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SPECIAL ISSUE ON BRITAIN AND CANADA AND THEIR LARGE NEIGHBORING MONETARY UNIONS, PART II

Guest Editor: Amy Verdun

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INTRODUCTION TO PART TWO: “BRITAIN AND CANADA AND THEIR LARGE NEIGHBORING MONETARY UNIONS”: IS IT ALL POLITICS?

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Britain and Canada each are located next door to a large monetary union. The Brits are faced with the euro that is floating freely as legal tender in twelve Member States (and this number is rising). Canada’s southern neighbor is the United States (US); the elephant whose currency is circulating not only in that federation but also in many other sovereign states further to the South and in many other nations. To make the comparison is of course academic. There is not a strong advocacy coalition, in Canada or elsewhere in North America, calling for a North American Monetary Union (NAMU) or a North American currency. As we have seen from the discussions in the first part of this two-part special issue, there have been calls for the creation of the ‘amero’ but they did not find sufficient political support to gain momentum. By contrast, the option in the United Kingdom (UK) to join the eurozone is a real one. The European single currency is a reality that – if the political will is there on the part of the government and its citizens – the UK can join.

Though the differences between the two countries are profound, we think it is attractive to study the reasons behind the similarities and differences between the Canadian and the UK cases. Why is Canada not seriously interested in integrating

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more closely with the US or other states located on the American continent? Why are the UK government and citizens skeptical of the European single currency when so many of their counterparts on the European mainland are pleased to be part of the eurozone? What economic and political reasons explain the policies we see in both countries? Under what circumstances might their respective stances on the issue change?

The first part of this two-part special issue examines the main issues ranging from an overview of the issues (Verdun, Padfield and Young) to a review of the Optimal Currency Area literature (Willett) to an assessment of the UK tests for the euro (Artis) and various articles that examine the case of Canada from various perspectives (Laidler, Schembri, Grubel and Crowley). This second part of the two-part special issue turns to a number of different aspects of these questions, which in many ways emphasize the deeply political nature of these decisions. Helleiner shows Canada's recent history and experience with exchange rates and takes those insights to reflect on the British case. Howarth offers an analysis of the British government's stance not to move on the issue of the euro, and traces much back to the domestic setting and factors within government leadership. Cohen offers an analysis of what the US perspective is on these issues. He stresses that the US hegemonic position allows it to dictate the rules, and not share sovereignty (i.e. not pool sovereignty); thus making NAMU unattractive to the Canadians. Pereira examines systematically what options Canada has. Bowles moves the focus 'Down Under' and examines what lessons can be drawn from the Australian experience. Seccareccia and Lequain as well as Bolukbasi each in their own way look at how Economic and Monetary Union might have repercussions for adjacent policy-making areas, such as social welfare states. They ask the question what lessons one can draw from the European experience in this realm if one juxtaposes it with the case of Canada, even though the latter in many ways is not in the same situation as the EU countries are (and thus Britain is).

This second part of the special issue addresses many of the political economy questions that are raised when one assesses the exchange rate regime chosen. But many of these contributions go a step further so as to include various political factors that sometimes get left out in pure economic assessments of such a choice of regime. It will not have gone unnoticed that Canada and the US share many things (language, some historical heritage and culture, a long border, much of the economy is intertwined – in 2004 more than 75 percent of Canadian exports went

to the US²). In fact, the Canadians have very few things that they can point to so as to differentiate themselves clearly from the US. How many Canadians can truly see their lives as independent from the US? Or which sovereign state does not have its own international telephone country code? Thus, currency, and the ability to influence one's own monetary policy is important for more than pure economic reasons. The Brits do not need to be as concerned as the Canadians about the state of identity if the pound were to be given up in favor of the euro. Without the pound the British people can still find a large number of symbols that clearly distinguish them from their neighbors (language, some historical heritage and culture, a watery border that divides them, and the economy is only moderately intertwined with that of the EU – in 2003 just over fifty percent of British exports went to the EU³). Of course the key issue is that the political system and the balance of power are fundamentally different in North America than in the European Union.

With the European Union in a state of near-crisis over the Constitutional referenda debacle and the Canadians not even talking about NAMU or fixing exchange rates, we are perfectly aware that this topic will not be picked up on in the near future by journalists, the general public or the governments in these countries, unless a major event occurs that pushes the issue onto the agenda. However, paraphrasing David Laidler who said during the October 2003 conference at the University of Victoria, where these papers were first presented, “Although no one seems to be interested in this topic at the present time, nor will they likely become interested in the near future, that does not seem to be a reason why we should not spend some valuable academic time discussing the issues.” In fact, we hope these academic contributions will be read and commented on if and when interest in this topic picks up again. Seen that our conclusion is that whether or not to join a monetary union is highly political, we are convinced that the time

² “Sixth Annual Report on Canada’s State of Trade”, Department of Foreign Affairs and International Trade, Minister of Public Works and Government Services Canada, Spring 2005, ISBN 0-662-40077-1-5.

³ Department of Trade and Industry, International Trade for Europe and World Trade, <http://www.dti.gov.uk/ewt/uktrade.htm#annex>, 2005.

will come in which these issues are once again hotly debated. At that point we hope students and scholars will re-read these articles and learn some important lessons from this study.

TO JOIN OR NOT TO JOIN: CANADA, BRITAIN AND THE POLITICS OF MONETARY UNION

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The birth of the euro in 1999 was an important monetary development not just for Europeans. It also generated new interest in the idea of regional monetary unions elsewhere in the world. Indeed, many analysts predicted that the world would soon be divided into giant currency unions. National currencies were said to be passé and predictions were made countries around the world would increasingly be forced to choose to join one monetary zone or another (e.g. Beddoes 1999).

Canada was no exception to these trends. Beginning in 1999, an active and high level debate broke out in the country about the need for a North American Monetary Union (NAMU). Supporters argued that the Canadian dollar's days were numbered and that NAMU was inevitable. The issue suddenly received front-page press coverage and became the subject of Parliamentary debate and Senate hearings.

Five years later, the issue is more or less a dead one within Canadian politics. The commitment of Canadian policymakers to an independent floating Canadian dollar appears as strong as ever. In fact, this commitment is often now cited as a model to follow by European opponents of regional monetary union, most notably in Britain. What is the political basis of the enduring Canadian commitment to a floating rate? Does this commitment reflect similar political circumstances as those in Britain? What does the Canadian case tell us about the political basis of exchange rate regimes?

In this article, I explore these questions. I begin by highlighting how unusual the Canadian NAMU debate was from an historical perspective, given that Canada has employed a floating exchange rate for much of the 20th century. The second section examines how the NAMU debate was launched in 1999 not just by external circumstances but also by two domestic groups – neoliberal economists and Québec sovereigntists – each of whom had quite distinct reasons for putting this issue on the Canadian political agenda. I then describe the nature of the opposition of the NAMU idea, highlighting the importance of disagreements within neoliberal circles as well as the role of broader nationalist sentiments. The fourth section compares the politics of Canada’s NAMU debate with the British debate about the euro, arguing that there are indeed a number of interesting similarities. In the conclusion, I highlight some broader implications of these two cases for the study of international monetary politics.

THE CANADIAN FIXATION WITH FLOATING

The emergence of the Canadian debate about NAMU in 1999 was a highly unusual phenomenon when viewed in the context of the country’s history. The idea of joining a monetary union with the United States had never been discussed seriously in Canadian politics throughout the 20th century. The only precedent that I have been able to find for this debate took place during the early 1850s when policymakers in the Province of Canada (then a colony of Britain) discussed whether to abandon the existing colonial sterling standard. This discussion took place at a time when Canadian trade with United States was expanding rapidly and negotiations were underway to sign a free trade agreement between the two countries (the soon-to-be Reciprocity Treaty of 1854-66). In order to facilitate the expansion of trade, Canadian policymakers chose – in the face of British resistance - to introduce a new dollar standard that matched that of the US (Helleiner 2003a). The new Canadian dollar then remained fixed to the US dollar until World War I.

Since that time, however, Canada has demonstrated an unusually strong commitment to a floating exchange rate regime vis-à-vis the US dollar (and all other currencies) (see Helleiner 2005a). The first period when the Canadian dollar floated was between 1914 and 1926. Canada’s policy at this time was not in fact

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abnormal; many countries embraced a floating exchange rate and Canadian policymakers, like those in most other countries, hoped to return to a fixed exchange rate on the gold standard as soon as possible. At the height of the international financial crisis of 1931, Canada also joined Britain and many other countries in leaving the gold standard. But while many other smaller countries soon fixed their currencies to that of a major power, Canada was one of the few countries to allow its currency to float almost completely freely for the rest of the decade.

When World War II broke out in 1939, the Canadian government abandoned the float and fixed the Canadian dollar to that of the United States. This commitment to a fixed rate was soon confirmed at the 1944 Bretton Woods conference. But within a few years, the Canadian preference for floating reemerged. Between 1950 and 1962, Canada became the only major industrial country to demand and receive special exemption from the rules of the Bretton Woods system to pursue a floating exchange rate. It then became the first Western country to move to a floating exchange rate again in 1970 and the only one not to accept the new (ultimately temporary) fixed rates agreed to in 1971. Canada has had a floating exchange rate regime in place continuously since that time.

What explains the Canadian fixation with floating over this period? I have noted elsewhere how this preference partly reflected the absence of a strong business lobby for fixed exchange rates of the kind that has existed in some other smaller open economies (Helleiner 2005a). One reason has been the large presence of multinational corporations in Canada. Because they can cope with exchange rate fluctuations through transfer pricing, these firms have been relatively unconcerned by the floating exchange rate vis-a-vis the US dollar. The business lobby for a fixed rate has also been muted by the fact that the floating Canadian dollar has less volatile than many other currencies.

Private sector preferences were also significant in another way. After the Great Depression, and especially during the postwar years, many other countries relied heavily on capital controls to maintain a fixed exchange rate. By contrast, Canada employed such controls for only a brief period between 1939-1951 because Canadian businesses objected to the way these controls interfered with their international activities and discouraged US investment. Faced with a choice between controls and a floating exchange rate, the Canadian business sector – and Canadian policymakers – opted for the latter. The choice has remained quite consistent since that time.

Even without capital controls, Canadian policymakers could have maintained a fixed exchange rate if they had been willing to adjust domestic monetary conditions to keep the country's balance of payments in equilibrium. But rather than focus

monetary policy on this external goal, Canadian policymakers since the 1930s have placed a high value on national monetary policy autonomy. A floating exchange rate has been the logical consequence; it provided a way to preserve monetary policy autonomy in an environment of high cross-border capital mobility. This commitment to policy autonomy existed not just in the Keynesian age but also after the mid-1970s when policy makers converted to neoliberal approaches to monetary policy making. Throughout this period, the desire for monetary policy autonomy very frequently reflected a distrust of US monetary policy making.

Finally, Canadian policymakers have often seen a floating exchange rate as a useful tool for fostering adjustments in the country's balance of payments. This tool has been valued particularly because the country experiences quite distinct external shocks as a result of the significance of commodity exports in the Canadian economy. In addition, Canadian officials have argued that the country's prices and wages are less flexible than those in some other countries. While some small European countries were able to adjust domestic wages and prices quickly through nation-wide corporatist arrangements in response to changing circumstances, Canadian policymakers recognized that key features of the Canadian political economy – particularly disorganized wage bargaining - made this difficult. In this context, the floating exchange rate has been used not just to buffer external shocks but also to help accommodate domestic wage and price trends.

Canadian officials have also appreciated how a floating exchange rate has helped to ease adjustments in the bilateral US-Canada economic relationship. During the periods of a fixed exchange rate, the officials from two countries found themselves engaged in various bilateral negotiations that were designed to resolve bilateral payments imbalances. The negotiations covered subjects such as the country's level of foreign exchange reserves, the use of capital and trade controls, and the specific level at which Canada's currency should be pegged. These negotiations were not only a cumbersome way of managing the country's bilateral imbalances; they also left Canada vulnerable to US pressure on a range of issues and raised Canadian nationalist concerns about American interference in Canadian sovereignty. The introduction of a floating rate provided a way to cut Canada loose from these problems.

THE EMERGENCE OF THE NAMU DEBATE

Given this history, Canada would seem one of the least likely countries to consider a monetary union with the United States. And yet in 1999 a high-profile

debate on this topic suddenly erupted within the Canadian polity. As noted above, one catalyst for this debate was the creation of the euro which generated new interest in the idea that NAFTA should have an accompanying common currency. This interest emerged not just in Canada (and Mexico) but also within the US where members of US Congress began to debate whether their country should be encouraging foreign countries to adopt the US dollar (Helleiner 2003b). The possibility that the US might soon back a formal dollar zone in the region only reinforced the notion within Canada that this was a topic deserving debate.

Another catalyst was the collapse of the value of the Canadian dollar around this time. Throughout the various periods when the Canadian dollar had floated during the 20th century, its value had rarely fluctuated more than 25 percent on either side of the value of US dollar. In response to the 1997-98 global financial crisis and slumping commodity prices, the Canadian dollar fell to a low of 63c by the fall of 1998. This historic low undermined confidence in the currency and left many Canadians wondering about whether their membership within the Canadian monetary community had become a liability.

The debate about NAMU did not emerge only because of these specific circumstances. Two groups within Canadian society also played a key role in putting the issue on the political agenda of the country at this time. The first involved some prominent economists, namely Herb Grubel (1999), Thomas Courchene and Richard Harris (1999). They proposed the creation of a North American monetary union that would be governed by a European-style North American central bank in which Canada had a significant voice. They advanced three principal arguments in favor of this kind of NAMU, each of which echoes what is often called the 'neoliberal' case for European monetary union. To begin with, they argued that NAMU would eliminate economic costs associated with currency exchange, short-term exchange rate volatility, and longer-term exchange rate misalignments. This, in turn, would not only bolster efficiency but also enable Canadians to realize the full benefits of NAFTA as economic integration within North America accelerated.

Second, these economists argued that NAMU would encourage greater market discipline within Canada by eliminating the possibility of currency devaluations and by promoting price transparency across North America. Workers and firms would now experience more directly the international competitive consequences of their wage demands and business decisions. They would also need to confront the impact of external economic shocks in a more direct fashion by adopting greater wage and price flexibility. The elimination of the devaluation option would, they hoped, have the effect of forcing manufacturers to bolster productivity and prompting workers to moderate wage demands.

Finally, Grubel hoped that NAMU would help to constrain the macroeconomic activism of the Canadian government. The Canadian government would no longer be able to finance fiscal deficits by printing money nor pursue Keynesian goals via discretionary monetary management. As he told the Canadian Senate, 'I would like to have an institution that protects me against the future, when another generation of economists is rediscovering Keynesianism, or whatever threats there might be in the future' (Government of Canada 1999: 62). Grubel also hoped that the government's fiscal behavior would be constrained by a North American equivalent of Europe's Stability and Growth Pact which limited the maximum size of budget deficits and public debt of the members of the monetary union.

Québec sovereigntists were the other major group within Canada to begin to promote the idea of NAMU at this time. In December 1998, even before the publications just mentioned the leader of the sovereigntist party in Ottawa, Giles Duceppe of the Bloc Québécois, suggested publicly that Mexico and Canada should consider adopting the US dollar. Other prominent Québec sovereigntist politicians then quickly took up the idea and promoted it. The alliance between Québec sovereigntists and the above-mentioned economists in support of NAMU was a strange one at first sight. The sovereigntist movement has historically been associated with social democratic values rather than the kind of neoliberal arguments being endorsed by Grubel, Courchene and Harris. In addition, the issuing of a national currency has usually been seen as a key symbol of the sovereignty of new nation states. Québec sovereigntists, however, made it clear that they would continue to favor NAMU even after Québec became a sovereign state.

How do we explain the enthusiasm for NAMU from the sovereigntist movement? Their position has deep historical roots (Helleiner 2005b). Since the origins of the modern Québec nationalist movement in the 1960s, its leadership has long argued that Québec sovereignty would not be associated with the creation of a national currency. Until their recent endorsement of NAMU, they promised that an independent Québec would continue to use the Canadian dollar. This promise was strongly criticized at key moments by many of their own followers who argued that sovereignty without a national currency would be somewhat of a hollow shall. But Québec nationalist leaders stuck to their position. The central reason was a strategic one: they hoped it would help them win more support for political independence.

Sovereigntist leaders in Québec have long recognized that a large portion of the Québec electorate is wary of their project of building a sovereign state. This point has been brought home by their loss of two referendums on question of

sovereignty in 1980 and 1995. In this context, one of their central goals has been to convince undecided Québec voters that the path to sovereignty would be a relatively painless one involving few sacrifices. These undecided voters have been particularly fearful of the monetary instability that might result from the creation of an independent currency after political independence. Sovereignists have endorsed the use of the Canadian dollar as a way of addressing this concern. The importance of this strategy, from a sovereignist standpoint, was well demonstrated when they used the Canadian coin as the 'O' of the 'Oui' signs in the 1995 referendum campaign.

If the promise to use the Canadian dollar was designed to calm the Québec electorate's fears of monetary instability, the more recent idea of endorsing NAMU was even more effective for this purpose. An independent Québec that adopted the US dollar would be better insulated from potential currency instability because of the US dollar's wide use. More generally, an independent Québec would be less vulnerable to Canadian pressure if it no longer relied on the use of the Canadian dollar. It would be particularly useful to the sovereignist cause if Canada adopted the US dollar before the next Québec referendum. This would allow various issues associated with this monetary transformation to be resolved in advance, such as the need to access US dollar payment systems and lender of last resort facilities.

Québec sovereignists thus have had quite a different central reason for backing NAMU than the economists discussed above. That said, they have also advanced some broader economic arguments that are similar, although sovereignists have given the arguments a more nationalist flavor. For example, some sovereignists have embraced the idea that NAMU would force businesses to improve productivity, arguing that this would help boost the competitiveness of Québec firms. They have also highlighted how NAMU would facilitate the growing trade between Québec and the United States, a trade relationship which is now larger than that between Québec and other Canadian provinces (Marceau 1999). Others have questioned the goal of having an independent monetary policy, but usually on the grounds that this goal is increasingly futile for small countries who find themselves vulnerable to speculative financial attacks. They also highlight how volatility in foreign exchange markets ensures that the national exchange rate is often a *source* of external shocks to the domestic economy, rather than a means of adjusting to such shocks. In these new conditions, sovereignists argue that a national currency is increasingly a liability rather than an asset from a nationalist (and social democratic) standpoint.

One further economic argument has been that NAMU might result in a monetary environment more conducive to their social democratic goals than that

provided by the Bank of Canada. In the late 1980s under the direction of Governor John Crow, the Bank of Canada pursued an aggressive zero inflation strategy that was deeply unpopular in Québec (and elsewhere in Canada) (Lemco 1994: 140-2). In justifying their support for NAMU, Québec sovereigntists sometimes note that the US central bank has embraced a more expansionary approach to monetary policy in recent years. In Marceau's (1999) words, 'if the past is any indication of the future, the American pro-employment monetary policy might be more advantageous for our economy than an anti-inflationary Canadian monetary policy designed to reflect the prerogatives of Ontario.'

THE OPPOSITION TO NAMU

As soon as the NAMU issue was raised, it provoked strong opposition within Canada. Interestingly, the most prominent opposition initially came from economists and policymakers who endorse neoliberal economic values, but who disagreed with Grubel, Courchene and Harris on this issue. After publishing Harris and Courchene's paper, the C.D. Howe Institute – a think-tank normally associated with neoliberal economic advice – quickly produced prominent work critiquing the NAMU idea (Laidler and Poschmann 2000, Robson and Laidler 2002). Economists and policymakers in the Bank of Canada who often endorse neoliberal economic thinking – including ex-Governor John Crow – also played a lead role in opposing NAMU. In the journalistic world, *The National Post* – the national newspaper most closely associated with neoliberal views – highlighted the disagreement in neoliberal circles by publishing a weeklong feature in which Milton Friedman defended floating exchange rates in a debate with Robert Mundell. Neither of the two political parties that are most supportive of neoliberalism on the right – the Progressive Conservatives and the Canadian Alliance – were willing to back the NAMU idea (although a few members of these parties have expressed in the idea – see LeBlanc 1999).

Neoliberal opponents of NAMU have highlighted the two macroeconomic arguments that have long been used in Canada to defend the floating exchange rate regime. First, they have called attention to the economic costs of losing the exchange rate as a tool of microeconomic adjustment. Because Canada and the United States experience the asymmetrical economic shocks, Canada's participation in NAMU would force it fall back upon alternative means of adjusting to these shocks. In the European context, adjustments can be fostered not just by corporatist arrangements, but also by labor movement between countries and intra-regional fiscal transfers. Neither of these latter mechanisms are

available in the North American context. The bulk of the adjustment mechanism would thus fall upon the flexibility of domestic wages and prices. An external shock that would presently provoke a depreciation of the Canadian dollar, for example, would require domestic wages and prices to be forced downward under NAMU. Since wages and prices are relatively inflexible in the short-term, the result would likely be higher levels of unemployment and lower levels of real output.

This argument in favor of floating exchange rate echoes Milton Friedman's famous 1953 case that it was much more efficient to adjust to an external shock by changing one price in the economy – the exchange rate – than millions of domestic prices which are often inflexible and slow to adjust. Interestingly, Friedman himself was intrigued by the Canadian case from a very early date; one of the first times he put this argument forward in favor of floating rates was during a public radio debate in Canada in 1948 (Friedman and Friedman 1998: 189). Neoliberal supporters of NAMU contest this defense of floating rates on the grounds that the inflexibility of domestic wages and prices should not be taken as a given. One of their goals in advocating NAMU, after all, is to transform the monetary environment in a way that forces businesses and workers to become more flexible and responsive to changing economic conditions. But the likelihood of this result is questioned by NAMU opponents (Robson and Laidler 2002).

Second, neoliberal opponents of NAMU have argued that monetary union with United States would not necessarily bring any greater price stability than Canada already has. In the European context, neoliberal enthusiasm for the euro in many countries has stemmed from the promise that the European Central Bank – modelled as it is on the inflation-fighting Bundesbank – would offer more 'disciplined' monetary policy than their own national monetary authorities have provided. This argument has much less appeal to neoliberals within Canada because of the recent history of Bank of Canada policy. The Bank's zero inflation policy of the late 1980s was fought with a determination that even many liberals found too extreme. The new commitment to low inflation was then institutionalized in 1991 through the use of inflation targets that are established by the government for the Bank. From a neoliberal standpoint, inflation targets have subsequently provided a successful way of anchoring price expectations in floating exchange rate regime.

It is not all clear that NAMU would provide a more stable domestic monetary environment. Many neoliberal opponents of NAMU echo the argument of Marceau that the US Federal Reserve's anti-inflation credentials have been less strong than the Bank of Canada's in recent years. While this argument leads the sovereigntist Marceau to endorse NAMU, it prompts these neoliberal economists

to view NAMU skeptically on the grounds that it would represent a 'soft' currency bloc (e.g. Crow 1999). Canadian neoliberal distrust of American monetary policy has long roots. The Canadian decision to float its currency in 1970 was strongly supported by many economists at the time on the grounds that it would insulate Canada from American inflationary pressures. For the same reason, John Crow opposed the idea of fixing the Canadian currency to the US dollar during the late 1980s. In his view, the Bank of Canada's efforts to fight inflation at that time would have been inhibited by such a monetary regime since the Fed was less aggressive in its pursuit of price stability (Laidler and Robson 1993: 175-6).

In addition to highlighting the costs of NAMU, neoliberal opponents of NAMU have argued that its benefits are easily overstated. In particular, they do not think that the efficiency gains to be realized by eliminating transaction costs associated with currency exchange and a floating exchange rate will be very large in the Canadian context. This view appears to be reinforced by the position that the Canadian business community has taken within the NAMU debate. Grubel (1999: 38) has hoped that it would become a major advocate of NAMU because of businesses' desire to eliminate transaction costs in an age when US-Canada commerce is expanding very rapidly. But true to historical pattern, the issue of eliminating currency related transaction costs is not one that has generated much passion in Canadian business circles. The major business associations in Canada have been unwilling to endorse the idea of NAMU. This has even been true of the major banks and the business associations representing the most internationally oriented firms (Helleiner 2004).

Opposition to NAMU has stemmed not just from these neoliberal economic arguments. It has also reflected political concerns many Canadians have about the loss of national sovereignty. Many neoliberal economists have in fact made nationalist arguments a central part of their case against NAMU (Robson and Laidler 2002). Within the business community, those who oppose NAMU also cite concerns about Canadian sovereignty and national identity much more prominently than any specific economic argument (Rubin 2001). These concerns are also shared by many others in Canadian society.

Some supporters of NAMU have tried to minimize nationalist opposition by stressing that Canada could still retain distinct images on one side of future North American coins and notes (e.g. Courchene and Harris 1999: 22). But the concerns of NAMU opponents do not focus so much on the question of imagery on money. Much more prominent has been the concern that NAMU would produce the loss of a crucial tool with which the national community manages its economic destiny. This argument has particular force because it seems unlikely that Canada

would have the kind of political voice within a North American monetary union that Grubel, Courchene and Harris hope for. Opponents of NAMU have argued that the United States would inevitably dominate a North American monetary union because of the asymmetries of power within the region. They suggest that the common currency for North America would very likely simply be the US dollar, and Canada would be given very little influence over its management.

This concern has been a more difficult one for NAMU supporters to address. The most interesting attempt has come from Courchene and Harris who have suggested that Canada could lobby to join the US central bank as a new 13th Federal Reserve district. If it was successful, they suggest that Canada's voice would parallel that of individual European countries within the new European central bank. As Harris (2000: 95) puts it: 'Consider the currency choices facing Canada and Britain...in Canada's case, this means sharing of voting membership on the North American Federal Reserve with the 12 existing US Federal Reserve Banks and the Mexican central bank. In Britain's case, this means joining the euro with a similarly small voting share – one of twelve votes.'

Given British concerns about the limited influence they would have on joining the euro zone (see below), this parallel is not perhaps the best one for assuaging Canadian nationalist concerns. Equally important, however, is the fact that it is not accurate. The federal characters of both the US central bank and the new European Central Bank are more complicated than Courchene and Harris imply. If Canada became a 13th Federal Reserve district, it would not be guaranteed a 1/13th share of voting on the all-important Federal Open Market Committee (FOMC) that currently sets US monetary policy. The committee does indeed have 12 voting members at present. But only five of these votes are allocated to the presidents of the district Reserve Banks. The remaining seven are assigned to members of the Board of Governors of the Federal Reserve System who have been appointed by the US president and confirmed by the US Senate. Canada would not even be guaranteed to receive one of the five Reserve Bank votes since these are shared on a rotational basis among the presidents of the other Reserve Banks. At present only the president of the Federal Reserve Bank of New York has a permanent vote on the FOMC.

A further complication concerns the fact that the Reserve Banks are not presently designed to represent the broad public interest of the districts they represent. The Bank of Canada is a publicly owned institution whose governor and board members are selected by the Canadian government. By contrast, the Reserve Banks are privately owned by commercial banks that exist within their district. Six of their nine board members are elected by these private banks, while the remaining three are chosen by the federal Board of Governors. The latter also

selects the chair of the nine-member board and approves the selection by the board of the Reserve Bank president. Interestingly, the Reserve Bank president is also not even bound by the preferences of the local board when casting votes within the FOMC. If Canada became a 13th district represented by a Reserve Bank of this kind, this Bank could hardly be counted on to be a representative of the Canadian public interest. Instead it would reflect a strange combination of Canadian private bank preferences and the opinions of the US appointed members of the federal Board of Governors.

Decision-making within the US Federal Reserve thus represents a rather odd form of federalism. Its Board of Governors holds most power with the system as a result of majority voting share on the FOMC and the fact that it has a central role in the appointment of the Reserve Bank presidents and their boards. If the Reserve Banks express regional preferences, it is the opinions of local private banks that are dominant. To be guaranteed a 1/13th voting share on the FOMC, Canada would need to lobby hard for the Bank of Canada to become a permanent member of the FOMC, as the Federal Reserve Bank of New York (FRBNY) presently is. But if this option was pursued, Canada would also need to maintain some degree of control over the process by which the head of the Bank of Canada and its board was selected. The other option would be to press for a permanent Canadian representative on the Board of Governors.

The European Central Bank is organized in a more decentralized manner that gives greater influence to the 'regions' of the common currency zone than the Fed. The key decision-making body is the Governing Council on which national central banks hold a majority of the votes vis-à-vis a six-member Executive Committee of the Council. At the time of the ECB's creation (and the time that Courchene and Harris were making their argument), the head of each national central bank was in fact guaranteed one vote on the Governing Council. The kind of rotation system that exists among Reserve Bank presidents in the Fed was, in other words, not initially replicated in the ECB. The Executive Committee members are also selected by the unanimous approval of the national governments participating in the euro-zone. As a result, even small European countries hold a veto which gives them much more power than Canada would likely acquire with respect to the selection of the Fed's Board of Governors and its chair. Unlike the Fed's Board of Governors, the ECB's Executive Committee also has no influence over the selection of the heads of national central banks; this selection process is controlled entirely by each national government.

With the prospect of the entry of many new countries to the euro zone, the European Union Council of Ministers approved in March 2003 a new system of voting that will dilute the influence of national central banks somewhat. It allows

for a Governing Council whose size can never exceed 21 members. The six-member Executive Committee is retained, but the remaining 15 voting members will be selected from national central bank governors according to a system of rotation from groups of countries that are organized according to their economic and financial significance within the euro area. The proposed groupings are organized in a manner that will give larger countries afloat more often than smaller countries.

This rotation system moves the ECB closer to the Fed model of decision-making. But the ECB's model remains a distinctive one that is characterized by a greater degree of decentralization. In addition to the other differences mentioned above, it must report to, and consult with, a number of pan-European institutions, in which each country has a voice. When the Bank's president and Executive Council is selected, the European Parliament must be consulted (although it can not reject nominations). The Bank's annual report is also presented to the Parliament which can also request that the Bank president or Executive Committee members appear before its committees. The ECB president also reports to the European Council and European commission (Dyson 2000). In North America, there are no equivalents for these kinds of pan-regional bodies that the Fed could report to or consult with. In the absence of such regional political institutions, many critics of NAMU have argued that a future North American Fed would lack legitimacy (e.g. Buiters 1999, Fortin 2000).

Critics of NAMU also highlight how comparisons between the ECB and a possible North American Fed assume that the US would be interested in allowing Canada to join the Fed. This possibility briefly seemed worth discussing in 1999 when US Congress began to hold hearings on the question of whether it should be encouraging foreign countries to adopt the US dollar. But it quickly became apparent that US politicians had little interest in the idea of giving Canada and other countries even a limited decision-making role within the Fed in such a scenario. Their discussions focused almost exclusively on the narrow economic question of whether the US government should agree to share seigniorage revenue with countries adopting the US dollar. US policymakers made it clear that they had no intention of extending lender of last resort facilities to such countries, let alone the idea of sharing decision-making power within the Fed. In the end, Congress was not even willing to endorse the idea of sharing seigniorage (Helleiner 2003b).

The content and outcome of the US congressional debate has thus only strengthened nationalist opposition to NAMU within Canada. It suggests that the most likely scenario under which the North American monetary union would come into being would be one in which Canada (and perhaps Mexico) unilaterally

adopted the US dollar. If monetary union was to take place in this ‘quasi-colonial’ manner (Laidler and Poschmann 2000: 18), many Canadians who might have been more sympathetic to the idea have turned against it. Leaving aside the question of lost seigniorage and the need to develop lender of last resort facilities, Canadians would be left with no say over monetary policy.

The only group within Canada that seemed relatively unconcerned by this outcome was the Québec sovereigntist movement. During the 1995 referendum campaign, many sovereigntists had already announced that they were willing to unilaterally adopt the Canadian dollar even if an independent Québec had no representation within the Bank of Canada. This stance was designed to convince Québec voters that independence would be associated with monetary stability even if the rest of Canada refused to share decision-making power with the Bank. It was not a very large step to move from this position to the idea of embracing a unilateral adoption of the US dollar (Helleiner 2005b).

COMPARING THE DEBATE IN CANADA AND BRITAIN

Five years after the outbreak of the NAMU debate in Canada, it is clear that the country is very unlikely to embrace a monetary union with the United States anytime soon. Within elite policymaking circles, the idea of NAMU still provokes some interest, but this interest is primarily driven by intellectual curiosity rather than a sense of political possibility. The political defeat of the NAMU idea was caused partly by the fact that the neoliberal economists advocating NAMU were unable to find significant support for their proposal either within the business community or among enough of their colleagues within the academic and policymaking world. As we have seen, it also reflected the emergence of broader Canadian nationalist concerns, concerns that were only strengthened by the US congressional discussions on dollarization. Although Québec sovereigntists supported NAMU on a different kind of nationalist basis, they were dealt a political setback with the 2003 defeat of the Parti Québécois government in Quebec. Finally, it is worth noting that the sudden currency depreciation of 1998 that helped to generate interest in NAMU was soon reversed, and by early 2004, analysts in fact worried about the rapid *appreciation* of the Canadian dollar above 75c.

The political defeat of the NAMU proposal within Canada is of interest not just to Canadians. It is increasingly cited by opponents of regional monetary unions elsewhere, most notably in Britain. British opponents of EMU ask: if Canada can resist joining a monetary union with the US, why can't Britain reject

the euro? The question is, of course, a rhetorical one, but it raises an interesting comparative question about the political basis for the enduring floating exchange rate regime in the two countries.

