Making Free Trade Work by Fixing the Dollar

BY PATRICK GRADY

The 1990s are off to a very disappointing start. While the Canadian economy has certainly been buffeted by adverse international forces, serious mistakes in domestic monetary and fiscal policy have compounded our difficulties. Wide policy-induced swings in the value of the Canadian dollar have been allowed to undercut the Canada–U.S. Free Trade Agreement (FTA), depriving Canada of its expected benefits and making new converts to the increasingly vocal anti-free-trade movement.

The government's inability to continue to bring the deficit down when the economy was strong in 1988 and 1989 left the job of fighting inflation to the Bank of Canada and resulted in increases in short-term interest rates from 8½ per cent at the beginning of 1988 to a peak of almost 14 per cent in March 1990. The FTA came into effect at an inopportune time, when the Canadian dollar, buoyed by monetary restraint, was badly undermining the competitive position of our manufacturing industries. Subsequently, the untimely introduction of the GST gave rise to an outbreak of inflationary expectations that could be curtailed only by continued monetary restraint and a further appreciation of the dollar.

The main factor making for a worse recession and more languid recovery in Canada than in the United States was the greater degree of monetary restraint. The severe impact of this restraint on the economy was probably not intended and must have given pause even to the Bank of Canada. It produced an economy so sluggish that

> A FLUCTUATING DOLLAR HAS PREVENTED CANADA FROM REALIZING THE BENEFITS OF FREE TRADE

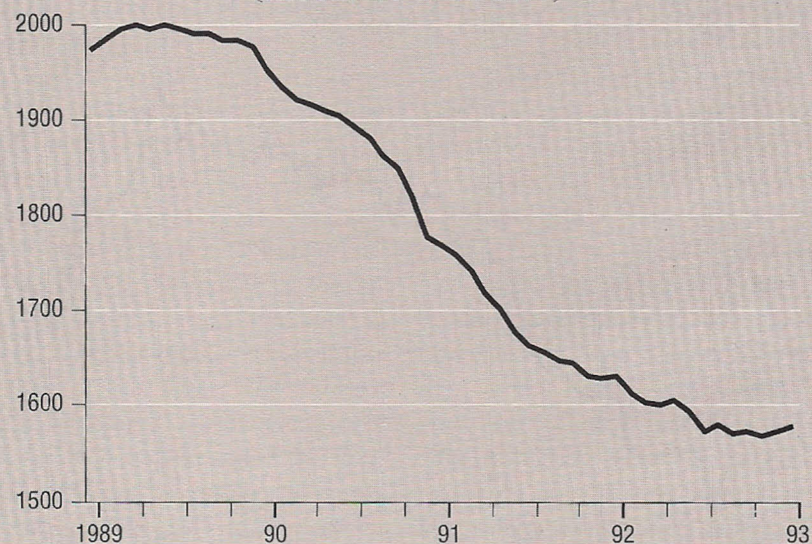
inflation dropped right out of the bottom of the Bank's target range last year.

The recovery in Canada, fuelled by declines in interest rates, the depreciation of the Canadian dollar and a strengthening U.S. economy, finally began in earnest in the fourth quarter of last year, and preliminary monthly indicators suggest that it continues unabated. It would be a mistake, however, to let our improved cyclical fortunes distract us from the economy's structural vulnerability. It is important that we fully understand the difficulties that can be created by the combination of a floating exchange rate and the FTA and that we resolve to make the FTA work for Canada rather than against it.

The Free Trade Experience

The FTA was a watershed in Canadian economic history. In signing on the dotted line, Canada accepted, for better or worse, a much higher degree of economic integration with the United States. The North American Free Trade Agreement (NAFTA), signed December 17, 1992, will reinforce this enhanced interdependence

CHART 1
MANUFACTURING JOBS DROP
(THOUSANDS OF PERSONS)



Source: Statistics Canada, *Employment, Earnings and Hours*, Catalogue 72-002.

and bring Mexico into the free trade area. Unfortunately, the implications of greater continental integration for Canadian monetary and fiscal policy have been neither fully understood nor taken adequately into consideration by Canadian policy makers.

