The Political Economy of a Single North American Currency

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Chapter 1: Introduction

North America is a highly integrated economic zone. Each year, massive volumes of trade and investment flow between Canada, Mexico, and the United States, along with a substantial number of migrating workers. This integration has also been entrenched by a wide-ranging treaty in the form of the North American Free Trade Agreement (NAFTA), enacted in 1994. NAFTA served to further enhance the economic integration that had been taking place on the continent for decades, removing barriers to trade and investment and dramatically boosting annual flows. In addition to goods market integration, the continent also enjoys flexible and well integrated labour market and capital market institutions in comparison to other regions, such as Europe and East Asia.

Indeed, North America is increasingly regarded as a single, highly integrated economic bloc, comparable to the European Union in terms of population and economic output. Unlike Europe, however, North America has never taken any steps toward monetary integration, nor have the three national governments ever seriously discussed the possibility. The purpose of this dissertation is to explore the prospect of monetary integration in North America, and the potential for a single currency in particular. Four research questions will guide the discussion, and each will be addressed in a separate chapter.

First, why did NAFTA not include a monetary dimension in 1994? In light of substantial *de facto* integration and the arrival of an historic opportunity for wide-ranging formal integration, monetary issues were almost entirely absent from the NAFTA discussions and negotiations. Chapter 1 will review the history of North American integration from an economic and monetary standpoint in order to explain why this was so.

Second, why is North American monetary integration now worth discussing, ten years later? If North Americans and their governments were unprepared to explore these issues in the early 1990s, what has changed since that time? Chapter 3 will discuss economic, social, and political trends that have moved the North American countries closer to a serious discussion of their monetary options, of which a single currency is the most realistic.

Third, if monetary integration is to be discussed in North America, what is the economic case for it? If Mexico, Canada, and the United States are to alter their monetary regimes, they will require sound economic reasons for doing so, and at the very least, will require appropriate macroeconomic conditions. Chapter 4 will discuss the potential economic costs and benefits of a single currency for the North American countries.

Finally, what are the political realities surrounding monetary integration in North America? Regardless of the economic conditions, a single currency is unlikely to appear without strong public and political support in each of the three countries. Chapter 5 discusses Canadian, Mexican, and American politics in order to assess the future likelihood of monetary negotiations in North America. Chapter 6 concludes.

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2.1. Introduction

When NAFTA was implemented in 1994, it represented a major step towards formal integration on the North American continent, substantially liberalizing economic transactions and laying a framework for trilateral economic and political relations. Liberalization and deregulation had been taking place in Mexico and Canada, edging the region closer to factor market integration, and NAFTA was meant to further enhance the already-extensive economic integration on the continent. However, despite close economic ties, certain favourable economic conditions, and the arrival of a unique political opportunity for formalized integration, no steps toward monetary integration were taken in NAFTA, nor was the subject even seriously discussed. Why did NAFTA not include a monetary dimension in 1994? By exploring the pre-NAFTA history of economic integration in North America, the following chapter seeks to answer this question, as well as to provide a background for understanding the potential for future integration on the continent.

2.2. The History of Economic Integration in North America: Bilateralism

The concept of North America as a single economic entity is, in the minds of most observers, a relatively recent one. Indeed, economic and political relationships on the continent have been almost entirely bilateral since the three nations that occupy it were first formed. The effect of the position and dominance of the United States on this evolution is difficult to overstate. At the time of NAFTA's implementation in 1994, both Canada and Mexico had integrated extensively with their powerful neighbour, but scarcely at all with each other. In addition, very few trinational agreements or mechanisms had been established prior to the 1990s, as bilateral relations were the norm. It is therefore logical to review the history of North American integration up to 1994 in terms of the three bilateral relationships which have dominated it.

2.2.1. US-Canada Economic Integration

The United States and Canada are each other's largest trading partners and enjoy the largest trading relationship in the world, measured in terms of total annual value. At the height of the North American auto industry, 5% of *all* world trade in goods was occurring across the bridge between Detroit, Michigan and Windsor, Ontario. When the Canada-US Free Trade Agreement (CUSFTA) was implemented on January 1, 1989, bilateral trade in goods and services between the two countries totaled US $169 billion in the previous year. That year, 71.2% of Canadian exports went to the US, and 62.3% of imports came from there. From the US perspective, 17.3% of its imports came from Canada, and 22.2% of its exports were sold there.[1] In 1987, two-way direct investment between the countries totaled $83 billion.[2] These figures reflect the fact that the two economies enjoyed a high degree of *de facto* economic integration well before the signing of a comprehensive trade agreement. This should perhaps be no surprise, given that the countries share a 3000 mile border, mostly speak a common language, and have similar governmental, legal and business institutions. In the late 1980s, both were mature

[1] Eden and Molot, 68.
[2] Cavitt, 69-70.

industrial economies with similar income levels, demonstrating a certain amount of mutual economic dependence.[3]

Indeed, the two countries had long recognized their economic importance to each other, and factions within each had long entertained the idea of a special trade relationship. Concluding actual agreements, however, proved to be much more difficult and contentious, with both sides taking forward and backward steps for more than a century before the signing of the CUSFTA. As observed by a Canadian historian, there is one economic issue in Canada that "comes close to rivaling the linguistic and race question for both longevity and vehemence, and this is, of course, the question of free trade with the United States."[4]

The earliest expression of US-Canada free trade was the Reciprocity Treaty of 1854, Canada's response to Britain's own moves toward free trade. However, the US abrogated the treaty in 1866 in response to an unfavourable trade balance, Canadian protectionism in manufacturing, and the British role in the US Civil War.[5] Despite annoyance with this action, the Canadian government attempted unsuccessfully to reinstate the treaty seven times between 1869 and 1923, meeting political obstacles on both sides of the border. The Depression was a particularly low point in trade relations, with the implementation of the Smoot-Hawley Act in the US and the signing of the preference-based Ottawa Agreements by Canada and other Commonwealth nations. By the mid-1930s, however, the Roosevelt Administration reversed American protectionist policies and a limited US-Canada trade agreement was signed. At the end of the Second World War, both countries decided to base their trade on the most favoured nation (MFN)

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[3] Eckes, 96.
[4] Cohn, 256.
[5] Ibid.

principle, and subsequent trade liberalization took place under the auspices of GATT multilateral negotiation. Exceptions to this included the 1965 US-Canada Auto Pact, a crucial sectoral agreement that dramatically expanded the Canadian auto industry and led to billions of dollars of new exports within just a few years of its implementation. The Auto Pact eventually became a source of conflict, however, preventing the negotiation of other sectoral agreements.[6]

Major shifts in US and Canadian thinking on North American trade and integration began to occur in the 1980s. Leading the trend was Ronald Reagan, the first modern North American leader to articulate a bold vision for continental integration. On the campaign trail in 1980, he "dreamed of a common market stretching from the Yukon to the Yucatan." While many in the US were mainly interested in greater access to Canadian and Mexican oil supplies, Reagan himself seemed genuinely interested in long-term continent-wide integration with the potential to benefit all three nations. These ideas were certainly visionary but were also ahead of their time, given that both Canada and Mexico were as yet unprepared for even a proper trade agreement. Reagan's ideas were rejected by both countries, and in particular by Canadian leaders such as Pierre Trudeau, who had often steered the country away from integration with the US during more than a decade in the Prime Minister's Office. Instead, Trudeau aimed for reduced dependence on the US and increased trade links with other regions, especially Europe.

By the mid-1980s, however, the Canadian position had begun to change. US protectionism had begun to revive itself, as internal forces sought to erode liberal trade policy in the face of an appreciating dollar. These trends alarmed export-reliant Canada, whose attempts to foster trade links with Europe had been largely unsuccessful as that

[6] Dodds, 29.

continent focused on its own "1992" initiatives. The influential 1985 report of the Canadian government's "Macdonald Commission" also dealt a blow to economic nationalists, concluding that Canada should pursue freer trade, and free trade with the US in particular. Perhaps most significant to the liberalizing trend, however, was the 1984 election of the Progressive Conservative government of Brian Mulroney, who could be described as Reagan's ideological counterpart. In 1985, Canada proposed a bilateral free trade agreement to the US in order to resolve growing trade tensions, to secure access to the world's largest market, and to boost the competitiveness of the Canadian economy.[7] The proposal was well-timed from a US point of view, as Reagan continued to fight domestic protectionist influences. The US had also accepted the idea of regional trade negotiation, partly out of frustration with the GATT process in the early 1980s, and also in response to the consolidation of the European regional trading bloc.[8] Ultimately, Canada and the US entered into negotiations in 1986 in order to substantially liberalize trade and investment rules.

This process was not without controversy. While the US government and public generally had little to fear from a Canada-US Free Trade Agreement, many Canadians were deeply troubled about the implications of the pact for long-term national sovereignty. The asymmetry of the countries' economic relationship had long been a concern, and not all segments of the Canadian population were ready to embrace closer integration. Specific fears included the potential "selling out" of Canadian businesses to US investors, loss of control of cultural industries, and the potential for lost jobs. The national debate over these issues was long and acrimonious. Ultimately, however, the

[7] del Castillo and Canovas, 88-89.
[8] Fatemi and Salvatore, 5.

Mulroney government was reelected in 1988 when the two anti-CUSFTA opposition parties split 60% of the vote, and the agreement was signed that same year.[9]

Despite a difficult start involving short-run adjustment costs in Canada and poorly-timed recessions in both countries, the CUSFTA appears to have provided an eventual net benefit, with substantial increases in two-way trade and investment apparent by the mid-1990s. In particular, Canadian exports to the US rose by 45% between 1988 and 1993 despite the relatively high value of the Canadian dollar and a sluggish US economy[10] US FDI (foreign direct investment) in Canada more than doubled during the same period.[11] There was also evidence by the mid-1990s that Canadian labour productivity had experienced significant FTA-induced growth.[12]

Two key points arise out of this brief history of the US-Canada economic relationship. The first is that *de facto* economic integration had long been occurring between the two countries and had risen to impressively high levels by the 1980s.[13] Such integration is among the key requirements of formal monetary integration. The second point, however, is that although a trade and investment agreement promised significant benefits for both sides, steps towards any such agreement were historically very difficult to take. In this light, progress toward a farther-reaching agreement that included a monetary component would have been very unlikely in the late 1980s, particularly as the sovereignty implications for Canada would have been greater. Indeed, the CUSFTA agreement came through a window of political opportunity that had rarely been open during over 100 years of discussion on the issue, and was signed in the midst of a fierce

[9] Rugman in Baer and Weintraub, 113.
[10] Bhalla and Bhalla, 124.
[11] Dodds, 44.
[12] Trefler.
[13] It should be noted that regulations continued to restrict US-Canada labour market integration.

Canadian debate. Any proposals for monetary integration in CUSFTA would likely have been premature, a point which will be returned to below in the discussion of Canada's monetary history.

2.2.2. Mexico-US Economic Integration

Like Canada, modern Mexico is also highly economically integrated with the United States, its largest trading partner and source of investment. Mexico is also the United States' second largest trading partner behind Canada.[14] Mexico's history of integration with the US is somewhat unlike Canada's, however. Despite a certain amount of silent integration over the years and the development of substantial trade links, the US relationship was not a key part of Mexican economic policy for decades, as will be discussed below. In addition, Mexico and the US lack certain similarities from which the US-Canada relationship has benefited, such as a common language, common political and legal traditions, and comparable economic maturity. Finally, not only were Mexico-US economic agreements elusive, but they were rarely sought during most of Mexico's history. Although the road to the CUSFTA was difficult, US-Mexico trade relations have been even more fraught with tension and conflict over the years.

Mexico has historically not been short of reasons to resent the United States. Among the more significant events were not only the war of 1847 in which half of Mexico's territory was annexed, but also the invasion of Veracruz in 1914 and the search for the hero Pancho Villa in 1916. These latter events reflected US efforts to intervene and protect its economic interests after the Mexican revolution of 1910-11.[15] Years of

[14] In addition to these extensive economic links, the two countries have also experienced a substantial amount of labour market integration, with at least 10 percent of the growth in the US labour supply since World War II coming from Mexican migrants. del Castillo and Canovas, 99.
[15] del Castillo and Canovas, 99.

tension came to a head in 1938 when Mexico expropriated the properties of American and British oil companies over a labour dispute. Only World War II and the US desire for security cooperation led to an eventual settlement of the issue.[16]

Indeed, World War II marked something of a shift in US-Mexico relations, as the Camacho Administration identified rapid economic growth and industrialization as key Mexican goals. However, these ends were largely sought through a program of import substitution, industry protection, and a desire for autonomous development. Although Mexico and the US extended MFN status to one another, no significant trade agreements were signed, and Mexico did not join the GATT. In the postwar years, foreign trade accounted for less than 10% of Mexico's GDP. This protectionist system was initially successful in developing Mexico's industrial base, contributing to the "Mexican miracle" of the 1950s and 1960s when GDP growth averaged 6-7% annually. Over time, however, the policy became increasingly dependent on foreign investment, introduced economic distortions, made for internationally uncompetitive industries, and was limited by a small domestic market.[17] By the 1970s, the system was seriously faltering, but was propped up by oil revenues and international borrowing. The collapse of these sources of income combined with fundamental economic problems led to the crisis of 1982-83 and forced a change in Mexican economic strategy.[18] Following a US and IMF bailout, the Mexican public and government recognized that fundamental restructuring was required.

Like Canada, Mexico had rebuffed Ronald Reagan's vision for North American free trade and integration in 1980. If Pierre Trudeau's anti-Americanism had been an obstacle to Canada-US integration, anti-US feelings were an even greater problem in

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[16] Ibid., 100.
[17] Ibid., 103-105.
[18] Ibid., 106.

Mexico. The Mexican public still resented US treatment of their country over the years, and historically had little interest in allowing US influence in their affairs. However, the economic difficulties of the late 1970s and early 1980s had revealed that autonomous Mexican development was unlikely to be a long-term success. Economic reality had caught up to Mexico's aspirations, and the country needed to reach out to the US and the rest of the world. In 1985, the country undertook substantial trade reforms, and acceded to GATT in 1986 to help entrench liberalization. The Economic Solidarity Plan of 1987 made further progress, and in 1989, sweeping reforms were made to foreign investment rules, allowing 100 percent foreign ownership in many industries. By the end of the decade, this rapid program of reform had made Mexico one of the most open developing economies in the world, and large gains in exports, imports, and productivity were soon apparent.[19]

Somewhat ironically, this period of trade reform in Mexico led to new conflicts with the US. In particular, Mexican companies entering the US market ran up against a rash of new antidumping and countervailing duties. As Mexico had increasingly come to see the US export market as the primary engine for growth, insecure access to that market posed a problem, just as it did for Canada. This situation led Mexico to seek negotiations with its northern neighbour, and agreements were signed in the late 1980s that dealt with subsidies and laid a framework for future concessions by both sides.[20] Thorny issues remained, however, and Mexico looked with particular interest upon the conclusion of the CUSFTA in 1987. North American integration looked even more attractive when Mexico's attempts to reach out to Europe were met with little interest, as that continent

[19] Ibid., 110.
[20] Ibid., 115.

focused on the political and economic transitions taking place to the east. As part of a growing consensus that Mexico needed to secure greater market access as well as new external capital, President Salinas proposed the idea of a US-Mexico FTA to George Bush in 1990. This "Salinas Opening" not only demonstrated the extent of Mexico's ideological transition, but also confirmed that the three national governments in North America now held similar views on free trade, a condition that would be crucial to the negotiation of NAFTA.