One important parallel is that British opposition to monetary union – like that in Canada – has been driven above all by concerns about the loss of national sovereignty. As we have seen, Canadians have more reason to fear on this account. But British nationalist opposition to the euro remains a potent political force because it is tied to a broader worry about the fact that the project of European integration is undermining British sovereignty (Engelmann et al. 1997). This nationalist opposition is not shared by all in Britain. A substantial sector of British society supports the euro because they hold a favorable view of the goal of strengthening European political integration. Although there is little equivalent Canadian enthusiasm for the project of North American political integration, we have seen how support for NAMU does exist among the one group that does not embrace Canadian nationalism: the Québec sovereigntist movement. Here too there is a parallel in Britain where support for the euro is much stronger among Scottish nationalists than elsewhere in the country (Howarth this issue).

Another similarity between the two countries is the fact that neoliberal opinion is divided on the question of monetary union in both countries. These cases highlight the important theoretical point that neoliberalism does not generate a consistent policy preference vis-à-vis monetary unions. In the continental European context, the shift to neoliberal thinking during the 1980s and 1990s is frequently credited as one of the central causes of the growing interest in monetary union within the region (e.g. McNamara 1998). In Canada and Britain, however, the same ideational shift did not produce this result. To be sure, it has encouraged the idea of monetary union to be put on both countries' political agenda. But many neoliberals have emerged as key opponents of monetary union and they see the continuation of their country's floating exchange rate regime as fully compatible with their preferences. In both cases, neoliberals worry about the loss of the exchange rate tool of adjustment in a context where their countries are considering joining a currency union that does not meet the criteria of an 'optimum currency area'. Neoliberals in Canada also fear that NAMU might represent a 'soft' currency zone. British neoliberals are less concerned that the European central bank might be soft on inflation, but they do worry that the creation of the euro may encourage a more interventionist European super-state to emerge over time (Howarth this issue).

Interestingly, this very prospect helps to explain why many British social democrats and labor leaders *favor* the euro (Gamble and Kelly 2001; Josselin 2001). Some labor leaders hope that EMU will strengthen Europe-wide collective

bargaining and help workers to obtain better employment rights at the European level. Many social democrats also believe that it may encourage larger fiscal transfers across Europe as well as the creation of Europe-wide countercyclical fiscal policies in the future. Others support for the euro because it will ensure that countries are no longer vulnerable to speculative attacks from global financial markets. They hope that, by creating a more stable macroeconomic environment in this way, the euro will enable national governments to pursue progressive supply side reforms.

These arguments from the left in favor of monetary union are heard much less often in the Canadian context. We have seen some of them come from social democrats within the Québec sovereigntist movement. But outside of Québec, the Canadian left has been opposed to NAMU. They see no prospect for the North American integration to be associated with social democratic values in a European mode. Indeed, closer economic integration with United States has long been seen as a threat to social democratic values on the Canadian left because it is associated with downward harmonization to US standards in areas such as labor legislation and social policy. Even the Canadian left's strong opposition to John Crow's zero inflation policy during the late 1980s has not led them to echo the Québec sovereigntist case that NAMU could act as a means of preventing a repetition of this experience (Helleiner 2004).

If the support of many on the left thus provides a wider basis of support for monetary union in Britain, the same is also true of the positions of the business sectors in the two countries. In the Canadian case, we have seen how the leading business associations have not been very supportive of NAMU. In Britain, by contrast, key British business associations, such as the Confederation of British Industry, have endorsed British entry into the euro zone primarily on the grounds that it would reduce currency-related transaction costs. Many financial firms in the City of London have also been supportive of the euro (Howarth this issue).

In sum, it does make some analytical sense for British opponents of the euro to see Canada as a kind of political model. The political basis of opposition to monetary union is, after all, quite similar in the two countries. In both cases, the role of nationalism is crucial in generating opposition - although its role is also complicated by the support for monetary union that stems from Québec and Scottish nationalism. The divisions within neoliberal circles also play an important role. But the parallels with Canada should also not be overstated. In Britain, the question of embracing the euro is likely to remain much more politically prominent because it is sustained by a wider coalition, including many on the left and within the business community as well as supporters of European integration more generally.

CONCLUSION

The Canadian debate about NAMU has been an interesting and significant one for scholars of international monetary politics in two ways. First, and most generally, it demonstrates that the trend towards giant currency blocs is far from an inevitable phenomenon that is driven by global trends. Distinctive domestic and regional political factors will continue to determine the choices that national governments make concerning this issue. And these choices may often involve a strong rejection of the option of joining a monetary union.

Second, many of the factors that are frequently cited by scholars of International Political Economy (IPE) to explain choices about exchange rate regimes do not fit the Canadian (or British) case well. Some scholars highlight the importance of 'partisan' or ideological factors (for a survey, see Broz and Frieden 2001). This literature assumes that left-of-center political parties and ideologies will favor growth and income redistribution, while those on the right will be more concerned with price stability. We have seen, however, how these distinctions do not translate into consistent exchange rate regime preferences in the Canadian and British cases. For example, the growing political prominence of neoliberals who favor price stability is often said to be a key cause of the new interest in monetary unions. But this ideational shift has played a much more ambiguous role in Canada and Britain; it has been compatible with support for *both* monetary union and a floating exchange rate regime. Indeed, more generally, it is worth noting that the debate between floating rate and fixed rates/monetary union is one that has long divided neoliberal opinion. Similarly, while the Canadian left outside Québec opposes monetary union, much of the British left supports it. The difference in their position reflects the views each group holds about the nature of the monetary union their country would join. In short, partisan politics and ideologies matter, but they are highly situationally dependent.

The Canadian case also calls into question the prominent role assigned by some IPE scholars to private sector preferences in the determination of exchange rate regimes. The most prominent advocate of this approach is Frieden (1991, 1996, 2002) who argues that countries with open economies are much more likely to favor of a fixed exchange rate regime or monetary union because of the prominence of internationally oriented businesses who seek to minimize cross-border transaction costs. Despite being one of the most open economies in the industrialized world, this prediction is not borne out in the Canadian case. As we have seen, the private sector in Canada is relatively unconcerned by the issue of

currency related transaction costs. This finding reinforces the argument of McNamara (1998: 37-41) who found the same to be true in the European context.

Another analytical argument that receives little support from my analysis is that which stems from rational choice models which assume politicians are 'survival-maximizers' influenced by distinct institutional and political environments. Hallerberg (2002), for example, attempts to attribute Canada's preference for a floating rate to its majoritarian (single-member plurality) electoral system. Because the costs of losing office are very high in this kind of system, he predicts that ruling Canadian politicians will place a high value on the role of discretionary monetary policy – and thus a floating exchange rate system – in generating support in advance of elections. The preference for floating exchange rates, he argues, is only reinforced by the federal nature of Canada's political system in which fiscal policy is less useful as a form of national microeconomic management (because the fiscal policies of provinces cannot easily be controlled by the federal government). Hallerberg's explanation is a deductive one rather than one drawn from conducting research about the sources of Canadian exchange rate policymaking. My own analysis of the reasons why Canadian policymakers have favored monetary policy autonomy both in the past and during the NAMU debate does not provide much support for his argument. As we have seen, the much more important source of this preference has been a distrust of American monetary policy.

Finally, both the Canadian and the British cases suggest that nationalism can be a very important factor in explaining country preferences vis-à-vis monetary unions. Strangely, the significance of nationalism for exchange rate politics has received relatively little attention from IPE scholars. This neglect may partly reflect the dominance of 'rationalist' analytical models in the IPE discussions of exchange rate regimes. But even scholars sympathetic to more 'constructivist' analyses have devoted much more attention to the significance of specific economic ideologies than they have to the role of more deeply rooted national identities. As we have seen nationalism can play a complicated role in explaining views towards monetary union. While it often encourages opposition towards monetary unions, it can also generate support for them when the nationalist movement is a sub-state one seeking greater autonomy or separation from a central government. If theoretical lessons are to be drawn from the Canadian and British debate on monetary union, then, one of the most important should be that these kinds of links between nationalism and monetary politics are deserving of more attention from IPE scholars.

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THE DOMESTIC POLITICS OF BRITISH POLICY ON THE EURO

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INTRODUCTION

British entry into the Third Stage of Economic and Monetary Union (EMU) and adoption of the euro to replace the pound has been one of the most divisive issues in British politics since the debates on the ratification of the Maastricht Treaty. This article examines four leading explanations of British policy on the euro rooted in an analysis of domestic politics: intra-party political (ideological divisions and leadership battles); inter-party political-electoral; public opinion focused; and pluralistic (interest group). Other explanations have been posited by various academics including: structuralist (Talani 2000a & b, George 1998 and Young 1999); ideological-economic (ideational) (Blair 2002); geo-strategic (George 1989); ideological-nationalist (ideational) (Berrington and Hague 1998; Blair 2002; Rawnsley 2001; Seldon 2001; Young 1999 and Wilks 1996; with Risse 2003 writing on identity politics and the euro); and liberal intergovernmentalist (Moravcsik 1998). While ideology – notably views on the nation state, European integration and on economic matters – infuses the domestic political debate on EMU, ideological (ideational) explanations of British policy are not explored here for lack of space. The degree to which the economic debate on British participation in EMU – with the arguments against tending to gain the upper hand in British academic and political debate – is also not examined here. (See Forder and Huhne (1999) and Blair (2002) for a rehearsal of these arguments and the latter for a further analysis of the political impact of the economic debate).

This article posits that British government – and in particular Labor Government – reluctance to support EMU membership can be explained more in terms of ideologically infused intra-party politics and the realities of pluralist politics, while explanations rooted in an analysis of inter-party policy and public opinion are less helpful. The article also compares the relevance of the four domestic political explanations of British policy with regard to the positioning of respectively the two largest political parties in the country: (New) Labor and Conservative (Tory).

Much has been written of Britain’s “awkward partner” (George 1989) or “semi-detached” (Bulmer 1992) status in the country’s relations with Europe (see also Baker 2002; Baker and Seawright 1998; Bishop 2003; Hale 1999 and Young 1999) and a diversity of explanations for this “awkwardness” have been provided. Numerous examples serve to illustrate British skepticism towards European integration: from the decision not to join the original communities in the 1950s, the demands for a renegotiated terms of entry, the budget rebate debate of the early 1980s, to the opt outs on the social protocol and EMU in the Maastricht Treaty and obstructionism in European Union (EU) policy-making during the BSE (bovine spongiform encephalopathy or “mad cow disease”) crisis. The very large majority of British politicians – Labor, Conservative or Liberal Democrat (the third, relatively pro-European party) – oppose any form of European federalism. Most Conservatives, many Labor and even many Liberal Democrat politicians have been principally interested in (or, in the case of left-wing Labor, opposed to) the EU as a regional free-trading bloc. The transfer of policy making to the EU level in most areas has been opposed by British governments and, when accepted, only at an intergovernmental level.

For Young (1999: 492), Prime Minister Tony Blair’s favorable but hesitant position on the euro simply demonstrates the traditional European policy line of British political leaders “who ... were sceptical about the success of the weird integrationist scheme, and argued that we must wait and see if the Common Market worked, which it probably wouldn’t”. Thus, the Prime Minister’s announcement in the Fall of 1997 not to participate in the euro from 1 January 1999 reflects “the politics ... the culture and the psychology” of the United Kingdom (Young 1999: 493). Albeit very popular as an explanation of Conservative and Labor government policies on the euro, relying on this traditional “reluctance” and “awkwardness” leaves many questions unanswered about the details of British policy.

¹ The author would like to thank Amy Verdun, Melissa Padfield, Patricia Young and two anonymous reviewers for their constructive suggestions and comments.

On the euro, Conservative government policy prior to 1997 was to forward an alternative policy for monetary integration and then, when this had clearly failed to win over the other European governments, demand a British optional opt-out from Stage Three (thus accepting the macroeconomic convergence of Stage Two but refusing the single currency) with a “wait and see” policy, according to which the success of EMU and Britain’s outsider position would be evaluated once EMU began (Stephens 1996). Under the leadership of John Major, the Conservative government initially maintained a “non-position” on the euro, not ruling out a referendum prior to the start of stage three of EMU (in 1997 or 1999) but not promising one either (George 1998), publicly believing and hoping that the project would collapse. In the Spring of 1996, Conservative Central Office (not the government) stated in a protocol that *if*, following the 1997 elections, it adopted a position in favor of the euro, it would then hold a referendum prior to British entry. This was not much of a commitment on the matter. “Wait and see with extreme scepticism”, one leading commentator has called the Conservative position (Young 1999: 467). In the meantime, many Conservative MPs fought the 1997 election with a “never” policy on the euro. In opposition since 1997 – under the leadership of William Hague, then, from September 2001, Ian Duncan Smith (IDS) and then, from November 2003, Michael Howard – the Conservative leadership’s position became more rhetorically hostile to membership, demanding an immediate referendum on the euro, criticising the Labor government’s “five economic tests” established ostensibly to determine the appropriate timing of British entry (see below) and promising a no reconsideration policy for the life of the next Conservative government and then a policy shift only following a referendum in the life of the subsequent government. Interestingly, official Conservative policy has *never* promised to seek to keep Britain out of the eurozone indefinitely.

In opposition, the Labor party during the early 1990s was very much in favor of British participation in stage three of EMU. Enthusiasm moderated after the forced British departure from the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS). The party (as “New Labor” under the leadership of Tony Blair from July 1994) only embraced the idea of a referendum on the issue – on which Blair would personally campaign for the “yes” side – a few months after the change in Conservative party policy on a referendum in 1996. In the lead-up to the 1997 elections, Blair became even more cautious in his pro-euro rhetoric. Once in government from June 1997, Blair balanced carefully between an enthusiastically “pro-Europe” rhetoric, a cautiously pro-euro position and a hesitancy on setting a date for a referendum on the matter. The announcement in the week following the election of the decision to render the

Monetary Committee of the Bank of England autonomous suggested strongly that the new government was preparing the country for eventual membership. However, on 27 October 1997, the Labor Government made a clear pledge not to join EMU during the life of the government until following elections in 2001. Gordon Brown, the Chancellor of the Exchequer, told the House of Commons that disjunctions between the British and EU economies prevented any rapid move to British membership but also that membership should take place if the economic benefits were “clear and unambiguous” which signposted the priority of politics in any future decision on the euro! Brown called for government efforts to align the British and EU economic cycles but also efforts to prepare public opinion for eventual membership. The government sought to legitimize its policy with a veneer of economic analysis, allowing a referendum on the policy only once its five economic tests had been satisfied (as determined officially by the Treasury) (Treasury 1997).² These five tests comprise the following:

- “whether there can be sustainable convergence between Britain and the countries of the single currency;
- whether there is sufficient flexibility [in the British economy] to cope with economic change;
- the effect on investment [in Britain];
- the impact on [Britain’s] financial services industry;
- (and) whether [euro zone membership] is good for employment”

On 9 June 2003, the Chancellor of the Exchequer, Gordon Brown, presented the Treasury’s eighteen reports on the five tests to the House of Commons, concluding that only one of the criteria had been met – the success of British financial services in adjusting to EMU – but that progress was being made in meeting the others. Gordon Brown and the Treasury defended the reports as the “best application of economic theory to a public policy decision in the history of British government”. It certainly cost more ink and paper than any previous Treasury study. However, the reports also conveniently embody the full ambiguity of the Labor Government’s policy of “Yes in principle but only when the timing is right”, postponing any decision on holding a referendum until after the next legislative elections at the earliest following a further assessment.

The five economic tests conform in many respects to the conditions laid down by the Major Government prior to the 1997 elections. However, since the

² Many commentators (journalists, politicians and academic economists, including Michael Artis in this special issue) have attacked the five tests as overlapping and imprecise.

elections, the rhetoric of the two leading parties has been markedly different: Tory, the rather negative and pessimistic “wait and see”; Labor, the more positive and cautiously optimistic “prepare and decide” (Blair 2002). There have been two principal differences in real policy between the two parties: engagement to convince the public and precision. First, the Labor Government is – at least officially, if not much in practice – committed to leading a change in public opinion on the euro. Second, the Labor Government has outlined specific plans for the move by the UK to membership in EMU. Brown set up the Business Advisory Group (BAG) in late 1997 to examine the practical implications of EMU.³ The Treasury’s Outline National Changeover Plan of February 1999 (Treasury 1999) – modified by a revised second plan in March 2000 (Treasury 2000) presents a draft timetable for joining, the central government’s preparations to date and to come, and recommendations to a number of sectors of the economy to prepare them for membership (the preparation among British business for EMU membership is acknowledged to be “poor”). The eighteen Treasury reports of June 2003 also propose necessary developments in the British economy to enable four of the five tests to be met in the upcoming years. As one practical step, Gordon Brown hired the services of a professor of economics at Imperial College to looking into encouraging the use of longer-term fixed rate mortgages which would diminish the impact of accession to the eurozone on the UK housing market and economy.

INTRA-PARTY POLITICS: IDEOLOGICAL SQUABBLING AND LEADERSHIP MANOEUVRES

Aspinwall (1999) examines the impact of the British electoral system to explain the reluctance of the two largest parties on the most sensitive European questions. The First-Past-the-Post (plurality / single-member district) system contributes to the deep divisions that plague the Conservative and Labor parties on the Europe issue. The FPTP system penalizes small parties (without a regional vote concentration) while favoring the two dominant parties which remain broad churches of opinion. Much of the anti-Europe opinion on the left and the right will remain in the two main parties. This anti-integration opinion cannot be ignored by Labor and Conservative leaderships: they still need these voters and party

³ The BAG includes representatives from business and trade organizations, the Consumers’ Association and the Trades Union Congress (<http://www.hm-treasury.gov.uk/pub/html/docs/emu/emubag.html>).

supporters to secure parliamentary majorities, especially because euro-phobes and skeptics are more likely to turn out to vote than the euro-agnostics. Both Labor and the Conservatives must tolerate a degree of internal dissent and both must tailor at least some of their programs and policies towards these supporters. This is especially true for the Conservative party (Berrington and Hague 1998) but Labor must also still play this game with its left-wing and some of the affiliated trade unions such as the RMT (transport union) (Gamble and Kelly 2000). Major and Blair both embraced a policy centred on economic appropriateness and a referendum in order to defuse the divisiveness of the issue within their respective parties.

Currently the divide between pro and anti-euro factions within the Conservative Party is very heavily weighted in favor of the latter, with very active anti-euro groups with large memberships – notably Conservatives Against a Federal Europe – opposing less active groups with smaller memberships, including the “Tory Reform Group”, “Conservative Group for Europe” (Leon Brittan) and the “Tory Europe Network” (which Kenneth Clark launched in the *Times* on 14 May 2002). Although less divided than the pre-1997 Conservatives on the question of the euro (Gamble and Kelly 2000), there persist important divisions on the euro question within the Labor government and backbench. These divisions were given organizational form in 2002 with the creation of polarised party groups: the pro-euro “Labor Movement for Europe” and its rivals the “Labor Euro-Safeguards Campaign” and “Labor Against the Euro”⁴ set up in early 2002, which makes the establishment of a more committed Labor government policy line more politically problematic than would have been the case in the government’s first term.

The divisions within the two major parties relate to on-going battles for leadership, with regard to which European issues (and in particular the euro) have considerable relevance. This is most obvious in the Conservative party. Throughout his period as Prime Minister, John Major was plagued by constant challenges to his leadership led by anti-Europeans because of his support for the Maastricht Treaty (Young 1999) and sought to weaken the challenge to his leadership through the adoption of the “wait and see” policy. The democratization of the Conservative leadership selection process in 1997 pulled the party leadership in a considerably more Euroskeptic direction better reflecting the views of the ageing party rank and file which is overwhelmingly hostile to euro

⁴ See <http://www.congressfordemocracy.org.uk/>.

membership.⁵ William Hague and Ian Duncan Smith (IDS) adopted a strong anti-euro (and anti-EU: “in Europe; not run by Europe”) rhetorical position and were selected over the more experienced and well-known pro-euro / EU contenders Michael Portillo and Ken Clark. It is particularly demonstrative of the relative importance of intra-party squabbling that IDS based his leadership campaign on an anti-euro / EU stance even though Hague’s strategy to focus on European issues during the 2001 national elections clearly backfired (see below).

Disagreements persist between the two leading Labor government actors on the euro. The quality British press has dedicated a considerable amount of attention to the relationship between the Chancellor of the Exchequer Gordon Brown and Prime Minister Blair as a determining variable in the euro referendum debate. Brown has long coveted the leadership of the Labor Party and the post of Prime Minister and has always felt that Blair usurped the position from John Smith’s rightful heir as many in the Party desperately sought to appeal to the wavering voter of Middle England. Although Brown joined Blair to establish the pro-euro / Europe campaign group Britain in Europe, Blair has been widely reported as the more pro-euro / European of the two (Blair 2002). Despite Blair’s growing public support for British entry, it is claimed that Brown has repeatedly demonstrated his reluctance, most notably, through his reported “non-commitment” at Treasury Select Committee sessions on the euro in February 2003 (Miles 2004).

The use of the five economic tests has reinforced the power of Brown over the timing of any future referendum, essentially giving the Chancellor of the Exchequer “a veto over if and when the government recommended entry” (Stephens 2001, 201). Moreover, the use of the tests has also reduced divisions in the Labor Government, notably between Brown and the pro-euro former Foreign Secretary, Robin Cook. It has been claimed that Brown has the final say on the holding of the euro referendum but that he has not chosen to allow a referendum given the danger that it could create for his ambition to become Prime Minister. Tony Blair, bearing in mind the fate of the Conservative Party during the 1990s, was concerned by the potential divisiveness within the Labor party that the euro issue could create. Blair sought to suppress Cook’s enthusiasm for the euro so as to prevent these divisions (see, for example, comments in the *The Guardian*, 8 July 2000). It has been suggested (Blair 2002) that the replacement of Robin Cook as Foreign Secretary in the June 2001 cabinet reshuffle with Jack Straw owed in

⁵ Polls indicate that Conservative Party voters are far more likely to oppose British participation in the euro (see for example, 25 June 2000 MORI, Commissioned by News of the World <http://www.mori.com/polls/2000/notw.shtml>).

large part to the former's strong and vocal pro-euro position and the latter's cautious euroskepticism. In fact, all the foreign ministers were replaced with more cautious euroskeptics, including the new Minister for Europe, Peter Hain. Blair sought to maintain unity in the government between the Chancellor of the Exchequer and other leading ministers on the euro question. If the Prime Minister might have previously been interested in pressing Brown on a referendum, since the Iraq invasion – and the considerable drop in support for his leadership within the Labor Party and the country at large – Blair is now in no position to force a euro referendum if Brown remains opposed.

INTER-PARTY POLITICS

The inter-party electoral competition dimension of the euro debates attracts considerable attention in the British press coverage of the issue. The two parties have over the past fourteen years demarcated their differences on the euro for partisan purposes. A Downsian analysis (Downs 1957) of Conservative and Labor party euro policy would suggest that the two leading British parties, competing for a large number of the same voters, would, acting rationally, embrace policies which correspond to the views of the majority of the voting population. A Downsian analysis provides a useful explanation of the shift in Labor policies in the 1980s on macroeconomic policy-making and European integration in terms of the party's attempt to appear more credible to the majority of British voters after its poor record in government in the late 1970s and left-wing turn in opposition under the leadership of Michael Foot (Daniels 1998). On the euro, Conservative opposition, but also the hesitation of the Labor government, conform superficially to a Downsian analysis, although the marked differences in the rhetorical thrust of Conservative and Labor policies suggest limits to its explanatory use. The considerable emphasis placed on "saving the pound" by the Conservative government and party in opposition since 1997 appear to go well beyond the moderate opposition of a large number of those who claim that they are opposed to the euro. Tory policy has been shaped by a virulent euroskepticism from within the party – as noted in the previous section – but also by the fear of a loss of votes to right-wing anti-European parties (Ashford 2000; Berrington and Hague 1998; Stephens 1996; Young 1999). The Referendum Party created and led initially by Sir James Goldsmith was committed to an immediate referendum on the Maastricht Treaty / further integration. Many Tory MPs adopted strong anti-euro positions in the 1992 election campaign to see off votes for Referendum Party candidates (Ashford 2000; Berrington and Hague 1998;

Stephens 1996; Young 1999). Goldsmith committed twenty million pounds of his personal fortune to the anti-euro cause and his party fielded 550 candidates in the 1992 elections. Although achieving the best showing for a single issue party in the history of British democracy, the Referendum Party only won 3.1 percent of the vote in 1992 and even less in the 1997 elections. The UK Independence Party which also ran in the 1997 and 2001 parliamentary elections (winning 3 percent of the vote in the former) was less well-funded but has had more staying power, winning 6.9 percent of the British vote (excluding Northern Ireland) in the June 1999 European Parliamentary elections and three seats – although hardly to the detriment of the Conservatives which did particularly well in those elections – but 16.2 percent of the vote in the June 2004 elections and an impressive twelve seats, to the great consternation of the Tories which lost nine percent of the vote (down to 26.7 percent) and eight of their seats.

It is important not to overestimate the extent to which former Conservative voters switched their allegiances because they sought a more specifically euroskeptical option. Many former Conservative supporters had left the party prior to the 1992 and 1997 elections for a variety of other reasons and then selected to vote for the Referendum and UK Independence parties rather than Labor and the Liberal Democrats because European integration was one of their preoccupations (Heath et al. 1998). Moreover, very few seats swung as a result of the Referendum Party's success so Goldsmith's aim to inflict maximum damage on the Conservatives must be deemed a failure. Nonetheless, the fear of Conservative strategists and many individual Conservative Members of Parliament of the loss of euroskeptical supporters to these smaller parties has contributed to pulling the party in a more determined euroskeptical direction (Ashford 2000; Stephens 1996; Thompson 1996; Young 1999) contrary to the Downsian thesis which would predict a more moderate euroskepticism to correspond to the shift in British public opinion against further integration in the 1990s (Heath et al. 1998).

The consistently hostile opinion of a majority of British voters towards the euro – albeit hostility of a shallow nature for many in this majority – has not convinced the Labor government to abandon its pro-euro rhetoric and commitment to membership. However, the Downsian thesis is apparently corroborated by the Labor Government's exceedingly meek campaign on the euro. Tony Blair has thus opted to ignore the advice of a leading New Labor think-tank, the Foreign Policy Centre, which argues that the euro referendum could be won and demonstrates how (Leonard and Arbuthnott 2001; Leonard 2003; Mortimer and Atkinson 2003). In September 2003, Simon Buckby, the director of the pro-euro Britain in Europe campaign – set up by Tony Blair and Gordon Blair and other pro-euro politicians from the three major parties –

announced his resignation, complaining that the government was not pursuing a consistent strategy on the euro and failed to do much of anything to lead a change in public opinion: “one speech every six months does not a campaign make” (quoted in the *Guardian*, 10 September 2003).

A Downsian analysis might still be useful to explain recent Conservative party developments on the euro. Following the election of 1997, the Conservatives under William Hague, responding to demands within the party and the menace of the smaller euroskeptic parties, became excessively hostile on European matters including the euro, highlighting the party’s euroskepticism above other issues of greater concern to the general voting population. The strong anti-euro (“a vote for Labor is a vote to lose the pound”) and more broadly euroskeptic strategy paid off for the Conservatives in the 1999 European Parliamentary elections, given poor voter turnout (at 23 percent). However, in the parliamentary elections of 2001 – where the large majority of the voting population did not prioritise the euro – this strategy failed to win the Conservatives many votes.⁶ The “Europe” issue is important to many voters but not as important as Health and Education in the context of national elections and few voters feel passionate either way about “Europe”. The political salience of the “Europe” issue over time also varies a great deal, much more so than the salience of core public services. Periodic debates and discussions on the matter can have a major effect on the public’s perception of the issue’s importance: anticipation of the Chancellor’s speech on the euro in June 2003 sparked interest in Europe in May and June, with 22 and 26 percent prioritising the matter. However, since then the issue has declined dramatically in salience to less than 13 percent. Prior to the last two national elections, “Europe” was prioritized by many but fell behind the more immediately salient issues of Health and Education.⁷ In the lead up to the EP elections in June 1999, “Europe” was considered the most important issue but only by 37 percent of the voting age population. In other words, prioritizing opposition to the Europe and euro issue during elections might make some electoral sense for the Tories but it is only likely to pay significant electoral dividends in the context of European Parliamentary elections. The Conservative strategy to prioritize hostility to the “Europe” and specifically euro issue might have been embraced because the Conservatives were unable to credibly challenge the Labor Government on Health and Education. In the population at large the

⁶ For a full list of MORI polls over the past three decades on the public’s views of priority political issues see <http://www.mori.com/polls/2003/mpm030916-top.shtml>.

intensity of negative attitudes to the euro is not great: polls consistently show that a large number of those who oppose euro membership could be persuaded in favor of it if it was thought that it would be good for the British economy.⁸ Thus a Downsian analysis may not be able to explain the intensity of Conservative party anti-euro rhetoric from 1997 to 2003. However, it would suggest that the party would eventually tone down its rhetoric to appeal more to the moderate median voter which is favorable to EU membership but opposed somewhat to the euro.

PUBLIC OPINION: BRITISH POLICY AS A REFLECTION OF A RESPONSIVE DEMOCRACY?

The assumption of Downsian theory is that public opinion is the most important determining factor shaping the policy of “catch-all” parties. The Labor Government’s constant use of focus groups during its first term in office suggests its responsiveness to public opinion. More recently, however, during the government’s second term it has embraced very unpopular decisions and stood by them – on foundation hospitals, the war on Iraq and top-up tuition fees for universities – each stance demonstrating that the government is willing to adopt policies that are far more unpopular than EMU membership. An issue here may be the extent to which the Conservative opposition can transform public frustration with the government on a particular matter into votes: the Conservatives are more likely to be able to do this with the euro than these other unpopular policy decisions.

British public opinion on the euro has been consistently negative over the last decade (see www.mori.com/europe/index.shtml for a full list of surveys since January 1999). Support for EMU rose slightly in the period around the Maastricht Summit of December 1991 – perhaps linked to partisan inspired opposition to the Conservative Government on the matter. The pound’s forced exit from the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) in September 1992 (“Black Wednesday”) marked the turning point for public opinion. Poll after poll, including Eurobarometer surveys, have shown a hostile

⁷ In June 1997, Europe was important at 30 percent but well behind Education and Health at 45 and 51 percent respectively. In June 2001, Europe was important at 24 percent but well behind Health, Education and Crime with Health reaching 58 percent.

⁸ This also applies for those who support British adoption of the euro. Since 1996, ‘waverers’ (those that could be persuaded to change their minds when voting in a referendum) range from 42 percent of the population to 59 percent. See <http://www.mori.com/Europe/euro-participation.shtml>.

British public.⁹ If the drop in the value of the euro in 1999 and 2000 confirmed the suspicions of many opponents of the euro as to the workability of EMU, the more recent rise of the euro in relation to the dollar has not yet had a noticeable effect on opinion. The Eurobarometer poll of 2003 showed only 24 percent in favor and 63 percent against British participation in the euro – considerably more negative than in both Denmark and Sweden where populations voted “no” in their euro referenda. A plurality and frequently majority of the supporters of each of the three major parties (including the officially pro-euro Liberal Democrats) has been consistently opposed to eurozone membership and in favor of a public debate and referendum prior to entry.¹⁰

The Danish “no” to the euro (September 2000, 53 percent against) and the Swedish no (of September 2003, 56 percent against) – despite overwhelming support of the political class, business and trade union leadership and most of the media – have reinforced perceptions that it is not necessary for the British to join the euro (Miles 2004). The results are particularly discouraging for the Labor Government which does not want to embark on a referendum campaign that it is unlikely to win, especially given that it has conditioned holding the referendum on the Treasury’s green light based on meeting the five economic tests and an officially pro-euro government position. Likewise, the Swedish referendum result confirms the sensible politics of the Brown’s cautious strategy. In the view of the *Guardian* newspaper (15 September 2003): “Tony Blair’s lingering hopes of staging a euro referendum in this parliament were finally shattered”. The failure of the Eurogroup to apply the Stability Pact rules with regard to France and Germany has likely further increased public skepticism with regard to the euro (Miles 2004).

However, other polling results suggest that negative public opinion is not an overwhelming obstacle to entry and that public opposition to other government policies is greater and more intense (such as the war on Iraq). While a majority of

⁹ For a recent Eurobarometer survey of opinion see http://europa.eu.int/futurum/documents/other/oth170603_en.pdf.

¹⁰ For example, a 25 June 2000 MORI, Commissioned by News of the World (<http://www.mori.com/polls/2000/notw.shtml>) show results to responses to the following question: ‘In a referendum, would you vote for or against Britain replacing the pound sterling with the single European currency?’ Sixty-four percent of those surveyed would vote against with only 24 percent in favor, with 83 percent of Tory supporters opposed (only 12 percent in favor), 51 percent of Labour supporters opposed (with 35 in favor) and 56 percent of the pro-euro Liberal Democratic party supporters opposed (with only 28 in favor). The same poll also indicated that a majority of voters of each of the three parties wanted a public debate and referendum before joining (57 Conservatives, 63 Labour, 57 Liberal Democrat).

the public oppose Britain adopting the euro, a large majority (74 percent) also think that it is very (31 percent) or fairly likely (43 percent) that Britain will adopt the euro in the next five years.¹¹ The intensity of feeling on the euro issue has already been mentioned in the inter-party section. However, it bears repeating that polls show consistently that a sufficiently large number of people could be convinced to join the euro if they were convinced that the euro would have a good effect on the economy.¹²

Hix (2000) provides the most detailed examination of British public opinion. Voters offer their support for a political system or policy through affective support (ideological or non-material belief in the value of the policy/system) and utilitarian support (when the system or policy increases the material (economic) well-being of an individual. According to Hix, much of the opposition to the euro stems from the affective belief that the euro is not of particular ideological or non-material benefit to the British which suggests the relevance of nationalist sentiment and identity politics combined with affective support for the pound. However, among professional employees and owners of businesses who perceive material gain from the introduction of the euro, utilitarian attitudes prevail. The export oriented business sector is the most consensually supportive group in favor of the euro.

