction costs, small as they are, tend to be overstated. For example, 60% of Canada-US trade takes place among different affiliates of the same transnational corporation. As intra-firm transactions, they appear merely as book entries and involve no

Benefits of Canada’s floating exchange rate system:

member commercial banks in each district. Inserting the Bank of Canada, a public, politically accountable, institution, into the quasi-privatized US system, would be challenging indeed.

The governing structure of the EMU also has problems, notably, a lack of political accountability. But member countries can argue with some justification that it constitutes a pooling of sovereignty with each country having an equal voice. No such claim could be credibly made for NAMU. Canada would almost certainly surrender sovereignty to the dominant partner. More importantly, unlike NAMU, European monetary union has been undertaken as part of a process whose stated goal is the political unification of Europe.

In the real world of today the best alternative for Canada is, indisputably, the status quo. The independent floating exchange rate system has served Canada reasonably well over the last 75 years. An independent monetary policy and a national currency have long been vital instruments of economic management, nation-building and national identity for Canada. Over and above the questionable economic benefits claimed by NAMU proponents, the political issues of sovereignty, national identity and democratic accountability will no doubt dominate any future debate around NAMU.

In multilateral forums, Canada should advocate reforms that both promote international monetary stability and enhance the policy tools available to all national governments to promote the well being of their citizens to whom they are (or should be) democratically accountable.

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