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The euro: Its economic implications and its lessons for Canada

We have just witnessed the dawn of a new era in Europe. Beginning this month, 11 of the 15 member countries of the European Union have joined in a currency union. And they are using the euro as their common currency. The currency union is yet another step on the road to greater economic, social, and political integration in Europe -- a vision some 50 years in the making.

To be sure, this is a remarkable achievement. Especially when you think that not too long ago many observers were still very sceptical that these countries would be prepared to give up their national currencies. Or, indeed, that they would be able to meet the requirements for participation.

The launching of the euro has naturally piqued public interest in Canada, leading some commentators to suggest that we should consider a similar type of monetary arrangement as a follow-up to the North American Free Trade Agreement (NAFTA).

Today, I would like to talk about some of the economic implications of the European currency union. I also intend to examine whether this common-currency model has any relevance for North America. Should Canada be thinking of a new monetary arrangement along similar lines?

A common currency for Europe

The introduction of the euro no doubt qualifies as an economic event of historic proportions. And some of the commitments required of the participating countries have, indeed, been momentous. This month, 11 European countries permanently locked in their exchange rates, adopted a common currency, and effectively ceded the conduct of their national monetary policy

to a supranational institution -- the European Central Bank (ECB). To some degree, the national central banks of the participating countries are now like the regional federal reserve banks in the United States.

To understand how this major change in European monetary arrangements came to be, it is important to keep in mind that profound political forces started the process and have provided the impetus for action through the years. Indeed, one could argue that had this been a strictly economic initiative it might not have materialized. The impetus essentially stemmed from the belief that greater economic integration would foster permanent reconciliation, and thus peace and stability, among European nations. And with a shared currency, the economic integration would become much more difficult to reverse.

The history leading up to the adoption of the euro is fascinating, with roots extending back to the years immediately following World War II. I will not go through the steps that led to the introduction of the euro. Suffice it to say that the process has been a major political, administrative, and technical feat.

Imagine the logistics of transposing monetary values from national currencies -- German marks, French francs, Italian lire, etc. -- into euros during the first weekend of 1999. And apparently this conversion was carried out without any major hitches.

But the process of conversion is not yet complete. New euro notes and coins are not actually circulating yet, and will not be until January 2002. While financial market transactions must be carried out in euros, for all other transactions the use of the euro is optional over the next three years. The euro can now be used for purchases by credit or debit card, cheque, or traveller's cheque. Companies may do their accounting and pay their workers' salaries in euros. But, on the whole, most Europeans are unlikely to notice much change right away in their daily lives, other than that prices in stores may be quoted in both euros and the old domestic currency.

What is crucial, however, is that the conversion rates of the national currencies in the monetary union are now irrevocably fixed against the euro and against each other. In this sense, the national currencies now exist only as price measures and as temporary subdivisions of the euro. Just as the Canadian dollar is composed of 100 cents, you can think of the euro as being temporarily composed of 6.56 French francs or 1.96 German marks.

What are the economic implications of the euro?

What does it mean for these 11 countries to be sharing a common currency?

First, you may have noticed that, as much as the launching of a common currency across these countries (collectively referred to as Euroland) was a major event, it did not have a dramatic initial financial or economic impact. This is because of arrangements that have been in place for some time. For example, all currencies in the system had been effectively pegged to the German mark since May 1998; and some for much longer. With pegged exchange rates, interest rates in participating countries have tended to move together, in line with German interest rates. And over the past year, short-term official interest rates in all 11 countries gradually converged to the current single rate of 3 per cent. Moreover, with an effective common market already operating in Europe, a common trade policy and more integrated internal markets have been in place for some time.

Just what does the arrival of the euro change, then?