By contrast, those in the lower paid industrial and service sector jobs and small business owners – less affected financially by currency fluctuations and more preoccupied with the potential difficulties created by the “sound money” dimension of EMU – tend to be more anti-euro, paralleling their counterparts in other EU member states. The persuasiveness of the economic alternatives to the euro and the relatively strong affective support of the British for the pound combine to undermine support for the euro and stoke the opposition.

It is tempting to conclude that public opinion directs policy making in Britain and that British governments are perhaps more responsive than those in Germany where hostile public opinion failed to block support for EMU. In other words, can an approach rooted in an understanding of the unique features of British democracy and policy making as somehow more responsive to public opinion help to explain British policy on the euro? The British have engaged in a lengthy and detailed debate and discussion on the economic merits and demerits of the euro in a variety of fora from the parliament and the political parties to various media, universities and so on. Unlike the interest group and elite-based approach

¹¹ MORI poll published 1 July 2003; see also <http://www.mori.com/polls/2003/mpm030622-top.shtml>).

¹² See footnote 8.

to understanding European integration, an understanding of British policy on EMU could therefore be understood within the framework of popular sovereignty — especially in the insistence upon the need to use referendum.

Such claims are highly contestable.¹³ There may be preference for wide consultation and debate in British liberal democracy but this has not prevented British governments from appealing to Burkean notion of representative democracy — which is as important to the British conception of parliamentary democracy as popular sovereignty — sidelining public opinion and containing public debate. Moreover, British governments have rarely used referenda in the past. They have done so only on very important matters of change in governance which need the sanction of a public vote to reinforce the legitimacy of the decision: notably, joining the European Community (EC) (post facto in 1975 on the renegotiated terms of entry) and devolution in Scotland and Wales. Referenda have not been used on other very important issues of governance — with the potential exception of the Treaty Establishing a Constitution for Europe, no EC / EU treaty since 1973 has been subject to a British referendum, nor have significant developments in British governance such as House of Lords reform. British governments have for the most part opposed the use of referenda seen as crude devices subject to grotesque manipulation and contrary to the Burkean ideal. Conservative governments have never held a referendum and refused to hold one on entry into the EC, even though the three other countries which had negotiated to join with Britain — Norway, Denmark and Ireland — each held one. One should thus appraise skeptically the Conservative Party's insistence upon a referendum on both Britain's participation in the euro and the EU constitution. One must conclude that the Conservatives have called for a referendum for reasons unrelated to their preoccupation with popular sovereignty. It is likely that the development of European integration has progressed to such an extent that Conservative leaders are now willing to accept referenda as part of a blocking strategy if only out desperation. Party politics and the ambition to avoid intra-party squabbling on European matters also help to explain the current Tory preference for referenda.

A Labor government held the first British referendum in 1975 principally to prevent a politically debilitating split in the party given that several high profile ministers, the majority of the party's members of parliament and much of the party rank and file were opposed to membership. The Conservative party is in a similar position today. However, this does not help to explain why the Labor

¹³ For a survey of different policy styles in Britain and several West European countries see Richardson (1982).

government has promised a referendum on the euro, as divisions within the party on EMU and European integration are far less profound than they were on EC membership in the 1970s and 80s. The Labor Party has been more willing than the Tories to use referenda to legitimize significant modifications of governance: holding a referendum on EMU — which obviously involves a significant modification of governance — thus conforms more to recently developed Labor tradition than a Conservative one. Furthermore, the decision to hold a referendum is seen by many in the party as rooted in party strategy to avoid a backlash at the polls were the government to press ahead with euro membership in the face of widespread public opposition in the country. However, the holding of a referendum that the government is likely to lose is also opposed on strategic grounds. While some in the Labor Government leadership may have initially harboured hopes that public opinion could be brought around in favor of euro membership (thus the creation of the lobbying association “Britain in Europe”) the commitment to invest the political resources to accomplish this transformation of opinion has never materialised.

The Print Media

It has been argued that the division in elite opinion on the euro, the collapse of the left-right divide on the issue and the technical nature of the debate gives the British media a very important role to play in shaping public opinion on this particular issue (Firmstone 2003). The British print media is divided on the “Europe” and euro issues with more of the leading dailies in favor but circulation of the anti-European integration and anti-euro dailies far greater.¹⁴ This should be juxtaposed with the almost unanimous support for EC membership in the run-up to the 1975 referendum on membership. Of course, some of the broadsheets can present a range of views in their guest commentaries (Kuhn 2000) but the leader editorial comment presents the “official” position of the paper. The two best selling UK national daily broadsheets have been firmly against: the *Daily Telegraph* and *Times* with over 60 percent of the national broadsheet circulation between them and almost 1.5 million readers. The *Financial Times*, *Guardian* and *Independent* (with a combined circulation of just under a million (970,000)) have been generally but critically in favor of euro membership – while accepting the economic difficulties in the eurozone (Firmstone 2003) – reflecting a broader

¹⁴ All figures are from August 2003. Audit Bureau of Circulations. See <http://media.guardian.co.uk/presspublishing/tables/0,7680,1037778,00.html>

Europhilia. These three broadsheets are in favor of holding a referendum on the matter in the near rather than distant future, without the constraint of the five economic tests. The two best selling UK national daily tabloids have been consistently opposed to British membership of the eurozone, reflecting a virulently antagonistic position on European integration: the *Sun* and the *Daily Mail* with a combined circulation of 5.9 million (August 2003 figures). The *Sun* famously greeted the introduction of euro notes and coins as the “Dawn of a new Error”. The third, fourth and fifth best selling national tabloids, the *Mirror* (2 million circulation daily), the *Daily Express* (956,000) and the *Daily Star* (929,000) – with a combined circulation of almost 3.9 million – have embraced a consistently positive stance on the euro.

Of particular concern to both the Major and Blair governments was the determined anti-euro position of the press owned by the Australian-American tycoon Rupert Murdoch (including the *Times* and the *Sun*, the best selling British tabloid newspaper and also the Sky satellite channels). Murdoch swung the *Sun* and *Times* firmly in favor of a Labor victory in the June 1997 elections and New Labor’s preference to retain Murdoch’s allegiance encourages caution on the euro issue (Young 1999; Leonard and Arbuthnott 2001). Blair’s earlier claims to be willing to “take on” the euroskeptic press in a future referendum (*Guardian*, 30 January 1999) should be judged by his caution hitherto on the issue.

Interest Groups

Neo-pluralist analyses of British politics tighten our focus upon the role of powerful interests and in particular the Confederation of British Industry (CBI) – the peak association for large British companies – with well-established, albeit informal, connections to the Conservative Party, and the Trades Union Congress (TUC) – the confederation of British trade unions – through its direct influence on the Labor Party with one-third of votes on party policy, financial support and overlap of personnel. On other European policy developments, the CBI actively pushed the Thatcher Government to agree to the Single European Act and Single European Market programme and actively opposed the social policy provisions of the Maastricht Treaty. The CBI adopted a policy in favor of the pound’s entry into the ERM in a majority vote in February 1985 as a means to bring down inflation and interest rates and completing the Single Market. On EMU, the CBI initially presented a critical but neutral policy, insisting that British entry “is largely a political decision” (Confederation of British Industry 1989, 17, quoted in Talani (2000b)) but by 1990, the CBI was considerably more positive, recommending

British entry into the ERM to play a full role in discussions on EMU. The CBI adopted a cautiously supportive role on EMU, initially approving the Delors Report but opposing the fiscal policy rules, but then, by 1992, supporting these fiscal rules to ensure convergence.

The TUC was largely responsible for the Labor Party's 1988 policy shift on European integration, with the Congress being won over to a social democratic vision of European integration as presented by the then Commission president Jacques Delors at the 1987 Bournemouth Annual Conference. However, the TUC trailed the Labor Party in embracing the EMU project. After over seventeen years of official hostility to British participation in European monetary arrangements, in 1989, the TUC voted to approve British entry in the ERM although there was a split on EMU membership, with the TUC Secretariat in favor but major component unions opposed. Finally, in July 1996, the General Council of the TUC endorsed a report advocating British membership in the proposed EMU. Support was qualified – in favor of a relaxed EMU timetable and flexible application of the convergence criteria – but the TUC had become “in the words of John Monks, ‘more committed to EMU and a single currency than any other national institution’” (Josselin 2001: 62; see also Verdun 2000). The official support of both the CBI and TUC and keen support from the leadership of these associations has led to the conclusion that “[r]arely has there been such wide interest group support [in the UK] for such a major decision of economic policy” (Gamble & Kelly 2000, 2002). The gap between the CBI and Conservative positions has been marked, whereas the TUC secretariat's position has very much conformed to that of the Labor Party, while the TUC itself lagged behind the Party in embracing a pro-EMU position. This suggests that focusing upon interest groups is not very helpful in explaining government policy.

However what helps to explain the divergence in views between the two parties and their supporting constituencies is the significant divide between the elite of these organizations and their rank and file which corresponds to a more a generalised division between elite and mass public opinion on the euro (Hix 2000) (elite support for the euro at 60 percent is double that of mass public support). The directors of numerous high profile member companies of the CBI oppose British membership in the euro and participate in the well-resourced group “Business for Sterling” which merged into the no-euro group in 2000 (see www.no-euro.com/whoweare/bfs.asp for a full list of current members). Support for membership amongst the directors of the 500 largest British companies has fluctuated over the past decade, reaching heights of 70 percent in favor in 1998 with less than half by mid 2003 (*Financial Times*, 15 December 2003). Small and medium sized businesses represented by the British Chambers of Commerce with

activities directed principally at the domestic market have adopted an even less favorable position on the euro. In October 2002, asked what their position would be if the Treasury found that the five economic tests were met, 13 percent would not join under any circumstances, 49 percent wanted the government to wait and see how the euro developed before joining, 35 percent would support entry as soon as practicable.¹⁵ These figures should be compared to those for CBI members – respectively 15, 31 and 52 percent – demonstrating division but a more overall pro-euro stance.¹⁶

The rapid rise of the pound in relation to the euro in 1999 and 2000 (from 1.41 euro at the start of 1999 to 1.63 euro 21 months later) resulted directly in several high profile manufacturing closures in the UK yet did not result in any dramatic shift in manufacturing or public opinion or Labor government policy with regard to British participation in the euro. There was considerable lobbying of the Monetary Policy Committee of the Bank of England to cut interest rates and lobbying on the Blair government for British entry into the euro. The collapse of the British Rover Group in August 2000 contributed to the widespread perception at the time that the exchange rate between sterling and the euro was damaging the profitability of British automotive production, deterring foreign investment and damaging British industry more generally. Although automobile production constituted only a small percentage of British manufacturing and economic output, this was a politically sensitive sector of the economy. Rather than modify its policy on the pound, the government sought to subsidise the automobile manufacturers (Jones 2002: 133). Other industries affected badly by the strong pound saw such subsidies as insufficient. During the winter of 2000-2001, the management of Corus, the Anglo-Dutch steel manufacturer and former British Steel, without even bothering to explore the possibility of government aid, decided to lay off more than 6000 mostly Labor voting workers citing lack of competitiveness as the principal justification. The government clearly put such high profile closures in the wider economic context with unemployment at its lowest levels since the early 1980s. Many other manufacturing and service sector companies did not suffer irreparable damage. Thus exchange volatility and the considerable appreciation of the pound did not create sufficiently strong political pressure on the government to act on the euro question.

Two of the major component unions of the TUC have consistently embraced strong anti-euro positions – UNISON (the public sector union) and the Transport and General Workers Union (TGWU) – and form the leading components of

¹⁵ <http://www.mori.com/polls/2002/bcc-topline.shtml>.

¹⁶ Mori poll from 1999 cited at <http://www.cbi.org.uk>.

Trade Unions Against the Single Currency campaign group (TUASC). As Frieden (1991) predicts the sectoral orientation of the trade union broadly dictated the policy line taken, with private sector unions (such as the Amalgamated Engineering and Electrical Union (AEEU)) with members affected by exchange rate fluctuations particularly supportive of EMU and forming a main component of the Trade Unions for Europe campaign group. However, Josselin (2001) points out that the centralised nature of the TUC enabled the secretariat to take a strongly favorable position on EMU despite the opposition of a large number of members. The Labor government, it might be argued, has been more sensitive to the significant division of views in the labor movement. In 1997, the newly elected Blair government rejected the TUC leadership's call to move to quick referendum on EMU. The divisions within the CBI and TUC on the euro can be seen as an example of a more general division in these two organizations on a range of issues (Jones and Kavanagh 1998) and more fluid ties to their former chosen party which has arguably weakened their influence over the past two decades.

The attitudes in the financial services sector have been likewise divided between the pros and cons of British entry into EMU siding towards the cons (Talani 2000a & b) with a large majority of directors of leading British banks and other financial services companies consistently indifferent to British participation (see for example *Financial Times*, "City Indifferent to Euro", 5 June 2003) with similar attitudes among the hundreds of foreign banks and companies operating in the City. Negative attitudes reflect the view that British participation in EMU would potentially undermine the City's leading international role. However, there is a pro-euro lobby in the City (City in Europe). Given the importance of the City of London (and the financial sector more generally) to the prosperity of the UK, such attitudes have provided backing for negative Conservative policy on the euro and hesitant Labor Government policy. Reluctance in this sector to participate in European monetary integration is long-standing. British Banks and financial services companies were highly skeptical of the merits of British membership of the ERM, although by the late 1980s most approved of British membership but principally to contain inflation. A majority of City firms were opposed to EMU generally and British participation. The City was concerned that placing the future ECB elsewhere would be a damaging blow to its status as many smaller European banks might migrate to Frankfurt but this was not enough to ensure support for British participation. Since 1999, the "City" (financial sector) has adjusted well to the advent of the euro. With only a limited threat of lost business to continental financial centres, the majority of financial firms see no need for Britain to join EMU in order for the City to maintain its position as far and away the leading European financial centre.

**Groups campaigning for and against the euro in Britain, 1999-2002
(not including party fractions and specifically business and union organizations)**

| Type of organization | Pro-euro | Anti-euro |
|--|---|--|
| Research organization (single issue think tanks; focusing principally upon the policy arena) | Action Centre for Europe (Lord Geoffrey Howe) | New Europe Global Britain European Research Group European Foundation |
| Campaign organization (coalition/alliance) | Britain in Europe | No Campaign Anti-Maastricht Alliance (AMA) Congress for Democracy The European Alliance of EU-Critical Movements (TEAM) Campaign Alliance for Referendums in Parishes |
| Campaign organizations (single issue groups) | Citizens for Europe European Movement Young European Movement | Democracy Movement Campaign for an Independent Britain (CIB) British Democracy Campaign Campaign Against Euro-Federalism Freedom Association New Alliance Youth for a Free Europe The Bruges Group Anti-Common Market League |

From Gray (2003)

Over the past decade several new interest groups have been established by politicians and business leaders opposed to and in favor of British euro membership. Unlike the sectoral interests of the CBI and TUC, these single issue groups have been created to shape public opinion specifically on the euro, although in the “pre-campaign” stage lobbying efforts are directed principally towards the policy and increasingly media arenas rather than waging a full battle for public opinion (Gray 2003). Nonetheless, some very public campaigning has already taken place in particular from the no-side, engaging the services of high profile celebrities. Not all the no-side groups associate themselves with the

broader euroskepticism of, say, the Bruges Group. The “New Europe” group led by former Labor Foreign Secretary and SDP founder, Lord David Owen, is officially in favor of British membership in the EU (www.new-europe.co.uk/). Gray (2003) provides a full list of research organizations, campaign coalitions and campaign organizations on the euro issue, part of which is reproduced in table 1. Usherwood (2002) sees these campaign groups as the continuation of intra- and inter-party politics by other means, which if true, would deny the distinct importance of these groups in shaping government policy. However, given the large number of non-political leaders involved in these groups, Usherwood’s claim is at best problematic.

The number of anti-euro groups far exceeds those in favor of the euro: five umbrella alliance organizations versus only one (Britain in Europe). However, the anti-euro campaigners are more diverse ideologically and form looser alliances (Gray 2003). Although precise figures are not available, the anti-euro groups also spend a great deal more than the pro-euro groups. One anti-euro businessman who has attracted a great deal of media attention is Paul Sykes, having dedicated a large amount of his own personal fortune to the cause as part of the Democracy Movement and the British Democracy Campaign.

The two major pro and anti-euro alliances attract the lion’s share of media attention because they are well-resourced and are seen as the principal authoritative sources of information on the euro from the two perspectives. The leading no-side group is the “No campaign” (www.no-euro.com/) which is officially in favor of British membership in the EU, unlike some of the anti-euro groups, but opposed EMU. Formed in 1999 by leading pro-euro politicians from the three largest parties, the “Britain in Europe” campaign is an umbrella organization for diverse pro-European and euro groups (www.britainin-europe.org.uk). Currently headed by Anthony Nelson Vice Chairman, Citigroup Global Markets and former Minister at HM Treasury and the Department of Trade and Industry and until recently by Colin Marshall, the Chairman of British Airways, “Britain in Europe” brings together pro-European politicians from all the parties, leading figures from the world of business, trade unions and other sections of society. Each of these groups is funded by donation and comprises a full time secretariat dedicated to compiling large amounts of information supporting their respective positions and disseminating this information through websites, the media and talks to the public, various organizations and university students. It is problematic to claim that the activities of these groups explain government policy on the euro. However, the energetic “no-side” – emphasising a “people versus politicians” campaign – has likely contributed to the Labor Government’s caution on the matter. Moreover, research has demonstrated the

great impact that referendum campaigns can have on public opinion on British membership especially “where elites are divided on the referendum issue, where ideological alignments on the issue are unclear and there are low levels of public knowledge on the issue” as on the euro (Gray 2003: 3; Le Duc 2002). There are more constraints imposed on the Britain in Europe group as, created by pro-euro members of the three main parties, it is in a difficult balancing position and cannot push the government too hard on holding a referendum. The former director, Simon Buckby, has called on the government not to chicken out and hold a referendum (“Euro campaign urges Blair to act”, BBC News Online, 8 May 2002). However, since the June 2003 announcement of the Treasury Report on the euro and the certainty of a much delayed referendum, the wind is very much out of the sails of this pro-euro group, with donations drying up. As mentioned above, in September 2003, Buckby resigned in protest at the government’s inaction.

CONCLUSION

It can be concluded that two explanations are most helpful in explaining British government, Labor and Conservative party policy on the euro: one rooted in an examination of intra-party politics and the other focusing upon the positions of powerful interest groups in the country. Analyses of inter-party politics and public opinion appear less helpful. A Downsian analysis explains some features of the two main parties’ policies given the nature of public opinion on the euro question but the alignment is only partial between median voter attitudes and party / government policies: a less hostile Conservative opposition policy and a more active Labor government campaign to shift public opinion might be expected. The pro-referendum policy embraced by the two parties owes less to the party leadership’s respect for public opinion than intra-party division and the opposition of powerful interests.

Intra-party politics has been of great significance in shaping Conservative party policy and it is very likely (although impossible to prove for the time being) – through the dynamics of the Blair-Brown rivalry and simmering euroskepticism in Labor party ranks – explain the current government’s delay in holding the referendum. The disinterest and opposition of many important manufacturing and financial companies to EMU has an impact on government policy, which effectively counters the strong support for EMU in both the CBI and TUC leaderships. The dangers of the powerful euroskeptic press and lobby further dissuade government activism on the issue. For the Labor Government in its second term and very likely to enter a third, why bother spending a great deal of

effort and political capital on a second (even third) order issue even if a majority of public opinion could be convinced to support the euro.

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NORTH AMERICAN MONETARY UNION: A UNITED STATES PERSPECTIVE

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Few issues of public policy roil Canadians more than the idea of a North American Monetary Union (NAMU) establishing one currency for Canada and the United States (US). As other contributions to this special issue testify, opinions among Canadians differ sharply and divisions run deep. From the Maritimes to the Pacific, Canadians are far from consensus regarding the future of their national money, the much belittled “loonie.”

But what about opinion south of the longest unguarded border in the world? Largely lost in the din of debate among Canadians is the perspective of the United States, Canada’s putative partner. The US’s interest in NAMU is rarely addressed in any systematic manner. This is surely a critical omission. Even if Canadians could unite in favor of currency union as a policy goal, a vital imperative would remain – namely, the need to gain support from Washington. How would US Americans view a monetary initiative from Ottawa? Would the prospect of NAMU be greeted with open arms or with hostility? As a practical matter, a common currency would be impossible without the concurrence, or at least the compliance, of the United States.

This essay explores the NAMU issue specifically from a US point of view, addressing both economic and political aspects. The big question is: what does the United States have to gain? The short answer, which may disappoint some Canadians, is: not much. The US greenback, as the world’s leading international

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currency, already generates considerable benefits for US Americans. That is the starting point from which analysis must proceed. As compared with the *status quo* of US's *de facto* market dominance, a formal monetary union with Canada, though not without advantages, would provide more risks and losses for the United States than gains. Moreover, this negative assessment holds true no matter what form NAMU might take – whether modeled on Europe's euro, substituting an entirely new North American currency for the continent's two existing dollars; or if instead it were simply to replace the Canada's loonie with the greenback, a “dollarization” model. Either way, under present circumstances, the idea can be expected to elicit little interest among US Americans and even less encouragement.

Are there any conceivable circumstances that might alter this conclusion? Certainly it is possible to imagine future developments that could dispose US Americans more favorably toward NAMU. None, however, is a contingency to which we can reasonably attach a high degree of probability in the near term. In fact, dispassionate analysis suggests that for a great monetary power like the United States, under normal circumstances, national interest is better served by avoiding the constraints and responsibilities that would accompany a formal monetary union. So long as the benefits of *de facto* market dominance can be effectively sustained, little is gained by formalizing the informal.

THE *STATUS QUO*

To suggest that NAMU offers little gain to the United States might seem, at first glance, counterintuitive and perhaps even naive. Any arrangement between the two countries would clearly be dominated by the much larger and wealthier US side. Canada, in effect, would become a monetary dependency; and as Jonathan Kirshner has remarked, “monetary dependence can create a sphere of influence [that] can provide considerable political benefits for core states” (1995: 8, 17). Monetary dependence may be exploited, Kirshner astutely notes, in four ways: (1) enforcement – manipulation of standing rules or threats of sanctions; (2) expulsion – suspension or termination of privileges; (3) extraction – use of the relationship to appropriate real resources; and (4) entrapment – transformation of a dependent state's interests. Why should the United States not want to avail itself of all these considerable advantages?

The answer lies in the *status quo*, which already generates significant economic and political advantages for the US side. The US dollar today functions as the only truly global currency – a national money used for international

purposes in virtually every corner of the world. The US interest in NAMU must be compared with that stark reality.

The Dollar's Market Leadership

Broadly speaking, currencies may be employed outside their country of origin for either of two purposes – for transactions either between nations or within foreign states. The former is conventionally referred to as international currency use or currency internationalization; the latter goes under the label currency substitution and can be referred to as foreign-domestic use. Both types of use reflecting the accelerating competition that exists today among national currencies – a process I have described elsewhere (Cohen 1998, 2004) as the *detritorialization* of money.

For each of these two purposes, the US dollar is employed on a very broad basis. Indeed, the greenback is indisputably the market leader among world monies, perched at the peak of what I call the “currency pyramid” (Cohen 1998, 2004). Its only serious rivals to the title of “top currency” are two “patrician” currencies, the euro and, more distantly, the yen. Canada’s loonie, by contrast, along with a few other familiar names such as the pound sterling and Swiss franc, is located in the next rank down – the rank of “elite” currencies, which qualify for some international use but are of insufficient weight to carry much direct influence beyond their own national frontiers.

The clearest signal of the greenback’s leadership in international currency use is sent by the global foreign-exchange market where, according to the Bank for International Settlements (2002), the dollar is the most favored vehicle for currency trading worldwide, appearing on one side or the other of some 90 percent of all transactions in 2001 (the latest year for which data are available). The euro, in distant second place, appeared in just 38 percent of transactions – higher than the share of its popular predecessor, the deutschmark (DM), which had appeared in 30 percent of transactions in 1998, but lower than that of all the euro’s constituent currencies taken together that same year (53 percent). The yen was even further behind with only 23 percent.¹

The greenback is also the most favored vehicle for the invoicing of international trade, where it has been estimated to account for nearly half of all world exports (Hartmann 1998), more than double America’s share of global

1. Because each foreign-exchange transaction involves two currencies, the total of shares sums to 200 percent rather than 100 percent.

trade. The DM's share of invoicing in its last years, prior to its replacement by the euro, was fifteen percent, roughly equivalent to Germany's proportion of world exports. Preliminary evidence from the European Central Bank, the ECB (2003), suggests that the euro's share may have increased modestly since its introduction in 1999, but mainly for Europe's trade with the outside world rather than in exchanges between third countries. The yen's share of global invoicing was just five percent, significantly less than Japan's proportion of world exports. Likewise, the dollar dominates in global financial markets, even after the arrival of the euro. According to the ECB (2003), the euro has cut into the greenback's share of the bond market, now accounting for some 30 percent of all international issues as against 45 percent for the dollar and less than ten percent for the yen. But in global banking outside Europe the dollar still dominates, with a share of 63 percent of cross-border loans as compared with just 8 percent for the euro and 12 percent for the yen (ECB 2003).

The clearest signal of the greenback's leadership in foreign-domestic use is sent by the swift increase in the currency's physical circulation outside the borders of the United States, mostly in the form of \$100 bills. Authoritative studies by the US Treasury (2000) and Federal Reserve (Judson and Porter 2001) put the value of all notes in circulation abroad at between 50 and 70 percent of the total outstanding stock – equivalent at the turn of the century to roughly \$275 billion to \$375 billion in all. Estimates also suggest that as much as three-quarters of the annual increase of US notes now goes directly abroad, up from less than one-half in the 1980s and under one-third in the 1970s. By the end of the 1990s, as much as 90 percent of all \$100 notes issued by the Federal Reserve were going directly abroad to satisfy foreign demand. Appetite for the greenback appears to be far greater than for either the euro or the yen.

Advantages for the United States

Not surprisingly, all this international use of the dollar appears to translate into considerable advantages for the United States, both economic and political. Four distinct gains can be cited.

Most familiar is the potential for seigniorage. Expanded cross-border circulation of a country's money generates the equivalent of a subsidized or interest-free loan from abroad – an implicit transfer that represents a real-resource gain for the economy as a whole. Consider just the circulation of Federal Reserve notes, which are a form of non-interest bearing liability. Updating earlier estimates by Jeffrey Frankel (1995) and Alan Blinder (1996), current interest

savings from foreign circulation of the greenback may be conservatively calculated at some \$16-22 billion a year. To this may be added a saving of interest payments on US government securities, which are uniquely attractive to foreign holders because of their greater liquidity. Portes and Rey (1998: 309) call this an “often neglected source of seigniorage to the issuer of the international currency.” In their words (1998: 309): “This international currency effect reduces the real yields that the United States government has to pay” – a “liquidity discount” that they suggest could amount to at least \$5-10 billion a year. Put these numbers together and, paraphrasing former Republican Senator Everett Dirksen’s celebrated remark about the Federal budget, we are beginning to talk about real money.

A second gain is the increased flexibility of macroeconomic policy that is afforded by the privilege of being able to rely on one’s own money to help finance foreign deficits. Expanded cross-border circulation reduces the real cost of adjustment to unanticipated payments shocks by internalizing through credit what otherwise would be external transactions requiring scarce foreign exchange. In effect, it reduces the need to worry about the balance of payments in formulating and implementing domestic policy. Who can remember the last time Washington decision makers actively incorporated concern for our large current deficits or exchange rate in debating the course of monetary and fiscal policy?

Third, more psychological in nature, is the gain of status and prestige that goes with market dominance. Money, as I have written elsewhere (Cohen 1998, 2004), has long played a key symbolic role for governments, useful – like flags, anthems, and postage stamps – as a means to cultivate a unique sense of national identity. But that critical role is eroded to the extent that a local currency is displaced by a more popular foreign money, especially a money like the greenback that is so widely used on a daily basis. Foreign publics are constantly reminded of America’s elevated rank in the community of nations. “Great powers have great currencies,” Robert Mundell once wrote (1993: 10). In effect, the dollar has become a potent symbol of American primacy – an example of what has come to be called “soft power,” the ability to exercise influence by shaping beliefs, perceptions, and identities. Though obviously difficult to quantify, the role of reputation in international affairs should not be underestimated.

Finally, there is the gain of “hard” political power that derives from the monetary dependence of others. On the one hand, an issuing country is better insulated from outside influence in the domestic arena. On the other hand, it is also better positioned to pursue foreign objectives without constraint or even to exercise a degree of coercion internationally. Money, after all, is simply command over real resources. If another country can be denied access to the means needed

to purchases vital goods and services, it is clearly vulnerable in political terms. Its dependence, to recall Kirshner's terminology (1995), can be exploited via enforcement, expulsion, extraction, or entrapment. The dollar's widespread use puts all these possibilities in the hands of Washington policymakers.

Admittedly there can be limits to these benefits, particularly if they are abused. At present, the United States is running a current-account deficit in excess of \$600 billion a year. To many, this appears to be an over-exploitation of privilege that could eventually jeopardize the advantages of market leadership. As US external liabilities rapidly accumulate, increasing supply relative to demand, foreigners might naturally be expected to worry about the risk of future depreciation or even restrictions on the usability of their holdings. As a result, Washington's autonomy could eventually be constrained, to a degree, by a need to discourage sudden or substantial conversions through the exchange market. Both seigniorage income, on a net basis, and macroeconomic flexibility would be reduced if a sustained increase of interest rates is required to preserve the dollar's market share. And all of this could be exacerbated even more if the rising level of anti-US sentiment evident around the globe today, provoked by the present Administration's foreign policies, were to induce additional switching from the greenback to politically more acceptable currencies like the euro. At the time of writing, however, there was still little sign of any serious threat to the dollar's past dominance.² Even admitting the possibility of limits, there seems little doubt that presently the United States still derives considerable advantages, as numerous sources acknowledge (e.g. Portes and Rey 1998: 308-10).

The question is, given these already considerable advantages, what would be added by creating a NAMU?

THE AMERO MODEL

Consider first the version of NAMU promoted by the likes of economists Thomas Courchene, Herbert Grubel, and Richard Harris.³ Modeled on Europe's Economic and Monetary Union (EMU), this version calls for a full sharing of monetary sovereignty between the United States and Canada, replacing both the

2. One reason for the dollar's continued dominance is undoubtedly the incumbency advantage that the currency enjoys as a result of network externalities. For more on such inertias in international currency use, see Cohen 2004: ch. 1.

3. See e.g., Courchene 1999; Courchene and Harris 2000a, 2000b, 2003; Grubel 1999, 2000, 2003; Harris 2003.

greenback and the loonie with a wholly new joint currency, which Grubel (1999) would label the amero.⁴ Call this the amero model.

Clearly, the amero model would not be without benefit for the United States. Most important would be the prospect of reduced transactions costs as compared with a geography of two separate national currencies. Savings on commercial exchanges between the United States and Canada could be realized because there would no longer be a need to incur the expenses of currency conversion or hedging. The usefulness of money would thus be enhanced for all its basic functions: medium of exchange, unit of account, and store of value. These savings, in turn, could generate significant increases in trade volumes and, ultimately, incomes per capita.

The magnitude of these potential gains, however, should not be exaggerated. Analysis suggests that in relative terms benefits for Americans would be rather small. According to one source (Robson and Laidler 2002), annual savings on US-Canadian currency transactions would amount to less than \$3 billion annually. Moreover, since in practice much of the business that US Americans do with Canada is *already* conducted in their own money, it would be not US Americans but Canadians – with up to 90 percent of their exports going to the United States – who would benefit most from the anticipated efficiency gain. Likewise, estimates by Jeffrey Frankel and Andrew Rose (2002) suggest that monetary union, by eliminating a “home bias” in international trade, can be expected to increase trade volume by as much as a factor of three. For Canadians, with exports to the United States already accounting for upwards of 40 percent of gross domestic product (GDP), income per capita could increase by as much as a third over a twenty-year period (Frankel and Rose 2002: 457). For US Americans, by contrast, with their much more closed economy, income gains would be little more than negligible.

On the other hand, the amero model could bring with it real losses and risks for the United States as compared with the status quo. All the advantages presently derived from the greenback’s Top-Currency standing – seigniorage, macroeconomic flexibility, prestige, and political power – could be significantly compromised.

4. An earlier proposal to call a joint US-Canadian money the “North American dollar” (von Furstenberg and Fratianni 1996) attracted little favor.

Seigniorage

For advocates of NAMU, seigniorage is a non-issue. True, the amero model would presume creation of a joint monetary institution much like the European Central Bank (ECB). A North American Central Bank (NACB), as Grubel would call it,⁵ would subsume if not replace the Federal Reserve System as well as the Bank of Canada (BOC). Hence seigniorage revenues presently earned by the Federal Reserve and BOC would now go to the NACB. (These revenues are derived from the difference between the central banks' interest-free liabilities – cash in circulation – and the interest they receive on their counterpart assets.) For Canada, this might mean a diversion of some C\$2-2.4 billion annually (Grubel 1999: 16; Robson and Laidler 2002: 12). However, as EMU has demonstrated, arrangements can be easily negotiated to assure that all seigniorage earned by the NACB would be returned equitably to the partner countries. In Europe, net profits of the ECB are distributed in proportion to the shareholdings of each member of the European System of Central Banks. No doubt, advocates confidently assert, some similar formula could be agreed for NAMU as well. Courchene and Harris (2003: 313) dismiss the subject in a single sentence.