While free trade would inevitably have entailed serious adjustment costs in addition to those already being imposed by the forces of globalization, the transition to free trade has been made much more difficult by the unanticipated fluctuations of the Canadian dollar. Since the FTA came into effect in January 1989, plant shutdowns have occurred with dismal regularity, accompanied by the loss of some 400,000 jobs, or one-fifth of total manufacturing employment (see Chart 1). This is much greater, relatively speaking, than the 8 per cent of manufacturing jobs lost in the United States over the same period. Against such a backdrop, is it any wonder there is talk about de-industrialization?

Canada's current account deficit has almost doubled since the FTA came into effect, going from $15.5 billion in 1988 to $28.6 billion last year. Net external debt is now running at over $300 billion, or 44 per cent of GDP, making Canada the second largest foreign debtor after the United States. Canada's external position is clearly unsustainable. While it would be unfair to lay all the blame for Canada's current account problems on the FTA and the overvalued dollar (eroding domestic competitiveness and the success of some of the newly industrialized countries have also contributed), these factors unquestionably deserve the lion's share of the blame.

> "CANADA HAS MISSED THE CRUCIAL EARLY WINDOW OF OPPORTUNITY OPENED UP BY THE FTA."

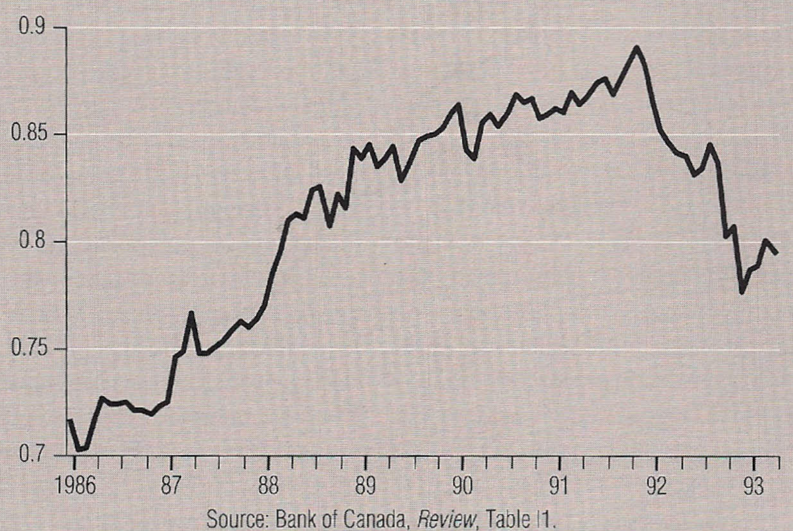
When the process of negotiation was launched in 1986, the Canadian dollar was trading near 70 cents U.S. and Canadian industry was eagerly competitive. By late 1991, the Canadian dollar was close to 90 cents and our manufacturing sector was flat on its back (see Chart 2). Now, following last year's referendum on the constitution and the related turmoil in financial markets, the dollar is back under 80 cents and Canadian industry is starting to revive.

But the depreciation of the dollar does not undo all the damage that has been done. Canada has missed the crucial early window of opportunity opened up by the FTA. Many business decisions to take advantage of the new continental market through investment have already been made to the disadvantage of Canada and are unlikely to be reversed for many years. Plants that were closed down because of the overvalued dollar will not be quickly reopened just because the dollar drops, nor will plants that were moved to the United States be immediately shifted back to Canada. Canadian companies will have to work harder to regain lost markets.

It is not just the level of the Canadian dollar that has been handicapping our industry. Its volatility and the associated uncertainty have been almost as damaging. How can a company decide if it is profitable to locate production in Canada to service the North American market if it cannot predict its costs of production in U.S. dollars? Does it really make sense for a manufacturer to locate in Canada if it has no guarantee that its costs in U.S. dollars will continue to be comparable to those of its competitors? Who can blame a manufacturer for playing it safe and investing in the United States?