Mexico's 20th century economic history demonstrates that although economic integration has long been taking place with the United States, formalized integration was rarely seen as vital, inevitable, or even desirable. Indeed, the Mexico-US relationship was marked by tension and resentment for many decades. It was only after the country's inward-looking policies ended in disappointment in the 1980s that Mexico began to seek and entrench a more open relationship with its neighbour, eventually resulting in NAFTA negotiations. As in Canada, trade liberalization had only recently been accepted, and farther-reaching proposals for monetary integration would likely have been premature, both economically and politically.

2.2.3. Canada-Mexico Economic Integration

Of the three bilateral relationships in NAFTA, the Canada-Mexico relationship is by far the smallest and weakest. Not only do Canada and Mexico exhibit basic cultural, linguistic, and institutional differences, but they are also separated by thousands of miles. It is significant that the nation between them is the world's leading economic and political power. Indeed, the greatest similarity between Canada and Mexico may be the fact that they have both had to contend with the United States as a neighbour. As a result, the two countries often share similar attitudes in external relations, such as in their policies toward Cuba and Latin America. Through much of the 20th century, however, both countries were understandably preoccupied with their US relationship, and comparatively little effort was devoted to furthering Canada-Mexico relations. It was largely in 1990 that the countries "rediscovered" each other on the road to NAFTA.[21]

In the late 19th and early 20th century, however, Canada and Mexico did enjoy significant economic relations. In the wake of Mexico's war with the US in 1847 and the end of Canada-US reciprocity in the 1860s, both sides were uneasy with their US relationship. Canada in particular explored the possibility of increased trade with Mexico to decrease dependence on the US.[22] By the turn of the century, the Mexican regime of Porfirio Diaz openly welcomed foreign investment from Canada as an alternative to the US. Canadians became substantially involved in the development of Mexican infrastructure, bringing with them the latest technology and management practices, and finding it easy to operate in the largely unregulated Mexican economy.[23] For example, the Mexican Light and Power Company was founded by a Canadian, supplying hydroelectric power to Mexico City. By 1911, Canada and Great Britain accounted for 89 percent of foreign investment in Mexican telegraphs, telephones, water, and electricity.[24] These developments ended abruptly with the 1910-11 Mexican revolution, however, which soon resulted in a national economic policy. Canadian businessmen were forced out of Mexico and had to leave their investments behind. By 1938, Great Britain had

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21 Wilson-Forsberg, 3.
22 Haces, 60.
23 Ibid., 62-63.
24 Ibid., 63.

broken off diplomatic relations with Mexico over the oil expropriation incident, and Canada was left with no diplomatic representatives in the country.

Canada-Mexico economic relations remained relatively stunted for decades, though small steps forward were occasionally taken. In 1946, the two countries concluded an agreement based on the MFN principle, opening the doors for modest economic discussion. Through the 1960s and 1970s, both public and private forces in Canada and Mexico quietly entertained the idea of expanding their economic relationship, but the primacy of their US relationships generally interfered with any plans.[25] By the 1980s, progress was made in certain areas, including a trade agreement on agriculture in 1981. Trade began to increase through the 1980s, particularly Mexican exports to Canada, and further agreements on tourism, migration, and forest products were concluded in 1988.

Despite these developments, Canada-Mexico integration in terms of trade, investment, and migration remained marginal compared to both countries' US relationship. In the year prior to NAFTA's implementation, just 0.4% of Canadian exports went to Mexico, in contrast to the 81.3% that went to the US.[26] Indeed, following the "Salinas Opening" to the US in 1990, Canada initially saw little point in joining the negotiations. It quickly realized, however, that for defensive reasons, it would need to be at the bargaining table.[27] Thus, the fall of 1990 marked a turning point in Canada-Mexico economic relations. Increased communication and exchange began to occur between the two sides, as Mexico sought to learn from Canada's experience in negotiating the CUSFTA, and Canada sought to prepare the ground for NAFTA negotiations. In

[25] Ibid., 71.
[26] Dodds, 43. Transshipment through the US may understate these figures.
[27] Dodds, 34.

particular, a state visit to Mexico by Brian Mulroney in 1990 concluded with the signing of ten new agreements on such issues as customs, trade, investment, and dispute settlement.[28] Though comparatively small, actual flows of trade and investment were on the rise as the two sides attempted to catch up on 50 years of weak relations and set the stage for the NAFTA negotiations.

The preceding history of Canada-Mexico economic relations illustrates several important facts regarding the potential for monetary integration in North America. The first of these is that Canada and Mexico, having experienced very low levels of economic integration, had little to gain from formalized monetary integration with each other in the early 1990s. In addition, both countries supply resources to the US, and flexible exchange rates can potentially be the source of competitive advantage. Also significant is that Canadian and Mexican exchange rate ambitions do not naturally coincide, given that Canada produces output in a relatively high-wage, high productivity economy in comparison to Mexico. Monetary integration involving the two countries could only conceivably have come about in the early 1990s if one of the countries had begun to negotiate it with the US, and the other had insisted on being included in order that it should not lose out. This scenario is, to some degree, how the NAFTA negotiations unfolded.

The Canada-Mexico relationship also demonstrates the overwhelmingly bilateral nature of past integration in North America. The US has acted as a central hub for the spokes to the north and south, which themselves have experienced comparatively little integration over the years. It is illustrative that the first comprehensive trade agreement on the North American continent was a bilateral one between Canada and the US, and the

[28] Haces, 71.

second agreement was originally proposed between the US and Mexico only. Indeed, it was largely the prospect of the second agreement that spurred new development of the Canada-Mexico relationship. As a result of this bilateralism, North America has historically been difficult to conceive of as a single entity or community, in comparison to the European Union, for example. In this context, continent-wide monetary integration was not necessarily a logical step for North America to take in the early 1990s.

2.3. North American Monetary Arrangements: Mixed Experiences

Having explored the history of North American economic integration as it relates to the prospect of monetary integration, it is worthwhile to discuss the operation and evolution of the three North American monetary regimes. The experiences of the Canadian dollar,[29] the Mexican peso, and the US dollar provide further perspective on why monetary integration was not considered as part of NAFTA.

2.3.1. The Loonie: Independence

The following historical view of Canada's monetary arrangements demonstrates that Canadians have long valued the independence of their dollar, and would have been unwilling to give it up or otherwise compromise it during the negotiation of NAFTA in the early 1990s. It must be said that the very early history of the Canadian dollar did include a certain amount of monetary integration with the United States, when from 1854 to 1931 it was usually fixed at or near par with the US dollar as part of the Gold Standard arrangements. Various fixes with the US dollar were then used until 1949, with capital

[29] The Canadian dollar has been colloquially known as the "Loonie" since 1987 when a new dollar coin bearing the image of a native Canadian bird, the Loon, was released.

controls to moderate the increasingly large financial flows to and from the United States, which had replaced Britain as Canada's largest source of foreign capital.

The more recent history of the Canadian dollar has involved a great deal of independence, however. One of the most significant events in the history of Canadian currency occurred in 1950 with the government's decision to float the dollar, which was experiencing upward pressure due to rising exports, commodity prices, and foreign investment.[30] By 1951, exchange controls had been largely eliminated. These developments put Canada at odds with the Bretton Woods fixed rate system and the IMF, as well as the majority of the international community. Under Bank of Canada Governor James Coyne, the floating rate experiment proved to be a success through the 1950s, providing an essential adjustment mechanism for the economy. Canada's experience inspired a great deal of academic work on the merits of flexible exchange rates, and would serve as a model for other countries following the collapse of the Bretton Woods system in the 1970s.[31] However, in a textbook example of political interference in central banking affairs, a battle erupted between the Canadian government and the Bank of Canada in 1962, resulting in not only the resignation of James Coyne, but the weakening and ultimate refixing of the Canadian dollar.[32]

By 1970, Canada was once again ahead of the world as it floated the dollar in response to upward pressure. Proposals to refix the dollar, including calls from the IMF, were not implemented in order to maintain internal balance, and by 1973, the Bretton

[30] Unless otherwise noted, historical information on the Canadian dollar is from Powell.
[31] Among the first to advocate a floating exchange rate for Canada was Milton Friedman. He argued for such a move in a 1948 University of Chicago debate with, among others, Deputy Governor of the Bank of Canada Donald Gordon. By 1949, future Bank of Canada Governor James Coyne was also advocating this position.
[32] This dispute was analyzed in the original "Mundell-Fleming" work, which has become a foundation for academic theory on macroeconomic management under flexible versus fixed exchange rates.

Woods system had disintegrated. From 1970 to 1990, the Canadian dollar followed long upward and downward tracks against the US dollar. Upon floating, the dollar appreciated quickly due to rising commodity prices and capital inflows, exceeding par with the US dollar in 1974. By the end of the decade, however, the dollar had fallen back to the mid 80 cent range in response to a variety of factors, including falling commodity prices, political uncertainty over Quebec, a substantial current account deficit, and concerns over the country's external competitiveness. The falling trend continued into the 1980s, with a low of $0.69 US in 1986. This trend was reversed by Bank of Canada intervention and higher interest rates, and the dollar then continued to rise in the latter half of decade with the help of rising commodity prices and expansionary fiscal policy.

At the beginning of the 1990s, the Bank of Canada under John Crow adopted aggressive inflation targeting as its primary goal, and largely abandoned any desire to affect the value of the dollar. Widening interest rate differentials pushed the dollar to a peak of just over 89 cents US in 1991. Shortly thereafter, however, monetary easing in a recession, government budget problems, current account deficits, and weakening commodity prices conspired to drive the dollar down again, reaching 75 cents US by the time of NAFTA's implementation in 1994.

From this history of the Canadian dollar, it is clear Canada had little desire to pursue monetary integration during the NAFTA negotiations. The first reason for this is that despite having tried several types of exchange rate regimes, Canada has favoured a floating rate in the last half-century, and in fact has floated more than any other major currency. Indeed, the flexible Canada-US exchange rate represents the most persistent attempt at flexibility among world currencies, and inspired the influential Mundell-

Fleming theory of macroeconomic management under flexible exchange rates. Economically speaking, Canada's preference for flexibility has been the result of three main factors: Canada's role as a major commodity producer and exporter, high levels of capital mobility, particularly between Canada and the US, and a desire to use macroeconomic policy to achieve domestic goals. The swings in the value of the Canadian dollar in the decades preceding NAFTA suggest that the exchange rate was a crucial adjustment mechanism for the Canadian economy during those years. Ultimately, it appears that Canada's floating exchange rate regime has been an integral part of its overall economic strategy for decades, and a return to a non-floating regime in the early 1990s would have been unlikely.

A second reason why Canada would not have sought monetary integration as part of NAFTA is that the development of an independent dollar has been an important part of the process of establishing Canadian national sovereignty, of which it remains a symbol. Canadians who in the early 1990s were still wary of free trade would not have been willing to accept any arrangement that jeopardized the independent existence of the Canadian dollar, either as an economic concept or as coin in their pockets.

A third reason why Canada was not raising monetary issues in relation to NAFTA was that the floating and independent dollar had not been seen to impose any serious costs. Despite significant fluctuations in the relative value of the dollar between 1970 and the early 1990s, Canada-US trade and investment continued to grow at a high rate, and few economists suggested during those years that the floating dollar posed a serious impediment to cross-border economic transactions. In addition, exchange rate movement and the associated movement in interest rates can be favourable to financial activity, and thus the powerful financial system in Canada has had an interest in supporting the maintenance of an independent currency.[33]

2.3.2. The Peso: Instability

The history of the Mexican Peso, established in 1814, extends beyond that of the Canadian dollar. Like Canada, Mexico also experienced transitions between fixed and essentially floating exchange rate regimes during the 20th century. However, the Mexican case has involved serious monetary and economic instability, making it an unlikely candidate for formal monetary integration with the United States and/or Canada in 1994.

Following independence from Spain in 1821, Mexico maintained the Spanish monetary system and generally adhered to a metallic standard. Under the Gold Standard in 1905, 2 Pesos were worth 1 US dollar. After a return to the Silver Standard in 1916, however, the Depression years saw the beginning of Mexico's first major currency depreciation of the 20th century. In 1933, the Peso was devalued to 3.6 per US dollar, after which a series of economic setbacks and devaluations saw the peso slide to 12.5 per US dollar by 1954. The period from 1954 to 1976, on the other hand, was one of remarkable stability for the Mexican Peso and for the Mexican economy in general, particularly in light of the instability which preceded and followed it. Indeed, these were the years of the "Mexican miracle," when the national economic strategy of import substitution had its greatest success and fiscal and monetary policies were relatively prudent. The Peso was held at the 1954 rate of 12.5 per US dollar throughout the period, and inflation was low, especially by Latin American standards.

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[33] The financial sector in London has largely opposed British entrance into the Euro area for similar reasons.

By the beginning of the 1970s, however, the import substitution strategy had begun to lose its effectiveness, and there was growing national dissatisfaction with increasing income inequality and poverty. Upon his election in 1970, President Luis Echeverria sharply increased fiscal expenditures, leading to increased public debt, balance of payments problems, and double-digit inflation.[34] By the end of his term in 1976, crisis forced Echeverria and the Bank of Mexico to allow the Peso to depreciate to approximately 22.5 Pesos per US dollar.

The stability brought about by the 1976 devaluation proved to be temporary. High oil prices and the discovery of Mexican oil reserves led to substantial earnings in the petroleum market, which in turn led to dramatic increases in public and private debt through the late 1970s under President Portillo.[35] In 1981-1982, oil prices collapsed as borrowing continued, and Mexico was faced with a severe debt crisis and inflation nearing triple digits. The currency was again forced downward by capital flight and fell steadily through 1982, as the government introduced a dual exchange rate system and exchange controls. The Free Market Rate fell to 149.25 Pesos per US dollar by December. The 1982-1988 administration of President De La Madrid introduced new reforms and the economy began to experience some stability, but the nominal value of the Peso did not. The currency fell almost continuously through the 1980s, largely through a program of controlled depreciation as Mexico struggled to find equilibrium and regain its economic footing.[36] At the end of De La Madrid's presidency, 1 US dollar could be exchanged for 2,289 Mexican Pesos.

[34] Clement et al., 227.
[35] Weintraub.
[36] Ibid.

By the 1990s, Mexico had begun to regain economic strength, and exchange controls were eliminated in 1991 as part of President Salinas' liberalization programs. These reforms combined with inflation caused further overvaluation of the Peso,[37] however, and it continued to slide, exceeding a rate of 3000 Pesos per US dollar. This trend continued through 1993 when the Mexican New Peso was introduced, replacing the existing Peso at a rate of 1 to 1000.