But this approach neglects the critical *international* dimension of seigniorage – the net resource transfer that America currently enjoys as a result of the greenback's widespread foreign circulation. An amero, we may assume, is no less likely to be used around the world than today's US dollar. Hence the magnitude of the interest-free loan from abroad would most probably remain sizable. But whereas at present Americans are the exclusive beneficiaries of this advantage, now the gain would have to be shared with Canadians, who currently earn nothing like the same benefit from their much less widely used loonie. Canadians, in effect, would free ride on the inherited popularity of the greenback, enjoying a windfall gain at America's expense. The loss to the United States might not be "real money," but it could be cause for considerable resentment.

Macroeconomic Flexibility

Even more serious could be a loss of flexibility of macroeconomic policy in Washington. With the amero model, US monetary policy would be directly affected, owing to the limited convergence of the American and Canadian

5. See Grubel 1999, 2000, 2003. Buiter (1999) suggests the name NAMUFed.

economies. Fiscal policy could be constrained, too, depending on the nature of any budgetary provisions that might be incorporated into NAMU.

The challenge to monetary policy could be particularly severe. To be sure, the two neighbors are not entirely divergent in aggregate terms. How could they be, given their close integration through trade and direct investment? Inflation and employment rates in Canada tend to be acutely sensitive to developments below the border, and business cycles have long been highly synchronized. Yet not even the most ardent of NAMU's advocates would suggest that at the microeconomic level, the pair come anywhere near to approximating what might be described as an optimum currency area. Quite the opposite, in fact, as many specialists have noted.⁶ As compared with the United States, Canada remains disproportionately dependent on its farming and extractive sectors, which still account for as much as a third of all Canadian exports. For all the synchronization of business cycles, the underlying structures of the two economies remain strikingly divergent, with their terms of trade tending to move in reverse directions in response to frequent fluctuations of commodity prices. Asymmetric shocks, acting in combination with wage and price stickiness, could cause considerable instability on both sides of the border in the absence of a flexible exchange rate between the greenback and the loonie.

Designing a single monetary policy for two such divergent economies would not be impossible, of course. Both the Federal Reserve and Bank of Canada are thoroughly experienced at the kinds of compromises that are required to address the often conflicting needs of different regions of their continent-wide countries. Similar adjustments could be managed by the NACB, too. But for Americans this would represent a distinct sacrifice, since now Canadian interests and preferences would have to be factored into the monetary policy intended for the United States. Autonomy would be lost as compared with the status quo.

Obviously, Americans would not be alone in this. Formally, Canadians would lose autonomy, too. Subordination of national policy independence is simply the price to be paid for a sharing of monetary sovereignty. But for Canada the price in practical terms would be relatively low since, *de facto*, autonomy is already severely constrained by the looming presence of the United States next door. Canadians are long accustomed to adjusting their monetary policies to the vagaries of the American economy, twenty times the size of their own. Indeed, for Canada there would now be a net gain, insofar as Canadians would gain a seat at the table where North American monetary policy is made. Few observers expect that in a joint monetary institution, Canada would have a voice equal to that of the

6. See e.g. Laidler 1999; Arora and Jeanne 2001.

United States. More likely, most analysts agree, would be an arrangement making the Bank of Canada the equivalent of a thirteenth district bank within an expanded Federal Reserve System (Helleiner 2003). But even that much voice would enable Canada to speak with more authority than it can at present.

For Americans, by contrast, the sacrifice of policy flexibility would be a novel and, for many, unwelcome prospect. As John McCallum (2000: 2), a NAMU foe, accurately observes, “the European Union model, in which independent states share decision-making and sovereignty, is alien to American thinking and American history.” US Americans, as Canadians well know, much prefer to act on their own. In the words of another respected source (Clarkson 2000: 155-6): “American politicians’ tenacious determination to retain every possible speck of national sovereignty would make it very hard to sell the idea that Canada... should be granted membership in a continentalized Federal Reserve Board.”

The sacrifice for US Americans could also extend to *fiscal* policy, depending on how closely the European model is followed. In EMU, currency union incorporates formal constraints on national fiscal policy as well via the controversial Stability and Growth Pact (SGP). In accordance with the Maastricht Treaty of 1992, the SGP mandates a medium-term objective of fiscal balance in all participating economies as well as, in principle, a strict cap on annual budget deficits of just three percent of gross domestic product. The rationale for these fiscal restraints is clear. It is to prevent potentially profligate policymakers from tapping into the EMU’s broader pool of savings to finance large spending programs at the expense of partner countries. But the effective impact of these restraints is equally clear. They make it far more difficult for elected officials to use budgetary policy for contracyclical purposes at home. Even in the best of times, most governments tend to run deficits of some magnitude. Little room is left, therefore, for participating states to raise public spending or cut taxes when needed to promote output and jobs (unless, like France and Germany today, they are prepared to flout the rules). Indeed, under a strict reading of the SGP, officials might be obligated to act in a *pro*-cyclical manner, tightening policy even when the economy slows in order to maintain momentum toward the goal of budget balance.

Incorporation of similar restraints into NAMU would be anathema to US Americans. Not all Americans approve of the fiscal profligacy of the country’s present Administration, which has produced some of the biggest budget deficits in US history. Proposals for a cap on the growth of public debt, up to and including a constitutional amendment, have frequently been mooted and are widely popular. But it is one thing for US Americans themselves to set a limit on their

government's room for maneuver, and quite another to do it by international treaty. This too would be a hard sell to politicians determined to retain every speck of national sovereignty.

Prestige

In the psychological realm of soft power, the amero model could jeopardize the prestige that the United States currently derives from the market dominance of its dollar. The greenback, in effect, has become something akin to a registered trademark, a global symbol not unlike the Nike "swoosh" or the three-pointed star of a Mercedes. As economist Robert Aliber quips (2002: 16), "the dollar and Coca-Cola are both brand names." The risk is that replacement of the greenback by an untested new brand, the amero, might weaken perceptions of US American primacy around the world.

The importance of brand-name competition in international relations should not be discounted. In fact, in today's rapidly globalizing world economy, state branding increasingly is becoming a key imperative of foreign policy. As one source observes (van Ham 2001: 3-4): "Globalization and the media revolution have made each state more aware of itself, its image, its reputation, and its attitude – in short, its brand.... Smart states are building their brands around reputations and attitudes in the same way smart companies do." And nowhere is the rise of the "brand state" more evident than in the realm of money, owing to the acceleration of competition among national currencies. Deterritorialization deprives governments of the monopoly control they once claimed over monetary management, forcing them to compete actively to preserve or promote market share for their currency – effectively, to "sell" their money. In practical terms, this means that they must now do all they can to invest in their money's reputation. "To out-perform rivals," notes a prominent commentator (Shelton 1994: 231), "a money producer would have to offer the public a better brand of money than the competitors."⁷

Today, of course, there is no more respected brand of money than the US dollar – the world's foremost currency. Could an amero fare as well? US Americans might be legitimately concerned, as reputations cannot be established overnight. It might well take some time for the unfamiliar amero to become as universally popular as the comfortable old greenback. Moreover, even assuming success, the symbolic benefit for the United States would be diluted, since the

7. The argument in this paragraph is spelled out in more detail in Cohen 1998 and 2004.

new currency would not be directly identified with the United States alone but rather with some ambiguous new entity labeled “North America.” Unlike EMU, NAMU is not promoted as a possible precursor of a political union. But without political union the amero has no single state for which to be a distinctive brand. The United States would lose the close one-for-one association that is currently seen between the prestige of its money and its status as a superpower.

Political Power

Finally, there could be adverse implications for US hard political power in world affairs. As the sole issuer of the world’s most desired currency, Washington today is happily placed, if it wishes, to exploit the monetary dependence of others. With the amero model, by contrast, coercion could be exercised only with the assent of Ottawa, which might not always be easy to obtain.

Would Washington ever dare to use the leverage provided by the greenback? The answer is obvious: of course. A case in point is provided by Panama, which since its independence in 1903 has always used the US dollar as its main legal tender. Although the national currency, the balboa, notionally exists, only a negligible amount of balboa coins actually circulate in practice. The bulk of local money supply, including all paper notes and most bank deposits, is accounted for by the dollar. In economic terms, observers rightly have mostly praise for Panama’s currency dependence (e.g. Goldfajn and Olivares 2001). Though reliance on the dollar has by no means induced a high degree of fiscal discipline, it has succeeded in creating an environment of monetary stability, helping both to suppress inflation – a bane of most of Panama’s hemispheric neighbors – and to establish the country as an important offshore financial center. In political terms, however, Panama has been especially vulnerable in its relations with Washington, as Panamanians learned in 1998 when the administration of President Ronald Reagan initiated a campaign to force Manuel Noriega, the country’s *de facto* leader, from power. Panamanian assets in US banks were frozen, and all payments and dollar transfers to Panama were prohibited, effectively demonetizing the economy. The effect on the economy was devastating despite rushed efforts by the Panamanian authorities to create a substitute currency, mainly by issuing checks in standardized denominations that they hoped recipients would then treat as cash. Over the course of the year, domestic output fell by a fifth, undoubtedly hastening Noriega’s eventual downfall in 1999.

Though extreme, the Panama case aptly illustrates the potency of the money weapon currently available to US policymakers. Implicitly, it suggests as well

how much more difficult it would be for Washington to throw its weight around if the greenback were to be replaced by an amero. Can anyone imagine the Canadian government, well known for its preference for diplomacy over naked force, agreeing to this kind of overt arm-twisting? The US money weapon would be critically blunted, if not wholly neutralized.

THE DOLLARIZATION MODEL

Given these potential disadvantages from a US point of view, it is hardly surprising that the amero model might hold little appeal to US citizens. In fact, opposition south of the common border is prodigious. In a 2002 survey of US public opinion, an overwhelming 84 percent of respondents rejected the notion of a new joint currency for North America (Robson and Laidler 2002: 25). As McCallum (2000: 2) writes, the United States “is obviously light years away from...contemplating a move to a supranational, euro-style currency.” Most NAMU advocates ruefully concur. “The biggest obstacle,” concedes Grubel (1999: 39), “will be indifference in the United States.”

What, then, of the dollarization model – straightforward replacement of the loonie with the greenback? Though dismissed by most NAMU advocates as a distinctly second-best alternative, dollarization would have one appealing merit from a Canadian point of view. In principle, this version of monetary union could be implemented unilaterally, in contrast to the amero model that would require formal negotiation with Washington. Canada could simply adopt the US dollar on its own, much as did Ecuador in 2000 and El Salvador in 2001. Bank of Canada (BOC) reserve holdings of US Treasury obligations would be liquidated to acquire the greenback notes and coins needed to replace Canadian cash in circulation, and the US dollar would officially supplant the loonie as the country’s sole legal tender.

In reality, however, this is a merit that exists *only* in principle. As a practical matter, it is difficult to imagine Ottawa taking such a radical step without at least tacit approval from Washington. Canada is no remote banana republic, puny enough to dollarize without noticeable impact on America’s monetary system. Quite the reverse, in fact. Canada boasts one of the largest and wealthiest economies in the world, and is right next door. Washington’s *imprimatur* – informal if not formal – would doubtless be regarded by both sides as essential for moving forward. So the question remains: would Washington approve?

US concurrence, or at least compliance, is certainly conceivable – but unlikely. Little enthusiasm exists among US Americans for adoption of the

greenback by other governments; a bill designed to promote formal dollarization, introduced in 1999, went nowhere in the Congress.⁸ Elsewhere I have suggested that dollarization in Latin America is not in the national interest of the United States (Cohen 2002a, 2002b). Here I would argue that the same is true of dollarization by Canada. As compared with the amero model, dollarization threatens fewer losses and risks for the United States. But as compared with the status quo there would still be more disadvantage than advantage, suggesting no less opposition from the US side.

Advantages

From the US point of view, the key benefit of the amero model – reduced transactions costs – would be fully duplicated by the dollarization alternative. A single currency produces efficiency gains whether it is called the amero or the greenback. That would certainly be an advantage as compared with the present geography of two separate national currencies. It is also the only assured advantage of the dollarization model.

Some would add a second possible advantage for the United States – expanded seigniorage earnings. With an amero issued and managed by a joint central bank, there would be no question of Canada's right to share in the net profits of currency issue. The only question would be the details of the formula to guide distributions. With dollarization, however, all seigniorage revenues would in principle accrue automatically to the United States. The BOC would lose the interest previously earned on its liquidated reserve assets – a pure windfall profit for the US Treasury – and henceforth it would be the Federal Reserve, not the BOC, that benefits from the difference between the interest earned on its assets and the interest-free liabilities in circulation as cash in Canada. America's gain would be at the direct expense of its Canadian partner.

As a practical matter, of course, the prospect of a rich windfall for Washington seems dubious. No matter how eager they might be for some form of NAMU, Canadians are unlikely to accept such an unequal – not to say exploitative – bargain. If they are to give up their monetary sovereignty, Canada's policymakers can be expected to insist on compensation for at least part of their lost seigniorage revenues. Otherwise, dollarization simply will not happen.

Historically, there is ample precedent for incorporating some form of seigniorage sharing into a regional currency agreement. In southern Africa, for

8. For more on the dollarization debate in the United States, see Cohen 2004: ch. 3.

example, where under the terms of the so-called Common Monetary Area (CMA) South Africa's rand circulates as legal tender in two partner countries, Lesotho and Namibia, the South African government makes annual payments according to an agreed formula to compensate both neighbors for seigniorage revenues foregone. NAMU advocates confidently assume that something similar would be possible between Washington and Canada in the event of dollarization by Ottawa.⁹ But then, of course, there would be no gain for the United States beyond reduced transactions costs to make the model more appealing than the status quo.

Neutral Effects

In two respects, the dollarization model would be more or less neutral as compared with the status quo. Unlike the euro model, dollarization by Canada would threaten neither the soft nor the hard power that the United States currently derives from the greenback's market dominance. At the psychological level, the US would continue to enjoy all the prestige presently accorded its money. No effort would have to be invested in building up the reputation of an untried new alternative. Likewise, at the level of hard-nosed politics, the US money weapon would remain as potent as ever. No assent from Ottawa would be needed should Washington wish to make use of the leverage provided by the greenback to promote foreign objectives.

Conceivably, the symbolic role of the greenback might actually be enhanced. Few people were shocked when Ecuador and El Salvador opted to become, in effect, monetary dependencies of the United States. These small, poor economies had long been seen as part of an informal US empire. Canada, by contrast, has always placed a high premium on sustaining its distinctiveness and independence as a political community. A voluntary surrender of monetary sovereignty by the US's touchy northern neighbor might well reinforce popular perceptions of US primacy. But given the already widespread recognition of the dollar as a global symbol, any positive impact would, most likely, be marginal at best.

Yet, it is conceivable as well that the symbolic role of the dollar could turn negative, to the detriment of US interests. Reputation can prove a two-edged sword, depending on circumstances. What in prosperous times might be accepted as benign, even natural, could become a focal point for hostility in the event of recession or crisis. Formal dollarization creates a convenient target for protest. When the greenback was adopted in Ecuador, demonstrators marched in the

9. See e.g. Grubel 1999: 27.

streets denouncing what they feared would be the “dollarization of poverty.” It is not difficult to imagine at some point similar emotions erupting in Canada, blaming the greenback – and thus Washington – for failures of economic management at home. It is even possible to imagine the occasional politician in Canada, concerned about re-election, deliberately fomenting popular protests as a way of diverting attention from his or her own policy errors. Prestige for the United States could come at a high price, creating an easy target for grievances.

Disadvantage

Even worse, from the US point of view, Canadian grievances could translate into demands for policy accommodations by Washington, compromising US macroeconomic flexibility. For most Americans, that risk alone would be enough to make the dollarization model a non-starter. A prospective threat to policy autonomy at the macroeconomic level would decisively outweigh the attraction of efficiency gains at the microeconomic level.

Formally, of course, dollarization would require no substantive concessions from Washington. A country that dollarizes technically cedes all authority over monetary management to the Federal Reserve, voluntarily surrendering control of its own money supply and exchange rate. In effect, the country becomes a currency dependency, a client of the United States. Washington is under no legal obligation to assure that the dollarizer’s specific circumstances will be taken into account when monetary decisions are made; nor must access be granted to the Federal Reserve’s lender-of-last resort facilities should the dollarizer’s banks get into difficulty. Indeed, US officials have gone out of their way to deny that American policy or institutions would be adjusted in any way to accommodate the interests of nations that choose to adopt the greenback. Certainly no commitments were made to either Ecuador or El Salvador when they decided to dollarize.

It bears repeating, however, that Canada is no Ecuador or El Salvador. In reality, it would be difficult for the United States to ignore adverse developments in the economy of its largest trading partner. Washington might make no explicit commitments to Ottawa. But implicit in any Canadian decision to dollarize would surely be an expectation of special consideration – a kind of contingent claim on neighborly goodwill. At a minimum, the Federal Reserve might be expected to take Canada’s specific priorities and fragilities into account when setting policy goals, or to open its discount window to Canadian financial institutions in time of need. More radically, Ottawa might even presume a right to indirect or even direct representation on the Federal Reserve Board or Federal Open-Market Committee.

Legalities notwithstanding, obligations would be assumed, introducing a potentially serious constraint on US policymaking. To say the least, such a development would be unwelcome to most US Americans.

ALTERNATIVE CIRCUMSTANCES?

On balance, therefore, apart from a saving of transactions costs, there seems little in present circumstances to recommend NAMU to the United States, whatever form it might take. As compared with the status quo, the amero model would compromise all the substantial benefits that Americans presently enjoy as a result of the greenback's global popularity; and even with the dollarization model, there would be more disadvantage than advantage. The obstacle of US indifference will be extremely difficult to overcome.

Are there any foreseeable circumstances that might alter this conclusion? Four possible scenarios come to mind. None, however, appears especially probable.

First, it is possible that a winning coalition of domestic interest groups in the United States might be mobilized to overcome popular resistance. Certainly there are key sectors that, because of their heavy involvement in cross-border activity, could be expected to profit materially from a monetary union between the two countries. Among others, these would include US banks and other financial intermediaries as well as export and import interests and portfolio investors. And so certainly an incentive exists for such constituencies to get together to campaign on behalf of NAMU in some form, perhaps in coalition with like-minded Canadian interests. But would the incentive be great enough to overcome inherent collective-action problems among such groups? Until now, lobbying in Washington on the issue has been most conspicuous by its absence, suggesting little practical appeal. As a practical matter, prospective gains seem too marginal or uncertain to motivate a serious political initiative. Even Grubel (1999: 24) admits that the idea of NAMU "will have little support from American interest groups."

Second is the possibility of a grave deterioration of economic conditions on one side of the border or the other – a risk of downturn so painful that it might drive the two countries, in effect, to huddle together for protection. In Canada, for instance, misdirected policies or a reinvigorated Québec independence movement could threaten prolonged recession or financial collapse. On the US side, runaway current-account deficits might severely erode confidence in the greenback, raising the specter of a sudden exchange-rate crash. In circumstances like these, a

monetary union could begin to look far more attractive to US Americans than it does now, offering the equivalent of a lifeboat in a storm. But as with all weather developments, the challenge is in the forecast. How serious are the risks? Though such contingencies are not implausible, few observers see any reason to raise high-level storm warnings for the near term. Economic conditions would have to get a lot worse than anyone now anticipates to dent the US present indifference to NAMU.

Third, there is the euro, which many observers foresee as a future rival to the US dollar. A serious challenge from Europe's new currency, eroding the advantages presently derived from the greenback's market leadership, could greatly alter America's calculus of interest in NAMU. This *deus ex machina* is repeatedly invoked by NAMU advocates. Grubel, for example (2003: 331-2), writes that the euro represents "a real threat to the current status and power of the US dollar and the benefits US citizens derive from it.... The United States should consider that the creation of a North American monetary union will reduce the size of these losses." Likewise, Courchene and Harris (1999: 23) speculate hopefully that because of the rise of the euro, "the Americans may well wish to expand the reach of the dollar area." In reality, however, there is less here than meets the eye. As I have argued elsewhere (Cohen 2003), the euro's putative challenge to the dollar is actually much less serious than suggested. Europe's new currency, I contend, is fated to remain a distant second to the greenback. Hence little pressure will come from across the Atlantic to alter Washington's views on NAMU.

Finally, it is not inconceivable that a broader movement might develop toward full-scale political integration between Canada and the United States, *à la* the European Union. The two North American neighbors are already closely linked by a dense network of economic and social linkages, formally institutionalized in the North American Free Trade Agreement and a variety of other pacts and treaties. Although monetary union is not promoted as a possible precursor of a political union, it could certainly be sold as ancillary to one. Opposition to NAMU would surely be softened if the idea were packaged as part of a projected United States of North America. But there is little sign at present that the American public, let alone Canada, might be prepared to think along such ambitious lines. Indeed, given the conflicted histories of the two countries, this may be safely assumed to be the least probable scenario of all.

CONCLUSION

In short, Canadians may debate the pros and cons of NAMU all they like. But they can expect little support, let alone encouragement, from the US side of the border. For US Americans, the status quo is preferable. Circumstances can be envisioned that might alter US attitudes, but their probability is limited at best.

The general point is clear. So long as a monetary power, such as the United States today, can expect to enjoy the substantial benefits of de facto market dominance, there is little to be gained, and possibly much to lose, from formalizing the informal. Only if those benefits are seriously threatened – say, by economic crisis or the emergence of a serious rival – would the option of *de jure* union take on more appeal.

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DOLLARIZATION OR A NORTH AMERICAN COMMON MARKET? REVIEWING THE OPTIONS FOR CANADA

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INTRODUCTION

In spite of a long-term commitment to flexible exchange rates, the sharp depreciation of the Canadian dollar vis-à-vis the US dollar in the 1990s originated much debate about the viability of the Canadian currency. This debate on the fate of the Canadian dollar also occurred at a moment when the financial crises of the 1990s reignited the debate on the reform of the international financial architecture as well on the appropriate exchange rate regime for individual countries. There are two important developments regarding the latter question. On the one hand, although many countries have increasingly adopted flexible exchange rates in the last few years, most evidence seems to suggest that there is also a pervasive “fear of floating” (Calvo and Reinhart 2000). Thus, the monetary authorities of countries with flexible rates have extensively intervened in the foreign exchange markets trying to stabilize the value of their currencies, which has implied higher foreign reserve volatility and higher interest rate volatility. On the other hand, many of the countries with fixed rates also have been subjected to several crises,

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which led to a plethora of realignments (e.g. the 1994 devaluation of the CFA franc²) and/or the return to flexible rates (e.g. Mexico in 1994, Brazil in 1999). These crises suggest that fixed-but-adjustable exchange rates are not sustainable, especially when countries suffer from problems of credibility, since they are prone to speculative attacks. The current prevailing view is that, in a world of freely flowing capital, countries have been increasingly forced to choose between fully flexible rates and “hard” fixing, such as unilateral or multilateral dollarization (B. McCallum 1999; Robson and Laidler 2002). If these arguments are correct, Canada should then choose between the current regime of flexible rates and a currency union (unilateral or negotiated) with the United States.

This paper argues that Canadian authorities will face a crucial dilemma if they choose to ‘dollarize’: although a symmetric monetary union with the US would be more economically attractive to Canada, it is likely that political conditions will prevent such an arrangement. Unilateral adoption of the US dollar might also not be possible because of many economic difficulties. Therefore, in the foreseeable future it is likely that Canada will maintain its own currency. Nevertheless, there might be a reversal of policy if North Americans created a European-style common market. In fact, this paper contends that the introduction of a common market might offer an intermediate step between unilateral dollarization (not desired politically) and a North American Monetary Union (NAMU) (not feasible). The paper then debates some of the merits and problems associated with establishing a common market in North America. We proceed as follows. The next section analyzes the status quo of flexible rates, sections three and four discuss the alternative regimes, whereas the last section reviews some aspects of enhanced economic integration in North America.

THE STATUS QUO: FLEXIBLE EXCHANGE RATES

One of the main benefits stemming from flexible exchange rates is the maintenance of an independent monetary policy, which is often seen as an important tool of national sovereignty. However, large depreciations can originate temporary bouts of imported inflation, which has led several countries to abandon their commitment to floating. In Canada, inflationary pressures stemming from

² The CFA franc is a currency used in twelve formerly French-ruled African countries, as well as in Guinea-Bissau and in Equatorial Guinea. Strictly speaking two different currencies are called CFA franc: the West African CFA franc and the Central Africa CFA franc. These two CFA francs exchange one for one and have the same exchange rate with the euro.

flexible rates have not been considerable, especially after the introduction of inflation targeting in the last decade, which has allowed for a reduction of the inflation rate to levels lower than those of the US.³ Therefore, any change in the exchange rate regime will not be motivated by problems associated with high inflation or the low credibility of Canadian monetary authorities.

Flexible exchange rates also act as macro shock absorbers, which can be valuable especially when a country is subjected to asymmetric shocks. In Canada, most provinces are still highly specialized in the production of a few goods and commodities. This specialization is then reflected into the pattern of provincial exports. In 1998, more than 90 percent of merchandise exports from the Atlantic provinces, Alberta, British Columbia and Saskatchewan was resource-based. This percentage was substantially lower for Québec (about 50%) Manitoba (about 55%), and Ontario (only 25%).⁴ Due to the high degree of provincial specialization, floating rates are often perceived as a crucial insulator against price volatility of internationally traded goods.

Nevertheless, in the last few years, the benefits from flexible rates have increasingly been under scrutiny due to the sharp depreciation of the Canadian dollar vis-à-vis the US dollar. First, critics argue that the persistently low dollar has been the source of sluggish productivity improvements (Courchene and Harris 1999, 2000), originating the so-called endogenous productivity argument. Grubel (1999) claims that a weak Canadian dollar has caused Canadian managers to become “lazy”, delaying a reorganization of firms and perpetuating uncompetitive practices. Harris (2001) argues that the low Canadian dollar of the 1990s has delayed the restructuring of the Canadian economy, by artificially helping low-value added natural-resource industries to survive, diverting investment from high-value added sectors such as the Information Technology industry. Furthermore, according to Courchene and Harris (2000), the low dollar has led to a relative decline in Canadian living standards, which has fuelled a brain drain of many of high-productivity Canadians.⁵ Critics also contend that the volatility of

³ However, inflation targeting does not necessarily imply an improvement in macroeconomic performance, as Ball and Sheridan (2003) have shown.

⁴ Figures calculated from John McCallum (1999).

⁵ Unfortunately, the evidence on the endogenous productivity argument is still not definitive. Robson and Laidler (2002, p. 9) have argued that if the “lazy manager” and lagging productivity story is accurate, then there are serious implications to corporate governance within Canada beyond the current monetary regime, since similar effects might occur due to lower energy prices, wage restraint, or lower taxes. On the other hand, it is plausible that a persistently lower currency might persuade firms to postpone some restructuring in the short run due to the insulation effects of the exchange rate. However, in the longer term, exchange rates are only one of many considerations in a

short- and medium-run exchange rates is much higher than the volatility of the macroeconomic fundamentals. Hence, countries are vulnerable to bouts of significant and lengthy exchange rate misalignments, which can overturn the benefits from flexible rates (Courchene and Harris 1999: 4). All in all, if the critics of flexible exchange rates are correct, what are the alternatives for Canadians? The next section surveys the advantages and disadvantages of alternative exchange rate regimes for Canada.

THE ALTERNATIVES: FROM FIXING TO NAMU

There are several alternatives to flexible rates, ranging from a traditional pegged exchange rates regime to a full-fledged monetary union with North American partners.

Fixed Exchange Rates

Canadians could choose to peg the Canadian currency to the US dollar. Fixed exchange rates entail no uncertainty, and economic transactions could arguably receive a boost. Furthermore, fixed rates imply that there would not be any “lagging” productivity problems (if they exist). However, a return to fixed exchange rates would entail several problems that might not be easily solved. First, at what level should the peg be? Is the current rate of about 85 cents acceptable, or should the peg take into account future improvements of Canadian terms of trade (due, say, to an increase in the prices of natural resources)? If yes, is 90 or 95 cents the appropriate level? The question of the “right” peg is crucial, because not only it partly determines the short-run competitiveness of Canadian exporters, but also has significant implications to the domestic inflation rate. Second, assuming that the Canadian monetary authorities manage to find the right peg for the Canadian dollar, it is possible that the peg cannot be maintained for a substantial period of time. That is, the peg might not be credible in the long run, and hence it might be prone to speculative attacks, especially whenever there are disequilibria and misalignments. Finally, a peg might not provide enough flexibility for Canada, especially if there are substantial adverse movements in the

firm’s decision on whether or not restructure. Hence, the endogenous productivity argument might not apply in the long run. In addition, Helliwell (1999) has provided evidence suggesting that the brain drain was three times as large in the late 1950s than in the 1990s.

prices of natural resources. Therefore, a return to fixed exchange rates does not appear very viable.⁶

Currency Board

Another possibility could be the establishment of a currency board. Currency boards have several characteristics: 1) the domestic currency is fully backed up by foreign reserves, 2) the fixity of the exchange rate is determined by law, and 3) the balance of payments is self-correcting, ensuring that a balance of payments surplus (deficit) increases (decreases) automatically the money supply. Currency boards were originally established in many British colonies, but recently this monetary institution has been resurrected in some countries, such as Hong Kong in 1983, Argentina in 1991, Estonia in 1992, Lithuania in 1994, Bulgaria in 1997 and Bosnia in 1998 (Frankel 1999: 18). Currency boards became more popular for two reasons. On the one hand, some high-inflation countries have established currency boards to stank inflation and provide some nominal stability. On the other hand, recently independent countries introduced currency boards to augment the credibility of their governments and monetary authorities. However, the recent collapse of the Argentine currency board shows that this type of arrangements also entails serious credibility problems, which might endanger its sustainability. Furthermore, a currency board is not flexible enough in the case of recessions, and it does not require a lender of last resort, which should be a crucial determinant in the choice of any alternative exchange regime⁷ (Buitier 1999). In short, since Canada is not a high-inflation country and its monetary authorities do not have a credibility problem, it is not likely that a currency board will be introduced.

Unilateral Dollarization

A more credible option for Canada could be unilateral dollarization. In this context, there are two possibilities: *de facto* dollarization and *de jure* dollarization. De facto (or market) dollarization occurs when individuals and companies in a

⁶ The possibility of quasi-fixed exchange rates in the context of an Exchange Rate Mechanism (ERM) in North America similar to that of the European ERM is discussed in Crowley and Rowley (2002).

⁷ The loss of the lender of last resort is an important consideration in currency boards and for unilateral dollarization, since as Buitier (1999: 2) emphasizes: "An effective response to systemic national financial crises requires an agency with deep and readily accessible pockets. There is no adequate substitute for a central bank in this role".

country adopt a foreign currency (e.g. the US dollar) in their daily transactions. Partial market dollarization has taken place in many countries, especially in Latin America. In Canada, in 2001, almost seven percent of all deposits in Canadian banks as a percentage of M3 were foreign currency deposits. This figure is higher than a decade ago (when it was only three percent), but lower than in the 1970s, when almost ten percent of all Canadian deposits as a percentage of M3 were in foreign currency (Robson and Laidler 2002). Murray and Powell (2002) also find compelling evidence that *de facto* dollarization is not occurring in a significant scale in Canada. A second possibility, a future sharp fall of the Canadian dollar might once again boost the calls for *de jure* dollarization, in which Canada would unilaterally adopt the US dollar. This option has several costs and benefits, and it will be more thoroughly surveyed in section 4.

NAMU

Another possibility is the establishment of a symmetric monetary union (NAMU) similar to Economic and Monetary Union (EMU) in Europe, which should involve the creation of a new central bank (the North American Central Bank) and the creation of a new currency (if the US dollar does not become the base currency). In order to assess the desirability of a monetary union we need to look at the optimal currency criteria and the *ex post* effects that might stem from such a monetary arrangement.

The OCA Criteria and Currency Unions

Since Robert Mundell's (1961) seminal work, assessing the adequacy of monetary unions is usually done within the framework of the theory of optimal currency areas (OCA). Mundell defines an OCA as an economic unit composed of regions, which are symmetrically affected by shocks and have free mobility of factors of production (especially labor). If a region is an OCA, then it should have its own currency and its own monetary policy (Frankel 1999). In an OCA, in case of an idiosyncratic demand shock, the two main mechanisms that restore the equilibrium of relative prices are wage flexibility and the mobility of labor from high to low unemployment regions. Nevertheless, a currency union might face asymmetric shocks across its regions and still be successful. For instance, the high degree of provincial specialization in Canada implies that the inter-provincial real exchange rates are highly variable (Eichengreen 1997). The Canadian example shows that a monetary union can be sustained even when the participant regions

(countries) are not structurally similar if there is political cohesion between the regions as well as a mechanism of fiscal solidarity between them.

Typically, OCA-based studies find that there are significant microeconomic benefits from the establishment of a monetary union (due to the reduction of transaction costs), while the main costs are related to the associated loss of monetary independence (Rose 2000), which are not easily quantifiable. However, in spite of theoretical appeal, the OCA criteria often do not provide firm guidance on whether or not countries benefit from joining monetary unions. For instance, Bayoumi and Eichengreen (1997) find that many of the euro countries did not satisfy the OCA criteria. In short, based solely on the OCA criteria, it is difficult to assess whether or not North America should have a monetary union.⁸ Nevertheless, a recent study by Alesina, Barro and Tenreyro (2002) suggests that North America is increasingly becoming an optimal US dollar zone. Namely they find that, between 1960 and 1997, Canada has one of the most significant trade-to-GDP ratios⁹ (18.3%) with the US, it is the third country in the world with the highest price co-movement with the US economy¹⁰, and it is the country with the highest co-movement of output with the United States. These results could thus imply that there might indeed be a case for a North American Monetary Union.

More importantly, it is widely accepted that the concept of optimal currency areas should be merely a departing point in a thorough examination of the costs and benefits of currency areas. Recently, Frankel and Rose (1999) have claimed that the OCA criteria are endogenous, since the *ex post* effects from a currency union might be higher than *ex ante* considerations. Some of the *ex post* effects of currency unions include: 1) trade impacts, 2) business cycle synchronization, and 3) the effect on foreign direct investment.

