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Inflation targets versus international monetary integration: a Canadian perspective☆

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Abstract

The debate about Canadian–US monetary integration is surveyed. The choice is not just among exchange rate regimes, but among overall monetary orders, and questions of policy credibility and political accountability are crucial to it. Canada's recent economic performance under inflation targets, and arguments that the flexible exchange rate has undermined real economic performance are assessed. The most economically attractive among alternative monetary orders—the adoption by Canada of the US dollar with provision for meaningful Canadian input into policy decisions and supervision of the financial system—is not politically attainable. Intermediate arrangements are unattractive and clearly inferior to Canada's current monetary order.

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1. Introduction

To say that the world's monetary system is in a state of constant evolution is platitudinous, but true. At the moment, international monetary arrangements seem to be veer-

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ing towards two extremes: national currencies supported by exchange rate flexibility, or extremely hard fixes, of which monetary integration across national boundaries is the limiting case. In the post-World War II period, Canada has been the most steadfast of floaters, having "temporarily" abandoned its Bretton Woods peg to the US dollar in 1950, and having returned to a fixed rate only once for a little under 10 years (1962–1970) in the interim. But even Canada is open to change, and for the last few years, particularly since the international financial upheavals of 1997–1998, there has been an ongoing local debate about whether the country would be better off with some sort of fixed exchange rate on the United States dollar, and more specifically, as that debate has evolved, the adoption of a common North American currency has emerged as the alternative of choice to the status quo.[2]

This paper provides an overview of the debate in question, and a defence of Canada's current monetary arrangements. The following pages first establish a framework for discussion by arguing that, in dealing with the issues at stake here, one needs to consider a country's overall monetary order, including its political aspects, rather than the exchange rate regime in isolation. Then Canada's current inflation-targeting monetary order and the economy's performance since its inception in 1991 are discussed. A survey of the forms that North American monetary integration might feasibly take leads to the conclusion that the degree of US hegemony over Canadian affairs that is implicit in any monetary arrangement to which the US might be willing to be party presents a serious political deterrent to Canada's pursuing such a goal, and that, given the satisfactory performance of the current monetary order, it should be kept in place.

2. A framework for discussion: the monetary order

All national economies use money and are open, and yet economists have often broken the discussion of their monetary arrangements into self-contained segments to be discussed in isolation from one another. Thus, when domestic matters have been the centre of attention, they have discussed such topics as rules versus discretion, real versus various nominal targets for monetary policy, and within the latter grouping they have debated the relative merits of money growth, nominal GDP growth, and inflation. When the design of central banks has been on the agenda, they have analysed goal and instrument independence, not to mention interest rate and base control as alternative means of implementing monetary policy. And when specifically international matters have been in the forefront, they have talked, among other things, about fixed versus crawling versus flexible exchange rates, with and without policy co-ordination, and so on.

Now to break a topic down into manageable portions has its uses, but it has its perils too, for it is easy to lose sight of the interconnectedness of topics, and to fail to notice that the conclusions reached about one area have implications for others. In the monetary policy field, this has sometimes happened, and that is why the first substantive step in this paper

[2] Among early contributions to this debate are Courchene and Harris (1999a), Grubel (1999), Laidler (1999), Orr (1999) and von Furstenberg (2000).