The preceding overview of Mexico's monetary history provides a major reason for the absence of monetary integration in the NAFTA negotiations of the early 1990s. Canada and the US could scarcely have contemplated formal monetary integration with Mexico at that time, following 15 years of nearly continuous Mexican economic and financial instability. Mexico's debt crises, rampant inflation, major currency devaluations, unsound economic strategies, and imprudent fiscal and monetary policies could hardly have laid the foundation for anything as grand as a currency union with its northern neighbours. While Mexico could have unilaterally adopted the US dollar, any proposed arrangement that would have subjected the United States to greater responsibility for Mexico's monetary and financial system would likely have been rejected out of hand by the US. This would have been particularly true at a time when many Americans were lukewarm about the prospect of a trade agreement alone, as will be discussed below.

From the Mexican perspective, few in that country would yet have been willing to pursue monetary integration, for several reasons. First, given their negative experiences with fixed exchange rates, there was little reason to believe that a new type of firm fixing (short of a common currency) would have been more successful than in the past.[38]

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[37] Espinosa, 78.
[38] De La O, 14.

Second, since Mexico was a relatively low income country attempting to boost its economic performance through exports, fixing the peso in such a way that might expose it to overvaluation could have been harmful. Finally, despite the instability they had suffered over the years, few Mexicans would yet have been willing to surrender the Peso and the political sovereignty and symbolism that are associated with it.

2.3.3. The Greenback: Dominance

The US dollar dates back to 1792, and ironically owes its origin to the silver dollar or "thaler" which was circulated in Mexico under the Spanish. Following its establishment, the US dollar was generally on a metallic standard for close to two centuries, with suspensions of convertibility during the Civil War, the First World War, and the Depression. In the latter half of the 20th century, however, the position of the US dollar in the world was one of increasing dominance. A crucial development occurred towards the end of the Second World War, when the new economic and political position of the US allowed it to lead the world into a new monetary order. The Bretton Woods system, agreed upon in 1944, saw most world currencies tied to the dollar, which in turn was fixed to gold at $35 per ounce. Over several decades, this fixed-rates system proved successful and allowed the US dollar to become the cornerstone of the international monetary system. During these years, the dollar established itself as the world's transaction and reserve currency of choice, with the US enjoying the accompanying seigniorage privileges.[39] By the 1960s, however, increasing fiscal and monetary imprudence in Washington began to threaten the foundation of the international system. In 1971, the Nixon Administration suspended gold convertibility and forced a

[39] Gilpin, 237.

devaluation of the dollar.[40] International attempts to reestablish the system failed, and by the mid-1970s, most major world currencies were floating.

Following the collapse of the Bretton Woods system, the US dollar largely remained the world's reserve currency and the international benchmark for valuing all currencies. The dollar itself remained strong into the 1980s as the US offered attractive interest rates, a stable economic system and many opportunities for investment. Efforts were made during this period by the world's major economic powers to cooperate in the managing of approximate currency values. US concerns often centered on trying to find an appropriate value for the dollar against the German Deutschmark and against the Japanese Yen in particular. In 1985, the US belief that the dollar was too high led to the Plaza Agreement, in which the G5 countries agreed to work to bring the dollar down, though international markets have often interfered with these kinds of intentions.

This history of the US dollar demonstrates one overriding point: the United States has generally had little motivation to pursue monetary integration in North America. This is true for several reasons. First, the primacy of the dollar in the international system has conferred substantial benefits upon the US, which would be unwise to take steps that might dilute those benefits or destabilize the dollar, even temporarily. Second, the US has had few reasons, at least since the collapse of Bretton Woods, to want to either dilute control of its monetary policy, or to take other countries' concerns into account when formulating that policy. Third, the US would have been unwilling to provide formal financial backing to other countries' financial institutions unless it could at least gain regulatory authority over them. Fourth, while the US has been concerned with the value of the dollar in relation to the Yen and the Mark, the currency values of Canada and

[40] Ibid., 238.

Mexico have been of comparatively little concern. Neither Canada nor Mexico appears to have engaged in any serious competitive management of their currencies,[41] and thus the US has had little desire to constrain their values. Finally, the power and role of the US dollar in the world (like the power and role of the US economy itself) reminds us that of the three North American nations, the US generally has the smallest potential gain from steps toward integration, or at the very least, can most afford to avoid them.

2.4. The Road to NAFTA: Different Goals

Having reviewed the history of economic integration and monetary arrangements in North America up until the negotiation and implementation of NAFTA, it is important to understand the environment that surrounded the final process. In pursuing the agreement, each of the three countries had its own agenda, motivations, and concerns. Understanding the nature of these interests is not only important to understanding the dynamics of North American integration, but also to understanding why monetary issues were not part of NAFTA.

2.4.1. Canada and NAFTA

As has been discussed, the CUSFTA was fiercely debated in Canada, and it is likely that a majority of Canadians were opposed to it during the heated 1988 election campaign. While Canada stood to receive long-term benefits through secure access to the US market, many Canadians were concerned about the effects of the agreement in light of the asymmetry of the Canada-US relationship. As mentioned earlier, issues of particular concern were the "selling out" of Canada to US investment, the possibility of a

[41] The Bank of Canada's adoption of a strict inflation targeting regime means that it has virtually abandoned any desire to manage the dollar's float.

difficult economic adjustment, and the potential for lost economic, political, and cultural sovereignty.

Thus, when Mexico proposed in 1990 the idea of its own free trade agreement with the US, Canada was at first reluctant to get involved. Not only were trade and investment ties with Mexico marginal, but the government was also mindful of the battle that had been fought over the CUSFTA, which itself had yet to provide any clear benefit as the country slid into a deep recession.[42] However, the Canadian authorities quickly realized the potential danger of not joining in the trade talks. Two bilateral trade agreements on the North American continent would have created a true "hub and spoke" model in which the US received the greatest benefits and its neighbours competed with each other for market share. Rather than sit on the sidelines and hope for the best, Canada resolved to seek full negotiating status in order to protect its gains in the CUSFTA and to try to benefit from the Mexican market.[43]

In retrospect, it is clear that Canada was not seeking a NAFTA in 1990, nor was it necessarily expecting such negotiations to come about. In reality, Mexico's opening forced Canada to the bargaining table to avoid the potential costs of being left out.[44] In this context, Canada was clearly not about to propose any substantial new steps such as monetary integration, particularly so soon after the conclusion of the controversial CUSFTA.

2.4.2. Mexico and NAFTA

[42] Dodds, 34.
[43] del Castillo and Canovas, 123.
[44] Ironically, this negotiating position was an advantage for Canada. With the CUSFTA in hand, Canadian negotiators could technically do no worse, and were able to bide their time and strategically withhold concessions, occasionally to the exasperation of the Mexican and US negotiators. Cameron and Tomlin, 235.

President Salinas' motivations for his opening to the US in 1990 were mainly economic. Key desires of the Mexican regime were to entrench the domestic liberalization that had been achieved in the previous five years, and to secure access to the US market as part of the new export-led growth plan.[45] Also of concern was the potential loss of market share to Canada as a result of the CUSFTA.[46] Perhaps the greatest desire of the Mexicans in 1990, however, was to secure new external capital and foreign investment in order to fund a sustained economic recovery.[47] Despite expectations of an anti-American backlash, a significant proportion of the Mexican public seemed to share some enthusiasm for negotiations, even in view of their historical concerns about asymmetry and US infringements on their political and cultural sovereignty.[48] In 1991, 66% of Mexicans thought that NAFTA would be mostly good for Mexico, the highest level of support found in the three North American countries.[49] This support was due in part to the presentation of the agreement by the government as a chance for prosperity and recovery after a difficult decade. Also significant was the widespread belief among many Mexicans that NAFTA would make it easier to immigrate to the US and Canada.[50] This was ironic given that in the US, the agreement was advertised as *reducing* northward migration pressure from Mexico. President Salinas himself told Americans that NAFTA was a way "to export goods, not people" to the United States.[51]

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[45] Ostry, 27-28.
[46] Clement et al., 261.
[47] Ostry, 28. del Castillo and Canovas, 121. It must also be said that NAFTA was important for the Mexican government in that it helped to legitimate the new strategy of economic management after a string of failures by previous governments.
[48] Loaeza, 146.
[49] Castro-Rea., 92.
[50] Ibid.
[51] Orme, 316.

The NAFTA negotiations were less controversial in Mexico than in the US, and it might be tempting to conclude that of the three North American countries, Mexico would have been the most likely to also propose monetary integration in the early 1990s. It must be remembered, however, that the positive Mexican attitude toward integration with the US was a very new development, representing a new cultural outlook as well as part of the "first long-term policy toward the United States."[52] According to one author, Salinas' free trade proposal would have been "unthinkable" ten years earlier.[53] As noted earlier, a proposal for monetary integration, particularly one that threatened sovereignty, might have been as premature for Mexicans as it would have been for Canadians and Americans. While years of economic hardship seemed to leave ordinary Mexicans open to the idea of a new relationship with the North, there is nothing that suggests they were ready for farther-reaching integrative steps. Indeed, in his 1988 election campaign, President Salinas had been obliged to reject calls for a North American common market, and later took care to describe NAFTA in much narrower terms.[54]

2.4.3. The US and NAFTA

When the US agreed to enter talks leading to the CUSFTA, its motives were several. On the economic side, while the United States stood to gain generally from a more open trading relationship with its largest trading partner, access to energy supplies and the liberalization of Canadian investment rules were of particular value to the US. On the political front, the Reagan Administration was interested in subduing internal protectionist pressures that had been mounting in the 1980s. In addition, the regional

[52] Loaeza, 156.
[53] Orme, 289.
[54] Ibid.

negotiations were an alternative to the bogged-down multilateral GATT negotiations and were partly intended to remind the EC and other parties of that fact.[55]

US motivations for agreeing to trade talks with Mexico as part of NAFTA were even more political. It is true that the US was interested in entrenching freer trade, gaining access to energy supplies, opening up investment, and protecting intellectual property rights, but given the relative size of the US and Mexican economies, the potential economic impact for the US was not initially thought to be dramatic. What was more important for the US administration was to improve relations with Mexico, encourage its North American outlook,[56] and help strengthen it politically and economically so that it might serve as a model for other Latin American countries. In addition, as mentioned above, it was hoped that freer trade would stem the controversial flow of migrants across the Mexican border by creating Mexican jobs and allowing goods to move, "not people."[57] Finally, increasing regionalism in Europe and Asia had encouraged the US to develop its own economic bloc and continue with its "dual strategy" of trade negotiation.

Despite the good intentions of the Bush Administration in initiating negotiations, NAFTA ran up against fierce and well-organized opposition in the US, particularly during the 1992 Presidential election campaign. While few were concerned with the Canadian relationship, the prospect of an agreement with Mexico was not welcomed by labour unions, the agricultural industry, environmentalists, the radical Left and Right, as well as presidential candidate Ross Perot.[58] The chief arguments against NAFTA arose

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[55] Ostry, 25.
[56] Castro-Rea, 92.
[57] Ostry, 27.
[58] Wiarda, 117.

out of the disparity between the US and Mexico in terms of wages, wealth, and standards. Many were concerned that wages and standards would be forced downward in the US (the "pauper labour" argument), or that many firms would relocate their operations and jobs to Mexico, inspiring Ross Perot's memorable soundbite about a "giant sucking sound." Another popular argument was that only large businesses and providers of capital would benefit, as opposed to regular workers in either country.[59]

After criticizing NAFTA during the election debates, President Clinton oversaw the negotiation of side agreements on labour and the environment to placate certain constituencies, and ultimately submitted the agreement to Congress. After another fierce battle, NAFTA was finally ratified in both the House and Senate, with Clinton relying heavily on Republican votes.[60]

In the context of this US struggle for NAFTA which saw substantial opposition to economic integration with Mexico, it seems likely that a deeper agreement with a monetary dimension would have been even more difficult, if not impossible, to negotiate and ratify. This would have been particularly true if the monetary arrangements required increased labour mobility, collective policymaking, or supranational institutions with real power. Americans were clearly not ready for extensive moves toward formal integration with Mexico in the early 1990s, and NAFTA's defenders took care to downplay its extent. As one Congressional proponent insisted during the debate, NAFTA "is a trade agreement, not an act of economic union."[61]

2.5. Conclusion

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[59] Gibb and Michalak, 171.
[60] Eckes, 98.
[61] Orme, 289.

The preceding discussion has provided an introduction to North American integration that will be crucial to understanding the following chapters. In addition, this chapter has developed an answer to the question that was posed at the beginning: why did NAFTA not include a monetary dimension?

A number of reasons have been put forward. It was clear that from the Canadian perspective, formal integration with the US had been a long and difficult process culminating in the CUSFTA, and NAFTA itself was not necessarily a Canadian priority when it was first proposed. On the monetary front, Canada had benefited from its history of floating an independent dollar and saw little reason to change, particularly in light of its historical fears about US influence. From the Mexican perspective, although a well-sold NAFTA gained public support, formal integration with the US was a very recent policy indeed. In addition, monetary instability made Mexico an unlikely candidate for cooperative monetary integration. As for the US, it was happy to enter into negotiations with its neighbours, but NAFTA itself proved highly controversial, and the country had few pressing reasons to seek further integrative steps. Monetarily, the US was enjoying the benefits of the world role of its currency, and would have had little to gain, at least economically, from monetary integration in the early 1990s.

Together, these reasons add up to the fact that North Americans did not see monetary integration as necessary or desirable during the negotiation of NAFTA, and quite simply were not ready for it. Indeed, CUSFTA and NAFTA have been described as arising during a relatively brief window of opportunity between 1988 and 1992 when the three North American leaders not only favored integration, but also had the domestic coalitions necessary to bring about an agreement.[62] In addition, although NAFTA is a wide-ranging agreement, it falls well short of a customs union or a common market, and the trilateral institutional mechanisms it establishes are relatively weak.[63] In this light, it is not surprising that monetary integration, which can entail deeper economic and political integration, was not on the negotiating agenda.