Currency Unions and Trade

Studies have shown that, due to a plethora of economic and social reasons, trade is substantially larger between regions of the same country than among comparable regions of different countries. McCallum (1995) and Helliwell (1996) estimate that trade between pairs of Canadian provinces were about twenty times

⁸ It is thus not surprising that many economists disagree with the project (see, for example, Helliwell 2002, J. McCallum 2000, Murray et al. 2000, Robson and Laidler 2002)

⁹ The only countries with higher trade-to-GDP ratios with the US are of a much smaller dimension, such as Trinidad and Tobago, Honduras, Guyana, Jamaica and Angola. In comparison, in the NAFTA region, Mexico's trade-to-GDP ratio is 8.7%.

¹⁰ The highest price co-movement belongs to Puerto Rico, and Panama, countries that use the US dollar. El Salvador, the other country that dollarized, has the fourth highest price co-movement (Alesina et al. 2002, tables 1-4).

larger than trade between comparable American state-Canadian province pairs. Anderson and van Wincoop (2000) show that the early estimates of this home-trade bias were probably too high, but still quite considerable. They estimate that the border effects reduce trade by 44 percent in Canada and by 30 percent in the United States. Nitsch (2000) claims that home bias is also very substantial in the European Union, since intra-national trade is almost ten times as high as international trade with an EU country of similar size and distance. The magnitude of this home-bias effect is important, because there seems to be significant gains from trade following the establishment of a currency union. In this context, Rose (2000) provides strong empirical evidence showing that trade is negatively affected by exchange rate volatility, and finds that trade between common currency countries is more than three times larger than between other countries.¹¹ Nitsch (2002) re-estimates Rose's regressions and finds that currency unions double instead of triple trade. All in all, although there is still some controversy about the magnitude of the effect, these preliminary results suggest that currency unions do indeed substantially enhance trade.

Trade is also important because there is an inverse relationship between the cost of a monetary union and openness: the higher the volume of trade as a percentage of Gross Domestic Product (GDP), the lower the cost of monetary union (Krugman 1990). Thus, countries that have substantial bilateral trade stand to gain more from currency unions than those that have lower trade linkages, since the elimination of transaction costs will be more beneficial for countries that are relatively more open. These gains from trade can be further compounded if economies of scale and economic rationalization accompany additional economic integration between countries.

An important question for Canada regards the nature of trade with the United States. Eichengreen (1997) shows that if the nature of the trade between the participant countries of a monetary union is mainly intra-industry, then exogenous demand shocks will affect these countries in a similar way. In contrast, if trade is primarily of the inter-industry variety, then exogenous shocks will be felt very differently throughout the participating countries. In this context, if we analyze the nature of trade between Canada and the United States, several features are noticeable. First, since the start of the Canada-US free trade area, there has been a dramatic increase in provincial exports to the US. As a share of GDP, the growth

¹¹ Note, however, that Rose's estimates of the effect of common currencies on trade are still controversial. For a critique of Rose's approach see, for instance, Rodrick's comments of Rose's paper at <http://ksghome.harvard.edu/~drodrik.academic.ksgh/comments%20on%20Frankel-Rose.PDF>.

of provincial exports to the US increased more than 50 percent for Atlantic Canada and British Columbia, and much more than 100 percent for Manitoba and Québec (J. McCallum 1999: 3-4). Second, as we saw above, the nature of trade varies widely between individual provinces. In this context, the high share of the resource industries in the exports of most provinces might imply that floating rates could be important in the absorption of asymmetric shocks (Murray et al. 2000). However, in the last few years there have been some signs that the Canadian economy is becoming increasingly more diversified. Between 1989 and 1998, the largest increase of exports to the world (and to the US) occurred in non-automotive manufacturing. In contrast, the relative importance of resource-based exports declined throughout the period (J. McCallum 1999: 3). Thus, the Canada-US Free Trade Agreement (FTA) and NAFTA led to an increase of the relative importance of intra-industry trade. If this trend persists or increases with further economic integration, then the benefits from flexible exchange rates might be diminished.

Currency Unions and Business Cycle Synchronization

Frankel and Rose (1998) find that the effect of an increase in trade integration between two countries on the correlation of business cycles is statistically significant and strongly positive. In turn, whenever business cycles are more synchronized, the benefits from monetary unions increase (Krugman 1990). Similarly, Alesina, Barro and Tenreyro (2002) find that countries that exhibit high trade-to-GDP ratios with their economic partners also tend to have a higher comovement of prices and output with them. In particular, their evidence on North America seems to suggest that further economic integration will strengthen the correlation of Canadian business cycles with those of the United States. It is likely that *ex post* a currency union would further reinforce this trend.

Currency Unions and Foreign Direct Investment

Another crucial *ex post* impact of currency unions concerns foreign direct investment (FDI). Blomstrom and Kokko (1997: 9) contend that regional economic integration should boost investment for the region as a whole by providing a larger common market that could improve overall efficiency. In this context, Andresen and Pereira (2005) find that economic integration is often associated with the occurrence of structural breaks in the volume of FDI. They show that not only FDI volumes have increased with regional integration agreements, but also that smaller countries enjoyed the highest percentage

changes in the post-break period. Thus, it is likely that smaller countries (like Canada) benefit relatively more from additional economic integration. In addition, as the recent introduction of the euro has shown, currency unions typically boost the movement towards mergers and acquisitions between companies of different member states, further enhancing the rationalization of economic operations and increasing scale economies.

All in all, the *ex post* impacts after a currency union might be at least as relevant as the OCA criteria in the evaluation of whether or not countries should join monetary unions (Frankel and Rose 1998). In the Canadian context, this research suggests that, although there is still not enough evidence on whether North America is an OCA, Canada might still benefit from engaging in a monetary union with the United States, especially if we take into account the *ex post* effects of monetary unions. The next section discusses which type of monetary union would be more beneficial for Canada.

NAMU OR UNILATERAL DOLLARIZATION?

A major benefit from the establishment of a North American monetary union would be the elimination of transaction costs from exchanging currencies. Since Canada trades more than a third of its GDP with the United States, the microeconomic gains from the end of these transaction costs might be important. These gains have been (guess) estimated by several recent studies, which suggest that, although significant, these savings in transaction costs are certainly not dramatic. The estimated microeconomic gains vary from up to 0.5 % of GDP per year (Buiter 1999), 0.4% of GDP annually (Grubel 1999), and 0.2 % of GDP per year (Robson and Laidler 2002).

In terms of seigniorage revenues, the introduction of NAMU should not impose any major obstacle. First, in developed countries seigniorage revenues are not a very large component of a government's revenues.¹² Second, the annual revenues from seigniorage could be shared among the participants of the monetary union, taking into account both a country's needs and the share of its GDP in the total output produced in the NAMU region. Therefore, a NAMU should not entail a decline in seigniorage revenues for individual countries. In fact, a GDP-based or population-based share of seigniorage in NAMU could provide Canada (and Mexico) even more seigniorage revenues than under the

¹² In Canada seigniorage revenues constitute less than one percent of the total receipts of the government.

current regime, because of the expanding US dollar seigniorage¹³ (Buitter 1999: 10-11). Other advantages and disadvantages of NAMU are related to the OCA criteria and the other *ex post* effects discussed above.

All in all, even when we take into account all the economic costs and benefits of NAMU, we do not have a clear-cut answer of whether or not a monetary union with the US would be good for Canada. At best, as discussed below, in economic terms, NAMU would be a better alternative than unilateral dollarization. Nevertheless, the implementation of NAMU might be riddled by some difficult political economy problems, which could compromise the whole project. In this context, we should not underestimate the highly asymmetrically relationship between the US and the other North American countries (which is much more significant than between Germany and the other EMU partners). This asymmetrical relationship is economic and political.¹⁴ Due to the huge asymmetries in North America, it does not seem likely that the US government will ever accept a monetary union that compromises its relative power in the continent. Furthermore, there are other political challenges that will have to be solved for a successful implementation of NAMU. First, what criteria should be established for sharing seigniorage revenues? Should seigniorage be shared based on relative population, GDP or other economic criteria? Should the revenues from the dollarization of non-North American countries be shared among the NAMU partners? Second, if a NAMU central bank is created, how many Canadian or Mexican representatives/governors should there be? This is an important question not only for political reasons, but also because it matters for the impact of monetary union on individual countries. Third, and more importantly, would NAMU be an intermediate step in the path of a political union? This is a crucial aspect, because Buitter (1999) suggests that some sort of political union might be necessary in order to secure the survival of a monetary union in the long run. In EMU, there are already multinational institutions (e.g. the European Parliament, the European Central Bank (ECB)) that safeguard the European cohesion and interests, and political integration could be an option in the future. However, so far, there is no sign that North Americans would accept the same trend of creating multinational institutions and/or any process of political integration. Thus, NAMU might not be politically feasible.

¹³ US seigniorage has grown considerably in the last few years due to the increasing wide use of the US dollar in many countries in the world.

¹⁴ The United States produces 90 percent of NAFTA's GDP, whereas Canada and Mexico produce, respectively, 6 and 4 percent. In addition, the United States has 69 percent of NAFTA's population, Mexico 24 percent and Canada 7 percent.

The Possible Alternative: Unilateral Dollarization

Since a full-fledged NAMU is not very likely due to political reasons, the remaining option for Canada would be to unilaterally adopt the US dollar. Unilateral dollarization would also eliminate potential “lagging” productivity issues, as well as all uncertainty related to exchange rate movements (*vis-à-vis* the US dollar). Another advantage of unilateral dollarization is the elimination of transaction costs of exchanging currencies. However, unilateral dollarization would involve several costs, such as the loss of monetary independence, the surrender of symbols of national political sovereignty (Frankel 1999: 21), and the loss of seigniorage revenues. Furthermore, unilateral dollarization would also preclude the existence of a lender of last resort for the Canadian financial institutions. According to Buiter (1999), by itself, this reason would be sufficient for Canadian authorities to refute unilateral dollarization outright.

In sum, as Robson and Laidler (2002): 1) have emphasized, unilateral dollarization “presents important macroeconomic and financial risks, and raises awkward questions about Canadians’ ability to hold monetary policy makers accountable.” Therefore, unilateral dollarization does not seem very likely in the future, unless Canadian monetary authorities face serious inflationary and credibility problems (or if *de facto* dollarization takes place on a large scale).

Taking Stock

From the sections above, we can conclude that it is probably a good idea for Canadians to maintain, at least for now, the *status quo* of floating exchange rates, since: 1) there is not enough evidence on whether or not the OCA criteria have been totally met in North America, and 2) flexible rates have done a relatively good job.¹⁵ However, as Frankel (1999) argues, the OCA criteria evolve through time. Hence, it is possible that Canada and the US might become more an optimum currency area in the future, especially if the trend of diversification continues in the Canadian economy. Furthermore, additional research on the *ex post* effects of currency unions might demonstrate that, indeed, there might be significant gains from NAMU or from unilateral dollarization. In this context, it is important to reiterate the *crucial dilemma* that Canadian authorities will face if

¹⁵ The idea that the 1990s were a “big outlier” is emphasized by Murray, Zelmer and Antia (2000), whose model shows that the variations of the Canadian dollar are greatly explained by movement in the world commodity prices and Canada-US interest rates differentials.

they chose to “dollarize”: although a symmetric monetary union would be economically more favorable to Canada, it is likely that politically the extremely asymmetrical relationship between Canada and the US will prevent the establishment of such a monetary union. Thus, unilateral dollarization might be the only political alternative to Canada. However, unilateral dollarization might also not be possible because of insurmountable economic difficulties, especially concerning the loss of a lender of last resort for Canadian financial institutions as well as the loss of symbols of national sovereignty.

Although dollarization will likely not be an option in the short run, North Americans might opt for an intermediate step in the quest for enhanced regional integration. In this context, the rest of this paper argues that a common market is the most appealing and feasible alternative to a multilateral monetary union. A common market will not only provide a substantial boost to regional integration in North America, but also will likely increase the chances for a future monetary union in the continent. That is, if NAFTA evolves towards a common or a single market, then the advantages from unilateral or multiple dollarization should increase. Hence, it is probably adequate for us to think about a North America Common Market before we think about NAMU. The next section discusses this question.

IS THERE A CASE FOR A NORTH AMERICAN COMMON MARKET?

Although highly criticized (and feared) initially, it is now more or less consensual that the NAFTA has been a considerable success. As table 1 shows, in Canada, trade and investment flows have increased considerably since the inception of NAFTA. The same is true for the other NAFTA partners¹⁶.

From 1993 to 1999, Canadian exports to the US and Mexico increased, respectively, 138 and 147 percent. By 2000, almost 87 percent of the CAN \$588.7 billion Canadian exports went to the NAFTA partners, whereas this share was only about 70 percent at the outset of the Canada-US free trade area. On the other hand, the share of the imports from the US in total Canadian imports increased from 64 percent in 1988 to about 68 percent in 2000 (DFAIT 2000). Thus,

¹⁶ For the United States, exports to Canada and Mexico increased between 30 and 35 percent between 1988 and 1998, whereas imports from Canada and Mexico rose, respectively, 41.5 and 92 percent. FDI inflows from Canada increased 86 percent (DFAIT 1999).

NAFTA was responsible for a substantial change in the direction of Canadian trade.

Table 1 Impact of NAFTA for Canada (1993-2000), Percentage change

| | | | |
|---------------------|-----|-------------------------|-----|
| Total exports | 122 | Total FDI inflows | 57 |
| Exports to Mexico | 147 | FDI inflows from Mexico | 63 |
| Exports to USA | 138 | FDI inflows from USA | 200 |
| Imports from Mexico | 225 | FDI outflows to Mexico | 324 |
| Imports from USA | 105 | FDI outflows to USA | 127 |

Source: CANSIM, DFAIT (1999, 2000)

Foreign direct investment (FDI) flows increased even more: since 1993, FDI inflows from the United States rose by 200% and from Mexico by 63%, whereas FDI outflows increased by more than 125 percent to the US and a staggering 324% to Mexico.¹⁷ Furthermore, the substantial rise in bilateral trade suggests that many US firms may have used NAFTA in order to substitute trade for FDI. NAFTA has also led to a substantial increase of FDI inflows from the rest of the world, and hence it is likely Canada has become a relatively more attractive investment location for foreign investors (Blomstrom and Kokko 1997: 18-19).

All in all, the success of NAFTA suggests that there might be further benefits to be reaped from deeper regional integration in North America. The creation of a free trade area across the Americas is still on the agenda, and it is possible that NAFTA will be extended to other countries. However, some problems will arise if overlapping free trade areas are created. Namely, Krueger (1997b) shows that overlapping free trade areas are often plagued by conflicting rules of origins between the different free trade areas. In NAFTA, it is estimated that rules of origin requirements between Canada and the US cost about 2-3 percent of NAFTA GDP (Goldfarb 2003: 2). According to Krueger (1999a), the existence of conflicting rules of origins implies that free trade areas are inferior arrangements (or Pareto-dominated) to customs unions, since the latter do not involve any rules-of-origins problems and lead to a further enhancement of trade. Hence, it might be preferable to increase the degree of cooperation and integration between the existing (and new) NAFTA members rather than to introduce parallel free trade agreements.

¹⁷ Part of the increase of US investment flows to Canada might have been stimulated not only by NAFTA but also by the low value of the Canadian dollar.

In terms of North American economic integration, the successor to NAFTA will probably be either a customs union or a deeper level of integration, such as a North American Common Market. The establishment of a customs union could happen in specific sectors (such as the one that already exists for computers and parts) or as an economy-wide agreement. Although it would be easier to implement a customs union for specific sectors, the fact that in 1983 the US rejected Canada's proposal for the establishment of sectoral FTAs suggests that this type of arrangement might not be politically feasible, unless it is part of a bigger negotiation package (Goldfarb 2003). In turn, in an economy-wide customs union, free trade between the member countries would probably be enhanced by an extension of the agreements to other industries, such as transportation networks, banking and financial institutions (Hoberg 2000: S43). This objective should be accomplished with extra rounds of negotiation between the different member states. However, the greatest challenge to the constitution of such a customs union would be the introduction of a North American common external tariff, which could become a more controversial issue due conflicting interests among participating countries. This is particularly true for the agricultural sector as well as for textiles and clothing. Once again, the problem of the asymmetrical relationship between NAFTA members might be crucial in the negotiation of the common external tariff. Still, it is possible to envisage a situation in which countries would agree to a gradual approximation of their external tariffs until a common external tariff is achieved.¹⁸

Even if such an agreement were achieved in North America, the European experience demonstrates that customs unions do not completely eliminate protectionism between member states. After the 1957 Treaty of Rome that established a European customs union, tariffs between European countries were substituted by several non-technical barriers to trade, including many restrictions and quotas against other member states. Many of these restrictions against other member states only ended with the implementation of the 1992 Single Market.¹⁹ Therefore, implementing a customs union in North America would not necessarily decrease the level of protectionism between the current NAFTA member states.

¹⁸ For instance, Dobson (2002) proposes the establishment of an evolutionary customs union, in which there would be a gradual convergence of sectoral tariffs until tariffs are equalized. After equalization of tariffs is achieved it would be feasible to adopt common external tariffs and to eliminate rules of origins conflicts. Other alternatives are surveyed in Goldfarb (2003).

¹⁹ Although the transposition of Single Market directives from the European Commission into national law has been largely accomplished by all member states by the end of 2003, the Single Market is still not complete in the services sector.

In turn, the implementation of a North American Common or a Single Market would bring several benefits, but also some serious challenges. If we extend Krueger's analysis to a common or a single market, it is clear that any of these arrangements would be (Pareto) superior to either a free trade area or a customs union. First, a common or a single market does not originate problems of conflicting rules of origin that plague overlapping FTAs. Second, a common or a single market would increase the rationalization of economic activities, boosting efficiency across the region, and it would increase the scale economies for companies producing and exporting to the region. In addition, since both goods and factors of production are free to move in either a common or a single market, trade would likely increase relative to a FTA, further decreasing the impact of the home-bias effect. In fact, it seems that the reduction of the home-bias effect is already occurring. Helliwell, Lee and Messinger (2001) estimate that NAFTA reduced the Canadian home-bias effect from a factor of twenty to a factor of twelve. A common market would likely further reduce the home-bias effect, since it should further increase cross-border transactions, especially between neighboring provinces and states. Furthermore, the increasing factor mobility in a common market could imply a faster convergence of the standards of living of the poorest regions towards the richest areas.

In spite of these economic benefits, a North American Common Market might not be feasible in the short to medium run due to several political and economic obstacles. First, it is likely that a common market might be easier to be established than a single market. Namely, the implementation of a single market entails the constitution of some common standards and cross-border institutions, which might not be desired by North Americans. In contrast, a common market solely involves the free movement of goods and factors of production, reducing the need for cross-border institutions and regulations. Second, the free movement of goods and people might face some serious barriers due to security and political constraints. For instance, Canada, Mexico and the United States have widely distinct gun control laws, which would present several challenges to the establishment of a common market with open borders. Additionally, the free movement of people in a common or a single market would pose many security and immigration concerns of various degrees of difficulty. It is likely that these concerns will be much lower and more easily accepted by the American government with respect to Canada than to Mexico. Therefore, in an earlier stage it might be simpler to implement a North American Common Market solely between Canada and the United States. In a later stage, after Mexican living standards converge further towards the US levels, the common market could be extended to Mexico. Paradoxically or not, a North American common market

might be more readily accepted in a post-September 11 world. Due to security concerns, the American and Canadian governments might engage in the establishment of a *cordon sanitaire* across North America, in which there would be common security rules in the threat against global terrorism (DeVoretz 2002). Similarly, Hufbauer and Vega (2003) advocated the establishment of a common frontier in which Canada and Mexico would cooperate on security issues in exchange for a more open US border. However, the establishment of a *cordon sanitaire* or a common frontier would entail several complicated procedures that might not be easy to implement.²⁰ A common market would represent a step beyond the creation of such a *cordon sanitaire* and it would provide a truly common frontier, because it would involve the free movement of people within the member states.

Additionally, a single market could reduce part of the impact of the huge asymmetries that exist in NAFTA. In contrast to NAFTA, a single market would entail common competition rules across North America, and hence the United States would be less capable of establishing temporary protectionist measures against its partners, as it happened with the recent imposition of unilateral tariffs on Canadian softwood lumber. A single market could potentially attenuate these problems resulting from the overwhelming dominance of the US in North America.

Canada and a North American Common Market

Assuming that Americans would be willing accept the establishment of a North American Common Market (a relatively big assumption) as part of a package that includes addressing the issue of common security threats, would a common market be welcomed in Canada? According to Dobson (2002: 7-8), deeper economic integration with the United States has to safeguard two principles for Canadians: it should provide greater access to US markets, but without sacrificing neither political sovereignty nor Canada's distinctive institutions such as public services, as well as different approaches to labor markets and immigration. A North American Common Market would comply with these requirements, although it would be necessary to negotiate some issues such as annual immigration targets and illegal immigrants.

²⁰ For instance, there are several contentious issues if the *cordon sanitaire* involved the utilization of a dozen or so airports around the world to act as checking points to all aircraft traffic to North America such as: How many and which airports would be selected? How could the aircraft traffic from other regions be effectively controlled?

In pure economic terms, a Common Market makes sense for Canada, since it would not only provide a greater access to US markets, but also it would promote the rationalization of economic activities across the continent. Nevertheless, the introduction of a North American Common Market would have very different consequences for individual groups of Canadians. Most elements of the business community would probably support the establishment of a common market, since this is the group that stands to gain more from opening up the borders with the United States. Still, it is likely that the proposal of establishing a common market might not be well accepted by groups from “sensitive” sectors, such as agriculture, textiles and clothing. Since it is unlikely that North Americans will be willing to accept any type of European-style common agricultural policy or any common institutions to regulate these sensitive sectors, it is probable that some sort of strategic bargaining would have to be done for these sectors. Also, the establishment of a North American Common Market would raise some concerns regarding the sovereignty of Canada. These concerns could be address either by establishing a single market with common institutions (which would probably would not be accepted by Americans), or by pointing out that economic integration is not synonymous of political integration.

All in all, although the Canadian economy would benefit from more access to US markets, some Canadian interest groups would likely lose with the establishment of a common market, and probably some sort of compensation would have to be worked out them. However, as emphasized above, it is likely that the establishment of a North American Common Market will not be accomplished in the near future, since there are several obstacles (regarding security, immigration, and the political economy of economic integration) that need to be removed before this happens. Meanwhile, the creation of a customs union or some sort of strategic bargaining could gradually advance the process of economic integration until North Americans are ready for a more ambitious agenda such as a Common Market.

Common Market and NAMU

Although there are serious obstacles for the creation of NAMU, it is probable that a monetary union would be more readily acceptable if a North America Common or Single Market were created. First, the OCA criteria would be more favorable after the introduction of a single market due to the free movement of the factors of production (especially labor mobility). Second, a single market would enhance even further the *ex post* effects of a monetary union. Third, as the euro

example demonstrates, a single market together with a monetary union would lead to an additional boost to the rationalization of economic operations, due to an increase in mergers and acquisitions. Finally, the establishment of a common market would increase the chances that NAMU could be negotiated in a package (which would include security and immigration considerations), which would increase the benefits for Canada from a monetary union.

From our previous discussion, we should emphasize that the creation of a North American Common Market would be good *per se* and not merely as a tool to raise the benefits that come from NAMU. That is, even if NAMU were never created, North Americans would probably greatly benefit from the creation of a common market.

CONCLUSION

This paper surveyed the pros and cons of the alternatives to the regime of flexible exchange rates in Canada. The paper argues that Canadian authorities will face a crucial dilemma if they chose to ‘dollarize’: although economically a symmetric monetary union with the US would be more favorable to Canada, it is likely that political conditions will prevent the establishment of such a monetary union. Thus, unilateral adoption of the US dollar might be the only real alternative to flexible rates. However, unilateral dollarization might also not be possible because of several important economic difficulties, especially concerning the loss of a lender of last resort for Canadian financial institutions. Thus, although the move towards the ‘dollarization’ (unilateral or symmetric) Canada might be inexorable, it is likely that this important step will not be achieved in the foreseeable future.

An intermediate step in the path for North American economic integration could involve the introduction of a European-style common market. A common market would enhance the benefits of economic integration emanating from NAFTA, address common security concerns in a post September 11 world, and increase the advantages of implementing a monetary union in the region.

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THE “TYRANNY OF GEOGRAPHY” AND “CONTINGENT NEOLIBERALISM”: CANADA’S CURRENCY DEBATE IN COMPARATIVE CONTEXT

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INTRODUCTION

The re-emergence in Canada, especially during the 1999-2002 period, of debate over the benefits and costs of monetary union in North America has again focused attention on the choice of exchange rate regime. While this debate is typically couched in economic terms, beneath the surface a variety of political factors are also at play. This has led Helleiner (this issue), for example, to examine the “political basis” for Canada’s current flexible exchange rate regime. In this analysis, and other “political economy” analyses of exchange rate regime choices (see, for example, Wise 2000), the interests of producers in different industrial sectors, of the financial sector, of consumers and the preferences of policy elites all play explanatory roles.

This paper contributes to the political economy tradition but introduces two considerations which, I argue, are important for understanding the distinctiveness

¹ Professor of Economics, University of Northern British Columbia, Email: paul@unbc.ca. Financial assistance from the Social Sciences and Humanities Research Council of Canada, as part of the “Globalism and Its Challengers” Project, is gratefully acknowledged. I am also grateful to Mark Beeson, Brian MacLean and Richard Pomfret for their comments and to Yong Wang for his research assistance. This research forms part of a larger book-length study entitled ‘Endangered *Species*?: National Currencies Under Globalisation’.

of the Canadian debate about exchange rate regimes. Both of these considerations point to the importance of understanding the country *context* for exchange rate regime debates.

The first of these considerations I will label here in shorthand as “geography”. Put simply, does the presence – or absence – of a “large neighboring monetary union” influence debate over the type of exchange rate that any country might adopt? This question takes the theme of this Special Issue not as a descriptive starting point but as an analytical issue in its own right.

The second consideration I have termed “contingent neoliberalism”. Neoliberalism, which has dominated economic policy debate globally for the past two decades provides no particular guide to the preferred exchange rate regime. Rather, the preferred exchange rate regime, from a neoliberal standpoint, is contingent upon the specificities of the country under consideration. That is, the preferred exchange rate regime is contingent upon country circumstances.

To make the case for incorporating these two factors into analyses of the Canadian debate over exchange rate regime choices, I will take a comparative approach. I analyze monetary union debates in Canada and Australia, two countries which have many similarities: both rely to a significant degree on commodity exports, both are advanced capitalist economies with relatively high degrees of foreign ownership in manufacturing, both have relatively independent inflation-targeting central banks, both have flexible exchange rates and both their currencies have similar recent trajectories vis-à-vis the US dollar, and both are parliamentary democracies. However, despite these similarities, exchange rate regime debates in the two countries have been very different. A good part of the explanation for this lies, I argue, in the differences between them in terms of “geography” and “contingent neoliberalism”. The comparative approach enables me to show, therefore, that differences in these two factors can help to explain why two otherwise quite similar political economies can have very different debates over monetary union.

The core of this paper consists of this comparative analysis. Having made the case for the inclusion of “geography” and “contingent neoliberalism” as factors explaining exchange rate debates in Canada and Australia, I also briefly explore the implications of this for analyzing the case of Britain and the euro. The paper is organized as follows. In the next section of the paper, I briefly review in more detail some of the similarities and differences between Canada and Australia in terms of economic structure and, more particularly, exchange rate histories. Section III then outlines differences in monetary union debates in the two countries. In the subsequent two sections the importance of “geography” and “contingent neoliberalism” as explanations for the differences in monetary union

debates are examined. The possible implications of the importance of these factors for analyzing Britain and the euro are also explored.

CANADA AND AUSTRALIA: EXCHANGE RATE AND ECONOMIC SIMILARITIES AND DIFFERENCES

In many ways Canada and Australia are similar as economic and political entities as noted above. Both have similar levels of Gross Domestic Product (GDP) per capita, both are relatively open economies², and have export compositions which, compared to most other OECD countries, rely on commodity exports for a significant part of their trade.³ Even though this latter characteristic is more pronounced in Australia than in Canada, it is still nonetheless common to find both of their currencies, based on this export composition, to be described as "commodity currencies".⁴

The characterization of the two currencies as belonging to the same particular class of currencies is given credence by the similar performance of the two countries' currencies against the US dollar over the past twenty-five years as shown below in Figures 1 and 2.

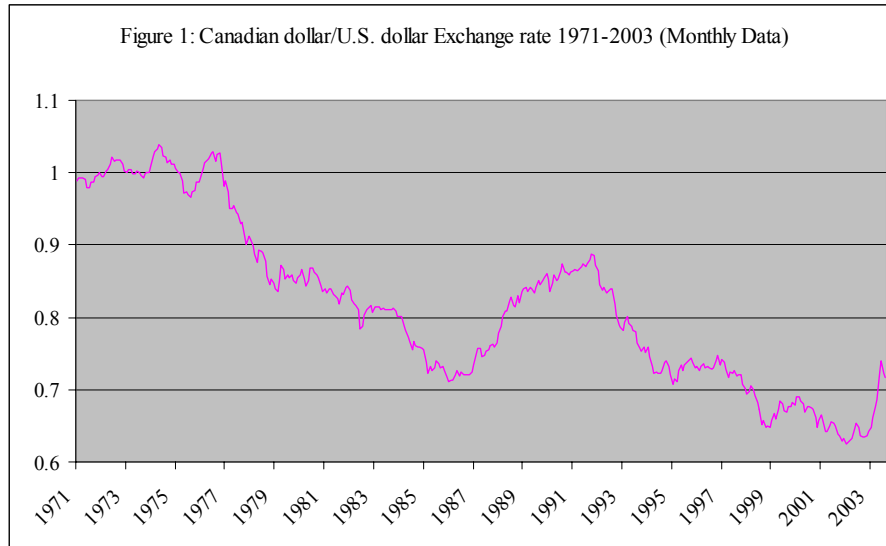
Both currencies have exhibited a general downward trend against their more illustrious US counterpart over the past two of decades. Both currencies reached historic lows against the US dollar in 2001 as they continued to decline in the aftermath of the 1997 Asian financial crisis and the slowing of the world economy. Both have also appreciated rapidly against the US dollar since 2003.

Despite these similar economic structures and recent exchange rate experiences, there has been one area of significant policy difference. In Australia, the most common exchange rate regime since the 1930s has been a fixed rate regime which dominated policy until the early 1980s. In Canada, in contrast, a flexible exchange rate has been most common with only relatively short intermissions of fixed rate regimes. These differences are indicated in Tables 1 and 2 below.

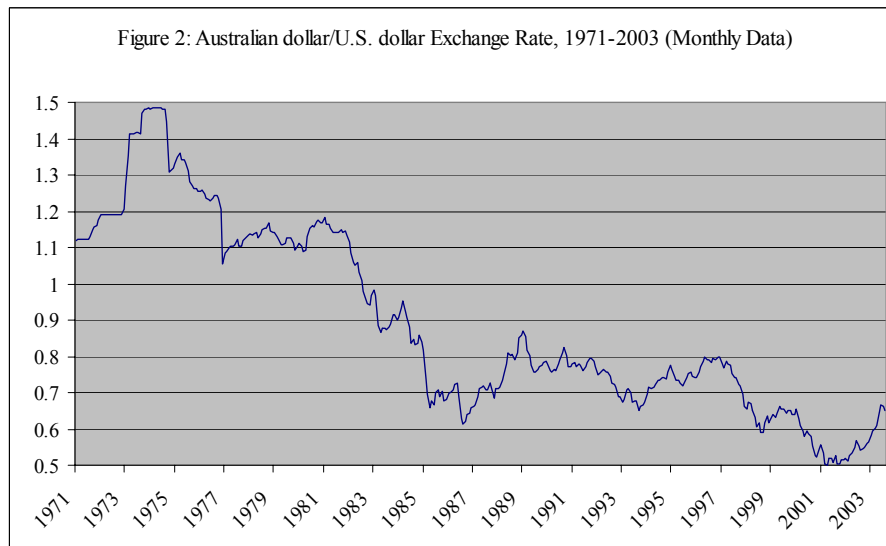
² Canada's trade/GDP ratio at 70.1 percent in 2001 is exceptionally high. Australia's trade/GDP ratio of 34.5 percent in 2001 was close to the 37.9 percent average for high income countries. See World Development Indicators, 2003.

³ Commodity exports accounted for 35 percent of Canada's total exports in 1996; for Australia the corresponding figure was 74 percent. These compare with 21 percent for the US, 15 percent for Germany and 5 percent for Japan. See McCallum (1999: 4).

⁴ See, for example, Djoudad, Murray, Chan and Daw (2000).



Source: <http://research.stlouisfed.org/fred2/series/EXUSAL/downloaddata>, Federal Reserve Bank of St. Louis, Economic Data FRED-II



Source: <http://research.stlouisfed.org/fred2/series/EXUSAL/downloaddata>, Federal Reserve Bank of St. Louis, Economic Data FRED-II

Table 1: Exchange Rate Regimes in Canada 1931-2003

| | |
|----------------|--|
| 1931 – 1946 | Managed float |
| 1946 – 1950 | Fixed (against US dollar) with changes |
| 1950 – 1962 | Clean float |
| 1962 – 1970 | Fixed (against US dollar) |
| 1970 – Present | Managed float |

Source: Bordo, 2000.

