Intelligence MEMOS

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To: Trade Observers

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Re: Keep the Dollar to Keep Our Independence

The loonie was trading below 70 US cents last week, a level not seen for more than 20 years. Every time it hits an air pocket like this one, calls emerge for Canadians to give up a separate currency and adopt the United States dollar. This time is no exception. Kevin O'Leary recently appeared on Fox Business News supporting the idea of an economic union between the two countries, which would mean adopting the US dollar.

This is a bad idea.

Granted, there would be some clear advantages to a single currency. Not having to worry about currency conversions when travelling between Canada and the US or doing business across borders would mean lower transaction costs and less risk of being caught off guard by unexpected currency swings. There is also an argument that a declining loonie, while good for exports, makes imports of things like equipment more expensive, hurting our investment and productivity.

But having our own currency with a flexible exchange rate more than compensates by letting us chart our own course on inflation – including a more hawkish one, if we choose – and gives us far more scope to deal with the unexpected shocks that from time to time batter our economy and financial system.

In times of stress, governments typically run deficits to provide financial support to Canadians and Canadian businesses. This often occurs in tandem with the Bank of Canada lowering its policy interest rate and, if necessary, buying government securities and other assets.

Suppose we experience an economic shock that's more severe than in the US. Ideally, interest rates in Canada should fall relative to American rates. But that won't happen if we adopt the US dollar: The Federal Reserve Board will be making policy, not the Bank of Canada.

By the same token, Canadian governments would find it harder to provide support to Canadians and their businesses in times of stress. There would be stricter limits on how much debt they could issue – unless we wanted to ask the Federal Reserve to buy their debt should the need arise. This is not simply a theoretical argument. Southern European governments struggled to issue debt during the eurozone crisis 15 years ago until the European Central Bank finally stepped in to backstop their borrowing.

The same is true in reverse. Should the US experience a shock like its sub-prime housing crisis while Canada did not, having a floating exchange rate would give us more flexibility to prevent any stimulative measures introduced by the US from spilling over into Canada and overheating our economy. In that case, the loonie would rise, which, despite its recent troubles, we know it sometimes does. (It was actually above parity through most of 2011, touching $1.06 in July before settling to 97 cents by year-end.)

Apart from its role in facilitating monetary and fiscal policy, the floating loonie is itself a key shock absorber. In down times, it falls automatically, helping stimulate exports and reduce imports, while the reverse occurs if our economy is performing better than south of the border – which it sometimes does. That is why in 1950 Canada was the first country to introduce a floating exchange rate: Our economy was booming relative to the US.

Jettisoning the loonie for the US dollar would leave the economy more vulnerable to shocks, much as it was before the establishment of the Bank of Canada in the 1930s. Canadian governments back then had limited ability to smooth business cycles. Shocks were absorbed – more painfully – through adjustments to prices and wages, and with much higher unemployment rates when workers resisted wage cuts. In short, a flexible loonie protects us against wild socio-economic swings.

Bottom line? If we adopt the US dollar, we give up made-in-Canada inflation and fiscal and monetary policies. In 1896, in a speech that won him the Democratic presidential nomination, Nebraska's William Jennings Bryan warned Americans against tying themselves too tightly to the gold standard, saying they should not "crucify mankind upon a cross of gold." His message is relevant for Canadians choosing the currency they wish to live under. We should think long and hard before abandoning the Canadian dollar: It helps us control our own destiny in a way that is fair for all Canadians. The potential gains from adopting the US dollar, such as they are, would not likely compensate for the freedom of choice a floating loonie brings us.

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