2.5.1. 1994: North America is Not Europe

Ultimately, it seems that in the early 1990s, the NAFTA area could not be thought of in the same terms as Europe's bolder integration schemes. NAFTA's aims could be compared to those of the EFTA (European Free Trade Association) in that it created a trade area without real supranational elements, although NAFTA does contain something of an institutional framework.[64] NAFTA also featured certain complicating circumstances, such as a high degree of asymmetry and the host of concerns that go along with it. Perhaps most important, however, was that North America lacked the history, political motivation, popular support, and sense of community found in Europe to push large-scale formal integration forward, despite high levels of *de facto* integration. The European experience of war and lost international power has contributed to a willingness to pool sovereignty and push integration forward for political reasons as much as for economic ones.[65] Accordingly, European monetary integration has been a logical step on the road towards "ever-closer union." In the early 1990s, the North American countries displayed no such overriding motivations. As one integration expert wrote in 1994, "no one

[62] Cameron and Tomlin, 5. Indeed, following NAFTA's implementation, sour political conditions in the US and instability in Mexico put further integration in the hemisphere on hold, and NAFTA supporters could feel lucky that an agreement had been achieved at all.
[63] Randall, 38.
[64] Reyes in Appendini and Bislev, 168.
[65] Doran, 77.

seriously suggests that NAFTA become a currency union or that the United States, Canada, and Mexico establish a single currency . . . No such aim (at least presently) is being discussed."[66]

Some observers, however, have argued that while its political motivations may differ, North America might simply be a few steps behind Europe on the path towards economic integration.[67] Although Europe's 1957 Treaty of Rome explicitly intended not to consider monetary integration, that issue has dominated the evolution of the EU, particularly since the Werner Report of 1970. Indeed, events occurring in even the first year of NAFTA's implementation clearly demonstrated that "the monetary dimension in any integration scheme cannot be ignored for long."[68] It is to the future potential for North American monetary integration that the following chapters will now turn.

[66] Salvatore, 28.
[67] McKinney, 31.
[68] Kondonassis and Malliaris, 135.

Chapter 3: Ten Years Later

3.1. Introduction: What Has Changed?

If monetary integration was not worth considering as part of NAFTA in the early 1990s, why would it be worth discussing now? What has changed? As will be explored below, the pace of economic, political, and psychological change in North America has been rapid over the past ten years. The deepening of NAFTA in general, and the possibility of monetary integration in particular, can now be more seriously discussed.

3.2. Toward a North American Community[69]

In the previous chapter, it was argued that unlike Europe, North America has rarely been thought of as a single entity or community. We also saw that North Americans, despite experiencing high levels of *de facto* integration with their neighbours, have not always been interested in moves towards formal integration. Indeed, the NAFTA agreement was not inevitable, and had to be limited in scope in order to gain acceptance. Nearly ten years into NAFTA's implementation, however, there are signs that North Americans may be developing a growing sense of community on their continent. They have also become more open to the prospect of deeper integration, an important trend in relation to the possibility of monetary integration.

First, it must be said that the CUSFTA and NAFTA represented historic choices on the part of North Americans to embrace formal integration rather than to shy away from it. As stated by Perrin Beatty, perhaps overdramatically, the Canadian election of 1988 was "the last federal election that offered voters a fundamental policy choice about

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[69] This is the title of Robert Pastor's 2001 book on North American integration.

their country's future direction."[70] When the agreements were signed, North Americans set a converging course that would be increasingly difficult to change. For example, even if NAFTA itself was not inevitable, some authors have argued that a North American common market now is.[71]

Indeed, NAFTA laid the initial groundwork for deeper formal integration and the development of a North American community, against the fears of critics who wanted to avoid just such an end. Some point out that NAFTA's trilateral institutions for such things as dispute resolution and environmental concerns are, in effect, an embryonic NAFTA government.[72] Ironically, by insisting upon the signing of side agreements and the creation of such institutions, NAFTA's opponents may well have strengthened its integrative effects. Perhaps most significant is that NAFTA's harmonizing of economic regulations accelerates a process of increasing interdependence that may make further coordination of policies, including fiscal and monetary ones, increasingly difficult to avoid.[73] At the very least, the trilateral process of negotiating NAFTA as well as the establishment of trilateral institutions, however weak, has caused a shift toward trilateral thinking about certain North American issues.[74] To some degree, the very existence of the agreement makes the national governments more likely to think in terms of North America as a whole when considering trade and other issues of concern to all three countries.

Regardless of whether NAFTA will oblige North America to formally integrate further, recent trends suggest that North Americans are increasingly open to the idea.

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70 Hakim and Litan, 37.
71 Orme, 288.
72 Ibid., 290.
73 Orme, 290.
74 Randall, 39.

Firstly, free trade is now popular, even in Canada, where it is supported by the business community, the general public, and the once-vehemently opposed Liberal Party (now in government).[75] A more general development, however, is that North America's political, economic, and in particular, psychological reorientation that began in the 1980s appears to have continued to run its course.[76] According to recent polls, the conventional wisdom about North Americans' fears and antagonisms may increasingly be wrong. Mexicans, Americans, and Canadians all appear to like each other more than skeptics admit, and are also more like each other. A majority in all three countries would be willing to join a larger administrative entity in North America if it would improve their standard of living.[77] Increasing numbers of North Americans also see major steps toward integration as increasingly likely.[78] Indeed, some observers have argued that North Americans are much more progressive in their views on integration than are their leaders, who often "zealously guard obsolete notions of sovereignty"[79] and seem less willing to consider new ideas for integration.

This is perhaps not true in the case of Vicente Fox, the Mexican President whose election in 2000 ended 71 years of one-party rule and ushered in a new political climate in his country.[80] On his way to victory visits to Canada and the United States, Fox made public his vision for the future of NAFTA, including a common market, free migration flows, and an eventual common currency.[81] That such Reaganesque proposals came from the President of Mexico, once among the least likely of leaders to propose such moves,

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[75] Hakim and Litan, 37-39.
[76] Randall, 37.
[77] Hakim and Litan, 114.
[78] Pastor, 162.
[79] Hakim and Litan, 114.
[80] In a 1993 article, George W. Grayson (211) explored the possibility that the liberalizing process of NAFTA would have a liberalizing influence on Mexican electoral politics.
[81] Jiminez.

demonstrates the extent and the speed of change that has taken place in some corners of North America. While the grandest plans of Fox were largely rebuffed by Canada and the US (ironic in light of Reagan's own rejection in 1980), the proposals were at least injected into public discussion, and in particular were picked up by the media, academics, and think tanks.[82]

Despite their reservations about Fox' boldest proposals, George W. Bush and Jean Chrétien have also shown some interest in working on the North American project. At the Summit of the Americas in April 2001, the leaders pledged to "work to deepen a sense of community," improve upon NAFTA, and "advance the trilateral relationship."[83] While actual resources have not always matched the sentiments expressed at this and other meetings, it seems that today's leaders are more likely to have a North American perspective in mind than ever before, even if they sometimes lag behind the general public in their outlook. More important, however, is that in calling for a greater North American community, the leaders have taken the first step towards moving beyond NAFTA and into "NAFTA-plus," where issues other than just trade and investment will be up for discussion.[84]

3.3. NAFTA at Ten: Successes and Shortcomings

The years since NAFTA's initial implementation in January 1994 have seen substantial economic successes as a result of the agreement, but have also revealed its shortcomings. Taken together, however, these results suggest not only that NAFTA is worth keeping, but that it is worth deepening and improving upon.

[82] Hakim and Litan, 73-74.
[83] Ibid., 7.
[84] Hakim and Litan, 75.

On the positive side, NAFTA has overseen considerable growth in trade and investment among the three North American nations. Total trade between Canada and the US now exceeds \$450 billion annually, more than two and a half times the volume seen a decade ago. US-Mexico trade has more than quadrupled in less than ten years, and now exceeds \$250 billion per year. Canada-Mexico trade has increased fivefold to over \$9 billion annually, and the two countries have become each other's third largest trading partner behind the US and the EU.[85] Integration has clearly progressed, as all three countries substantially increased their percentage of trade conducted within North America between 1990 and 1999.[86] For example, the percentage of total Canadian exports bound for the other two North American countries increased from 75.3% to 86.4% during that period. The figure for Mexico increased from 46.4% to 86.0%, and for the US, from 28.4% to 36.2%. These increases significantly outstrip European trade integration during the same decade. North American investment flows have also increased dramatically. FDI in Mexico and Canada has nearly tripled in the wake of NAFTA and CUSFTA, as has Canadian FDI abroad, over half of which is in the United States.[87]

The individual countries all have results to be pleased with. The United States did not suffer the catastrophic job losses predicted by Ross Perot and others, instead launching into one of the most prosperous periods in its history. 20 million US jobs were created between 1993 and 1999, far offsetting any NAFTA-related adjustment costs.[88] After recovering from a slow start in the first half of the 1990s, Canada had also

[85] Figures from Hakim and Litan, 4-5.
[86] Figures from Pastor, 10.
[87] Ibid., 71-72.
[88] Ibid., 69.

benefited substantially by the late 1990s. In addition to increased trade and investment, economic data suggest that Canada was experiencing significant gains in productivity as a result of free trade as early as 1996.[89] While as a developing country it still remained behind its northern neighbours, Mexico also appeared to have benefited from NAFTA by the end of the decade, with increased trade and investment leading to strong economic growth and new stability.

Before beginning to enjoy NAFTA's benefits, however, Mexico suffered a major setback that highlighted some of the agreement's shortcomings. While the Peso Crisis of 1994 arose partly out of NAFTA's successes (in terms of liberalized trade and capital movements), it highlighted the lack of a North American framework or institution to monitor or respond to such problems.[90] The fact that NAFTA neither included any mechanisms to promote monetary stability, nor any means to deal with instability, was apparent. Mexico suffered severe economic damage, including the loss of a million jobs and the failure of major banks. The US was obliged to provide the lion's share of a $53 billion international bailout package in which Canada was also involved, demonstrating the geopolitical necessity of assisting their southern neighbour in a crisis. Mexico was on the road to recovery by the late 1990s, aided by NAFTA's liberalization. However, the crisis had demonstrated the general point that while NAFTA had opened up trade and investment, it had developed few means to deal with the economic, social, and political consequences.[91] More specifically, the crisis demonstrated, as mentioned earlier, that "the monetary dimension in any integration scheme cannot be ignored for long."[92]

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[89] Trefler.
[90] Pastor, 5. Clement, 284.
[91] Pastor, 5.
[92] Kondonassis and Malliaris, 135.

This combination of success and failure in the story of NAFTA does not lead one to conclude that the agreement should be scrapped. Rather, on the whole, NAFTA has achieved its aims and has resulted in a net benefit for all three countries and many individual North Americans. However, if the agreement is to be kept, few would disagree that it can and should be improved, if not deepened in the coming years.

3.4. Why Monetary Integration?

If NAFTA is worth deepening and improving upon, what developments might suggest that monetary integration in particular is now worth discussing?

To begin, the last five years have seen a flurry of academic discussion on exchange rate regimes not experienced since the end of the Bretton Woods system in the 1970s.[93] This trend has been motivated largely by the string of financial and exchange crises occurring in the last decade, including the European ERM crisis of 1992, the Mexican crisis of 1994, the far-reaching Asian crisis of 1997, and Argentina's difficulties in 2002. While worldwide monetary arrangements have been of interest, a number of papers have focused specifically on the prospect of monetary integration in North America. This appears to have come about for a number of reasons. First, as has been mentioned, the Mexican crisis of 1994 demonstrated that monetary issues potentially bear addressing within the North American framework. Second, the introduction of the Euro in 1999 dramatically turned academic attention toward the monetary possibilities in the NAFTA area.[94] Third, certain leaders in the Western hemisphere (most notably Fox in

[93] Laidler (December 1999), 3.
[94] Courchene (2001), 1.

Mexico) have shown interest in some form of monetary integration.[95] Fourth, there is some evidence to suggest that unofficial use of US dollars is on the rise, both in Mexico and Canada.[96] Fifth, the fluctuation and long-term downward trend of the Canadian dollar (as well certain economic weaknesses relative to the US) has led several economists in that country to question the value of Canada's float. Sixth, North American citizens appear to be increasingly open to the idea of monetary integration.[97] Finally, as will be discussed in the next chapter, the economic case for monetary integration in North America may have improved since 1994, with all three countries demonstrating increased macroeconomic convergence, for example. For these reasons, discussion of changes to North America's monetary arrangements has begun to take place, not only among academics, but also among politicians and within the general public.

3.5. What is Monetary Integration?

Before proceeding to an in-depth discussion of the economics and politics of "monetary integration" in North America, it is necessary to clarify exactly what is meant by that term. Essentially, monetary integration is the process of reducing or eliminating exchange rate movements between countries. As can be observed among the various nations of the world, potential exchange rate regimes fall along a continuum ranging from entirely flexible to entirely fixed. The more fixed are exchange rates between two countries, the less scope there is for exchange rate movements, and the higher is their level of monetary integration.

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[95] Murray, 2.
[96] Pastor, 115.
[97] Hakim and Litan, 55.

On the entirely flexible end of the exchange rate continuum, a country allows its currency to float freely and does not attempt to influence its value in relation to other currencies, except perhaps to moderate excessive fluctuations. This fully-floating model is currently in place in Canada, where the monetary authorities target the rate of inflation almost exclusively. At the other end of the exchange rate continuum are fully fixed exchange rates. The most extreme case is a full currency union, where exchange rates cease to exist as only one currency circulates among member countries, and where monetary authority resides in a supranational central bank. This arrangement currently exists in Europe's Economic and Monetary Union (EMU). According to these examples of exchange rate regimes, Canada has a low level of monetary integration with its neighbours (if we assume for the time being that Canadians do not unofficially use their neighbours' currencies or vice-versa), while the countries of the EMU are highly integrated in the monetary realm.

Finally, monetary integration must be distinguished from financial integration between countries. Financial integration has to do with flows of money and investment across borders, and is measured by the percentage of a country's total assets and liabilities which are in another country. For example, while the North American countries have a low level of monetary integration in that their exchange rates are floating, they are highly financially integrated, experiencing massive annual cross-border flows of investment in an environment of unrestricted capital movement. Europe, on the other hand, is highly integrated monetarily, but is less financially integrated than the NAFTA area. North America's high level of financial integration forms part of the reason why

Canada, the US, and Mexico have avoided moves toward exchange rate fixity in recent years, as will be discussed below.

3.5.1. What are the Options?

If countries that are currently floating their currencies, such as Mexico and Canada, seek to increase their level of monetary integration with the United States, what might their options be? Any move toward the fixed end of the exchange rate continuum would be a move towards monetary integration, although some options would be more attractive than others. Of the many potential degrees of exchange rate stabilization that exist along the continuum, the main options will be briefly discussed below.

Exchange Rate Pegs. Canada and Mexico could choose to link their currencies to the US dollar by making a declaration that their central banks will intervene in the foreign exchange market to defend a chosen exchange rate.[98] The exchange rate might be allowed to fluctuate within a range of 1 or 2 percent, but otherwise the currency values would be stabilized. Such a regime has been employed by Canada and Mexico in the past, and many small countries currently use this means of anchoring their exchange rate to the currency of a large economy. According to most definitions, pegs fall short of full fixing in that they do not necessarily involve the unswerving commitment of monetary and fiscal policy, nor are they irreversible. Partly as a result of these characteristics, pegged exchange rates can invite speculative attacks when capital mobility is high and financial integration is deep (as it is in NAFTA) and can result in crises. This scenario was among Mexico's economic difficulties in 1994.