Table 2: Exchange Rates Regimes in Australia 1931-2003

| | |
|---------------------|--|
| 12. 1931 – 12. 1971 | Fixed (against sterling) |
| 12. 1971 – 9. 1974 | Fixed (against US dollar) with changes |
| 9. 1974 – 11. 1976 | Fixed (against trade weighted basket) |
| 11. 1976 – 12. 1983 | Variable (set daily against trade weighted basket) |
| 12. 1983 – 6. 1986 | Clean float |
| 6. 1986 – Present | Managed float (occasional interventions by RBA) |

Source: Schedvin, C.B., (1992: 550-552) and Kearney, C., (1997: 88)

Not only have Canada and Australia had different exchange rate regime histories, they also differ in the extent to which there has been debate over the possibilities for, and desirability of, replacing their existing currencies with another as discussed below.

CANADA AND AUSTRALIA: DIFFERENCES IN MONETARY UNION DEBATES

In Canada the debate over the status of an independent national currency has long historic roots. Indeed, these roots pre-date Canadian confederation with the issue of currency union with the US being actively debated in the 1850s (see Helleiner 2001). More recently, the debate re-surfaced in the early 1990s as a result of the prospect of monetary union in Europe raised by the Maastricht Treaty and as a result of the Parti Québécois's flirtation with some form of North American common currency as a stone on the path to Québec sovereignty.

The most recent round of debates started in 1999 with the birth of the virtual euro as its temporal spur. Added to this were the decline of the Canadian dollar against the US dollar in the wake of the Asian financial crisis (a decline interpreted by some of the looser talk of the pro-monetary unionists as

representing a decline in Canadian living standards), the publicity given to the award of the Nobel prize in Economics to Canadian-born Robert Mundell who has been widely seen as the “father of the euro”, and the continuing interest in a North American currency by the Québec sovereignty movement. These factors led to a flurry of conferences in both academic and government circles and to a lively debate in the news media about the future of the Canadian dollar.

The debate centered around a number of key issues both economic and political. These can be listed briefly (but not exhaustively) as follows⁵:

(1) Whether the advent of the euro indicated that there was a new trend towards fewer currencies. Proponents of monetary union argued that the euro was an epoch-defining event. For example, Courchene and Harris (1999: 3) argued that “The introduction of the euro in January 1999 represents a watershed in the annals of economic and monetary history. At one level, the advent of the euro signals the denationalization of national monetary regimes; at another, it signals that, in a progressively integrated global economy, currency arrangements are a supranational public good, one that is arguably consistent with a twenty-first-century vision of what constitutes national sovereignty.”

Even opponents of monetary union conceded that a trend towards fewer currencies might be underway and that this was problematic for the continued existence of the Canadian dollar. John McCallum (2000: 7), then chief economist at the Royal Bank, and prominent advocate of a flexible exchange rate, conceded “that in a world that would otherwise have only three currencies, it is unlikely that the Canadian dollar would constitute the fourth. However, to the extent that the reader agrees that the benefits of the status quo exceed the costs, the implication is that Canada should not seek to speed up this grand historical process that is allegedly leading to only one, two, or three currencies.”

(2) Whether the decline in the Canadian dollar reflected “fundamentals” or was the result of persistent “misalignment”. The Bank of Canada’s famous –or infamous depending on your perspective – exchange rate equation purported to show that the decline of the Canadian dollar tracked very closely, and was explained by, the downward path of world commodity prices. The sinking dollar was therefore behaving as expected (and hence blame for its fall could not be attributed to particular policy choices). This line, put forward by Bank of Canada economists (see Murray 2000) and their defenders (see Laidler 1999) was used to refute the arguments of proponents of monetary union such as Courchene and Harris (1999) who viewed exchange rates as being subject to long periods of

⁵ See also Bowles, Croci and MacLean (2004) for a fuller review of some of the issues in the debate.

misalignment; misalignments which had asymmetrically deleterious effects on the Canadian economy (on which more below).

(3) Whether the flexible exchange rate and the fall in the value of the Canadian dollar had been a cause of Canada's perceived poor record on productivity growth. The central issue here was the decline in the level of productivity in the Canadian manufacturing sector relative to that in the US over the past decade; a "puzzle" in that this contrasted with what pro-free traders expected to happen as a result of the greater competitive pressures on Canadian manufacturers emanating from the NAFTA. The falling dollar, the monetary unionists argued, insulated firms from these competitive pressures and led to lower levels of investment in productivity raising-capital (see Courchene and Harris 1999 and Grubel 1999). The flexible exchange rate therefore caused slower productivity growth. This argument met with its fair share of skeptics who questioned this so-called "lazy manufacturers hypothesis" on theoretical grounds (it was inconsistent with the neoclassical theory of the profit maximizing firm), on empirical grounds (it seems that this bout of laziness was confined to two sectors of manufacturing industry)⁶ and on logical grounds (if firms need to be induced to invest more in productivity enhancing capital goods why not increase wages rather than fix the exchange rate?). The skeptics were not being complacent about the so-called "productivity puzzle" but did not believe that the flexible exchange rate was a causal factor and argued that productivity questions should not be addressed by policies that sought to change Canada's hard-won "stable monetary order" (Laidler 1999).

(4) Whether a sharing of monetary sovereignty with the US was a politically possible option. While pro-monetary unionists debated various forms of common currency and shared monetary sovereignty arrangements, such as the North American Monetary Union (NAMU) and the amero, opponents argued that, given the reality of US power, the only realistic choice was between outright dollarization or the maintenance of a Canadian currency.

In Australia, the level and terms of debate have been very different. In the wake of the Asian crisis, the fall of the Australian dollar to historic lows against the US dollar led to little in the way of outbursts of angst about falling living standards. Rather the commonly held view across government, academic and business circles was that the flexible exchange rate did what it was supposed to do – depreciate so that Australia could weather the turmoil around it and avoid a recession. The fact that export growth continued and buffered the economy from

⁶ The two sectors are industrial machinery and electrical and other electrical equipment. See McCallum (2000: 7).

negative demand shocks was taken as evidence of the wisdom of having a flexible exchange rate regime. In Canada, continued export growth in the aftermath of the Asian crisis was also held up as displaying similar wisdom by some of the anti-monetary unionists (see Laidler 1999 and McCallum 2000). The difference is that in Canada they were opposed by a sizeable monetary unionist faction; in Australia they were not.

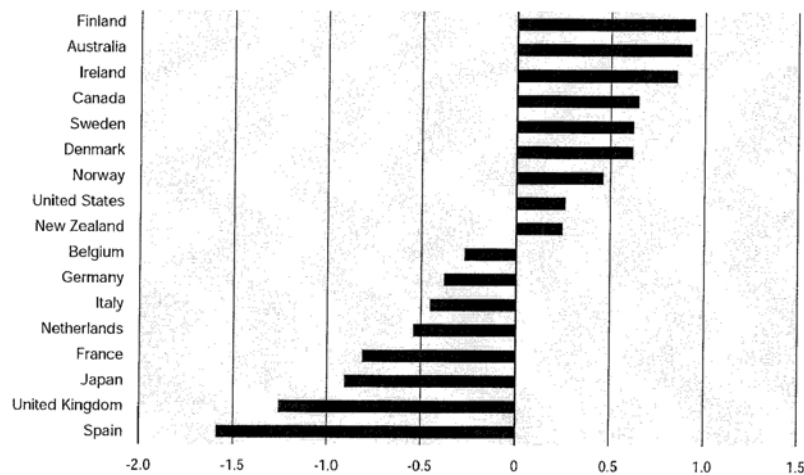
The birth of the euro was greeted with far less fanfare in Australia than in Canada and the threat that the euro posed to the “inevitable” elimination of the Australian dollar as the world moved to fewer currencies was not an issue. In fact, while McCallum, as noted above, lamented the possible loss of the Canadian dollar if there proved to be an historic trend towards fewer currencies, conceding that it was unlikely to be the fourth currency, on the other side of the globe another private sector bank economist, John Edwards, Chief economist at the HSBC in Sydney, was proclaiming the rise in the importance of the Australian dollar as the result of the abolition of European competitor currencies! In a Report entitled “The Fifth Global Currency”, Edwards (1998: 2) wrote that “the increasing integration of Europe and the coming recovery in Asia ... is about to catapult the Australian dollar to a new status as the fifth global currency.” Furthermore, he added, “over the next four or five years, the world’s most frequently traded currencies will be reduced to the US dollar, the euro and yen – with the Australian dollar, Swiss franc and the Canadian dollar vying for fourth place.” (ibid).

In Canada, the Bank of Canada held its annual conference in 2000 on the theme of *Revisiting the Case for Flexible Exchange Rates* which had a strong Canadian focus. In 2001, the Reserve Bank of Australia held its annual conference on *Future Directions for Monetary Policies in East Asia*. The focus was on fixed versus flexible regimes for East Asia with the one paper on Australia – looking at the case for a monetary union between Australia and New Zealand – being written by a former employee of the Reserve Bank of New Zealand working in the US.

In Canada, attention was focused on the “puzzle” of the relatively poor productivity performance in manufacturing industry and links with the exchange rate regime hypothesized. In Australia, academics and government agencies puzzled over the existence and causes of Australia’s productivity “miracle” of the 1990s. The irony is that productivity performance in both countries has actually been quite similar. For example, the Productivity Commission’s Dean Parham (2002), in a paper entitled “Productivity Growth in Australia: Are We Enjoying a Miracle?”, reproduced the following OECD figure as illustrating the “miracle” in need of explanation.

Figure 3 Trend multi-factor productivity growth increased in many countries

Average annual percentage change from 1980-90 to 1990-99



Australia has certainly performed well on this measure. But so has Canada; the “productivity miracle” on this measure is applicable to Canada as well as to Australia. Furthermore, in both countries, manufacturing productivity has lagged behind this aggregate measure. In Australia, the sectors in which productivity growth has been the highest are the wholesale trade, construction and finance and insurance. There has been no “miracle” in manufacturing; indeed Productivity Commissioner Gary Banks concedes that manufacturing’s contribution to overall productivity growth in the 1990s “slumped” (see Banks 2003). The “productivity puzzle” – of why trade liberalization has not spurred productivity growth in manufacturing – is applicable to Australia as well as to Canada.

However, in Australia, the focus of attention has been on understanding the causes of the good overall productivity record with the most common explanation being the importance of microeconomic and regulatory reforms. In Canada, the focus has been on Canada’s relatively poor productivity record in manufacturing despite the good overall productivity performance. The impact of a macroeconomic variable, the exchange rate, on productivity has been a significant area of debate as a result of the “lazy manufacturers hypothesis” as noted above.

There is no greater understanding of exchange rate movements in Australia than in Canada. Indeed, there is general acceptance that there is no model of the exchange rate which can plausibly explain the recent path of the Australian

dollar.⁷ This has not led to any discernible pressures from business or academics for greater currency stability or concerns over “misalignment”. The flexible exchange rate regime still enjoys overwhelming support. Indeed, Melinda Cilento, Chief Economist at the Business Council of Australia, was quite right in her comment that “in terms of the floating exchange rate regime, I suspect that you would struggle to find someone that doesn't support it.”⁸ There would be no such struggle in Canada and, while the business community is divided on the issue, a survey of business leaders reported in *The National Post* in 2001 nevertheless found that “almost half of Canadian executives favor adopting the US dollar.”⁹

Why should two countries with considerable similarities in economic structure and recent exchange rate history display such stark differences with respect to monetary union issues? The next two sections argue for the importance of the “geographical” and “contingent neoliberal” contexts in providing an answer to this question.

EXPLAINING THE DIFFERENCES: “GEOGRAPHY”

“Geography” has long been recognized as an important influence on the two countries’ political economies. Australia’s distinctive economic history was attributed in Geoffrey Blainey’s influential 1967 book to the “tyranny of distance”. Although in a globalized world “distance” has shrunk, it is still commonplace for Australians to regard their country as being “eight hours from anywhere” and surrounded by a “moat”. Australia remains isolated geographically from its historic imperial allies, first the U.K and since 1945 the US, and remains culturally isolated from its geographically closer (but still non-contiguous) Asian neighbors. Geography dictates that there is no obvious country with which Australia could form a monetary union except perhaps New Zealand, a union which is of only modest interest to Australia as I discuss further below.

⁷ See, for example, the set of papers in “The Falling Australian Dollar: A Forum”, *Journal of Australian Political Economy*, no. 46, 2000.

⁸ Personal communication March 4, 2003.

⁹ However, *The National Post* subsequently reported that support for “seriously considering” adopting the US dollar among Canada’s business leaders had fallen as the Canadian dollar appreciated during 2003. See *The National Post*, October 14, 2003. See also Ragan (2001: 41) who argues that “though non-economists seldom claim to understand most macroeconomic issues ... there is a surprising level of agreement among them that, for Canada, a fixed exchange rate would be preferable to the *status quo* of a flexible, sometimes even volatile, exchange rate.”

Canada, in contrast, shares the world's longest unprotected border and that with the world's only superpower which is also the issuer of the world's reserve currency. As Pierre Trudeau remarked, just two years after Blainey's book on Australia's tyranny of distance, Canada's geographical position was akin to "sleeping with an elephant". What might be called the "tyranny of proximity" ensures that the US looms large in any Canadian policy debate and offers an easy and obvious reference point for the discussion of monetary union in the Canadian setting.

While Blainey and Trudeau's descriptions refer primarily to geography as distance, "geography" can be defined more broadly than this. This is perhaps best illustrated by gravity models which measure the pull of a common border, and of the similarity of language, culture/ethnicity and political institutions on international trade and investment flows.¹⁰ Use of a common currency is also typically found among the independent variables influencing trade and investment flows. However, common currencies are also argued more likely to be economically beneficial for countries with high levels of trade integration. Thus, the influence of "large neighbors" on the possibilities for monetary union can similarly be thought of as being influenced by this broader set of geographical factors.

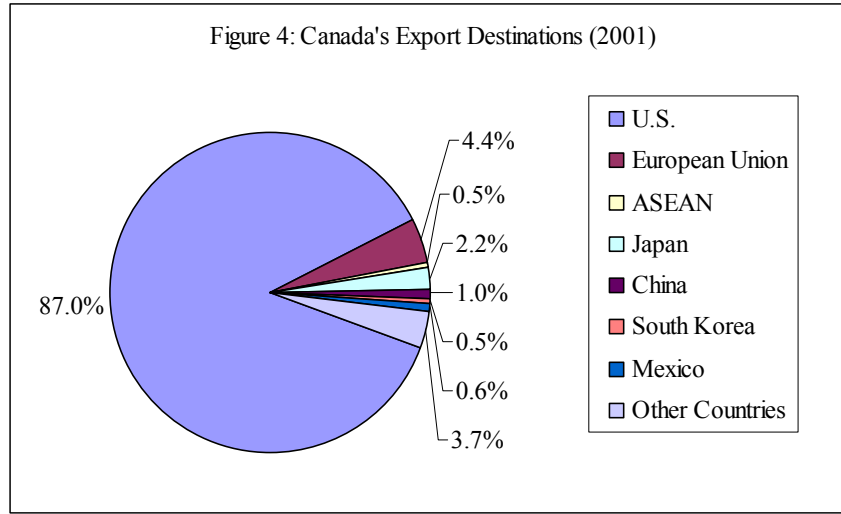
Studies in this genre typically use large data sets and empirically measure the influence of "geography" on trade and/or the benefits of common currencies. One explanation for the differences in exchange rate debates between Canada and Australia might simply be, therefore, that in Canada there is a very obvious and culturally and politically similar "large neighbor" with whom Canada could possibly enter some form of monetary union whereas in Australia there is not. Canada is highly integrated with the US economy in terms of both trade and investment. The US accounts for 87 percent of Canada's exports and a significant point in the debate over a fixed versus flexible exchange rate regime has been the extent to which North America consists of a series of regional economies which straddle the Canada-US border rather than two separate national economies. This issue is important for determining the strength of the argument that Canada is best served by a flexible exchange rate regime because it allows Canada to adjust differently to external shocks such as changes in world commodity prices.

Furthermore, a key to the argument linking low productivity with exchange rate misalignment is the "mobility of firms and highly skilled individuals across the Canada-US border". (Courchene and Harris 1999: 9). Thus the presence of a large neighbor, a presence which has real economic effects, provides a clear

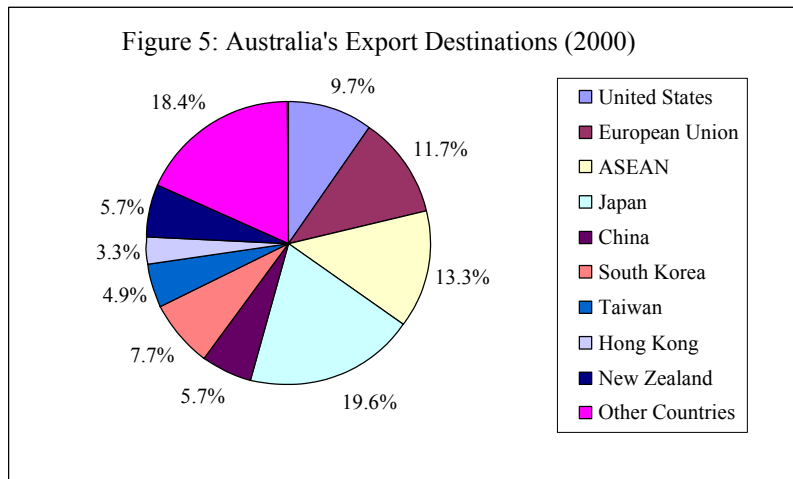
¹⁰ For discussion of gravity models see, for example, Frankel (1998).

reason why monetary union with such a neighbor should be an obvious debating point.

Australia, in contrast, has a much more diversified export composition, in country terms, than does Canada. See Figures 4 and 5 below.



Source: Exports by Country (2002) Micro media Limited, 65-003-XPB, Vol.58 No.4 Statistics Canada,



Source: <http://www.abs.gov.au/Ausstats/abs@.nsf/0/be75d8ff866cba97ca256aaa007fe175?OpenDocument>, the June Quarter 2001 issue of International Merchandise Trade, Australia (Cat. no. 5422.0)

Furthermore, Australia has a long history of ambiguity in terms of its relations with neighboring countries. As Beeson (2001: 45) has written "Australia has always been a long way from "home" and often painfully conscious of its isolation and potential vulnerability. The sense of being strangers in a strange land, surrounded by peoples of whom they knew little other than that they were different, alien, and possibly hostile, shaped much of Australia's early international relations. Indeed, it is still possible to trace the continuing influence of such insecurities and uncertainties in contemporary politics."

Of course, Australia did embark in the 1990s under Prime Minister Paul Keating to seek an "engagement" with Asia and to more closely integrate itself with the rest of the "region", a policy which is reflected in the country composition of exports illustrated above. Nevertheless, Australia's "position in Asia" was problematic even before the current Howard government's tempering of the explicit "engagement" policy. For example, as Asian Pacific Economic Cooperation (APEC) withered as a regional force, Australia's attempts at greater integration with Southeast Asia through a linking of the Closer Economic Partnership (CEP) and ASEAN Free Trade Area (AFTA) were rebuffed by ASEAN.¹¹ Australia was excluded from the Asia-Europe Meeting (ASEM) meetings and suggestions to expand the current ASEAN+3 to include Australia and New Zealand into an ASEAN+5 formula have come to nought.

While this points to the problematic path of economic integration in the "region" in general, more telling from the point of view of the topic of this paper is the fact that there is no obvious currency in Asia with which Australia might wish to join. An "Asian Currency Unit" is no more than a twinkle in the eye of the Japanese Ministry of Finance.¹² Furthermore, the experience in the Asian financial crisis showed that linking with any currencies in the region would be a dangerous proposition. Indeed, it has been argued by two Australian economists that "the international financial markets appeared to make a clear distinction between the Asian currencies that were tumbling in value and the Australian dollar so that "contagion" was largely avoided." (Meredith and Dyster 1999: 320). The Australian dollar did continue to fall against the US dollar as indicated in Figure 2 above although its decline on a trade-weighted measure was far less dramatic. While the Australian dollar was certainly not unaffected by the Asian crises, it did

¹¹ At the ASEAN meeting held in Thailand in October 2000, a recommendation to move forward on an AFTA-CER agreement was rejected. See Chong (2001).

¹² There have been a number of suggestions by Japanese officials, usually connected with the Ministry of Finance, about the long-term possibility of an Asian currency unit. See, for example, "Japanese Official Says Common Asia Currency Possible", Reuters, May 26, 2002.

avoid some of the worst problems. There would be little point in inviting contagion through some form of currency arrangement.

Where Australia has been involved, albeit mainly passively, in monetary union issues has been with respect to New Zealand. Here it is Australia which is the “large neighbor” and the debate over an ANZAC dollar (a new “would-be” common currency of Australia and New Zealand) has resembled that over a NAMU in several important respects. It was New Zealand Prime Minister Helen Clark who ventured in 2000 that a monetary union was “inevitable” given continuing economic integration with Australia (see Dore 2000). It was neoliberal academics in New Zealand who argued that there would be benefits for New Zealand of a common currency (see Grimes and Holmes 2000). It was New Zealand businesses which were polled to gauge their level of support for such a proposition; it turned out to be relatively high (see Grimes and Holmes 2000). And it was in Australia that Finance Minister Peter Costello replied that there would be no common currency but that if New Zealand wished to propose to adopt the Australian dollar then this would be considered (see Henderson 2000). The (limited) ANZAC debate therefore reinforces the importance of taking geography into account in examining monetary union debates and this debate, in important ways, mirrors the Canada–US debate with relative country size again being a key variable.

Differences in political geography, therefore, are important in explaining the very different debates over monetary union which have taken place in Australia and Canada. In Canada, the debate has been whether to forge closer monetary links with its large neighbor, the US. There has been no attention paid to this possibility by the US authorities. In Australia, it is New Zealand that is the small neighbor and Australia the large; it is New Zealand that has had the debate over the “inevitable” demise of its currency and Australia which has played the role of aloof regional power. Differences between the debates in Canada and Australia are at least partly explained by the fact that Canada has a large neighbor but Australia a small one.

Added to this are the economic consequences of this political geography. Canada is heavily dependent on the US market and experiences a relatively high level of capital and labor mobility across its borders. Australia has more diversified export destinations and was able to avoid the worst of the financial crises which engulfed many of its Asian neighbors in 1997.

The tyranny of distance in Australia’s case and the tyranny of proximity in Canada’s may therefore provide an important part of the explanation of the differences between them in terms of debates over monetary unions.

This argument has implications for how to view the British case. It is useful, not so much for asking whether Britain will or should join the euro, but for analyzing why Britain has proved more reluctant than many of her European neighbors to embrace monetary union. Howarth (2003) provides a useful starting point in this respect. He identifies a number of different approaches which have been taken to explain what he terms "British reluctance" (2003: 3) to join the euro. The analysis presented here lends credence to some of those approaches. Firstly, the importance of geography adds weight to those analyses of the British case which stress the role of the "politics of semi-detachment" or of being "semi-detached" from the continent" (Bulmer 1992 cited in Howarth 2003: 3). This politics is influenced by the broad array of "geographical" factors discussed here and provides a degree of "distance" to the monetary union debate not present in some of the other EU countries. This "distance" is reflected, for example, in strong cultural affinities across the Atlantic as well as across the English Channel and in a lower level of intra-EU trade in services in Britain than in other continental EU members. The EU may constitute a large economic unit but the question of how "close" a neighbor it represents for Britain remains open for debate and finds expression in the "politics of semi-detachment".

Secondly, the argument of this paper would also lend credence to the importance of considering further the importance of a "geo-strategic" approach to understanding the British case, an approach which Howarth argues "few analyses examine closely" (2003: 10) despite its potential to serve as an "initial analytical tool" (ibid).

EXPLAINING THE DIFFERENCES: "CONTINGENT NEOLIBERALISM"

Neoliberalism needs little introduction: it has dominated economic theory and policy-making for at least the past two decades. Important for my purpose here is one of its central propositions, namely, that the "discipline" of the market needs to be brought to bear on all agents in the economy, that is, governments, firms and workers. This central proposition, based on the broader claim that markets are (usually) the best way of coordinating economic activity, leads to clear neoliberal policy prescriptions in many areas: labor markets should be flexible, market methods of regulation are to be preferred to administrative methods, price controls and subsidies are to be avoided, low and non-distortionary taxes are preferred, trade should be free et cetera.

However, in some policy areas, neoliberalism has no standard prescription. For example, there is no “neoliberal position” on regionalism. Similarly, there is no neoliberal position on the exchange rate regime. It is possible to find economists with impeccable neoliberal credentials on either side of the debate. In the case of the exchange rate regime we have, for example, Milton Friedman in the flexible exchange rate corner and Robert Mundell in the fixed/single currency corner. While these two combatants might be wedded to their particular corners, in general neoliberal economists may be found in either corner and may even switch between the two. Indeed, given the “faddism” which surrounds exchange rate regime debates, many do. Determining which corner they might be in depends on their assessment of what forms of “discipline” are needed and how the exchange rate regime might contribute to these. Thus, neoliberalism in this instance is contingent upon the particular circumstances and the case in question.¹³ This, I argue, is what has happened in Canada. In Australia, in contrast, the flexible exchange rate corner has proved to be a magnet for the neoliberal disciplinarians.

Consider first the case of Australia. As shown above in Table 2, Australia had a history of fixed exchange rates prior to 1983. The fixed exchange rate regime was an integral part of the so-called “Australian settlement”, the social compromise between capital and labor which saw rising living standards based upon natural resource exports and a protected domestic sector with centralized wage bargaining.

The result of this was that, according to Anderson (1987: 165), “for the last fifty years Australia has been more protectionist towards its manufacturing sector than perhaps any other high-income country except New Zealand. This difference between Australia and other industrial countries became especially marked following the substantial post-World War II reductions in tariffs on manufactured goods imported by Western Europe, the United States and Japan.”

This view is also supported by Emy (1993: 12), who argues that “for 40 years after 1945, Australia was protected by high tariff walls from the impact of dynamic changes in the world economy. Other countries industrialised, and

¹³ As an example of this, in the Canadian debate pro-flexible exchange rate advocate Laidler (1999: 14) argues that “a flexible exchange rate does not, in and of itself, define a policy regime. It is a permissive arrangement that allows a wide variety of measures, good or bad, to be taken.” Pro-monetary union advocates Courchene and Harris (1999: 5) make the same point when arguing that “poor economic policies (whether micro- or macroeconomic) lead to undesirable economic consequences, whatever the exchange rate regime.” Support for one exchange rate regime over another is dependent therefore on its place within a broader set of policies.

adapted successfully to the accelerating pace of change in the global economy, while Australia stood still". As a result, "in 1983, Australia (along with New Zealand) was the most highly protected economy in the world." (Emy 1993: 18).

In 1983, however, the newly elected Labor party under Bob Hawke changed the pattern of Australian economic development. Neoliberalism, often known as "economic rationalism" in Australian parlance (see Pusey, 1991) was introduced in Australia. And the move from fixed to flexible exchange rates was an absolutely central part of this introduction.

During 1983 the Australian monetary authorities found it increasingly difficult to maintain the exchange rate in the face of high capital inflows. The newly elected Labor Party had devalued the Australian dollar by approximately 10 percent upon coming to office in March. However, speculative capital inflows led to this being almost entirely reversed over the course of the summer. There followed intense debates about how best to respond. Treasury secretary John Stone was the most notable amongst those who opposed any movement away from a fixed rate regime. According to Kelly (1992: 84), Stone's argument was that "the dollar would become a speculators' toy; it was inappropriate for a nation of Australia's size to float its currency; the exchange rate was a weapon of policy and should never be surrendered to the markets."

Reserve Bank officials, and some of Stone's own staff, however, felt that there was no alternative but to float. The forward exchange rate was floated in October 1983. Then, on December 9, "it was decided to float the dollar and abolish exchange controls in the face of a massive wave of speculative capital inflow that was wrecking attempts to manage the exchange rate and money supply. In a radical stroke, the Australian financial system was thrown open to world market forces as part of the seemingly inexorable process of global financial liberalization." (Bell 1997: 143)

The decision to float the dollar was not simply a technical economic decision. It was much more than a short-term technical fix and signaled a dramatic change in Australian economic policy as the basis of the "Australian settlement" was now directly challenged and a new neoliberal economic agenda emerged as dominant. A central part of this agenda was that Australia would need to integrate into the world economy and be subject to its discipline; the float was a key component of this.

This much is clear from the words of Labor Party Finance Minister Keating (quoted in Kelly 1992: 86-7) at the time: "One of the things is that ... the coalition [the opposition party]... have never lived with the discipline of a floating exchange rate. ... The float is the decision where Australia truly made its debut into the world and said, 'O.K., we're now an international citizen.'"

The shift to “the discipline of a floating exchange rate” meant that, in Bell’s (1997: 144) words, “the ALP [Australian Labor Party], a party with a long tradition of antipathy to “money capital” had accepted the “banker”’s agenda” ... The markets were delighted. In 1984 Keating was even awarded a special prize from Euromoney magazine – Finance Minister of the Year.”

This assessment of the shift in political dynamics is widespread. Gratton (1994: 41) for example argues that “The decision [to float] was extremely bold, not just in economic terms, but in political ones as well. ... The float set the Labor Party bravely on the course of economic rationalism.” For Meredith and Dyster (1999: 323) “the decision to float the Australian dollar in December was the shot from the starting gun in Australia’s move to ‘globalisation’.” According to Kelly (1992: 76) “the float transformed the economics and politics of Australia. It harnessed the Australian economy to the international marketplace – its rigours, excesses and ruthlessness. It signaled the demise of the old Australia – regulated, protected, introspective.” And, in Kelly’s words once more (1992: 77), “the float had a psychological significance almost greater than its monetary effects. It sealed the de facto alliance between the government and the financial markets.”

The decision to move to a floating exchange rate was therefore regarded as a major – the major according to John Stone, Treasury secretary at the time – economic decision of the post war period.¹⁴ It signaled an abrupt change in economic policy and a new shift in Australian politics. The “discipline” imposed by the foreign markets would lead to measures to introduce “discipline” into many other areas of economic policy in the quest for a neoliberal restructuring of the economy in order to more fully integrate into global markets. According to Gratton (1994: 42-3), “the medium- and longer-term consequences of the float have affected every area of economic policy. It put a discipline economically on the Government, which could also be turned into a political discipline. The fact that the local and international markets delivered their view on economic policy meant that the Government was forced to be responsible. To be otherwise would invite damaging consequences. This argument could be used to some effect against ministers wanting to spend, and with backbenchers who were exerting pressure for this or that policy.”

The disciplines imposed by the float were argued to be strong and binding. In Kelly’s (1992: 94) opinion “the floating rate and exchange control abolition meant that currency and capital markets would test every major economic policy decision made by Australia. The nation would be under permanent examination with savage consequences for failure. ... During the 1980s the discipline imposed

¹⁴ See Kelly (1992: 84)

by the markets through the float and capital movements imposed severe policy changes on Australia. It forced Labor towards small government, real wage cuts, lower taxation and industry deregulation.”

In the period after 1983, the discipline imposed by the float and the change in political direction chosen by the Hawke and then Keating governments led to a wave of neoliberal economic reform. After 1983, “many of the regulations that governed the behavior of the Australian economy were questioned and a great number were swept away or radically altered. Economic policy shifted towards a greater role for market forces and a disengagement from the economy by the State” (Meredith and Dyster 1999: 268). A neoliberal revolution had been born and its birth was marked by the change in exchange rate regime.

It is the reductions in tariffs, the move towards enterprise wage bargaining and away from centralized wage bargaining, and the deregulation of industry, which followed on from the float that have been commonly identified as the reasons behind the Australian “productivity miracle.” A floating exchanging rate has become entrenched as an icon of neoliberal orthodoxy. Twenty years after the decision was taken, the lead editorial in *The Australian*, under the heading of “Celebrating two decades of reforming government”, could look back upon the Hawke-Keating years and state that “by floating the dollar and lowering tariffs, they opened up the economy, forcing both management and workers to compete internationally.”¹⁵

The reason that there has been so little debate in Australia about monetary union is therefore not simply because there is no obvious “large neighbor” with which to join. It is also because a floating exchange rate regime has been a central part of the neoliberal agenda for the past twenty years, a regime which is argued to have brought the discipline of markets to all areas of the Australian economy. It was the decision to float the dollar and have its value determined by market forces, rather than by government decree, that started the neoliberal revolution. To renege on that policy now is barely imaginable for policy elites and business leaders.

Economically speaking, it can be argued that the abolition of capital controls was the more important decision for increasing discipline. However, the consensus among Australian policy-makers and commentators alike has been that “the float” was the critical psychological and political, as well as economic, act; it signaled the deregulation of an important area of economic decision-making and the primacy of “market forces”. The efficacy of “the float” in this respect has

¹⁵ Celebrating two decades of reforming government, *The Australian*, Tuesday March 4, 2003.

proved remarkably resilient and, the fallout from the Asian crisis notwithstanding, there has not been a “crisis” of sufficient severity to shake this consensus.

The decision to float the Canadian dollar in 1970 came about in similar circumstances: the dollar was coming under pressure from huge capital inflows and the pressures for appreciation could no longer be resisted. However, there the similarity with Australia ends. In Canada there is no association of the return to floating rates with exposing Canada to the discipline of the international market, no association with the launch of a neoliberal revolution.

When the decision was taken to float the Canadian dollar, concern was expressed at the time that despite the government’s argument that returning to a floating rate would help to fight inflation, the float would “encourage, as it had in the late 1950s, an unsatisfactory mix of financial policies” (Lawson as quoted in Powell 1999: 49). These concerns were evidently borne out. As Norrie and Owrain (1996: 420-1) argue “unfortunately, Canadian authorities did not avail themselves of this opportunity to reduce inflationary pressures. Inflation did come down in 1970, a direct result of the appreciation. But the money supply grew very rapidly, from the float through to 1975, in the range of 10-15 percent.”