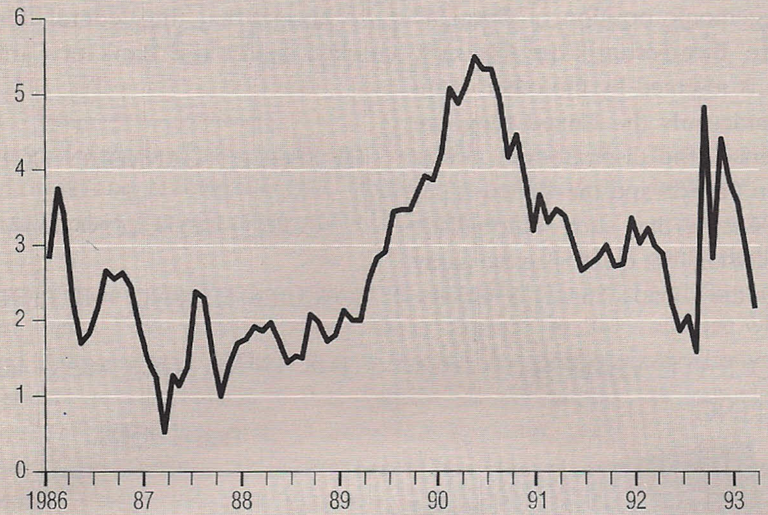
The Canadian dollar's roller-coaster ride has reflected both monetary restraint and political uncertainties. Together, these factors have served to build a premium into Canadian interest

CHART 2
WIDE SWINGS IN CANADIAN DOLLAR
(U.S. $/CAN. $)



Source: Bank of Canada, *Review*, Table I1.

CHART 3
LARGE GAP BETWEEN
CANADIAN AND U.S. INTEREST RATES
(CANADIAN MINUS U.S. RATES, 90-DAY PAPER)



Source: Bank of Canada *Review*, Table F1.

rates relative to those in the United States (see Chart 3). The differential between the interest rate on 90-day commercial paper averaged 3.43 per cent from 1989 to 1992 compared with an average of only 1.59 from 1981 to 1988 and 0.75 per cent from 1971 to 1980. This is a premium we can ill afford.

PEGGING THE DOLLAR

One solution to the problem of exchange rate instability and the interest

> "A FIXED EXCHANGE RATE WOULD FACILITATE DECISION MAKING BY CANADIAN BUSINESS IN A NORTH AMERICAN CONTEXT."

rate premium would be to peg the Canadian dollar to the U.S. dollar near current levels. Cost comparisons with the United States suggest that, with a dollar in this range, Canadian industry would be well able to compete. A fixed exchange rate would facilitate decision making by Canadian business in a North American context. It would put Canadian manufacturers in all provinces on an equal footing with producers in contiguous states. It would also reassure foreign investors that their investments in Canada were safe, and it would help to keep Canadian interest rates more in line with those in the United States.

A fixed Canadian dollar could be allowed to trade within a band of 1 per cent on either side of its specified parity. This would be similar to the arrangement in effect from June 1962 to May 1970, when the Canadian dollar was fixed at U.S. $.925. The Bank of Canada would have to intervene only when the dollar approached the floor or ceiling of the range. Similar ranges functioned successfully under the Bretton Woods agreement until it broke down in the early 1970s and under the European Community's Exchange Rate Mechanism (ERM). Provided that economic policies in Canada remained consistent with those in the United States, the increased globalization of financial markets based on improved telecommunications and computers would not prevent the operation of a fixed exchange rate.

> "IN THE PAST, WITH THE DOLLAR FLOATING, INFLATION HAS NOT BEEN CONSISTENTLY LOWER THAN IN THE UNITED STATES."