Fixed Exchange Rates. A fully fixed exchange rate regime requires not just a commitment on the part of monetary authorities to defend a non-adjustable rate, but it

[98] Courchene and Harris (1999), 17.

also requires the full commitment of overall monetary policy, and ideally fiscal policy as well. National interest rates are thus mainly determined by the exchange rate. Like pegged rates, fixed rates can also lead to trouble when capital is mobile. The fact that the fix is not meant to be easily reversed can result in crisis if monetary authorities fight unsuccessfully to defend it. In order for it to be viable, countries like Canada and Mexico would have to make the fixed exchange rate regime a cornerstone of their national economic policy, persuading international capital markets to view them as credible and lasting extensions of the US dollar area.[99]

Currency Board. Further toward the fixed end of the exchange rate continuum is a currency board arrangement. A currency board is an institution that backs all domestic currency with foreign currency, and stands ready to buy and sell at a fixed rate. In effect, a currency board arrangement is a fixed regime, but with "institutional cement" and the intention that the fix will not be reversed under any foreseeable circumstances.[100] Control over monetary policy is all but lost as the central bank serves little purpose. Currency boards can also lead to crises if the fixing country does not have the wealth and liquidity required to keep the system operating smoothly.[101] Argentina's troubles provide a recent example of a currency board failure. Some have suggested that in addition to pegging and fixing, a currency board could be an intermediate step toward a single currency. In an environment of mobile capital and deep financial integration, however, a gradual strategy would be difficult to implement.

Dollarization. The term "dollarization" is often used loosely. It refers to the use of a foreign country's currency in one's own country (usually the US dollar in the

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[99] Ibid., 19.
[100] Ibid., 20.
[101] Forsyth, 15 May 2003.

Americas). However, a distinction must be made between "market dollarization" and "policy dollarization." Market dollarization occurs when individuals and businesses simply begin to use foreign currency in their dealings, with the effect of reducing the significance of the national currency. Unofficial parallel use of the US dollar occurs in many countries. Policy dollarization occurs when the government makes an explicit decision to adopt a foreign currency, using it as the standard currency in public sector dealings and potentially ceasing to issue national currency.[102] Panama has been operating with the US dollar since 1904. Countries like Mexico and Canada could also make such a policy decision if they so wished, largely independent of the views of the United States. Such a course of action would eliminate the potential for a foreign exchange crisis, but it would also end the need for a central bank, leaving the dollarizing country with neither monetary policy control nor the crucial "lender of last resort" function, as will be discussed further in the next chapter.

Currency Union. In contrast to policy dollarization, currency union is a cooperative endeavour between countries in which the central bank is supranational, issuing a single currency for the whole currency area and taking the monetary policy needs of the whole area into account. Previously existing national currencies are abandoned, as has been done in Europe's EMU, and all transactions begin to be conducted in the new currency. Member countries also share in the seigniorage benefits from issuing currency. This arrangement provides the benefits of a single currency while allowing a country to "pool" its monetary sovereignty instead of giving it away under a dollarization scheme. National central banks could continue to exist but would undertake

[102] Forsyth, 15 May 2003. Courchene and Harris, 20-21.

a more regional function, along the lines of the 12 Federal Reserve banks in the United States currency area.

3.5.2. The Real Option: A Single Currency

Of the options for monetary integration described above, the discussion in the following chapters will be concerned with the potential for a *single currency* in North America; that is, policy dollarization or currency union. Both advocates and opponents of monetary integration in North America now see a single currency as preferable to some type of fixing, providing the potential benefits of currency stability with fewer of the economic dangers that have recently been demonstrated in Mexico and other countries. In NAFTA's environment of mobile capital and deep financial integration, pegged or fixed rates would be difficult to sustain, even as temporary measures.[103] If floating rates are abandoned, a single currency exists as the only realistic long-term option for significant monetary integration in North America.[104]

[103] Europe's Exchange Rate Mechanism (ERM) proved difficult to sustain, and levels of financial integration were significantly lower between the European countries at that time than they are in today's NAFTA area. Forsyth, 15 May 2003.
[104] The increasing unpopularity of partially fixed exchange rate regimes has been described in the economic literature as a "hollowing out" of the middle of the exchange rate continuum. Corden, 18.

Chapter 4: The Economics of a Single North American Currency

4.1. Introduction

In discussing the possibility of a single North American currency, a close examination of the economic issues is required. Setting aside the political aspects for the moment, how economically desirable is it for North America to use just one currency? If countries like Mexico and Canada are to consider abandoning their existing currencies, they will need good reasons for doing so. This chapter will discuss the potential benefits, and then the costs, of such an arrangement, in order to contribute to an emerging picture of NAFTA's monetary options.

4.2. The Potential Economic Benefits of a Single North American Currency

The move to a single currency in North America has the potential to bring about certain economic benefits and efficiency gains in the three national economies. Herbert Grubel has usefully divided the range of potential benefits into static gains, which arise directly out of the elimination of exchange rates, and dynamic gains, which accompany the process. Finally, there are additional gains which require discussion.

4.2.1. Static Gains

Interest Rates and Exchange Risk. A single currency in North America could have the effect of lowering interest rates, particularly for Mexico, and potentially for Canada. Interest rates on long-term government bonds often differ between countries as a result of factors such as currency risk, exchange rate fluctuation, risk of debt default, and bond liquidity. For example, investors have over several decades demanded an average one percent premium above US interest rates to invest in Canadian dollar-denominated assets.[105] Much more significant and costly has been Mexico's interest premium, exceeding 10% as recently as 1999.[106] By eliminating exchange risk, increasing stability, and reducing inflation differences between the three countries, a common North American currency could result in interest rate convergence. If interest rates fall in Canada,[107] and particularly in Mexico, it could encourage business investment and long-term planning, increasing productivity (though reducing saving).[108] Housing investments may also increase as the cost of borrowing is reduced. Over time, the cumulative effects of lower interest rates as a result of monetary integration could be of substantial benefit to Mexico.

Foreign Exchange Dealings. A single currency in North America would reduce the risk and volume of currency exchange, as well as trade in risk-reducing financial instruments. Currency dealings consume a certain amount of time and energy as well as capital and highly skilled labour. A single currency would mean that resources formerly devoted to North American currency exchange would be free to shift to the production of other goods and services in the economy.[109] However, in an era of high technology where currency exchange is handled efficiency in a few financial centers, the real savings from a single currency must not be overstated. More significant is the cost of currency exchange charged to businesses and consumers by banks and other institutions. As

[105] Grubel, 9-10. Kevin Clinton has attributed the bulk of this effect to the risk of Canadian currency depreciation. 17.
[106] Chriszt, 33.
[107] Laidler and Poschmann doubt that the benefits for Canada would be extensive. 8.
[108] Chriszt, 33.
[109] Grubel, 8. The European Commission's 1990 Report on currency unification estimated (optimistically) foreign exchange savings of 0.3 to 0.4 percent of European income as a result of currency unification, though more currencies stood to be eliminated in Europe than in North America. A recent sensible estimate put the potential savings on $9.7 trillion (CAD) worth of US/Canadian dollar trading in 2001 at approximately $2.9 billion, or 0.26% of Canadian GDP. Robson and Laidler, 4.

pointed out by Paul De Grauwe, the cost of exchanging money is a deadweight loss and acts as a tax for which the consumer receives nothing.[110] With a single currency, such charges would be eliminated in the NAFTA area.

Price Stability. Price stability includes not just low inflation, but also minimal fluctuations in the price level as a result of disturbances in trade and output. It is known that price stability encourages economic growth and efficiency because it increases the usefulness of money, and there is a theoretical argument that the larger a currency area is, the more stable is its price level.[111] The reason is that a larger currency area includes more regions and allows for greater economic diversity, dampening the effect on the price level of a shock to one sector. If this effect is significant, Mexico and Canada could conceivably benefit from linking their currency to the much larger and more diverse US economy. There is little empirical evidence to support this notion, however, and it should be noted that price level fluctuations need to be significant in order to damage growth and efficiency to any great extent.[112] In addition, the loss of a flexible exchange rate could actually result in *greater* movements in the domestic price level by removing an adjustment mechanism.

4.2.2. Dynamic Gains

Beyond the static gains that North America might realize through a single currency, there is also the potential for dynamic gains in efficiency, growth, and competitiveness following such a transition. However, estimates of their magnitude vary widely and economists often disagree on their significance. Several examples of potential dynamic gains are discussed below.

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[110] De Grauwe, 61.
[111] Grubel, 10-11.
[112] Forsyth, 15 May 2003.

Expansion of Trade. It is known that country borders affect trade flows. Even when international trade restrictions are minimal, regions of the same country tend to trade substantially more with each other than they do with a neighbouring country.[113] While estimates vary, a recent study by Anderson and van Wincoop argued that international borders reduce trade among industrialized countries by 30%, and by 44% between Canada and the United States in particular.[114] Among the costs associated with international borders is the existence of separate currencies, and many economists are curious about the potential for trade expansion as a result of currency unification.

More than a dozen recent studies have attempted to estimate the trade effects of moving to a single currency. The results have been shockingly inconsistent. Depending on the methods and data used, estimates have ranged from negative trade growth to as much as 290% in a widely-cited (and criticized) study by Frankel and Rose.[115] Those authors concluded that increased trade and the resulting increase in per capita income was the most compelling reason to pursue currency union. Early evidence from the Euro area is less dramatic, but also inconsistent. While Rose and van Wincoop found a 59% increase in intra-European trade since the advent of the Euro, de Souza found no such consistent trade effects yet occurring.

Among the most recent research, the consensus appears to be that a significant positive trade effect from currency union is likely to exist, though exact figures are still difficult to come by. A June 2003 report released by the UK Treasury concluded that EMU has intensified trade within the Euro area, with an increase of between 3% and 25%

[113] Alesina et al., 5.
[114] Anderson and van Wincoop.
[115] See Appendix Table 8 in Alesina et al. for a list of estimates from recent studies.

since 1999, depending on the specific study cited.[116] The potential trade gain for the UK as a result of joining the EMU was estimated to be between 5% and 50%. These estimates remain rough, however, and the Euro area has the potential to shed more light on the question of trade gains as better data becomes available in the next few years.

What *is* clear is that whatever the potential gains in trade may be, they will grow in accordance with the level of trade integration in a region. Given the massive volumes of trade conducted in the NAFTA area, the North American countries may stand to gain substantially from even a modest trade-enhancing effect of currency unification.[117] It has been suggested that on the basis of existing trade patterns, NAFTA under one currency would be substantially more open than the Euro area.[118]

Structural Adjustment. Flexible exchange rates can also interfere with structural adjustment and productivity growth in an economy. For example, falling world commodity prices tend to lead to depreciation of the Canadian dollar. This effect protects commodity producers from having to respond with increased efficiency. In addition, mobile capital and speculation results in exchange rate fluctuation, confusing price signals and further delaying adjustment within industries.[119] The result is that the economy fails to make optimal gains in productivity and fails to move resources away from commodity production and into growing and more profitable sectors such as high technology. There is also some evidence to suggest that slowdowns in manufacturing

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[116] HM Treasury, 3.
[117] It should also be noted that if gains in trade do prove to be substantial following the implementation of a single currency, they may be a "one-off" effect, beginning to tail off after an initial period of adjustment, as was observed after the implementation of NAFTA. Forsyth, 15 May 2003.
[118] Masson and Taylor, 13. Other authors, however, have pointed out that the existence of flexible and even volatile exchange rates in the 1990s did not prevent the explosion of North American trade in the wake of NAFTA. McCallum, 7.
[119] Grubel, 14.

productivity growth are linked to periods of exchange rate depreciation.[120] Further, it has been suggested that in the 1990s, Canada may have missed out on much of the high-tech productivity gains experienced in the US as a result of its undervalued dollar.[121] Generally speaking, the elimination of North American exchange rates (like the elimination of trade barriers) has the potential to force greater competitiveness and productivity, resulting in higher living standards in the integrating economies.

Price Structure. A single currency could also potentially result in a more efficient price structure throughout North America.[122] It is commonly known that the prices of identical products in two neighbouring countries can be significantly different, even on major products under minimal trade restrictions.[123] While price discrepancies can have several causes, the greater question is why they continue to exist when distances and languages should not be a barrier to arbitrage by consumers. In theory, different currencies can complicate price comparison. By making prices transparent in addition to eliminating transaction costs, a single currency can not only increase trade but might also help to equalize the prices of consumer goods across an area, forcing inefficient retailers to either become more efficient or exit the market.[124] There can also be an incentive for countries to end supply-management practices and to lower or harmonize taxation.[125]

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[120] The "lazy manufacturer hypothesis". For counterarguments in the Canadian case, see McCallum, 7 and Murray, 19.

[121] Courchene and Harris (1999), 9. Murray (20) has disputed the extent to which Canadian exchange rate trends have affected productivity, and the extent to which a common currency would help productivity. Also: Robson and Laidler, 10.

[122] Hufbauer (2000) has argued that price divergence in North America is substantial, and if reduced as a result of integration, could be the source of significant gains in Mexico and Canada. 4.

[123] Grubel, 11. De Grauwe, 63. The causes of such differences can be price discrimination, differences in taxation, the organization of markets, unionization, and efficiency in retailing.

[124] HM Treasury, 1.

[125] Grubel, 11-12. The lowering of taxes and the ending of supply-management practices are favourable from a classical economic standpoint, although the political left and those in favour of a redistributive model would perhaps be less enthusiastic.

North American consumers could gain from increased efficiency and lower prices, while the economies could gain generally from increased competitiveness and dynamism.[126]

Labour Market Discipline. A contentious idea is that a single currency may result in "increased labour market discipline", as was optimistically suggested in 1990 by Europe's Delors Commission. While this argument might apply more to Canada than to Mexico or the US, it has been suggested in the past that the effect of unions on wages and prices can be mitigated by currency union. In Canada, where unionization stands at around 35%, certain economists have argued that when currency depreciations have boosted export profits, unions have bid wages up, regardless of actual increases in productivity.[127] In theory, a currency union might help to end this cycle by eliminating exchange rate protection of industries and forcing greater competitiveness. If this effect exists, however, it is likely to be limited, and there is not yet any convincing evidence to suggest that a common currency has increased labour market discipline in the Euro area.[128]

4.2.3. Other Gains

Credibility and Stability in Monetary Policy. When several countries move onto a single currency, their inflation rates may begin to converge. For countries that have had difficulty in controlling inflation, monetary integration with a large, low-inflation economy can provide benefits in terms of microeconomic efficiency and overall stability.[129] While Canada's inflation record has been admirable over the past decade,

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[126] Kern. HM Treasury, 1. The jury is still out on Euro-induced price convergence in the Eurozone. Some observers have pointed out that internet marketing may also contribute to price convergence in coming years. Krugman and Obstfeld, 627.
[127] Grubel, 13-14.
[128] Forsyth, 15 May 2003.
[129] Masson and Taylor, 5.

Mexico's has only recently come under control. The move to a single currency would prevent future relapses and ensure credibility, assuming the central bank (either the US Fed in the case of dollarization or a supranational bank in the case of currency union) maintains a commitment to price stability. A related point is that in implementing just one monetary policy throughout the whole region, individual countries are unable to undertake politically-motivated adventures in monetary policy.[130] In both Canada and the United States in the 1970s, and more recently in Mexico, inflationary monetary policies resulted in economic pain. The move to a single currency, particularly a currency union with a properly isolated central bank, would reduce the likelihood of such occurrences in the future.