Laidler (1999: 14) writes in similar terms that “Canadian monetary and fiscal policies were totally incoherent in the early 1970s. The dollar was initially floated to relieve inflationary pressures emanating from the balance of payments, but within a year or two, expansionary fiscal and monetary policy were more than compensating for this. A monetary order based on money growth targeting was instituted in 1975, but it broke down in the early 1980s. Thereafter, monetary policy moved in fits and starts toward the pursuit of price stability as an ultimate goal, while fiscal policy delivered a constant stream of budget deficits until the early 1990s.”

The float did not bring discipline. Neither was it associated with a neoliberal revolution. In fact, quite the opposite as Canadian government policy reached new interventionist heights. For example, The Canada Development Corporation was set up in 1971 to promote investment by Canadians in Canadian companies while the Foreign Investment Review Agency was set up two years later to screen Foreign Direct Investment (FDI) for its benefits to Canada (see Norrie and Owrain 1996: 424). Furthermore, the year after the float saw a substantial expansion of unemployment insurance.

The exchange rate regime has not, as in Australia, been linked hand-in-hand with the shift towards neoliberal policies. The neoliberal “paradigm shift” did not occur until the 1980s (see McBride 2003) and the basis for the debate in Canada now is whether a change in the exchange rate regime would add to the neoliberal market disciplines being brought to bear on economic agents. For some,

macroeconomic self-discipline has been realized. Laidler (1999: 15), for example, argues that “Canadian macroeconomic policy changed in the 1990s. Inflation targets were instituted, were adhered to, and became credible; fiscal policy turned to deficit and debt reduction, and now poses no threat to the future stability of monetary policy. In macroeconomic policy, it seems, cause and effect do not run from a fixed exchange rate to disciplined monetary and fiscal policy but from a domestic political decision in favor of fiscal and monetary discipline to a coherent policy mix that need not include a fixed exchange rate. In Canada, the fundamental domestic political decision in favor of macroeconomic policy discipline has already been taken, and we could gain nothing further on this front by now adopting a fixed exchange rate.” (Laidler 1999: 15).

McCallum (2000: 8) shares this opinion. In his rhetorical questions to the pro-monetary unionists, he asks: “If you think that a flexible exchange rate results in fiscal and/or monetary indiscipline, how do you explain the fact that, over the past decade, Canada has taken giant strides to greater policy discipline under a flexible exchange rate regime? Do you subscribe to the “lazy manufacturers hypothesis” (i.e. private sector indiscipline under a flexible exchange rate regime)?”

McCallum clearly believes that policy discipline has been achieved under flexible exchange rates and that private sector indiscipline has not been encouraged by this regime. As he puts it, “Flexibility is a good thing – providing one has the discipline.” (2000: 4) It is not, therefore, an argument about whether “discipline” is a good thing or not but simply whether it is present.

For others, more discipline is needed and could be exacted by a fixed exchange rate regime. In academic terms, Courchene and Harris (1999: 6) write that “under a fixed exchange rate regime, it might have been possible to isolate the sources of the relative decline of Canadian living standards and so to identify the more likely policy repairs.”

These policy repairs would include measures to make labor and product markets more flexible since “a fixed rate regime ... implies a wholesale transformation in the way an economy responds to various shocks, whether external or policy induced” (ibid: 4). The aim of moving to a fixed exchange rate regime is therefore to encourage, or more strongly to force, the “wholesale” institutional changes necessary to make price and wage setting mechanisms more flexible. In short, for markets to impose more discipline.

Sherry Cooper, Vice President and Chief Economist at BMO Nesbitt-Burns, and for whom a fixed exchange rate regime is dollarization, has pointed to the disciplining qualities of such a regime in more populist terms (2000: D5): “the reality of dollarisation is difficult. It is a tough-love reality in that it will force us to truly compete through innovation and productivity-enhancing investments.”

The debate over exchange rate regimes in Canada, therefore, has been one that has been largely carried out within the dominant neoliberal paradigm. It has been a debate because there is no association in Canada of the flexible exchange rate regime with the emergence and subsequent dominance of that paradigm. The issue has been the extent to which sufficient discipline is being brought to bear on economic agents and whether a fixed exchange rate would bring additional discipline. In Australia, the debate has been largely absent because here there is an almost one-to-one correspondence between the switch to a flexible exchange rate regime, the opening of the Australian economy to international competition, and the shift to neoliberalism. A floating rate is unambiguously seen as an important disciplining device given the context of its introduction and the associated policy reforms. In Canada, the flexible exchange rate regime has not been a part of the neoliberal policy package and its status therefore a subject of much greater debate.

This analysis has interesting implications for understanding the “British reluctance” to join the euro. While there is a clear neoliberal consensus in many areas of British policy debate, such a consensus is harder to forge around the appropriate exchange rate regime than elsewhere. Britain has been through its own neoliberal revolution par excellence in the form of Thatcherism, followed by Blair governments which have adopted, in the words of former Deputy Labor Leader Roy Hattersley (2004), the policies of “benevolent Thatcherism”. The economic policy landscape in Britain has been dramatically changed over the past two decades firmly towards neoliberalism. However, this has been achieved within the context of a flexible exchange rate regime for most of the period. Just like Canada, the shift to neoliberalism occurred without the need for the “discipline” of a fixed exchange rate. The case for monetary union as a necessary disciplining device is therefore weak in Canada and, indeed, almost entirely absent in Britain.

This contrasts sharply with some other eurozone countries, Italy being the most obvious example, where political and business elites viewed the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) and then the euro as a desirable form of externally imposed discipline which would aid domestic policy makers in their quest to bring discipline to the economy.¹⁶ The same can be made for France where the adoption of the ERM was initially seen as a way a bring discipline to labor markets.¹⁷ Thus, in France and Italy most obviously, the neoliberal paradigm shift saw a fixed exchange rate and membership of the ERM and the subsequent adoption of the euro as a key

¹⁶ See Croci and Picci (2002).

¹⁷ See Bowles, Croci and MacLean (2003).

component of the needed disciplining policy package. However, the exchange rate regime is an optional part of the neoliberal package; it is a means to an end (namely, a deregulated economy in which market forces play a greater disciplinary role) not an end in itself. This is clear from the British case where neoliberals are more divided on the issue of the desirability of euro membership precisely because Thatcherism allowed them to be disciplinarians by other means. This is particularly the case for the British Conservative Party but the same can also be said of New Labor, although perhaps to a lesser degree. As a result, the fact that the neoliberal revolution in Britain has not relied on adherence to a particular exchange rate regime, has meant that euro membership has been a much more inconclusive and continually debated topic here than elsewhere. This may also explain why Britain and Italy reacted so differently to the effects of being forced to withdraw from the ERM during the exchange rate crisis of 1992. In Italy, rejoining the ERM was seen a necessity at the earliest possible date; it was a reassertion of a neoliberal policy path with imposed external discipline. In Britain, there was no such necessity; but there was no retreat from neoliberalism either.¹⁸

The exchange rate debate in Britain, similar to that in Canada, has not been subject to the ideological imperative of neoliberalism. Because fixed exchange rates were not part of the original disciplinary neoliberal policy package, neoliberals now differ on the benefits of moving to a currency union. In other European countries, such as France and Italy, neoliberals embraced the ERM and the euro as a desirable disciplinary device. In Australia, neoliberals have coalesced around a flexible exchange rate as a symbol of neoliberal orthodoxy. Neoliberalism may be found everywhere but a variety of exchange rate regimes have been used to support its implementation; in this sense, when it comes to exchange rate regimes, neoliberalism is contingent. Country context matters.

¹⁸ It is interesting to speculate whether Britain might be more like Latin American countries in this respect, where neoliberal policies have been implemented but where exchange rate regimes have frequently been changed without affecting the overall thrust of neoliberalism. In Italy and France, the persistence of the link between the fixed exchange rate and policy discipline is remarkable and has survived several crises. In Australia the hypothesized link between "the float" and external discipline has been similarly persistent. The reasons for this persistence – or lack thereof - would be an interesting area for future research.

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WHAT CAN WE LEARN FROM THE EMU MODEL? LESSONS FOR CANADA AND BRITAIN

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INTRODUCTION

Over the last decade in Canada, interest in greater North American monetary integration appears to have followed the ups and downs of the Canadian dollar. Ever since the original adoption of the dollar as a currency unit in 1854, debate over the issue of giving up the Canadian dollar in favor of another currency (or what is now generically described as dollarization) was unheard of in Canada, at least not prior to 1995. The closest that Canadians had ever gotten to debating openly this matter in the media (but with the question being posed somewhat in reverse) was over the issue of Québec independence. Indeed, in 1968, when becoming the founding leader of the *Parti Québécois*, René Levesque had proposed that a future sovereign state of Québec would share the Canadian dollar as a common currency. At the time, many in English Canada saw this primarily as an opportunistic political gesture on the part of the *independentistes* to nurture broad support from nervous Quebecers worried about what would happen to their financial assets, particularly pensions, in an independent Quebec. Few saw this as a viable long-term option for two sovereign states wishing to pursue their own separate political and economic destinies; and fewer still had heard of Robert

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Mundell and his views on optimal currency areas to garner any other logic from that original common currency proposal.

Yet, while that specific controversy over the unilateral adoption of the Canadian dollar by a possible future sovereign Québec faded with only some minor matters transpiring during the 1980 and the 1995 referenda, it was immediately after the 1995 referendum that a much wider debate over dollarization began to brew in earnest. Not surprisingly, given the similarities, discussion over the issue of a common currency appears to have originated within the *Bloc Québécois* itself.² Soon after the 1995 referendum, the task of studying the question of adopting the American, rather than the Canadian, dollar was turned over to Richard Marceau, a less well-known member of the *Bloc* caucus in Ottawa. Though politically audacious, at the time few in the *Bloc* saw this as a far-reaching proposal that would capture the attention not only of politicians and researchers in Quebec, but perhaps, even more so, of anyone in English Canada. It turned out, however, that the political timing was indeed quite appropriate. After almost two decades of a chronic, but fluctuating, decline in the foreign exchange value of the Canadian dollar, a small but increasing number of Canadians, especially in the export/import industries, began to see the option of dollarization for both Québec and the rest of Canada as a more desirable alternative to the monetary *status quo*.

As the Canadian dollar continued to fluctuate downward to unprecedented levels, during particularly turbulent times, first with the Asian currency crisis, then Russia and Brazil, debate over a common currency did gather some momentum. However, it was not until the launching of the euro in 1999 that those partial to greater North American integration got a strong boost in their political sails, when eleven countries (practically a whole continent) had united to abandon their national currencies in order to adopt what was then a virtual common currency. Given the fanfare around the original launching of the euro, and with the prospect of a continually falling loonie vis-à-vis the US dollar, one can see why dollarization took on greater legitimacy and came actually to be debated as a policy option in Canada's House of Commons in March of 1999.

Interestingly, however, despite some ambiguous statements coming from the current governor of the Bank of Canada over the last few years, concern with greater monetary integration has waned in the media and among many Canadian policy analysts, especially after the Argentine debacle at the end of 2001 and as

² Unlike the *Parti Québécois* that is active only at the provincial level since its founding in 1968, the *Bloc Québécois* is a sovereignist party that operates at the federal level in Canada. It was officially founded in June 1991.

the value of the Canadian dollar bottomed out and, in 2003, took a strong upward turn.

These ups and downs in public perception notwithstanding, however, when the question is posed regarding what would be the model of choice by Canadian advocates of greater monetary integration³, the European Economic and Monetary Union (EMU) is generally viewed as being the most desirable structure for a North American currency bloc. Usually this is done by extolling the EMU's various institutional virtues, including its shared seigniorage, its symmetrical treatment of member states, and its central bank independence, as well as by pointing to the usual cornucopia of economic benefits that a common currency arrangement would supposedly bring in terms of lower transactions costs, lower inflation, higher productivity and lower real interest rates (see, for instance, Courchene and Harris 1999 and Grubel 1999).

Because of its obvious popularity among Canadian supporters of greater monetary integration, the object of this article is to analyze briefly the logic of the EMU model and its workings, as well as to provide an analysis of the implications of greater monetary integration to macroeconomic performance. This will be followed by a discussion of EMU's practical relevance as an institutional structure for North America, and an evaluation of whether either Britain or Canada would want to join the dollarization bandwagon any time soon. This latter analysis is of special significance since, despite their obvious differences in history and economic/financial structures, on the question of greater monetary integration both Canada and Britain face a similar dilemma. This is because each country neighbors a large currency bloc (the United States in the case of Canada, and the EMU in the case of Britain) whose bilateral trade links have been increasing significantly over the last few decades. Hence, if the route of greater integration is chosen, Canada and Britain would face a similar prospect of outright dollarization, that is, the abandoning of their respective national currencies in order to adopt that of their neighbour, be it the US dollar or the euro. Indeed, much as in Canada, the advent of the euro has given rise to an interesting debate in Britain, often punctuated by loose economic considerations, especially since

³ The influence of the European model is not only theoretical but also political. Much before posing the question of dollarization for Canada, the *Bloc Québécois* used the European model to set and defend its agenda: "The free movement of people, capital, goods and services already exists inside Canada's economic space. The harmonization is done. The single currency exists. In other words, the economic integration of a sovereign Québec and Canada would be, at start, as deep as what would eventually follow the Maastricht Treaty for the European Community." (Bloc Québécois 1993: 92)

2003 when the British Chancellor, Gordon Brown, told the British members of parliament that the United Kingdom was not yet ready for the euro, but conditions would be put in place for a future referendum on the question of joining EMU. Since, in both Canada and Britain, it is on the basis of the EMU structure that the debates over greater monetary integration have taken place, it is to an analysis of this structure that we shall first turn our attention.

THE UNDERLYING STRUCTURE OF THE EMU MODEL

Theoretical and Political Economy Basis of the EMU Project

The current structure of the EMU originates primarily from the Maastricht Treaty on European Union (1991) and the follow-up Stability and Growth Pact (1997). As discussed elsewhere in greater detail (see Parguez, Seccareccia and Gnos 2003), the logic of this structure is steeped deep in Mundellian theory of monetary union, with the latter being founded on neoclassical monetary theory of Mengerian pedigree that views the choice of currency as the outcome of a market process rather than as an exogenous political decision of the state along Chartalist lines (see Goodhart 1998, and Wray 2002). The successful implementation of what in essence many political economists nowadays would characterize as an avowedly conservative or “pro-market” theoretical construct with a complete separation between money (an independent central bank) and the state (the elected representatives) was only made possible, however, because it fits a political plan favored by generations of European political leaders, spanning a period of over sixty years going back to the late 1930s, which projected the ultimate political unification of the European continent. This unification would be based on a set of constraining institutions whose long-term existence could be secured only if these institutions remained sufficiently remote from the market participants of the new Europe (see Parguez 2000).

With the political commitment from most of Europe’s political elite assured, what was needed was the particular set of evolving institutions that would start the process of establishing this new European monetary order, as well as eventually seeing it through to its final conclusion — the political unification of Europe. Hence starting from the Treaty of Rome, that opened the doors to greater commercial integration, Europe was expected to evolve through a series of Mundellian stages of integration, of which the monetary aspect would fare prominently since it necessitated a high degree of convergence of the respective economies constituting the new union. By first defining and opening up the core

“transactions space” (with the creation of the European common market within which goods would be moving freely), to choosing the respective “equilibrium” exchange rates of the old Exchange Rate Mechanism (ERM) (from which to convert eventually to the new composite currency, the ecu/euro), the final preparatory stage was to identify the precise convergence criteria that the countries of the old European Monetary System (EMS) would have to meet to become full-fledged members of the common currency system and, by implication, the European System of Central Banks.

The Maastricht Criteria and the Rules of the Stability and Growth Pact

These criteria were finally adopted in the Maastricht Treaty in 1991 and they reflected much of what was neoclassical conventional wisdom of the time, especially as it was prevailing at the German *Bundesbank* and, to a lesser extent, at the *Banque de France*. These criteria of entry to the EMU were: (i) to achieve relative price stability, which meant that a member country could not have an inflation rate in excess of 1.5 percentage points of the three best performing members of the new monetary union; (ii) to pursue a policy of sound finance with overall budget deficits not to surpass the threshold of 3 percent of GDP, and a public debt/GDP ratio of not more than 60 percent; (iii) long-term nominal interest rates that would not exceed the best-performing countries by more than 2 percentage points; and finally (iv) to have observed the previously-established ERM margins (or corridor) for the exchange rate over at least the two preceding years (see Arestis, Brown and Sawyer 2001; and Arestis and Sawyer 2003). When adding the condition that each country would have to abide by the rules of an independent supra-national European Central Bank (the ECB) that would be free from the political interference of its member governments, and of the European Council and Parliament, these rules of convergence/criteria of entry were quickly transformed into rules of conduct on matters of economic policy, as defined by the Resolution of the European Council on the Stability and Growth Pact in 1997.

Both the 1991 Treaty and the follow-up 1997 European Council Resolution spell out a constraining structure that is founded on questionable neoclassical precepts about money and the economy, which are then boldly transformed into an institutional/legal framework, with specific sanctions to be imposed for non compliance. In accordance with the Mengerian view of money that must be free from state interference, the EMU structure gives primacy to independent monetary policy, whereby technocratic decisions must be far removed from any

tinkering from the elected national authorities. On the assumption that the private economy is inherently stable, the sole objective of monetary policy ought to be price stability, at least over the medium term, as measured by the Euro-Area harmonized index of consumer prices. Although paying lip service to the old-line monetarist view about the controllability of the money supply with the central bank being the sole issuer of base money, the ECB's monetary policy objective would be achieved by controlling short-term interest rates (via the ECB repo rate), much as it has been instituted elsewhere (see Seccareccia 1998). This hybrid Wicksellian mechanism of inflation control would be done largely in conformity with the prevailing "new consensus" view of monetary policy in which inflation targeting is achieved without reference to any precise mechanism of transmission from interest rates to price changes (for further details and critique of the "new consensus" see, among others, Lavoie 2004).

With the primary role being accorded to monetary policy whose sole objective would be price stability, the use of other instruments of macroeconomic policy must be held in check. In particular, in conformity with old-line monetarism, fiscal policy must be severely curtailed so as to neutralize any possible macroeconomic repercussions arising from it. Member governments, for instance, would be free to enact a particular "micro" tax/expenditure policy; but only as long as the latter does not jeopardize the prime macroeconomic objective of price stability. Hence, under both the Maastricht Treaty and the Stability and Growth Pact, central bank financing of member countries' budget deficits is prohibited on the monetarist belief that central bank financing of the deficit is inflationary, thereby endangering the prime objective of price stability, even though the evidence in support of such an inflationary outcome of deficit monetization is, to say the least, very weak (Seccareccia and Sood 2000).

However, even if budget deficits were to be bond financed in the financial markets, "excessive" deficits are assumed to be a destabilizing factor that can derail the prime objective of price stability through interest rate setting. This is because of the presumed negative external effects of deficit spending (see Parguez 1999). Under a common currency arrangement, it is assumed that while a fiscal expansion in one country could raise the country's domestic income through the usual multiplier effect, the upward pressure that the expansionary fiscal action would exert on overall interest rates within the monetary union would have not only a dampening effect on interest-sensitive domestic spending across all the member countries but it would also lead to an appreciation of the foreign exchange value of the common currency and thus to a fall in overall net exports (see Carlberg 1999). The final outcome of a fiscal expansion is assumed to be a relative rise in domestic income of the country engaged in deficit spending that

would be done essentially at the expense of a fall in the incomes of the other EMU members. However, the overall effect on the monetary union would be negative, since it would be associated with higher interest rates (with the usual investment “crowding-out” implications) in all EMU countries, a higher euro exchange rate, and lower net exports of each member country vis-à-vis the rest of the world. Given the perceived moral hazard problem that any individual member country could somehow benefit, at least in the short run, at the expense of the other countries of the union, and since budget deficits can compromise overall macroeconomic stability, strict constitutional rules must be put in place to prevent fiscal indiscipline.

It is for this reason that, under the Stability and Growth Pact, governments of member states that have adopted the euro must not only fulfill the two fiscal requirements of containing deficits within 3 percent of GDP and their public debt-to-GDP ratios within the 60 percent ceiling, but they must also target zero budget balances over the medium term or what, under peer pressure among the member states, would actually mean seeking to target budget surpluses as an insurance against future destabilizing shocks (see Parguez, Seccareccia and Gnos 2003: 57). Any government that does not abide by such an orthodox rule of sound finance and engages in what the Council deems to be “excessive” deficits, could face fines of up to 0.5 percent of the member’s GDP. Although there does exist an escape clause when a member country is faced with a “severe recession” that may allow the Council to fudge somewhat the application of this restrictive rule, the fiscal situations of France and Germany with deficits exceeding the 3 percent threshold in 2003-2004 are interesting test cases, by showing whether such rules could be meaningfully applied to core member countries confronted with a destabilizing shock to their fiscal balance. In fact, rather than abiding by the 3 percent rule, as was the desire of the European Commission, in November 2003 the European Council of Finance Ministers agreed to postpone the compliance for France and Germany to 2005 on the basis of the “severe recession” clause. However, this decision has created such legal wrangling with the European Commission that this controversy has cast serious public doubt on the very logic of the Stability and Growth Pact. Indeed, after the question of the non compliance of the 3 percent rule was brought to the European Court of Justice in January 2004, six months later (July 2004) the Court upheld the November decision and confirmed that State members were no longer under the obligation to impose punishment on deviant countries, such as France and Germany! (Cf. the judgment of the Court of Justice in Case C-27/04 Commission/Council at:<http://curia.eu.int/fr/actu/comm.uniques/index.htm>).

However, this whole question of the application of these fiscal rules may be more academic than real to most countries of the EMU, especially to the constellation of EMU countries that are not as financially endowed and, perhaps, as creditworthy as the core member countries of France and Germany. As some have argued (see Bell 2003: 80), given the non-bailout provision and the fact that the ECB cannot lend directly to the member states nor purchase government securities from the primary issuer, there would be sufficient financial pressure on member countries coming from the bond markets that would largely make the threat of sanctions redundant. Much like provinces in a federal state, it is the credit-worthiness rules applied by the financial markets that would essentially be sufficient to prevent abnormal borrowing or “excessive” deficit spending. While that is probably true, nothing prevents the ECB from intervening in the secondary bond market. Unless the fiscal authority is constrained by the Maastricht 3 percent rule for budget deficits, the purchase of government securities being dumped by private holders, say, in times of severe financial crisis could still permit the ECB to facilitate some additional state borrowing indirectly.

The Macroeconomic Policy Structure and the EMU: A Constraining Policy System for Both Britain and Canada?

As was mentioned above, the policy system that underlies the two pillars of the EMU — the Maastricht Treaty and the Stability and Growth Pact — was put in place primarily in order to satisfy the deep desire of European political elites to separate money from the control of elected representatives. Indeed, with the elimination of member states’ fiscal policy as tool of macroeconomic stabilization and no effective European fiscal policy⁴, control over the macro-economy rests exclusively on the ECB, an independent institution that lacks transparency and accountability, and over which the European Parliament has no direct power. However, what is disconcerting is not so much the fact that there is an institutional separation between the central bank and government — the so-called “democratic deficit” (see Artis 2002: 25). After all, central bank independence has become fashionable in numerous countries, including the United Kingdom since 1997. What is most problematic is that, in a policy system in which discretionary fiscal policy is absent, and where the space for the conduct of macroeconomic policy within the EMU has been narrowed tremendously, the economic destiny of

⁴ In 2003, the European budget was 90 billion euro, a mere 0.96 percent of the eurozone GDP (European Commission, 2004).

the member states now rests in the hands of essentially unaccountable central bankers whose sole objective is to achieve price stability via the control of short-term interest rates. On the question of the choice of “rule” versus “discretion” in the conduct of policy, European political elites have clearly swung strongly in favor of the former. Consequently, the adoption of the euro by Britain would be no more than a complete abdication of the ability to formulate monetary policy.

The acceptance of such a narrow policy structure, in which discretionary policy is reduced to choosing the appropriate short-term interest rate to ensure price stability, has been made easier by the fact that current mainstream economics views the macro-economy in a way similar to that conceived by the original architects of the EMU. The old-line monetarism and the “new consensus” macroeconomics both start from the premise that (except for random shocks to the system) the private economy is inherently stable with actual output tending naturally towards potential output. If inflation were to arise because of some particular shock, such inflationary pressures would persist only if sustained by monetary demand. Inflation can thus be controlled by the central bank through interest rate policy that would bring into line the growth of monetary demand to capacity output growth. In this analytical context, inflation restraint via interest rate changes becomes the only scope for monetary policy. On the other hand, as it has already been mentioned earlier, fiscal policy is seen purely as a source of disturbance. Since the object of monetary policy is to choose an appropriate (or equilibrium) interest rate that would balance aggregate monetary demand with aggregate supply, discretionary fiscal policy is perceived as being disequilibrating — by creating a wedge between the actual and the equilibrium rate of interest, and therefore by causing a monetary disturbance that could jeopardize the goal of price stability. For this reason, fiscal policy must be made “neutral” by requiring governments to achieve at least budget balances over the medium run.

Also much like current mainstream thinking, the architects of the euro regard unemployment as a purely supply-side phenomenon that cannot be permanently affected by macroeconomic demand management policies that would endanger the ECB’s commitment to price stability. Only microeconomic policies that focus directly on enhancing labor market flexibility and eliminating programs that are seen to create labor market disincentives to work would be successful in reducing unemployment (Martin 2000). Active labor market policies that would promote worker mobility and the acquisition of labor market skills, or work-sharing proposals in terms of reduced working hours, would be the type of supply-side policies that would deal with unemployment without threatening price level stability. Although nowhere in the Stability and Growth Pact is there a direct reference to an equilibrium level of unemployment or a NAIRU, it is obvious that

the conception of unemployment as a purely social phenomenon that should not be made an object of macroeconomic policy, and thus ought not enter in the reaction function of the ECB, would imply that such a key concept of mainstream theory does underlie their thinking.

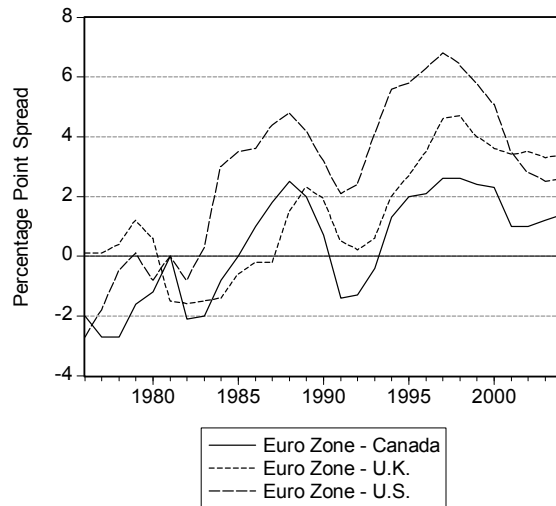
In light of this restrictive policy structure that largely denies macroeconomic stabilization policies, what would be the implications for countries that would dollarize along the lines of the EMU structure? An analysis of the eurozone economic dynamics over the last two decades, as the EMS/EMU members aligned themselves in order to fit this narrow policy structure, can illustrate to both Canada and Britain what would be the possible impact of this type of monetary integration.

SOME STATISTICAL EVIDENCE ON THE IMPLICATIONS OF MONETARY INTEGRATION IN EUROPE: ARE THERE LESSONS FOR CANADA AND BRITAIN?

As is well known, with the breakdown of the Bretton Woods system in the early 1970s, European countries did attempt, under follow-up agreements to the Werner Report of 1970, to establish a structure of exchange rates, but which led to extremely loose and fluid relations during the 1970s until the creation of the EMS in 1979 (see Apel 1998: chapter 1). The 1970s was thus a decade during which some of the major players of what ultimately became the EMU, such as Italy and France, experimented with much greater flexibility of their exchange rate system, especially subsequent to the first oil price shock in 1973. In 1979, this was to change somewhat as the core countries of what was to become the eurozone joined the ERM to establish a fixed exchange rate system in which the exchange rates of participating countries were allowed to fluctuate within a fairly narrow corridor — the so-called European “snake”. For this reason, although not without serious turbulence as during the 1992 crisis, there were two crucial stages to European monetary integration: the period of the EMS between 1979 and 1999, and then the post-1999 period of a single currency. While the structures that were put in place were somewhat different (with the core countries being members from its inception and others more peripheral sought to qualify by adopting convergence criteria during the early period of the EMS), we wish to argue that, whether the constraints faced were the result of their commitment to the EMS or self imposed, during both periods member countries of what ultimately would constitute the eurozone faced similar institutional constraints on macroeconomic

policy, broadly characterized as a deflationary or “anti-growth” bias (see Bibow 2002).

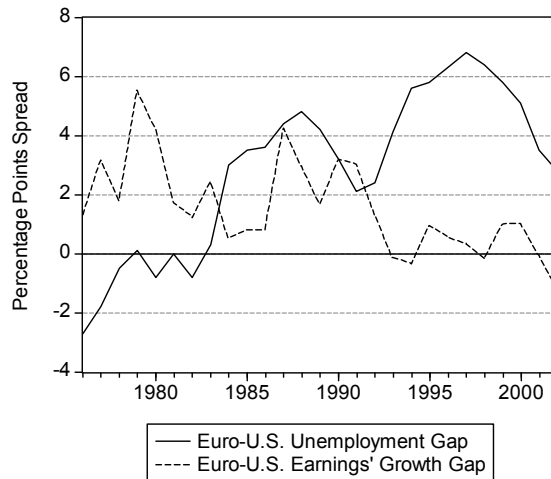
FIGURE 1: PERCENTAGE POINT SPREADS IN THE UNEMPLOYMENT RATES, BETWEEN EURO ZONE AND CANADA, EURO ZONE AND U.K., AND EURO ZONE AND U.S. 1976-2004



Source: OECD, Labour Force Statistics; and OECD, Economic Outlook.

As can be seen in Figure 1 for the complete period between 1976 and 2004 (with the last two years being based on forecasts of the Organisation of Economic Co-operation and Development (OECD)) when measured by the unemployment rate spread between the eurozone and the United States, the implication of greater monetary integration for the macroeconomic performance of the EMS/EMU countries is quite startling. Beginning virtually at the same aggregate rates of unemployment in 1979, the gap between the eurozone and the United States trended upwards by leaps and bounds, and only narrowed when the American economy went through major slowdowns or recessions, such as in the early 1980s, in the early 1990s and during the 2001-2003 period. Moreover, although to a lesser degree, the unemployment rate spread between the eurozone and the United Kingdom and the eurozone and Canada followed a similar upward pattern. There was clearly something pushing upwards the long-term unemployment rate in Europe that was not to be found in Canada, the United Kingdom and the United States, at least not to the same extent.

FIGURE 2: PERCENTAGE POINTS SPREAD IN UNEMPLOYMENT RATES AND REAL EARNINGS GROWTH BETWEEN THE EURO ZONE AND THE UNITED STATES 1976-2002



Source: OECD, Main Economic Indicators.

Contrary to the generally accepted view at the time about a growing NAIRU and the so-called “eurosclerosis”, we wish to argue that the principal culprit was not “real wage resistance” and problems arising from European labor market “inflexibility” that has traditionally been advanced as an explanation of the growing unemployment rate gap, but the conduct of macroeconomic policy in the context of the EMS and then EMU. Indeed, to question the validity of the traditional explanation, we have plotted (Figure 2) the spread in the growth of real earnings between Europe⁵ and the United States covering essentially the same period as in Figure 1 and then contrasted that series to the evolution of the eurozone-US unemployment rate spread from Figure 1. Just from casual observation, it is obvious from Figure 2 that there is a strong *negative* correlation between our two series. Real wage growth in Europe declined significantly throughout this period and, in fact, during certain years since the early 1990s, was

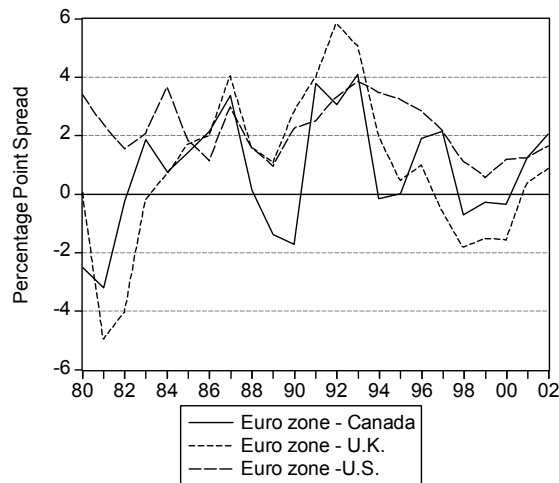
⁵ The lack of data for the complete eurozone restricted us to taking the weighted average of real earnings growth of only three major EMS/EMU countries, namely, France, Germany and Italy weighted on the basis of the three respective labor force series. With the exception of France where all industry data was available, the earnings series for the respective countries was average hourly earnings of the manufacturing sector only.

actually lagging US real wage growth, yet the eurozone-US unemployment rate gap continued to *rise*. Hence, on the basis of this evidence, it would be difficult to retain real wage growth as a major cause of the *rising* unemployment in Europe. On the contrary, the growing European unemployment rate appears more likely to have been the *cause* of real wage disinflation, thereby pointing to serious problems of effective demand on the European continent over the last two decades. As discussed below, our explanation of Europe's poor performance rests primarily on the conduct of macroeconomic policy that was put in place since post-1979, which placed governments more and more into monetary and fiscal straitjackets.