A shared currency undoubtedly brings a number of economic benefits to the euro-zone countries. The main benefit comes from eliminating the costs of conversion from one currency to another in the 11 member countries. Thus, the flow of goods, services, and capital across national borders is no longer complicated by the use of different currencies. Comparisons of prices among suppliers throughout the euro zone are easier to make, which should spur greater competition and efficiency. And there is no need for hedging to protect buyers or sellers against the risk of currency movements. On the whole, there is greater certainty about the future when the risk of exchange rate fluctuations is eliminated among countries that have highly integrated trade and investment.

The migration to the euro has required a major investment in time, resources, and technology by financial sector institutions to prepare for the conversion. But over time, Euroland is likely to end up with deeper and more liquid bond and stock markets. And that has the potential to enhance Europe's share of the global financial industry and the euro's attractiveness as a major international reserve currency. Of course, this will not happen overnight. It will take time.

As for economic policy, the main change that comes with the euro is the shifting of responsibility for monetary policy from national central banks to the European Central Bank. Beginning this month, a single monetary policy applies across all Euroland countries -- just as here in Canada we have the same monetary policy right across the country. The responsibility for monetary policy decisions for the euro zone is now in the hands of the Governing Council of the ECB. The council consists of six members of an Executive Board plus the governors of the

11 national central banks. The ECB is an autonomous institution with a mandate to achieve price stability.

Under these new arrangements, member countries give up that part of their national sovereignty which relates to monetary policy. In effect, individual countries no longer have the option to pursue an independent national monetary policy. What is the significance of this?

Over the longer term, monetary policy has its effects only on the rate of inflation. So if all Euroland countries were already aiming at price stability, the loss of sovereignty involved in not being able to choose a national inflation target may not seem all that important. Nonetheless, there can be differences of opinion about the appropriate definition of price stability or how quickly to return to the target inflation rate when unanticipated events cause a deviation from the target.

More importantly, with a common currency, individual countries can no longer benefit from having their national currency operate as a buffer in the event of an economic shock. Take the case of a sharp rise in world energy prices. In this instance, an energy-producing country would experience rising incomes, expansionary demand pressures, and perhaps increased capital inflows. Countries that are heavy users of energy would experience the opposite effects. Exchange rate movements can help smooth the economic adjustment to such a shock, through a rise in the currency of the energy-producing country and a decline in the currency of the energy-importing country. Where exchange rate movements are not an option, as within the current euro area, greater price and wage flexibility or greater worker and capital mobility between national economies will be needed in response to the shock. Otherwise, the adjustment will be more painful and costly, involving greater fluctuations in national output and employment. Europe is still characterized by significant wage and price rigidities and by low worker mobility, which could make the adjustment to shocks more difficult. Evidently, the hope is that participation in the currency union will act as a catalyst for action to reduce or eliminate these rigidities.

The economic case for a common currency in Europe rests mainly on a judgment that buffering differential shocks in the partner countries will be a less important consideration than the benefits from lower transactions costs and from the greater economic certainty because of reduced currency risk. This presumes that the economic structures of these countries are sufficiently alike that any shocks will be felt by all of them at roughly the same time and to a similar degree. A good number of the euro countries probably fall into this category. Those that do not may find themselves having to adopt measures to increase price and wage flexibility, as well as encourage worker and capital mobility, to take the place of adjustments in the exchange rate.

What are the implications and relevance of the European currency model for Canada?

Canada's trade links with Europe are relatively modest. Only 4 per cent of our exports go to Euroland countries and about 7 per cent of our imports come from there. So the direct economic effects on Canada from any developments in Europe related to the move to a common currency are likely to be rather limited, at least in the short run. Of course, should the new monetary union lead to changes in world trade and finance over time, Canada would feel an impact, like any other country. But it is difficult to assess the likelihood and extent of any such changes. In the meantime, I hope that Canadian businesses trading with Europe have made the adjustment to the new currency and are seeking to benefit from the lower costs of operating in Europe that go with it.