To recommend a fixed exchange rate is not to make a case for a cheaper Canadian dollar. Fixing the Canadian dollar near its current parity would be as likely to prevent a depreciation as an appreciation. The gain from establishing a fixed exchange rate would accrue from the dollar's stability near an appropriate level and not from its use to engineer an artificial competitive advantage. The pegging of the Canadian dollar in June 1962, followed by the Auto Pact in 1965, provided the impetus for the strong growth and prosperity of the 1960s. In tandem with the NAFTA, it could do the same for the 1990s.

Granted, this would mean giving up an independent Canadian monetary policy, but the benefits of such a policy have been more apparent than real. In the past, with the dollar floating, inflation has not been consistently lower than in the United States. Quite the contrary: inflation has usually been slightly higher. The Federal Reserve may right now be less hawkish on inflation than the Bank of Canada, but it is still strongly committed to combatting inflation. Canada would not therefore be in the position of having to accept the consequences of an inflationary U.S. monetary policy.

Our interest rates have almost always been above those in the United States, even when inflation was lower. Interest rate differentials have been extraordinarily wide in recent years. With price stability as the overriding objective of monetary policy, we might or might not be able to do better in the future.

Price and wage expectations in Canada are closely tied to those in the United States; unions and firms operate on both sides of the border; Canadians are deluged by the U.S. media. Decoupling Canadian price and wage expectations from those in the United States requires a jolt that can be delivered only by engineering painfully high idle capacity and unemployment. If the cost of outperforming the United States on the inflation front is as high as recent experience indicates, the game may not be worth the candle.

The European Community has long sought to stabilize the currencies of member countries through the ERM. Recognizing the increasing importance of stable rates of exchange as the degree of economic integration increases, the Maastricht treaty proposed the establishment of a single currency. Even though the European Community has been plagued by political and currency instability of its own in recent months, and it is far from certain that its ambitious plans will go forward, there are still important lessons about the benefits of stable exchange rates that the participants in NAFTA can learn from the longer experience of the European Community.

The recent currency problems in Europe stem to a large extent from the refusal of some member states to pursue a common macroeconomic policy. The hegemonic position of Germany and the Bundesbank in the new Europe is resented by the other countries, particularly the United Kingdom and France. The disproportion in size between Canada and the United States would ensure that such nationalistic rivalries would not destabilize the parity between the Canadian and U.S. dollars.

FIXED RATE VERSUS FLOATING

There are arguments in favour of a floating exchange rate. Fluctuations in the currency can help a country to adjust more smoothly to external shocks such as commodity price changes. This is particularly important if wages are not flexible. However, it is interesting to observe that when commodity prices were falling over the 1989 to 1991 period, the Canadian dollar appreciated. In this instance, the floating rate not only failed to facilitate the process of adjustment but actually hindered it. If carried to their absurd extreme, the arguments in favour of a floating exchange rate would suggest that individual provinces, such as Newfoundland and Alberta, that are dependent on commodity exports should have their own currencies.

A fixed exchange rate would not be a panacea for all Canada's economic problems. It would not obviate the need to pursue sound fiscal policies and to implement required structural reforms, such as strengthening the economic union. Its success would also depend on the adoption of responsible fiscal and monetary policies in the United States. Nevertheless, if we accept that the Federal Reserve Board shares the Bank of Canada's commitment to controlling inflation, it is the approach that is the likeliest to provide the monetary framework most suitable for strong growth and lower unemployment.

> "A PEGGED CANADIAN DOLLAR COULD GO A LONG WAY TOWARDS MAKING THE REST OF THE 1990S LOOK MORE LIKE THE 1960S."

A pegged Canadian dollar could go a long way towards making the rest of the 1990s look more like the 1960s. North American free trade offers enormous opportunities to expand exports and create jobs. To enable Canadian business to take advantage of these opportunities, a stable and predictable exchange value for the Canadian dollar is essential. This is something that a government bold enough to act can deliver. It is not too late to make free trade work for Canada. CBR

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