Fiscal Responsibility. It has been argued in the past that a single currency could bring about more responsible fiscal policies in a region such as North America. The adoption of a single currency alone is unlikely to impart fiscal discipline,[131] and may in fact cause the opposite. Discipline would thus have to arise through the implementation of rules regarding budget deficits and debt. This is the purpose of the EMU's Stability and Growth Pact (SGP). If observed, such rules can provide discipline for governments that might otherwise be tempted to borrow excessively, as has been the case in Canada and Mexico's past, and may now be the case in the United States. However, countries with different economic characteristics cannot necessarily accept both a common monetary policy and constrained fiscal policy at the same time. This arrangement is currently causing serious economic and political difficulties in the Euro area, where the president of the European Commission has gone so far as to call the SGP "stupid." If the

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[130] Grubel, 14-15.
[131] Crow, 31.

SGP continues to create headaches in Europe, a North American single currency area might be very unlikely to adopt such fiscal rules.

Confidence. Related to the above points about monetary and fiscal stability is the issue of investor confidence in a currency. When Mexico has run into severe difficulties with inflation and debt in the past, international confidence in the peso has disappeared, sending its value plummeting along with the international living standards of the Mexican people. A major incentive for Mexico to seek a single North American currency would be the confidence that it would command in comparison to the peso, resulting in a greater influx of capital and long-term investment. Canada might also receive modest gains in terms of confidence from a single currency, as the "second-tier" status of its dollar currently makes it more susceptible to speculation than the major world currencies.

4.3. The Potential Economic Costs of a Single North American Currency

While a single currency in North America could provide certain benefits, it could also impose serious costs on the economies of Canada, the United States, and Mexico. These potential costs will be discussed below.

4.3.1. Optimal Currency Area Criteria: Does One Size Fit All?

Major economic costs could arise in a North American single currency arrangement if it is simply not appropriate for one or more of the countries to share one currency and one monetary policy with the other countries; in other words, if "one size does not fit all." This point relates to the theory of Optimal Currency Areas (OCAs), around which a substantial economic literature has built up since Robert Mundell first introduced the concept in 1961. At that time, Mundell asked what the appropriate geographical domain for a single currency (or fixed exchange rates) might be, given that both the flexibility of exchange rates and independent monetary policy are no longer available to protect an area from asymmetric shocks, or economic shocks that affect it differently than its neighbours. Since Mundell's original work, economists such as McKinnon and Kenen have helped to develop a set of criteria for determining whether several regions do in fact comprise an optimal currency area. These criteria can be divided firstly into those which affect the nature of shocks to a region, and secondly, those which affect how such shocks are absorbed. These criteria will be discussed below as a means of assessing the potential economic costs of a single currency in North America.

4.3.1.1. Shocks in North America

Shock Asymmetry and Diversification. Assessments of shock asymmetry in North America, like the estimates of trade expansion as a result of currency union, have varied over time and depend on the methods used. In 1994, for example, Bayoumi and Eichengreen found major differences in supply shocks between the United States on one hand and Canada and Mexico on the other, concluding that the three countries "would have to undertake very major adjustments in policy and performance in laying the groundwork for monetary union."[132] Other studies have highlighted the value of flexible exchange rates for Canada and Mexico, given their large primary goods sectors relative to

[132] Bayoumi and Eichengreen, 35. These authors took special care to use methods that did not conflate the effects of shocks and responses. Studies that look purely at output or other criteria do not necessarily avoid this complication.

the US, and low observed correlation between supply and demand shocks, business cycles, and terms of trade movements in the NAFTA area.[133]

Other studies of shock asymmetry have been somewhat more favourable to the idea of a single North American currency. Michelis' methods found that Canada and the US likely comprise an OCA on the basis of shock similarity and business cycles, while Mexico has not yet converged sufficiently to make all of NAFTA an OCA.[134] Chriszt agreed that both the US and Canada responded similarly to economic shocks (with a caveat about deep swings in global commodity prices) while Mexico responds differently, partly due to its oil exports and vulnerability to international interest rate movements.[135] Past US-Canada correlation also exceeds that which is found in much of Europe.[136] In addition, advocates of a common currency in North America argue that the increasing north-south organization of economies on the continent makes the east-west organization of exchange rate regimes less useful in dealing with shocks.[137]

While there is no firm consensus among economists on the issue, it seems that in terms of shock asymmetry, the NAFTA area does not form an obvious OCA at the present time. Although the economies are not totally dissimilar, the importance of primary goods in the economies of Mexico and Canada seem to continue to play a role in

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133 White, 24. Lalonde and St-Amant. DeSerres and Lalonde. Murray, Schembri, and St-Amant, 1, 11. Murray, 9.

134 Michelis, 10-18. Among other things, Michelis found a correlation between Canadian and US GDP growth rates of 80.1%. The correlations for US-Mexico and Canada-Mexico were -6.6% and 15.7%. The fact that Canada-Mexico shows a higher correlation is likely due to the relatively larger primary goods sectors in those countries.

135 Chriszt, 30-31.

136 Beine and Coloumbe, 7. This should perhaps be qualified by the observation that North American business cycles have been somewhat divergent since the US downturn that began in 2000.

137 Courchene and Harris (1999), 12. Beine and Coloumbe point out that the heterogeneity of economic structure and business cycles across Canadian provinces means that some regions benefit more from a flexible exchange rate with the US than do others. They conclude that Ontario and Quebec could benefit from a fix with the US. 7. Murray, on the other hand, has pointed out that the response of national economies as a whole is what matters, given the existing national boundaries. 11-15.

distinguishing them from the United States. The fact that the NAFTA area experiences some shock asymmetry at the present time does not necessarily mean that it always will, however. Affecting how economies respond to shocks is their level of industrial diversification. The more diverse is a national economy, the less is the effect of a shock to a particular sector on the economy as a whole. Accordingly, the more diverse an economy is, the less is its need for exchange rate flexibility. It should be noted in the North American case that, firstly, the significance of the primary goods sector in Canada and Mexico is decreasing over time,[138] and secondly, the increased trade and financial integration brought about by NAFTA may accelerate this process.[139] Thus, in coming years, we might expect to see shock asymmetry decrease in North America. At the same time, however, it must be noted that increasing integration and the reduction of barriers to trade also results in specialization, which could lead to new shock asymmetries in North America.[140]

Openness and Regional Interdependence. Already discussed is the idea that more trade within a region may result in greater gains as a result of a single currency. McKinnon has also shown that flexible exchange rates are most useful to relatively closed economies in maintaining external balance and internal price stability. Very open economies, on the other hand (those with a large tradables sector), can make good candidates for fixed exchange rates, or currency union, with their major trading partners. While the Euro area is considered to be internally open, the NAFTA area is substantially

[138] The contribution of services to Canada's GDP rose from 56% in 1986 to 67% in 1996. Masson and Taylor, 15 and Buiter, 21. Buiter points out that Canada is "overwhelmingly" a service economy and is not particularly different from other industrial nations in terms of the significance of agriculture and other primary industries. 21.

[139] Michelis, 18. Murray et al., 33.

[140] Masson and Taylor, 16. If specialization occurs, its effect on the symmetry of shocks can depend on the extent to which increasing trade is intra-industry or inter-industry. Specialization through intra-industry trade can allow economies to remain diversified overall.

moreso. Recent data show openness and trade concentration within North America to be very high, having increased rapidly since NAFTA's implementation.[141] If openness and regional interdependence were the only criteria, Mexico and Canada could make good candidates for currency union with the US. Many other criteria must be taken into account, however.

4.3.1.2. Shock Absorption in North America

If a geographic area suffers from asymmetric shocks, as North America appears to, it is still possible for the area to use a single currency if certain mechanisms can absorb the effects of the shocks in the absence of flexible exchange rates. The potential for shock absorption in North America will be discussed below.

Capital Mobility. Capital, along with labour, is a factor of production that can move between regions to absorb asymmetric shocks when exchange rates are unable to, as would be the case under a single North American currency. In the NAFTA area, capital mobility is quite high and can assist in regional adjustment, though a distinction must be made between financial and physical capital. Financial capital in North American now flows easily to where it is needed on the continent (at least in times of stability), although smoothing through credit and capital markets is higher within the North American countries than between them.[142] Physical capital, on the other hand, such as plant and equipment, moves a good deal slower than financial capital, and responds to differences in regulations, taxes, and culture, in addition to exchange rate risk.[143] While NAFTA has eased the movement of physical capital in North America, it still cannot

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[141] Data from 1998 put total trade as a percentage of GDP at 67.1% and 63.7% for Canada and Mexico, respectively. Also in that year, 77.5% of Canada's trade and 81.0% of Mexico's trade was conducted with the US. Williamson, 5.
[142] Antia, Djoudad, and St-Amant.
[143] Masson and Taylor, 10.

respond quickly to shocks, and persistent regional disparities (even within countries) demonstrate that it is insufficient to eliminate significant differences in development. In general, however, North American capital mobility is high and might even be improved under a single currency, though additional mechanisms would be required to accommodate the loss of exchange rates.

Labour Mobility. Another important adjustment mechanism is labour mobility, or the ability and propensity of workers to relocate in response to shifts in demand and economic conditions. In North America, labour mobility within countries is considered to be significantly higher than within the Euro area,[144] and mobility *between* the countries would also be very high were it not for the administrative barriers which exist. Few cultural barriers exist between Canada and the US,[145] and a certain amount of labour mobility does take place between the two countries, particularly among the highly-skilled, whose movements were liberalized by NAFTA. Between Mexico and the US, the cultural differences which exist are more than overcome by the inequality between the two countries and the ease of assimilation into US Latino communities, which together produce a great deal of northward migration pressure. This issue is highly contentious in the US, which already treats North American migration asymmetrically: NAFTA imposes quotas on the movement of Mexican professionals into the US, but not on Canadians.

It thus seems that the US will be slow to embrace open borders in the near future,[146] a fact which is compounded by security concerns in the post-September 11

[144] Blanchard and Katz. Lafrance and St-Amant, 12.
[145] Only unilingual Quebecois would consider language to be barrier to Canada-US labour mobility. Differences in the provision of government services between the two countries may also have some effect.
[146] Crow, 33.

environment.[147] If borders are to be opened in North America, Mexico may not only have to experience substantial real convergence with its northern neighbours in order to reduce migration pressures, but may also be required to guarantee the security of its borders.[148] Thus, any near-term currency union in North America might lack full labour mobility. Although such an arrangement might be sub-optimal, it may still be feasible,[149] particularly if other mechanisms can help to accommodate the loss of exchange rates.

Wage/Price Flexibility. If exchange rate flexibility is lost, movements in North America's wages and prices could also potentially act as an adjustment mechanism. However, different countries experience different levels of stickiness in their wage/price movements. All other things being equal, a country with greater nominal wage/price flexibility is a better candidate for exchange rate fixing with a neighbour. Although accurate data on wage/price rigidities in different countries is hard to come by, North America is generally considered to have greater flexibility than Europe,[150] which suffers in particular from sclerotic labour markets. Wage/price rigidity in a country like Canada could pose an obstacle to currency union, although Canada (with its higher rates of unionization and lower rates of inflation) may well have the greatest rigidities of the three North American countries. Also unclear in the academic debate is the extent to which a single currency might result in greater wage/price flexibility.[151] As discussed earlier, the hope for greater labour market discipline (and thus more wage/price flexibility) has yet to

[147] Robson and Laidler, 25. De La O, 15. In June 2001, the US was showing some interest in harmonizing border controls and relaxing migration policies in North America. Following September 11, however, those ambitions were set aside for the time being.
[148] De La O, 16.
[149] Harris quoted in Dobson, 8. Harris points out that full labour mobility may not be essential, even in a North American common market, although more mobility would result in greater efficiency gains.
[150] Ragan, 44.
[151] Robert Mundell, among others, has argued that currency union might loosen prices and wages through deregulation, while Milton Friedman disagrees, suggesting that wage and price rigidity is a fundamental characteristic of economic behaviour. Ragan, 44.

be realized in the Euro area. To some extent, unions in Europe may even have become more militant in order to protect themselves following the Euro's implementation.[152]

Fiscal Stabilization and Redistribution. Another mechanism through which asymmetric shocks and regional disparities can be smoothed is fiscal transfers. Within countries, automatic taxes and transfers shift funds between regions of high and low prosperity, while discretionary transfers can serve the same function. In the United States, fiscal transfers may cushion over one-third of the effect of regional shocks on income.[153] Substantial stabilization effects exist in Canada as well, where a provincial equalization program also aims at long-term redistribution.[154] In addition, regional governments can be vital to the adjustment process. In Canada, the substantial role of provincial governments and their ability to run deficits serves an important smoothing function.[155]

However, the success of a single North American currency could depend on the potential for fiscal smoothing *between* countries. At present, there is virtually no means for fiscal transfers across North American borders, and the portion of cross-country shocks that are unsmoothed by capital and credit markets could pose a substantial problem.[156] Although some have argued that a supranational fiscal system may not be required in North America if national and regional fiscal authorities can carry out the necessary smoothing,[157] it seems likely that some kind of supranational system would

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[152] Forsyth, 30 June 2003.
[153] Masson and Taylor, 26.
[154] Lafrance and St-Amant. Masson and Taylor, 27. Pastor has pointed out that Mexico's fiscal arrangements are less effective than those of its northern neighbours. 38.
[155] Masson and Taylor, 27. Beine and Coloumbe have also found that while the Canadian equalization system has contributed to the substantial reduction of disparities in Canada over the years, its effectiveness has been reduced, and it now may contribute to disparity by discouraging labour mobility.
[156] Antia, Djoudad, and St-Amant, 18. At the same time, however, the researchers found greater consumption smoothing between Canada and the US through credit and capital markets than occurs across the OECD or Europe, according to results produced by Sorensen and Yosha.
[157] Buiter, 27.

need to be established. The political obstacles to such an arrangement are daunting, given that even Europe has had great difficulty in agreeing on the transfer of funds between countries.

Beyond the scope of cyclical smoothing is the longer-term issue of structural change and redistribution. The NAFTA area is marked by substantial disparities in wealth and development between the US and Canada on one hand, and Mexico on the other. Even if a North American currency union does not include supranational fiscal smoothing of shocks, it may be desirable to set up an arrangement that facilitates transfers to Mexico for the purposes of structural adjustment. As will be discussed below, the faster that Mexico can "catch up" with its Northern neighbours, the more efficient a single currency would be. To some extent, this is the idea behind the European Structural Funds which target regions in need of assistance.

4.3.2. Other Costs

While the North American countries could suffer serious costs if "one size does not fit all," they could also incur other direct costs as a result of altering their monetary regimes.

