Remarks by David Dodge
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Dollarization and North American Integration

Good morning, ladies and gentlemen. Thank you for inviting me to this Congress, and for choosing to spend part of your weekend listening to the discussion on this important topic.

The question before us sounds straightforward: "Should Canada adopt the U.S. dollar?" But the issues are complicated. I will not pretend that I can cover all the nuances of this topic in my allotted time. So I am running the risk that I may oversimplify matters. I should also say that I want to stick to economic facts and arguments. There is, of course, a big political dimension to the question, but I will leave that to the politicians. I want to confine my arguments today to the field of economics.

Choosing an Exchange Rate Regime

In the years following World War II, many countries operated under an exchange rate regime that one might call "fixed until further notice." This system, known as the Bretton Woods system, saw most countries peg the external value of their currencies to some other currency, most often the U.S. dollar. But for a number of reasons, this system of "fixed until further notice" exchange rates proved unstable. It has been abandoned by many countries in favour of one of two options—either a floating-rate regime or the use of another currency. Most have chosen a floating-rate regime. A few countries have decided to join some kind of monetary union or to use a foreign currency to replace their own.

Canada was one of the first countries to adopt a floating-rate regime. It did so at the beginning of the 1950s and, generally, this regime has served us well. But with increasing integration of the Canadian and U.S. economies, the question now being asked is whether Canada might be better off giving up the Canadian dollar, either through dollarization or by entering into a monetary union with the United States.

What I want to do today is to discuss the benefits and costs of a floating exchange rate versus dollarization at the present time, given the current degree of integration of the U.S. and Canadian economies. Then I will talk briefly about the implications for our floating exchange rate should the two economies become more integrated.

Let me just add here that Canada is not being inevitably drawn into adopting the U.S. dollar, or being *de facto* dollarized, as some have claimed. Recent research conducted at the Bank of Canada shows clearly that, if anything, Canada is now less dollarized than it was two decades ago. We are not drifting towards dollarization. If we go down that road, it will be a deliberate choice.

When choosing an exchange rate regime, it is crucial to remember that monetary policy needs to have a nominal anchor. In Canada, monetary policy is anchored by our use of an explicit inflation target. If a country chooses not to float its currency, it essentially adopts the monetary policy of the country to which it is tied. This may, or may not, provide an effective nominal anchor.

Let me briefly explain how the floating exchange rate fits into Canada's monetary framework. Our monetary policy aims to keep inflation at the 2 per cent midpoint of a 1 to 3 per cent target range. We protect the domestic purchasing power of our currency by keeping inflation low, stable, and predictable. By doing so, we support the conditions necessary for strong, sustainable economic growth.

With a floating currency, our exchange rate acts as a mechanism that allows the Canadian economy to adjust to important economic changes, or what economists call "shocks." These can include movements in relative world prices, changes in capital flows, or divergent economic conditions across countries.

Consider commodity prices, for example. As you know very well, Canada is an important producer of commodities such as metals, paper, and chemicals. When the world prices of these goods rise, it means that Canadian producers receive more income. This rise provides a boost to the Canadian economy. When commodity prices fall, it means less income for Canadian producers. This has a negative impact on the economy.

Changes in these sorts of relative prices are a signal to shift real resources out of some sectors and into others. The Canadian economy needs to respond to such signals. Under a floating-rate regime, movements in the currency help to smooth that process and attenuate the adjustments in output, employment, wages, and prices.

Without a floating currency, the Canadian economy would still need to absorb the effect of changes in relative prices. But the burden would fall initially on output and employment and, eventually, on <u>all</u> wages and prices. This would be a far more difficult and costly process for many.

There will always be economic shocks that require adjustments. But because the structures of the U.S. and Canadian economies are so different, the two economies often require very different adjustments to shocks. Canada's floating exchange rate facilitates these adjustments by reducing the amount of lost income and output during the adjustment process.

Weighing the Costs and Benefits

Our empirical analysis shows that these adjustment benefits are quite large during periods of significant shocks. But there is no free lunch. There are costs involved in choosing a floating currency, and these could be avoided under dollarization. These include the costs of currency transactions and the need to mitigate currency risk—costs that can be considerable. At the present time, however, the adjustment benefits clearly outweigh the costs. This is an empirical statement, not a philosophical one. It is possible that, at some future time, the structures of our two economies could converge to the point that the reverse would be true. But for now, and as far into the future as I can see, the floating exchange rate is the best choice for Canada given the degree of integration of the Canadian and U.S. markets for goods and services and labour.

The question can then be asked: "Would further integration of Canadian and U.S. markets change this assessment?" The fact that the structures of the Canadian and U.S. economies are so different argues against using the same currency. But this could conceivably be overcome if there was much greater integration of all markets between Canada and the United States. It is this integration that could help us reduce the costs of adjusting to shocks that I described earlier.

Specifically, the markets for goods and services, and particularly for labour, would need to become much more unified with those in the United States before it would make economic sense to adopt the U.S. dollar. Right now, our capital markets are fairly well integrated. Our markets for goods and services are supposed to be deeply integrated under NAFTA. But as any exporter will tell you, we are not quite there. There is always the threat that the United States could take a countervailing or anti-dumping action. In addition, NAFTA does not cover all goods and services.

Still, by far the largest problem is the labour market. Wages tend to be "sticky"; that is, adjusting wages often takes time. So, under dollarization, the brunt of the economic adjustment to shocks would be borne by the labour market. This would create a huge problem if workers were not free to move across the border in both directions. At times it would create periods of much higher unemployment in Canada than would otherwise be necessary, and at other times it would lead to periods of labour shortages. One important feature of the U.S. labour market and, in my opinion, perhaps the most important source of the U.S. economy's success, is that workers do, in fact, migrate easily—not just from job to job, but also from place to place within the United States. We would need to share in that flexibility.

But clearly, Canada and the United States are a long way from integrating their labour markets, and further integration of markets for goods and services is proving difficult. If these markets—for labour, capital, and goods and services—became much more highly integrated, then the benefits from having a separate currency could decline enough to make considering the adoption of the U.S. dollar worthwhile.

Here, the European experience is relevant for us. Some observers look at the successful launch of the euro and suggest that this shows that Canada could easily adopt the U.S. dollar. But the euro marked the end of a long process of political and economic integration, not the beginning. The countries in the euro zone undertook a massive effort to integrate their markets for goods and services, capital, and labour, and to harmonize their fiscal and regulatory policies. Only after all of this was in place did they move to launch the common currency. It would not have made economic sense to go through the process in reverse. It would not make sense in North America either. We would first need to more closely integrate trade in goods and services, and, particularly, our markets for labour. Only then would it make sense to deal with the currency issue.

Concluding Comments

As I said at the beginning, this is an important topic for discussion and research. At the Bank of Canada, we have been contributing to this debate for some time by laying out the economic facts and by promoting the research needed to determine the facts and carry out our analysis. We will continue to do this. But right now, our analysis tells us that Canada derives a significant benefit from having a floating currency—a benefit that far outweighs the costs. This system helps the economy to adjust to economic shocks, and allows us to have a monetary policy accountable to all Canadians. The floating exchange rate system serves the interests of all Canadians very well.