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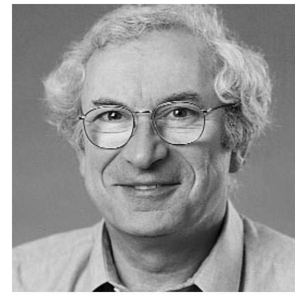

Dollarization: The Pros and Cons

Would dollarization be good or bad for Canada?

The eighteenth century was the age of gold, the nineteenth century the age of sterling, and the twentieth century the age of the U.S. dollar. Now, in the twenty-first century, the American dollar is expanding beyond the settlement of international transactions to widening use in normal domestic commerce: Ecuador and Panama have formally replaced their currencies with the U.S. dollar and, informally, the dollar has become commonplace in every location where business is done. The demand for American dollars to fill these formal and informal roles relative to the supply of dollars is, according to the Monetary Theory of Exchange Rates, the main reason for the dollar's high value: global demand for dollars has been outstripping the supply.

Partly as a result of the widening use of the U.S. dollar, debate is becoming louder every year about the adoption of a common North American currency. What that really means, since the U.S. dollar is unlikely to disappear, is essentially the adoption of the American dollar. Would this be good or bad for Canada?

On the positive side, costs of currency exchange and uncertainties about effective settlement exchange rates would be reduced or eliminated, and markets would be wider and deeper. Canadians would be forced to advance productivity to remain competitive rather than relying on an increasingly depreciated dollar. A further important gain would be a reduction in the cost of capital since covered Canadian borrowing costs have generally exceeded those faced by Americans. The playing field would become more level.

On the negative side, a common currency comes with a common monetary policy. Interest rates would be the same in Canada as in the partner countries, irrespective of economic conditions. For example, if the U.S. economy were buzzing while Canada was lagging behind, interest rates selected to keep the lid on U.S. inflation might be too high for Canada. Our common currency might also be too high if drawn up by the strong demand in the United States. However, two conditions can obviate the problem of a common monetary policy. First, a common policy is not a problem if the business cycles are synchronized: we will need the same policy at the same time. Second, it is not a problem if factors of production are mobile: underutilized factors in one country can seek opportunities in the other. Either of these conditions is enough: you don't need both. So is either condition met in the context of the U.S. and Canada?

The economics of Canada and the U.S. are already closely linked, and so we do have high correlation in the business cycles within industries, but the industrial compositions are different enough to make the correlation less than ideal. As for factor mobility, the potential is better than in Europe, where the success of the Euro is hampered by language and cultural barriers to mobility. However, unlike Europe, the Canada-U.S. border is a blockage to the movement of labour. If the visa requirements ceased to exist, there might be a stronger case for the common currency. For the time being, the loonie has its role. In future, expect pressure to build for a North American Monetary Union (NAMU) from Canadian business, and expect the Bank of Canada and the Ministry of Finance to continue to fight against it. ■

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