



ECONOMIC
RESEARCH

The Bottom Line

THE LATEST VIEW ON THE ECONOMY

BMO  Capital Markets™

Imagine Dollarization

August 19, 2010

Dr. Sherry Cooper
Executive Vice
President,
Chief Economist

1-800-613-0205

What if we had pegged our currency to the U.S. dollar back in the dark days of the multi-year currency drop (late-1991 to early-2002) as I suggested way back then? What would have happened between then and now, and would we be better or worse off? Of course, this is a hypothetical question. There was never a real possibility of dollarization as there was no political support for this in either Canada or the U.S. Lost monetary independence might have opened us up to the mistakes of the U.S. and no one in Ottawa was willing to give up financial sovereignty. But let's just imagine, for the sake of economic argument, that we had pegged the loonie at 62 cents U.S.

Some have suggested, with hindsight, that this would have turned out to be disastrous because the Canadian dollar has strengthened so much since then, so all of the benefits of a stronger Canadian dollar (such as increasing purchasing power and lower interest rates) would have been lost. But that doesn't mean that there would have been no winners from the currency peg. We would have essentially adopted the U.S. dollar, and our monetary policy would have been directed toward maintaining the peg, which would become increasingly undervalued.

Canada's growth would have been boosted by higher net exports, while U.S. growth would have been pretty much what it was. Put differently, Canada would have exported more to the rest of the world and imported less. In the actual case, the falling trade surplus was the major dampener of Canadian growth over the 2002-to-2010 period. The domestic Canadian economy remained much stronger than the overall U.S. economy, which was supported by improving net exports. Canadian export businesses would have benefited from both the elimination of exchange rate uncertainty and from an undervalued currency.

On the other hand, the price of imports would have risen as the U.S. dollar depreciated vis-à-vis the world's other currencies and there would have been upward pressure on inflation. The Canadian economy, already booming because of the rise in commodity prices over the early part of the period, would have grown even more rapidly. That would, of course, have meant lower unemployment and upward pressure on prices. Federal government budget surpluses would have been even larger, which might have encouraged the government to cut taxes or increase spending, but the upward pressure on prices might have mitigated that response.

All the losers from the actual C\$ appreciation—exporters, tourism and so on—would be winners. And the actual winners—consumers, importers, travel agents, etc.—would be net losers. All in, output would be stronger with higher inflation. Our banks, regulated by OSFI, would have remained very strong.

The stronger economy would have meant rising labour shortages, rising wages and a likely influx of American workers looking for jobs across the border. Assuming we allowed them in, there would be a boost to domestic spending, housing, tax revenues and additional government spending on health care, education and other public services. Household wealth relative to personal income, now already higher in Canada than the U.S., would be even higher still, although in real terms, inflation might have eaten up some of the gain.

In some ways, this hypothetical dollarization example is more similar to the China/U.S. situation than to the eurozone, as the yuan was pegged to the U.S. dollar at an artificially weak level, but China carried on independently in every other sphere. If we had pegged our currency to the U.S. in early 2002, we would have lost control of monetary policy, in exchange for a relative competitive advantage compared to what we actually experienced. The equilibrating mechanism in our case, however, could have been cross-border labour flows and rising import prices, which would have contributed to upward pressure on wages and prices. Housing demand would have been even stronger than it was, but assuming continued independent financial regulation, the excessive expansion in household debt that occurred in the U.S. would not have plagued the Canadian housing market. The rise in house prices would have been even bigger than it actually was.

This inflation pressure could have been offset, at least in part, by higher tax rates and/or cuts in government spending, a very different policy position than what we actually pursued.

Bottom Line: Pegging our currency to the U.S. dollar at the lows of earlier this decade would have boosted net exports, relative government spending and consumption (compared to what we actually experienced). The winners would be tourism and export-related businesses, and the losers would be consumers, which is all of us. Flexible exchange rates force changes in business practices to maintain competitiveness. Canadian exporters are compelled to improve productivity, enhance product quality, innovate and broaden their foreign customer base. The companies that cannot do this shrivel, get swallowed up by larger competitors, or disappear altogether. In this regard, the global credit crisis and recession was a period of enormous creative destruction, which allowed the domestic economy of Canada to relatively outperform the U.S., but not without our own adjustments. The sharp rise of the Canadian dollar from 2002 to 2007 generated restructuring of manufacturing prior to the onset of the financial crisis, leaving business in much stronger shape to handle the downturn. The challenge for Canadian business is to compete in a world with a relatively strong currency.

The information, opinions, estimates, projections and other materials contained herein are provided as of the date hereof and are subject to change without notice. Some of the information, opinions, estimates, projections and other materials contained herein have been obtained from numerous sources and Bank of Montreal ("BMO") and its affiliates make every effort to ensure that the contents thereof have been compiled or derived from sources believed to be reliable and to contain information and opinions which are accurate and complete. However, neither BMO nor its affiliates have independently verified or make any representation or warranty, express or implied, in respect thereof, take no responsibility for any errors and omissions which may be contained herein or accept any liability whatsoever for any loss arising from any use of or reliance on the information, opinions, estimates, projections and other materials contained herein whether relied upon by the recipient or user or any other third party (including, without limitation, any customer of the recipient or user). Information may be available to BMO and/or its affiliates that is not reflected herein. The information, opinions, estimates, projections and other materials contained herein are not to be construed as an offer to sell, a solicitation for or an offer to buy, any products or services referenced herein (including, without limitation, any commodities, securities or other financial instruments), nor shall such information, opinions, estimates, projections and other materials be considered as investment advice or as a recommendation to enter into any transaction. Additional information is available by contacting BMO or its relevant affiliate directly. BMO and/or its affiliates may make a market or deal as principal in the products (including, without limitation, any commodities, securities or other financial instruments) referenced herein. BMO, its affiliates, and/or their respective shareholders, directors, officers and/or employees may from time to time have long or short positions in any such products (including, without limitation, commodities, securities or other financial instruments). BMO Nesbitt Burns Inc. and/or BMO Capital Markets Corp., subsidiaries of BMO, may act as financial advisor and/or underwriter for certain of the corporations mentioned herein and may receive remuneration for same. "BMO Capital Markets" is a trade name used by the Bank of Montreal Investment Banking Group, which includes the wholesale/institutional arms of Bank of Montreal, BMO Nesbitt Burns Inc., BMO Nesbitt Burns Ltée/Ltd., BMO Capital Markets Corp. and Harris N. A., and BMO Capital Markets Limited. TO U. S. RESIDENTS: BMO Capital Markets Corp. and/or BMO Nesbitt Burns Securities Ltd., affiliates of BMO NB, furnish this report to U. S. residents and accept responsibility for the contents herein, except to the extent that it refers to securities of Bank of Montreal. Any U. S. person wishing to effect transactions in any security discussed herein should do so through BMO Capital Markets Corp. and/or BMO Nesbitt Burns Securities Ltd. TO U. K. RESIDENTS: The contents hereof are not directed at investors located in the U. K., other than persons described in Part VI of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001.

TM - "BMO (M-bar roundel symbol) Capital Markets" is a trade-mark of Bank of Montreal, used under licence. © Copyright Bank of Montreal.