Seigniorage. Seigniorage is the revenue that governments gain as a result of issuing currency. This includes direct gains as a result of issuing currency, the savings on the government interest bill, and the potential gains from the inflation tax. For Canada and the US, the value of seigniorage is small relative to the size of their economies, though it has been more significant for Mexico.[158] In general, adoption of the US dollar

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[158] Buiter, 8-9. Robson & Laidler, 12. In Canada, the seigniorage yield was only 1.3% of federal tax revenue is 2000-2001.

by Canada and Mexico would involve forgoing seigniorage.[159] In a currency union, on the other hand, all countries could potentially retain some of the seigniorage revenue, and their central banks could be responsible for issuing the new currency as part of the arrangement. Mexico and Canada could gain from a negotiated sharing of revenue in a currency union, given that US seigniorage is very large as a result of the dollar's international status.[160] In any case, while they are a factor, seigniorage issues would be comparatively easy to resolve in a move to a single currency.

The Lender of Last Resort. A crucial role of central banks is the ability to provide funds to financial institutions when the potential for a liquidity crisis exists. This "lender of last resort" (LOLR) function, if managed prudently, is vital to the stability of a country's financial system. If Canada and Mexico were to simply adopt the US dollar, however, they would give up this function. It would also not likely be assumed by the US Federal Reserve, which would have no supervisory or regulatory authority in the dollarizing economies.[161] Responsibility for Mexican banks would be particularly unattractive in light of that country's troubled financial past.[162] In a currency union, on the other hand, the central bank would serve as LOLR for the entire area, though such an arrangement would require the difficult negotiation of uniform financial guidelines and supervisory systems. Ultimately, LOLR issues would be a major factor and potential

[159] Chriszt, 32. However, recent legislation introduced in the US Senate proposes that the US return 85% of its net seigniorage gain to countries that dollarize, apparently in order to demonstrate that the US does not encourage dollarization as a means of revenue generation.
[160] Buiter, 10-11.
[161] Chriszt, 34. Laidler and Poschmann, 15-17. In 1999, US Deputy Secretary of the Treasury Lawrence Summers pointed out that the US would not be inclined to assist dollarizing countries or take their policy needs into account.
[162] In recent years, the Mexican government has spent $100 billion of public money (over 20% of GDP) bailing out domestic banks. As pointed out by De La O, "this memory alone should be enough to discourage any foreign central banker from contemplating being even a *de facto* lender of last resort to Mexico."

obstacle in discussions of a single currency in North America. None of the countries would be inclined to go without some form of LOLR, nor would the negotiation of a common LOLR be straightforward.

4.4. Convergence Issues: Are The North American Economies Ready?

Economic convergence between the regions of North America could also be crucial to the implementation of a single currency. “Convergence” can be divided into *nominal* convergence and *real* convergence.

Nominal Convergence. In general, a government can unilaterally adopt another country’s currency at any time it wishes. The establishment of a currency union, on the other hand, may involve agreement and coordination between prospective member countries in order to satisfy certain macroeconomic criteria. For example, Europe’s Maastricht Treaty intended that potential Euro entrants should have a budget deficit of less than 3% of GDP, a public debt less than 60% of GDP,[163] inflation and interest rates nearing those of the three lowest among EU countries, and exchange rates that were relatively stable with one another. While fiscal rules such as those enshrined in the Euro area’s SGP are now proving troublesome, economic wisdom suggests that new members of a currency union ought to satisfy at least some convergence criteria if the union is to be stable. How convergent are the North American economies in terms of key macroeconomic indicators?

It seems clear that Canada, the US, and Mexico are much more nominally convergent today than they were at the time of NAFTA’s implementation. US and Canadian inflation has been relatively low in recent years, while the Mexican rate has

[163] The debt ratio requirement for entry into the Euro area was waived in certain cases.

fallen from 52% in 1995 to a forecast of 3.0% for 2003. Central bank interest rates have also recently converged, though a range of 4% to 5% currently exists between the US and Mexico. In terms of budgetary balance, Mexico has recovered from a 16% deficit-to-GDP ratio when President Salinas took office in the late 1980s to a forecast of 0.5% for 2003. Canada has moved from a deficit-to-GDP ratio of 5.5% in 1993-1994 to an approximately 1% surplus today. For its part, the US has recently steered from surplus to deficit, with a GDP ratio potentially nearing 3% if new proposals for tax cuts are approved. In terms of public debt, Canadian debt-to-GDP ratio has fallen from a high of 74.4% in 1997 to 44.5% in 2002-2003, while the ratio is forecasted at 36% for the US and 22% for Mexico.

It must be said that exchange rate stability has also improved in the past decade, since Mexico's disastrous 1994 crisis and currency collapse. North American exchange rates have experienced no excessive drama since that time, but stability has still not been optimal for the formation of a currency union. On one hand, the peso's experience has been mainly positive, rising gently against the US dollar since 1999 and signaling new confidence in the Mexican economy and currency. However, the Canadian dollar has experienced significant movements against the US dollar in recent years, depreciating substantially in the late 1990s and beginning a relatively sharp appreciation in 2003.

In general, the North American economies are demonstrating a level of nominal convergence that has rarely been present in previous decades. This is particularly true of inflation and fiscal measures, suggesting that at a nominal level, a North American currency union is becoming increasingly feasible, whereas ten years ago it clearly was not. Barring unforeseen developments, a Maastricht-type agreement seems at least technically possible to implement in the NAFTA area. At the same time, however, the movements of North American exchange rates, particularly in the recent Canadian case, continue to pose a problem. Certain advocates of North American monetary integration have seen these movements in the Canadian dollar as a reason to pursue a single currency. A more popular reading of events, however, is that the movements are evidence of a still-important adjustment role for flexible exchange rates in North America.

Real Convergence. The issue of real convergence (convergence in development, wealth, and living standards as measured by such figures as real GDP per capita) is also central to the formation of currency unions,[164] and is particularly relevant to the NAFTA area, which features two wealthy, developed countries and one developing country. However, the question of real convergence in relation to currency areas is less clear than that of nominal convergence. While few economists would disagree that deficits and interest rates ought to converge before countries form a currency union, it has not always been clear whether convergence in living standards should be considered a prerequisite or a consequence of closer economic integration.[165] The "prerequisite" view suggests that Mexico could be harmed by entering a single currency area too soon, because its less-developed status could cost it both investment and people if both are attracted towards more developed northern centers. The "consequence" view suggests that closer economic integration would help Mexico converge with Canada and the US as freer flows of goods and services lead to equalization of factor prices and per capita output.[166]

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[164] As discussed earlier, there is evidence to suggest that several years of trade integration have led to some convergence in North American incomes, with Mexico experiencing the largest relative increase in potential GDP as a result of increased trade in the 1990s. Some economists have estimated that further integration, including a single currency, could result in continued gains in the form of price convergence, competition, and ultimately in Mexican and Canadian per capita income levels. Hufbauer, 3-4.
[165] Masson and Taylor, 30.
[166] Ibid., 31.

Data from the US currency union and the EC suggest that integration does not necessarily make convergence more difficult, though the experience of different countries varies.[167] Less clear is the specific role of monetary integration. Even if a single North American currency helps capital and labour mobility to smooth out regional disparities, fiscal transfers may also be required to aid real convergence, as is the intent of the European Structural Funds mentioned earlier. Perhaps most important for Mexican convergence, however, would be the introduction of a stable macroeconomic environment into a historically less-stable country, combined with coherent domestic economic policies.

Again: Does One Size Fit All? A final point to mention on the issue of convergence is that national economies at different stages of development require different macroeconomic conditions to optimize their growth. In Europe, for example, the less-mature southern economies can be expected to grow 1-2% faster than the Northern European economies, and have different optimal rates of inflation and interest.[168] This issue is contributing to the current economic strains in the Euro area. While the European Central Bank fights to control inflation in the less-mature economies, countries such as Germany are on the verge of deflation and desperately require monetary easing. This unhappy situation illustrates once again the fact that a single monetary policy may not be right for countries with significantly different economic characteristics. Such problems could also arise in a North American currency union, where the less-developed Mexican economy can experience faster growth and somewhat higher inflation than its northern

[167] Ibid.
[168] Kuczynski.

neighbours.[169] The faster that Mexico can be made to “catch up” in its development, either through trade and investment, through domestic restructuring, or even through direct transfers from the North, the happier a single North American currency would be for all involved.

4.5. Conclusion: A Weak Economic Case

Having explored some of the economic issues surrounding a potential single currency in North America, the economic case for such an arrangement is by no means overwhelming. To begin, it seems technically possible for Canada, the US, and Mexico to adopt and probably sustain a single currency through either dollarization or currency union. However, the potential economic gains from such an arrangement are not well defined. Mexico would clearly benefit from increased investor confidence and lower interest rates, but the gains for the other countries in terms of dynamism and trade remain unclear. Over the past decade, North America has done very well in this respect without any monetary integration.

In addition, the costs of a single currency could be significant, at least in the near term. Recent movements in North American exchange rates suggest that they continue to play an important adjustment role. While the continent does have the potential for other types of regional adjustment if flexible exchange rates were to be abandoned, shock asymmetry and different levels of development could still pose a serious problem. Key adjustment mechanisms such as fiscal transfers and labour mobility, not to mention the lender of last resort function, would also depend heavily on political arrangements that seem difficult to come by at the present time.

[169] Hufbauer, 5.

Indeed, given that the economic case is not particularly strong, political concerns will dominate any discussion of a single currency in North America. The economic case for the creation of the Euro was also not overwhelming, but 12 European countries chose to accept the risks as a matter of politics. Would Canada, Mexico, and the United States be willing to do the same in the foreseeable future? It is to the political aspects of North American monetary integration that the next chapter will turn.

Chapter 5: The Politics of a Single North American Currency

5.1. Introduction

The preceding chapter examined the economic aspects of a single currency in North America. However, economics does not tell the whole story. While it may be tempting to view it as a purely economic matter, the decision to adopt a single currency is also a highly political one. Indeed, it is impossible to find a currency union in the world that was motivated purely, or even predominantly, by economic reasons. In order to fully understand the potential for a single currency in North America, a broader, political economy view is required. The following chapter will explore the politics of a potential single currency in North America from the perspective of each of the three countries involved.

5.2. Mexican Politics

As was clear from the previous chapter, Mexico has the most to gain economically of the three countries from the implementation of a single North American currency. Also clear from Chapter 2 is that of the three North American currencies, the peso has historically been the least worth keeping. If Mexico were to either adopt the US dollar or enter into a currency union with the US and Canada, it would be quite likely to gain from such economic benefits as lower interest rates, increased international confidence, and an influx of capital. Also appealing for Mexico in the case of a currency union would be the possibility of additional benefits in the form of "catch-up" funds from the North, as well as increasingly liberalized border flows.

The attractiveness of using a stronger and more stable currency has motivated many Mexicans to use the US dollar instead of the peso for some of their dealings. This market dollarization has become widespread in the business community, which in recent years has called upon the government to move towards complete dollarization. In 1999, groups such as the influential Businessmen's Council, the Mexican Bankers Association, and various chambers of commerce clashed with the PRI government of President Zedillo, who fiercely resisted their calls for official moves towards dollarization.[170] The National Action Party was more open to the idea of monetary integration, and following his election in 2000, Vicente Fox listed a common currency as part of his bold vision for the future of the North American continent. The Mexican public also seems open to the idea of monetary change in their country, perhaps as part of the long-term shift in Mexican attitudes towards the US and integration. A poll taken just prior to Fox' election showed 80% of Mexicans in favour of adopting the US dollar,[171] suggesting that maintaining the peso is no longer seen as necessary, either for economic or symbolic reasons.

These developments might outwardly suggest that Mexico is on the verge of unilaterally adopting the US dollar. Such an occurrence seems unlikely in the near future, however, for a variety of reasons. Economically speaking, Mexico's performance and the stability of the peso have been admirable in the past three or four years, giving Mexicans fewer pressing reasons to abandon their historically difficult currency. Paradoxically, this increased stability makes the transition to a single currency much easier, but less economically necessary. On the political front, policy dollarization in Mexico appears unlikely because Fox seems to be hoping for the better option of a cooperative currency

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[170] Associated Press.
[171] McClenahen.

union. Mexico's influence in a currency union with the US would be small, but it would be superior to having no influence at all under a dollarization arrangement. In addition, a currency union is vastly superior to dollarization in that it would include a common central bank that could provide the lender of last resort function for the Mexican financial system. No such support would be guaranteed under dollarization, a major drawback in light of Mexico's troubled financial history.

However, if currency union is Mexico's preferred option, the United States is unlikely to propose such an arrangement to Mexico in the near future, as will be discussed further below. Thus, if currency union with the US is to take place, the impetus would have to come from Mexico. Having already been rebuffed once, however, Fox is unlikely to raise the subject again soon. Fox also walks a fine line with the domestic public, who despite their apparent support for dollarization might quickly become disillusioned with a leader who campaigns too vigorously for closer integration with the US and abandonment of the peso. Despite a softening of the mood in recent years, Mexicans, like Canadians, remain keenly aware of their relationship with the United States, and are apt to see a fervent integrationist as lacking patriotism, or as a tool for US influence.

The result of this tangled web is that Mexico may remain quiet on the issue of monetary integration in the near term. Despite having been the only country to openly advocate a single currency in recent years, Mexico can now afford to take a "wait and see" approach in light of its newfound stability. The country need not rush to dollarize, particularly if the possibility of a currency union may one day appear on the horizon. On the other hand, if the Mexican economy and the peso were to suffer another crisis, adoption of the US dollar might seem even more attractive. In that case, issues such as the lack of a lender of last resort could well pose serious problems. And, as was mentioned earlier, the US would be highly unlikely to assume that function for Mexico under a dollarization scheme. These dynamics from a US point of view will be returned to below.

5.3. Canadian Politics

In economic terms, Canada has much less to gain from a single currency in North America than does Mexico, although certain benefits might exist. More important for Canada than the economics is the political calculus.

The simple adoption of the US dollar is probably out of the question for Canada, at least in the foreseeable future. The potential gains of such a move are not well defined, while the costs would be obvious. It would be humiliating for Canada, as a prominent industrial nation, to give up an essentially sound monetary regime and hand most of the keys to the Canadian economy over to the Americans. On the whole, the Bank of Canada has done well over the past decade, as has the Canadian economy, and there is no economic reason so pressing that Canada would want to adopt the US dollar and suffer the political costs. If monetary integration is desired, a currency union would make more sense, theoretically allowing Canada to maintain some economic and political sovereignty in addition to keeping a lender of last resort and seignorage revenue. For these reasons, currency union has been the preferred option of Canadian economists who favour monetary integration.