One thing that the launching of the euro has done in Canada is to generate discussion of the notion that we should be thinking of a North American monetary union with the United States (and perhaps Mexico). The decline in the external value of the Canadian dollar over the past year has, no doubt, heightened interest in the issue.

Before I get into the arguments, let me remind you that we are talking about a currency union, not just a fixed exchange rate. Fixed rates that can be adjusted (that is, devalued or revalued) do not eliminate exchange rate uncertainty. Indeed, as we have seen recently in Asia, in Mexico in 1994, and in Europe in 1992, when adjustments are resisted, fixed exchange rates can become unsustainable.

To obtain the economic benefits that I described earlier, a currency union, not just a fixed exchange rate, is required.* But, as I have also noted, even with a currency union the economic benefits come at a price. And that price is the loss of a degree of political and economic autonomy and flexibility. Just how significant would that price be for Canada?

It is important to remember that, in the case of Euroland, the monetary union is a considered, conscious choice that fits into the long-envisioned larger plan of greater economic, social, and political integration. But in North America, there are no parallels to these profound political forces. Nor does NAFTA entail the degree of economic integration involved in the European Union.

* Another arrangement that would involve greater commitment to exchange rate stability than just a fixed exchange rate is a currency board. With a currency board, there is a legislated commitment to convert local currency into the currency used as an anchor, say the U.S. dollar, at a fixed exchange rate. And enough reserves would be held in U.S. dollars to cover all the local currency issued by the currency board country. But, as the recent pressures on the currency boards of Argentina and Hong Kong demonstrate, even then, exchange rate uncertainty is not completely eliminated -- especially at times of major global nervousness and volatility.

Moreover, for Canada, any monetary union one might imagine with the United States would not only result in a loss of autonomy over monetary policy but would work very differently from the European monetary union. In Europe, there are three large partners of roughly comparable size and eight other medium- and smaller-size participants. Any North American monetary arrangement would most likely mean that Canada would have to adopt the U.S. currency.

For Canada, the other major problem with a single North American currency is that we would be giving up the buffer that a flexible exchange rate provides in dealing with shocks that affect us differently from the United States.

An important contrast between Canada and the United States is the distinctly different impact that fluctuations in the world prices of primary commodities have on our two economies. To a significant degree, Canada is still an important producer of primary commodities. And we are major net exporters of such commodities, while the Americans are small net importers. Thus, Canadian and U.S. terms of trade (the ratio of export to import prices) move in opposite directions when there is a sharp movement in world commodity prices. Take the past two years or so: with a decline of over 25 per cent in such prices, our terms of trade deteriorated by about 6 per cent while the U.S. terms of trade improved by 5 per cent.

When the terms of trade turn against us, it means that, on average, we receive less attractive prices for the goods we sell abroad compared with the prices we pay for the products we import. As a nation, we become less well off compared with our trading partners. That is reality, and we have to adjust to it, whether we are on a floating or a fixed exchange rate or even in a currency union. The value of the Canadian dollar *reflected* that reality by moving lower last year. This helped to smooth the process of adjustment. If the exchange rate is not allowed to move, then the adjustment would have to take place primarily through declines in prices and wages and the movement of labour and capital. And if those did not readily occur, the adjustment would take longer and cost more in terms of losses in output and employment.

It is precisely for these reasons, and not by accident, that the Government of Canada has, for the better part of the past 50 years, operated a floating exchange rate.

Concluding remarks

The introduction of the euro ushers in an exciting new era for the Europeans, and we should all wish them well. But the euro is not a blueprint for a North American monetary union. The political objectives that motivated monetary union in Europe do not have a parallel in North America.

More importantly, Canada has a very useful economic safety valve in its floating exchange rate. Because movements in the Canadian dollar reflect external shocks as well as any domestic economic difficulties we may face, there is sometimes a tendency in Canada to blame such movements as the cause of our problems. In fact, these currency movements are a consequence, not a cause. Exchange rate flexibility has served us well over time. Why would we want to give it up?