As far as Canadian sovereignty is concerned, however, how different would a currency union actually be from dollarization? As Canadian economist and politician John McCallum has summed up in a simple equation, "North American Common Currency = US dollar."[172] In discussing the political realities of monetary integration, it must never be forgotten that the United States and its economy dominate the North American continent. Some observers have suggested that in terms of maintaining economic sovereignty, the best Canada might be able to hope for in a currency union would be to form the 13th US Federal Reserve District.[173] In reality, Canada would likely be divided into more than one district or added to existing districts to avoiding coinciding with significant political boundaries, as has been the tradition in the US.[174] In any case, a major voice for Canada in monetary policy decisions would be unlikely, given that a state like California, whose economy is larger than Canada's, is not guaranteed a voice of its own. In this light, it is obvious that like Mexico, Canada's influence in a prospective currency union would be small indeed, and the economic sovereignty retained over and above a dollarization arrangement would be mainly symbolic. This fact is significant, given Canadians' historical concern with sovereignty in their relations with the United States. Canada largely defines itself by being separate and distinct from the US, and a serious proposal for a currency union entailing the loss of economic and political sovereignty might well raise Canadian hackles. This was the case prior to the signing of the CUSFTA in the 1980s, as has been discussed.

On the other hand, there is increasing evidence to suggest that Canadians are coming to accept the idea of deepening integration and the erosion of sovereignty that

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[172] McCallum (2000), 1.
[173] Canada's GDP also happens to be about 1/13 of US GDP.
[174] Forsyth, 30 June 2003. Graboyes.

goes with it. As pointed out in a recent issue of *Maclean's*, Canada's leading newsmagazine, recent data on US ownership of Canadian businesses "would have had Canadians leaping to the barricades a couple of decades ago. Today, it barely elicits a yawn."[175] Perhaps as part of a global trend of interdependence and redefined sovereignty, Canadians no longer seem as nationalistic in relation to the US as they once were, particularly on the economic front. Indeed, the CUSFTA and the NAFTA are now popular in Canada. The opponents of those agreements have been proved wrong in their dire predictions of catastrophic losses of sovereignty and identity. Today, no such movement has yet reacted to the budding discussion of currency union in North America. Either the opposition simply does not exist, or would-be opponents, having "cried wolf" in the 1980s,[176] are hesitant to risk doing so again, lest they not be taken seriously.

In any case, recent hard evidence shows Canadians as being increasingly open to the idea of integration with the US, and monetary integration in particular. First, although September 11 drove administrative wedges into North American integration, it led to greater feelings of affinity between North American peoples. Economically speaking, a recent poll showed that 66% of Canadians would like to see the federal government foster even closer economic ties with the United States, while only 5% were adamantly opposed.[177] Separate polls conducted in 2001 showed 39.9% of Canadians in favour of adopting the US dollar,[178] and 55% in favour of a common currency, up from 43% in 1992 and 46% in 1999.[179] Perhaps most striking is Canadians' sense of inevitability on

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[175] Gatehouse, 21.
[176] Forsyth, 29 May 2003.
[177] Gatehouse, 19.
[178] Leger Marketing.
[179] Centre for Research and Information on Canada.

the issue: in 1999, 77% thought that North America would have a common currency within 20 years.

If the public is at least willing to consider the idea, what has been the position of Canadian politicians and authorities? Thus far, the Bank of Canada, the Prime Minister, and the Finance Minister have roundly dismissed the idea of a common currency for North America, citing the economic and political benefits of an independent Canadian dollar. In addition, a motion to study alternative currency options was quickly shot down in the Canadian parliament in 1999.[180] It therefore seems unlikely that the current Canadian regime would be willing to initiate any discussions with the US or Mexico regarding monetary integration. And, as with Mexico, it must be Canada who would initiate the discussion with the US, bringing demands and incentives to the table to motivate the Americans to respond. Despite the long-term softening of the Canadian mood toward integration, moves toward a currency union might only be accepted by Canadians if they came from Canada. It was Canada who initiated the CUSFTA talks in the 1980s, having rejected such ideas from the US a few years previous. As summed up by Hart, "the combination of US chauvinism and Canadian paranoia dictates that any initiative must emanate from Canada."[181]

If the political climate is crucial to any moves toward a single currency in North America, very recent developments in Canada-US relations are worth mentioning. Despite the long-term trend towards Canadian openness to integration as well as close Canada-US cooperation following September 11, other events have since led to rather

[180] The motion was introduced by the Quebec separatist party, the Bloc Quebecois, who have their own agenda in promoting North American monetary integration. Among the obstacles faced by separatists is uncertainty over Quebec's monetary arrangements in the event of separation. Another effect of a common currency would be reduced Canadian financial and economic influence in Quebec.
[181] Qtd. in Pastor, 112.

cooler relations. Among the recent difficulties have been poor personal relations between Jean Chrétien and George W. Bush, Canada's stance on the Iraq War, US friendly-fire killings of Canadian troops in Afghanistan, US duties on Canadian softwood lumber, a US ban on Canadian beef, and a series of hostile comments made by prominent individuals on both sides of the border.[182] At present, both the Canadian and US public hold a less favourable view of each other than they did a year ago. These kinds of issues will eventually be resolved, as they have been in the past. However, the prevailing environment is not conducive to new forms of political and economic cooperation (much to the chagrin of the Canadian business community), let alone serious discussions of shared sovereignty. Thus, it seems that short-term fluctuations in the political climate can affect the likelihood and timing of any moves toward monetary integration in North America.

From the above discussion, it can be concluded that the most likely course of action for Canada is inaction. Dollarization is unattractive since the economic arguments for a single currency are not overwhelming, and a currency union may not be all that much more enticing, particularly where sovereignty is a concern. This is particularly true in the minds of Canadian politicians, even if the public is not wholly opposed. Interestingly, however, the recent rise of the Canadian dollar against the US dollar has reignited discussion of monetary integration, as did the fall of the Canadian dollar in the late 1990s. The conclusion of several recent observers is that Canada must at least be open to debate and research of the options, particularly at a time of upcoming political transition. If and when monetary integration appears on the North American agenda,

[182] *The Economist*.

Canada will need to be ready to join the discussion with a coherent position and a full understanding off the issues.

5.4. US Politics

As should be clear from the discussion of the Mexican and Canadian positions, the United States would be the lynchpin of any realistic scheme for a single North American currency. The reality, as it was during the NAFTA negotiations, is that the US is the "big kid on the block," and has the least to gain from monetary integration with its smaller and weaker neighbours.

First, it is true that Canada and Mexico could unilaterally adopt the US dollar (although this is currently unlikely, as has been discussed). Certain data suggest that the US would not necessarily be opposed to such moves. From the public point of view, a 2001 poll showed that 58% of Americans would be in favour of Canada adopting the US dollar.[183] Indeed, there are specific reasons why the US might not oppose dollarization. Dollarization to the south could bring about increased stability in the Americas, could help to spread US influence, and could provide reasons for dollarizing countries to maintain friendly relations with the US.[184] Increased international usage of the US dollar also confers economic benefits on the United States and could help it to maintain an advantage over the Euro as the world's primary reserve currency.

At the same time, however, the US has no desire to take responsibility for the financial system of dollarizing countries (particularly ones with a history of crises), and

[183] Leger Marketing.
[184] Noriega's Panama provides a good example of a dollarized country which discovered the consequences of displeasing the United States. In 1988, all payments and dollar transfers to Panama were frozen, causing a severe liquidity shortage and a major loss of output.

has no intention of taking the needs of other countries into account when formulating monetary policy.[185] For these reasons, the US has been careful not to openly encourage dollarization, because to encourage it would be to assume a measure of responsibility for any unpleasant outcomes. Nonetheless, in the event of a crisis in a dollarized Mexico, for example, the US would come under serious pressure to intervene (as it did in 1994), despite neither wanting to take responsibility nor having a legal obligation to do so.

From the Canadian and Mexican perspective, currency union is preferable to dollarization, as has been discussed. What would be the position of the United States toward such an arrangement? To begin, a recent poll showed 43% of Americans in favour of a currency union.[186] But some observers have suggested that if the US refuses to take the needs of a dollarizing country into account, it would be even farther from considering a currency union that involved any sharing of sovereignty.[187] It must be said that a currency union would potentially do a better job of mitigating the risk of crises through a shared lender of last resort function, but the point still stands. As nicely put by Thomas Courchene, "Americans love to devolve sovereignty to the markets. But not to anybody else."[188] As mentioned above, any Canadian or Mexican influence in a North American currency union would likely be quite small, largely because the US has little willingness or incentive to give control away. And since the US has the least to gain from monetary

[185] Authorities such as former Deputy Secretary of the Treasury Lawrence Summers and Federal Reserve Chairman Alan Greenspan have made it clear that countries which dollarize will have access to neither US financial backing nor monetary policy decisions.
[186] Coinstar Inc. A 2002 NFO poll found much less American support for a three-way currency union, though the presentation of the survey questions seems biased toward that result.
[187] McCallum (2000), 2. This might be especially true if a currency union entailed the development of supranational or power-sharing institutions to oversee various aspects of its operation. Chriszt, 36, Robson and Laidler, 26.
[188] Quoted in Pastor, 112.

integration in comparison to its neighbours, it has the luxury of driving a hard bargain in negotiations, just as it did with NAFTA.

As with dollarization, the US approach to the possibility of a currency union in North America has been mainly to keep quiet (with the exception of gently rebuffing Fox' proposals in 2000). Although the Americans seem unlikely to embrace the idea at the present time, by not explicitly rejecting it out of hand, they leave themselves the opportunity to see what Mexico or Canada might bring to the table, should either country decide that it must seek a currency union. And, as has been discussed, proposals must come from either of the two smaller countries, and not from the United States. If by some chance the US *did* seek a currency union in North America, asking its neighbours to join (except on the most favourable of terms) might be a good way to ensure that such a project would not succeed, and at the very least, could embroil the US in Canadian and Mexican debates over national sovereignty.[189]

The essential point, however, is that if a currency union is the preferred option for Canada and Mexico, US cooperation is required, but could be difficult to come by. In order to motivate the US to make monetary concessions, Canada and Mexico would have to be prepared to make new and valuable concessions of their own.[190] As it is, the two countries are having enough difficulty maintaining North American economic integration at its current level. While the Bush Administration has signaled interest in further economic integration,[191] the reality has often been difficulties in the form of trade

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[189] Sands and Weintraub.
[190] Robson and Laidler, 26.
[191] Among the indicators of the position of the Bush Administration has been a June 2001 *National Post* interview (Fife and Toulin) with US Ambassador to Canada Paul Cellucci, in which he expressed US interest in a NAFTA-plus where policies would increasingly be harmonized (including immigration), and the significance of borders would be reduced. By September, however, priorities had changed.

disputes as well as tighter borders following September 11. The US has shown little interest in moving toward a common market, and thus a currency union seems even more unlikely in the foreseeable future.

Chapter 6: Conclusion

6.1. Questions Answered

At the outset of this thesis, four research questions were posed to guide the discussion. Chapter 2 reviewed North American economic history and explored why NAFTA did not include any steps toward monetary integration, finding that Canada, the US, and Mexico were simply not ready for it in the early 1990s. Chapter 3 explained why the debate can now be opened, pointing to a decade of economic, social, and political change on the North American continent. Chapter 4 delved into the economics of a prospective single currency, finding that although certain benefits might exist, the economic case is by no means overwhelming. Chapter 5 then tackled the political aspects of the project, revealing that while Mexico has expressed interest in a single currency, the governments are unlikely to pursue it vigorously in the immediate future. In the absence of pressing economic and political motivations, the three nations can and will move slowly in regards to monetary integration on their continent.

6.2. What Might Spark Negotiations?

However, it is not inconceivable that the North American countries could enter into monetary negotiations at some point in the coming years. If a currency union is the option seen as desirable in Mexico, perhaps tolerable in Canada, but largely unacceptable in the US, as we have seen, what future developments might bring the three parties to the negotiating table to work on such a project?

To begin, a currency union would look more attractive if the economic arguments became much stronger - strong enough to outweigh the political costs. The experience of the Euro area could be crucial. If, several years from now, it was observed that the Euro was an economic success that had sparked substantial new dynamism and growth in Europe, North American policymakers and citizens might begin to take a keen interest. This would be particularly true if Europe's success were to coincide with a period of staleness in the North American economies that left Canadians, Mexicans, and especially Americans looking for a new driver of growth.[192] To some extent, this is what happened in the 1980s when European integration appeared economically dynamic, partially motivating North American moves toward the CUSFTA and NAFTA.

Another economic motivator, albeit a lesser one, might arise if the Euro significantly displaces the US dollar as the world's most popular currency as well as the international reserve currency of choice. If more countries choose the Euro as their reserve currency, the benefits that have been automatically conferred upon the US for many years will diminish. In particular, the US could find it increasingly difficult to finance its large balance of payments deficit.[193] If a North American currency union (or dollarization) could bolster the international role of the US currency, it might provide an extra reason for the US to consider such monetary integration.

Economic developments could also lead Canada and Mexico to further interest in monetary integration. If, for example, market dollarization proceeded to such an extent in those economies that having a separate currency and monetary policy was of little value, one or both of them might be inclined to "give up" and seek a currency union, the costs having diminished. Increasing alignment of the North American economies over time might also contribute to a decreased necessity for independent currencies and policies.

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[192] Forsyth, 29 May 2003.
[193] Gilpin, 256.

From a political perspective, it is possible that North America could be swept by the kind of sentiments that have motivated the past 50 years of European integration. The development of overriding political goals and a vision for a North American community, or some kind of Pan-Americanism, could serve to overcome economic obstacles and fears about sovereignty. Such a transformation of North American political goals and values seems unlikely at the present time. What might be more likely are further moves toward economic integration, consolidation, and stability in the Americas as a whole. North American monetary integration could conceivably come about as part of a greater process of monetary integration and stabilization in the Americas, perhaps as a result of the US attempting to impart greater stability to parts of Latin America.

Also from a political perspective, the coincidence of like-minded politicians and governments in the three North American countries could be a vital catalyst to monetary integration. As has been observed, the historically rare election of three free trade-friendly governments in Canada, Mexico, and the US during the 1980s was a crucial enabler of the CUSFTA and NAFTA negotiations. It is conceivable that such circumstances could arise again, paving the way for monetary negotiations. The current Mexican regime seems to be in favour of an eventual currency union, and it is not impossible that a Canadian leader could be elected in the coming decades who also holds that view.

Most important, however, will be the position of future American leaders. Indeed, it is the American establishment and public who may require the most convincing before entering negotiations for a currency union that entails sharing of sovereignty. A charismatic, visionary US President could lead the continent toward monetary integration if Canada and Mexico were agreeable.[194] In the 1980 Presidential election, Ronald Reagan laid out his vision for sweeping economic integration on the continent and the development of a North American community. As discussed earlier, however, he was ahead of his time, and his proposals were rejected both north and south of the US border. In the future, a visionary US leader combined with cooperative Mexican and Canadian leaders could put monetary integration on the collective North American agenda.

6.3. NAFTA in 2013

Ultimately, North America is still some years away from deep monetary integration, if such a project ever comes to fruition. However, the continent is much closer to having a single currency today than it was ten years ago, when NAFTA had just been signed. Perhaps after another ten years of economic, social, and political change, and given the right catalysts, North America will be on the verge of trading in pesos, Loonies, and greenbacks for a new “NAFTA dollar”. In the meantime, Mexico, Canada, and the US must seek other ways to improve upon NAFTA and enhance integration on their continent.

[194] Forsyth, 29 May 2003.

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