Europe's macroeconomic appetite for austerity, which is at the origin of the unemployment problem, could be easily ascertained by studying the behavior of both the monetary and fiscal authorities. Under the constraints of the ERM and then under the limitations imposed by the EMU institutional commitment to price stability, the monetary authorities implemented much more austere macroeconomic policies in Europe than in either the United States, the United Kingdom, or Canada. To monitor the behavior of the monetary authorities, we have chosen as indicator of monetary tightness the real prime lending rate difference between the eurozone and the three other above-mentioned countries for the period between 1980 and 2002.⁶ Hence, as was done with the unemployment rates in Figure 1 above, we calculated the prime lending interest rate spreads between the respective countries vis-à-vis the eurozone. As we can observe from Figure 3, the Europeans generally followed much tighter monetary policy than was adopted, say, in the United States, with the exception of the late 1990s. Indeed, on average, European lending rates were 2.2 percentage points higher than in the US for the complete period between 1980 and 2002, 0.82 percentage points higher in relation to the British real rates, and 0.76 percentage points higher on average when compared to the real bank lending rates in Canada. These real interest rates were kept inordinately high despite the fact that unemployment rates soared to unprecedented levels in Europe, when compared to the United States, the United Kingdom and Canada.

⁶ Indeed, by reconstructing the time series from the IMF (with data on lending rates for Belgium, France, Germany, Ireland, Italy, Luxemburg, Portugal and Spain) for the period 1980-1995 and then linking it up with a series on the prime lending rate for the complete Euro area for the post-1995 period, we were able to obtain an approximate data series on the real lending rate which covered the whole period between 1980 and 2002. It was felt that such a series would be much more appropriate in measuring the interest burden faced by borrowers than such inflation-adjusted rates, as real central bank discount rates.

FIGURE 3: PERCENTAGE POINT SPREADS IN REAL LENDING RATES BETWEEN EURO ZONE AND CANADA, EURO ZONE AND U.K., AND EURO ZONE AND U.S. 1980-2002



Source: IMF, Financial Statistics.

A similar phenomenon is to be found with respect to the behavior of the European fiscal authorities. We have argued in our previous discussion of the experience in Europe that, as economies evolve in the direction of greater monetary integration, whether under the EMS umbrella or EMU, national governments tend to lose control of their fiscal policy, either *de jure* (as within the EMU structure) or *de facto* (as under market dollarization). This is because ultimately financial markets can impose financing constraints, whether they be real (as under dollarization) or perhaps artificial (as with the EMU structure), which force governments to abide by rules of “sound finance” that would have a destabilizing effect on growth. Hence, under the EMU structure, whenever a country is faced with a negative external shock to output growth, the recessionary pressures would bring about a fall in their budget balance because of the triggering of “automatic stabilizers”. Once actual budget deficits appear, the fiscal authorities would be under enormous pressures to *cut* discretionary spending or raise taxes to meet their common fiscal rule, thereby deepening the economic slowdown and reinforcing the rise in the unemployment rate. Yet, during periods of budget surpluses associated with falling unemployment, governments would feel that they would now have the “available” funds to engage in greater discretionary net spending, and therefore would seek to reduce their positive

budgetary balances. This suggests that *discretionary* net public spending probably behaves pro-cyclically in an EMU-type arrangement, regardless of what happens to actual overall accounting balances, which are essentially endogenous to the macroeconomic state of the economy. In countries possessing their own floating currency and central bank, as in Canada, Britain, and the United States, no such destabilizing behavior would be imposed for institutional reasons that relate to the fixed exchange rate regime or the common currency arrangement. The fiscal authorities, instead, would clearly *not* be under these same institutional pressures to cut discretionary net spending during a recession. Hence, within these latter regimes, governments would likely be under much greater public pressure to *increase* rather than to reduce discretionary net spending and, thus, to pursue contra-cyclical policies of “functional finance” over the business cycle.

To test this simple hypothesis, we have looked at the discretionary fiscal behavior of Canada, the euro area⁷, the United Kingdom and the United States. More precisely, we have chosen as an indicator of discretionary net spending the consolidated cyclically-adjusted primary balance of all levels of government, as produced by the OECD.⁸ This is a measure, for instance, which has been traditionally regarded by Canada’s Federal Department of Finance as a useful indicator of fiscal impulses originating from the public sector.

Does discretionary net spending of the public sector react to changes in the unemployment rate? And if so, in what direction do the public authorities react? A quick look at the four graphical illustrations displayed in Figure 4 would easily substantiate our hypothesis that it is only in regimes with shared common currency that the national fiscal authorities engage in destabilizing fiscal behavior. Hence, unlike the behavior of the fiscal authorities of the other three countries, especially the United States, who generally engage in some limited form of functional finance, the euro area displayed the opposite tendency.

Given the number of observations available and the difficulty of developing a complete structural model of these economies, no attempt was made to address other concerns relating, for instance, to possible problems of simultaneity bias. All that we did was to run some simple regressions, representing the presumed reaction functions of the fiscal authorities, just to see if the empirical relations that were illustrated by our four charts would glean, with our hypothesis being that when faced with higher unemployment the fiscal authorities would either seek to

⁷ The euro area is based on weighted statistical averages for France, Germany and Italy. They were weighted on the basis of the three respective countries’ GDP.

⁸ The data, provided on a semi-annual basis for all these countries, were available for the complete period 1981-2004, the latter two years being forecasted by the OECD.

reduce or increase their net discretionary public spending, even though we do recognize that changes in discretionary net spending could have a negative feedback on the unemployment rate.⁹ Because of problems of serial correlation that plagued our series, these regressions were run using variables expressed both in levels (in Table 1) and in first-difference (in Table 2). Since these estimated reaction functions merely contained one explanatory variable — the unemployment rate — it is not surprising to discover that, in terms of the overall goodness of fit, these results were rather poor. However, as shown by the t-ratios (in parenthesis below each estimated coefficient), the evidence in both levels and first-differences generally supports what we had already inferred from the four charts. The signs of the coefficients of the unemployment rate tended to be in the direction that we had hypothesized and, with the exception of the United Kingdom, they were found to be always statistically significant. In fact, if we focus on our two best statistical results in Table 2, the regressions for the eurozone and the United States, they indicate fundamentally opposed reaction functions. Only the United Kingdom estimated equations held a statistically insignificant coefficient for the unemployment rate with conflicting signs, depending on specification. The reason for this may have more to do with the behavioral particularity of the Thatcher regime in Britain during the early 1980s. Indeed, as Figure 4(c) suggests, since the second half the 1980s discretionary fiscal policy was clearly displaying a counter-cyclical behavior consistent with the Canadian and American cases.

Given this statistical evidence on the pro-cyclicality of fiscal policy for the eurozone, it would be difficult not to sympathize with those who have argued that the fiscal rules imposed on EMU members seriously impair these countries' ability to absorb macroeconomic shocks and, in essence, condemn them to rely on the limited monetary policy actions of an unaccountable ECB, whose sole responsibility is price stability (Arestis, McCauley and Sawyer 2001). In more recent times, even some of the most ardent supporters of the EMU system (see Fitoussi, 2000; and Fitoussi and Creel 2002, as well as the well-publicized statement in October 2002 by the then president of the European Commission, Romano Prodi, about the "stupidity" of EMU's fiscal rules) are beginning to raise questions about the current policy mix of the EMU that (i) has given too much prominence to orthodox monetary policy in favor of price stability, regardless of

⁹ It might be noteworthy that, if there is a simultaneity bias in our regressions, such bias would actually work to *underestimate* the positive relation that we found for the eurozone. This is because, as the budget surplus rises, the feedback effect on the

the performance of the unemployment rate, (ii) has led to complete perversion of fiscal policy as a macroeconomic tool for economic stabilization, and (iii) has imparted a deflationary bias on the EMU members and, by implication, on a very important segment of the world economy (for further discussion of this latter issue, see Bougrine and Seccareccia 2004).

Table 1: Empirical Relation between Cyclically-Adjusted Budget Balances as a Percent of GDP and Unemployment Rates: Regressions Using Levels Canada, Euro Area, United Kingdom and United States, 1981-2004

| Dependent Variable | Constant | Unemployment | AR(1) | Adj. R ² | D.W. |
|--------------------------------|-------------|--------------|------------|---------------------|--------|
| Canada | 13.6229 | -1.4452 | | 0.4766 | 0.0921 |
| Cycl.-Adjusted Primary Balance | (6.5126)* | (-6.4079)* | | | |
| Canada | 8.6568 | -0.3873 | 0.9845 | 0.9732 | 0.6847 |
| Cycl.-Adjusted Primary Balance | (0.8438) | (-2.1376)* | (34.8136)* | | |
| Euro Area | -10.0094 | 1.2390 | | 0.7164 | 0.1911 |
| Cycl.-Adjusted Primary Balance | (-10.3358)* | (10.9415)* | | | |
| Euro Area | -4.5561 | 0.6661 | 0.9458 | 0.9530 | 1.2049 |
| Cycl.-Adjusted Primary Balance | (-2.1435)* | (3.5026)* | (19.6699)* | | |
| UK | 1.9436 | -0.1238 | | 0.0002 | 0.0848 |
| Cycl.-Adjusted Primary Balance | (1.7685)* | (-0.1314) | | | |
| UK | 0.9768 | -0.2059 | 0.9568 | 0.9155 | 0.6448 |
| Cycl.-Adjusted Primary Balance | (0.3612) | (-1.3658) | (21.8383)* | | |
| US | 4.2165 | -0.6791 | | 0.3418 | 0.1264 |
| Cycl.-Adjusted Primary Balance | (4.8886)* | (-5.0408)* | | | |
| US | 0.8870 | -0.4604 | 0.9679 | 0.9217 | 0.6052 |
| Cycl.-Adjusted Primary Balance | (0.2283) | (-3.0960)* | (18.3295)* | | |

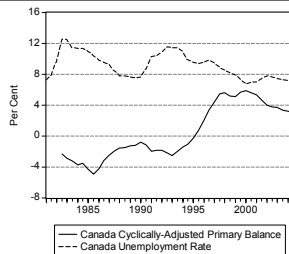
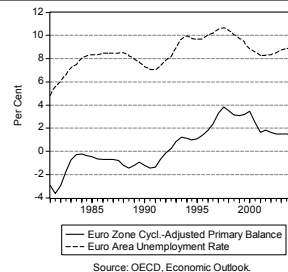
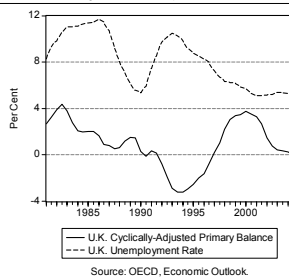
N.B.: the asterisk (*), adjacent to the t-ratios in parentheses, indicates acceptance at the 5 percent level of significance. AR(1) is the estimated first-order autoregressive factor.

unemployment rate would be to make the situation even worse than without a possible feedback — as we have implicitly assumed in our regressions.

Table 2: Empirical Relation between Cyclically-Adjusted Budget Balances as a Percent of GDP and Unemployment Rates: Regressions Using First-Difference Data Canada, Euro Area, United Kingdom and United States, 1981-2004

| Dependent Variable | Constant | Δ (Unemployment) | AR(1) | Adj. R ² | D.W. |
|---|----------------------|----------------------------|---------------------|---------------------|--------|
| Canada Δ (Cycl.-Adjusted Primary Balance) | 0.0734 (0.8300) | -0.3861 (-2.1739)* | | 0.0797 | 0.6903 |
| Canada Δ (Cycl.-Adjusted Primary Balance) | 0.1164 (0.6183) | -0.2934 (-1.8518)* | 0.6460 (5.4732)* | 0.4581 | 1.7535 |
| Euro Area Δ (Cycl.-Adjusted Primary Balance) | 0.0325 (0.5568) | 0.6795 (3.9677)* | | 0.2427 | 1.2480 |
| Euro Area Δ (Cycl.-Adjusted Primary Balance) | 0.0580 (0.8895) | 0.8305 (4.5060)* | 0.2380 (1.891)* | 0.4248 | 1.4436 |
| UK Δ (Cycl.-Adjusted Primary Balance) | -0.0727 (-0.8254) | -0.2197 (-1.4784) | | 0.0251 | 0.6626 |
| UK Δ (Cycl.-Adjusted Primary Balance) | -0.1057 (-0.4455) | 0.1015 (0.5085) | 0.7237 (6.9430)* | 0.4734 | 1.5016 |
| US Δ (Cycl.-Adjusted Primary Balance) | -0.0647 (-0.9331) | -0.4589 (-3.2289)* | | 0.1701 | 0.6194 |
| US Δ (Cycl.-Adjusted Primary Balance) | -0.0923 (-0.5602) | -0.3189 (-2.2372)* | 0.6919 (6.2496)* | 0.5694 | 1.2999 |

N.B.: the asterisk (*), adjacent to the t-ratios in parentheses, indicates acceptance at the 5 percent level of significance. AR(1) is the estimated first-order autoregressive factor.

FIGURE 4(a): UNEMPLOYMENT AND CYCLICALLY-ADJUSTED PRIMARY BALANCE
Canada 1981-2004 (Semi-Annual Observations)FIGURE 4(b): UNEMPLOYMENT AND CYCLICALLY-ADJUSTED PRIMARY BALANCE
Euro Area 1981-2004 (Semi-Annual Observations)FIGURE 4(c): UNEMPLOYMENT AND CYCLICALLY-ADJUSTED PRIMARY BALANCE
United Kingdom 1981-2004 (Semi-Annual Observations)FIGURE 4(d): UNEMPLOYMENT AND CYCLICALLY-ADJUSTED PRIMARY BALANCE
United States 1981-2004 (Semi-Annual Observations)

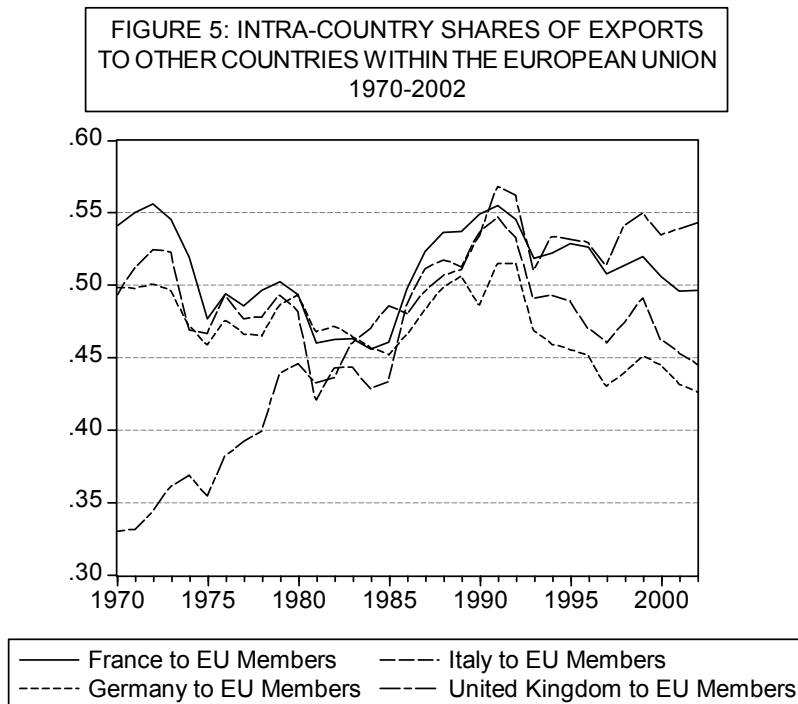
SHOULD CANADA AND BRITAIN JOIN MONETARY UNIONS?

From our previous empirical analysis, we have shown how constraining the institutional structure of the EMS/EMU has been on the conduct of macroeconomic policy. Because of the binding constraints of an integrated/common currency arrangement on the monetary authorities, throughout the period of the EMS and now perhaps under EMU, real interest rates have tended historically to be higher than US rates, with these higher rates being accompanied by lower growth and higher unemployment. At the same time, in their aversion to an activist fiscal policy along Keynesian lines, under both the EMS and EMU, fiscal policy has played a destabilizing role. When taken together, this has meant an inherent recessionary bias in the conduct of macroeconomic policy. Why would countries, like Britain vis-à-vis the eurozone (or Canada in the North American context), wish to join (or create) an overarching monetary structure whose inherent bias in favor of low growth may condemn them to still higher long-term unemployment rates?

At the same time, even if growth were to be lower and unemployment higher, would there be sufficient grounds to support such a move on the basis of traditional Mundellian arguments regarding optimal currency areas? If one looks at such indicators as the shares of British exports to/imports from EMU countries, it is quite clear that these shares have risen significantly. For instance, as shown in Figure 5, out of the four major players in the European Union, it is only Britain that increased its share of exports to Europe from about 33 percent in 1970 to almost 55 percent during the last decade. Interestingly this share has remained relatively stable since the early 1990s, while the shares of France, Germany and Italy actually declined during the recent decade. At the same time, as shown in Figure 6, Britain's share of exports to the NAFTA countries has remained relatively stable over the last thirty years, much like Canada's share of exports to Europe which has shown only a very mild decline. On the other hand, Britain's share of exports to the EU countries and Canada's share of exports to the NAFTA countries have both risen significantly, even though in the case of the UK this had occurred primarily during the pre-1990 period. This would suggest that both countries have been restructuring their trade progressively towards those economies that have closer geographic proximity, especially as trade has been liberalized within these distinct trading blocs. One could argue, therefore, that, on purely Mundellian optimal currency area (OCA) criteria, there is perhaps some case to be made for greater monetary integration. Yet, are these lower transactions costs of such magnitude to offset the obvious losses to national income arising from a more constraining macroeconomic environment? As discussed elsewhere in greater detail (see Seccareccia 2002), in reality such possible transactions savings of 0.1 (or even a 0.4) percent of GDP (see, for instance, Grubel 1999: 9) dwarf in comparison to the obvious tangible loss of output because of the existence of a long-term unemployment resulting from the anti-growth bias of the EMS/EMU institutional environment.

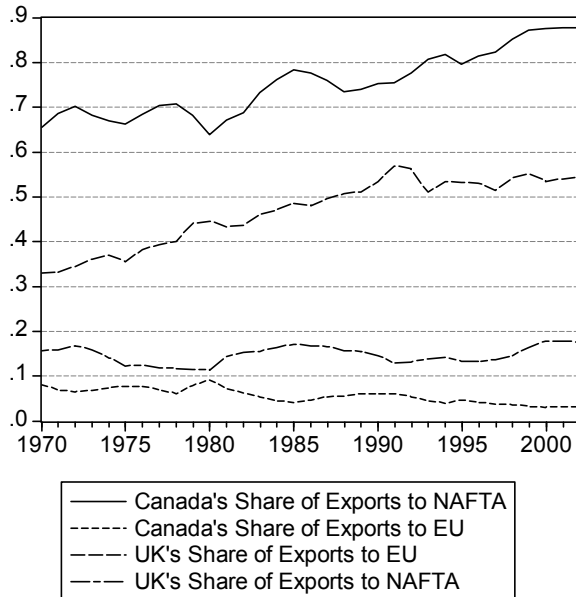
Moreover, as pointed out by Willett (2000), among others, despite the OCA rhetoric that was frequently employed by Europe's political leaders, OCA criteria were not the basis for European integration. Indeed, both Goodhart (1998) and Bordo and Jonung (1999) suggest that OCA criteria have rarely ever been the basis for monetary integration historically. As was stated from the outset, Europe's objective for integration was primarily political, and presumably the same would apply to both Britain and Canada in choosing to be in/out of any monetary union. It should also be noted that, in the case of Britain, despite this growing commercial integration with other European countries, British business cycles continue to vary more with the US than with continental Europe, and that there

are more political affinities with the former country than with the members of EMU.



Indeed, it is particularly noteworthy that, in his historic June 2003 statement on European Economic and Monetary Union (see the *Hansard*, June 9, 2003), the British Chancellor of the Exchequer, Gordon Brown did not make much of OCA criteria in joining EMU. After addressing the issue of growing convergence and recognizing the increasing importance of exports to EMU countries, he expressed two main concerns about joining EMU that are of specific interest to our analysis. The British government's concerns have only indirectly to do with OCA issues and relate much more to what has been the principal focus of our analysis: the problem of lack of "flexibility" in the conduct of macroeconomic policy.

FIGURE 6: SHARES OF EXPORTS TO EU AND NAFTA COUNTRIES
Canada and United Kingdom, 1970-2002



Source: OECD, Monthly Statistics of International Trade.

The first of these has to do with the problem of conducting interest rate policy in a non-optimal currency union like that of Europe. In pointing to the current use of the European Harmonized Index of Consumer Prices by the ECB, the Chancellor of the Exchequer raised the well-known problem of seeking to target an inflation rate for the twelve member states when the local inflation rates might be very different and where the variance of these inflation rates may be rising across the complete spectrum of EMU countries (for further discussion of such a problem, see Palley 2003). Secondly, the Chancellor pointed to the problem of “fiscal flexibility” and the need to consider more flexible arrangements that would better accommodate British fiscal policy needs inside an expanded EMU. In a sense, both of these concerns are related and point to the heart of the problem that was discussed previously on the constraining macroeconomic framework that the EMU structure imposes on its member countries.

Interestingly, we believe that these are the same type of concerns that countries like Canada, Mexico and the United States itself, would have if ever they would agree to a monetary union along the lines of the EMU in North

America. Indeed, because of the EMU model's structural anti-growth bias, Canadians, for instance, may have to face the prospect of still higher rates of long-term unemployment than they have been used to already, because of the constraining macroeconomic environment that such a structure would create (see Bougrine and Seccareccia 2004). This would hardly be an attractive macroeconomic scenario to be easily emulated by North Americans. Realistically speaking, the prospect of a North American EMU is hard to envisage politically. This is because of the obvious asymmetries in the power relation between the United States and its two North American partners. Americans would hardly wish to give up the US dollar for any supranational currency that would be shared by its neighbors whose economies, on an individual basis, are approximately one-tenth its size in terms of GDP.

As discussed elsewhere (see Seccareccia 2002, 2003-2004), much like the prospect of Britain joining the eurozone the only possible, but hardly desirable, alternative to the monetary *status quo* would be to dollarize *stricto sensu* by adopting the US dollar, with the hope that, in dismantling the current structure of the Bank of Canada, the latter would also be able to negotiate a seat at the Federal Open-Market Committee (FOMC) by entering as a 13th district of the Federal Reserve. This, together with the extension of US banking regulations to Canada, thereby hopefully widening the lender-of-last-resort provision to Canadian banking and financial institutions, may be the most that would be seriously conceivable by those partial to greater North American monetary integration, while still pretending to hold a semblance of fiscal policy independence. Other Maastricht rules, such as the strict prohibition of central bank financing of government expenditures, would most likely face a strong veto from the American government because of the fear of its ability to undertake military spending being severely hampered. The North American equivalent could hardly resemble the EMU structure (based on the symmetrical treatment of the member countries) that numerous advocates of greater monetary integration would want to import to North America. Hence, while a symmetrical structure would be a non-starter in the US, an alternative North American monetary arrangement with the asymmetrical treatment of member states would be a nonstarter in Canada, thereby entailing a political impasse.

More importantly, as was stated from the beginning, the euro project should be conceived as part of a broader plan, going back sixty years, for the political unification of Europe. Many of the problems stemming from the current structure of the EMU reflect the fact that no central political structure, to be found even in decentralized federal states such as Canada, has been accorded the political authority, as well as instruments, to conduct macroeconomic stabilization policy

for the EMU members as a whole. Hence, within this interim Mengerian halfway house, Europeans have dismantled their national macroeconomic policy system, but, based on questionable neoclassical precepts, have *not* put in place a supranational political structure for the meaningful conduct of European-wide macroeconomic policy. Much like a moving vehicle without its steering wheel, to use Bell's (2003) metaphor, Europeans have put in place a supranational policy structure that cannot prevent economic shocks from generating destabilizing consequences domestically in any of its member states. Given the current institutional stresses and strains, Europeans have only two choices available: either (i) to proceed forward towards a full-fledged federal political union, with a central fiscal and monetary authority being given the power to conduct active macroeconomic policy, or (ii) to see the current structure slowly unravel and risk a return to the *status quo ante*.

Why would North Americans wish to emulate such a malfunctioning interim Mengerian arrangement? None of the advocates of a North American EMU (or NAMU) ever mention the simple fact that the current structure of Europe must be conceived as merely another stage in a political process whose ultimate end is political unification. If such is also the underlying motive for those promoting some form of *de jure* dollarization in North America, then why not state it for what it is? Moreover, if some form of political unification is indeed the motive force behind those pushing for greater monetary integration, then why promote the adoption of some hybrid interim EMU structure for North America that is clearly not politically feasible and that, at least from our previous analysis about the appropriate conduct of both fiscal and monetary policies, would be unquestionably worse than the current *status quo*? This is the real dilemma facing those partial to greater North American monetary integration. Without such a deep political tradition in Canada in favor of political unification with the US, then much like in Britain, where support for political integration with the countries of the eurozone is absent, Canada-US monetary integration is unlikely to happen any time soon.

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WOULD MONETARY INTEGRATION WITH THE UNITED STATES THREATEN THE CANADIAN SOCIAL MODEL? INSIGHTS FROM EUROPEAN MONETARY UNIFICATION

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*'The economist must study the present in the
light of the past for the purpose of the future'*
John Maynard Keynes

INTRODUCTION: SETTING THE SCENE FOR NORTH AMERICAN MONETARY UNION

Debates on a possible North American Monetary Union (NAMU) between the United States and Canada have been lingering since the early 1990s in a period in which there have been numerous interventions calling for establishing a fixed exchange regime with the US (Courchene 1990; Grubel 1992 and 1993;

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Harris 1993; Mundell 1990).² After a few relatively dormant years, the debate has been re-launched in 1999 through lively discussions at various symposia, conferences, government inquiries, hearings, position papers, and academic exchanges including those in the popular press.³ This time, however, the debate revolved around establishing a full monetary union between Canada and the US with NAMU as the most preferred alternative against other forms of exchange rate fixing. Most notable among the reasons for the revival of the debate in Canada was perhaps the strong signals of the successful completion of currency union in Europe. With its successful introduction in 1999, the euro not only served as a catalyst in the Canadian policy debate but also conferred upon the proponents of a prospective NAMU a high degree of credibility.⁴

Several aspects of a future integration project surfaced on the Canadian policy agenda. In parallel with the literature on monetary integration in Europe these issues ranged from ‘calculating’ the economic costs and benefits to concerns around practical and political aspects of pooling sovereignty. The debate on the possible social consequences of NAMU, however, seems to be only in its incipient stages. It is, however, highly likely to intensify once the political initiative on establishing a North American single currency gains momentum.

It is interesting to observe that the arguments put forward by supporters and critics of the project highly resemble those in the European Economic and Monetary Union (EMU) debate. Drawing on parallels with the process of European monetary integration, both sides of the debate have acted on the presumption that a future NAMU would be based on the blueprint of the EMU *à la* Maastricht. Needless to say, while some commentators hail this possibility, others lament it. Yet they both expect that North American monetary unification would imply the imposition of stringent rules for macroeconomic discipline in general and fiscal rectitude in particular.

² This paper evaluates the social consequences of a future NAMU between only Canada and the US for reasons of simplicity. The analysis could very well be extended to the case of a larger NAMU integrating Mexico.

³ See, for example, Grubel (this issue) and Bowles, Croci and MacLean (2003) who trace the growing interest in the academic, policy and public debate in currency integration in North America.

⁴ One main proponent notes ‘it was the advent of the euro in January 1999 that unleashed a veritable flood of interest, papers and conferences on the evolution of Canada-US and North American currency arrangements’ (Courchene 2001: 1). In the official policy debate, for example, in opening the Senate hearings on the issue Senator Michael Kirby concurs by referring to the launch of the euro in spurring the Canadian debate (Government of Canada 1999).

Despite their diametrically opposed political motivations, supporters and skeptics of NAMU alike seem to agree on the view that forming a currency union would unleash forces that would lead to the downsizing (or 'rightsizing' for some) of the Canadian welfare state. On the one hand, supporters look forward to the creation of a monetary union as they believe that a future North American Central Bank modeled after the European Central Bank would provide the 'supranational public good' of sound money through prioritizing stability of the new currency. To that end, NAMU is viewed to help secure stable public finances by imposing much-needed fiscal prudence as exemplified by the European experience. Moreover, in order to achieve macroeconomic discipline, it is claimed, the new central bank would denounce employment and welfare programs that would be inconsistent with its mandate. Supporters predict, therefore, that NAMU designed as such would, by rendering long overdue welfare reforms imperative, culminate in the 'rightsizing' of the welfare state.

Critics, on the other hand, claim that an EMU-style North American monetary integration would impose macroeconomic discipline and in particular excessive fiscal prudence leading to severe fiscal cutbacks. These cutbacks, they argue, would be exacted primarily from the social expenditure budget. By precluding the option of deficit financing in this way and constraining public outlays in general, critics predict, NAMU would compromise fiscal policies through which the Canadian Social Model is sustained. Consequently, these processes would lead to the dismantling of the Canadian welfare state which, in the eyes of many, is the institution *par excellence* that differentiates them from their US American neighbors.

I aim to contribute to this emerging debate on the future of the Canadian Social Model in the shadow of the possibility of establishing a currency union with the US, by putting the North American debate in comparative perspective. A survey of the debate on the North American case reveals that its starting point is the strong expectation that NAMU's organizational structure will most likely be patterned after that of EMU. Given the successful launching of the bold European project, it is hardly surprising that debates on a blueprint for NAMU is informed by this experience. In addition to the expected similarities between the organizational structures of EMU and NAMU, the debate around NAMU's future ramifications on the Canadian welfare state bears striking parallels with that on EMU's social consequences on European welfare states. In these parallel debates, fiscal pressures emanating from monetary integration are expected to translate into inexorable constraints on welfare states.

Despite significant differences in terms of their origins and aims, parallels with respect to the debates on their organizational structures and their alleged

social consequences allow us to draw some insights from the European experience for the future of the Canadian welfare state. This paper will show that there are virtually no signs of systematic, across-the-board retrenchment in Europe's welfare systems even in the face of severe EMU-induced fiscal constraints during the 1990s when EMU's effects were expected to hit home. The analysis of welfare state expenditures in Europe below rests far from confirming the common prediction of a radical overhaul shared by all. In particular, in those countries that were exposed to EMU pressures most extensively, social protection levels point to signs of welfare state stability, if not expansion. Moreover comparative research on these critical cases which reveals that successive welfare reforms carried out in the name of EMU resulted in modest cutbacks confirm this finding. This body of research shows that the politics of welfare reform led to shelving of reform initiatives in most cases; in others it led to internal restructuring. In cases where reforms constituted retrenchment, their impact was postponed to future generations having no bearing on the immediate fiscal pressures emanating from EMU. Therefore, to the extent that NAMU resembles EMU, the lesson drawn from the European experience of the 1990s is that we do not need to expect a radical dismantling of the Canadian welfare state as a result of currency integration *per se*.⁵

In what follows, the second section will discuss NAMU's possible governance structure and its transition phase with references to EMU's as laid out in the Maastricht template. After providing a brief history of EMU, the third section will summarize the debate on the possible social consequences of EMU by identifying the main mechanisms suggested by the conventional wisdom shared by skeptics and supporters of the project. The fourth section will examine the fiscal state of affairs in the Eurozone in the early 1990s when the Maastricht convergence process began. In order to evaluate the predictions emanating from the Euro-skeptics' and Euro-philes' scenarios, it will trace welfare state trajectories by focusing on social protection expenditures and comparative case studies on Italy, Belgium and Greece. The paper shall conclude by drawing some lessons from the European experiment for the possible impact of NAMU on Canadian welfare futures.

⁵ While there are endogenous pressures the Canadian welfare state faces such as ageing population, transformations in labor markets, increasing healthcare costs due to technological advances, a discussion of these remains beyond the scope of this paper.

THE NAMU ALTERNATIVE: GOVERNANCE STRUCTURE AND TRANSITION

There is No Alternative to Fixing

Two main issues appear in scholarly discussions on the prospects of currency integration: the costs and benefits of a future monetary union and its possible future structure. On the exchange rate question, supporters of NAMU emphasize the inappropriateness of the Canadian floating regime. They have identified the Canadian float of the last three decades as the chief evil responsible for the relative under-performance of the Canadian economy which led to falling standards of living (Courchene 2001; Courchene and Harris 1999, 2003, 2003; Government of Canada 1999; Grubel 1999, 2003). These commentators seem to agree that a variant of fixed exchange rates is not only desirable for Canada but is also “inevitable”.⁶ Accordingly it is argued that options for Canadians are limited to only different *forms* of fixed exchange rate regimes. These include, first, a variant of *exchange rate pegging* where Canadian macro authorities “shadow” the US dollar, secondly a *currency board* tying domestic monetary conditions to policy rules and balance of payments conditions, third, unilateral adoption of the US dollar commonly called *dollarization*, and finally, a NAMU with a *common currency*. Among these regimes, proponents of fixing the Canadian dollar almost unequivocally find NAMU to be the economically optimal and hence the most attractive option. The discussion goes as follows. For pegged exchange rates, it is argued that periodic economic shocks and political crises in an environment of increased capital mobility could render these regimes difficult to sustain. Similarly, currency boards are currently less popular as the experimentation with hard currency fixes in Latin America has been blamed for the crises in these economies. Among the remaining alternatives of either abandoning the *loonie* altogether, dollarization or going for full monetary union, analysts prefer the last mainly because of its political advantages: a NAMU as such would be symmetric in the sense that Canada would have a say in North American monetary policy-making if sovereignty is pooled through a currency union (Courchene and Harris 2003; Government of Canada 1999; Grubel 2003).

⁶ On this issue, see, for example, Courchene (2001: 3). Of course, such claims of “desirability” and “inevitability” do not go without criticism. See, for example, Robson and Laidler (2002) and Seccareccia (2003) and Cohen (2003) for counterclaims, and the discussions on NAMU at the Senate (Government of Canada 1999).

Governance Structure of NAMU: The Maastricht Connection I

Since EMU is viewed as a success story in the history of currency unions it was expected that NAMU would be modeled after EMU: “North American monetary union would be the North-American equivalent of the euro. ... [T]his means an overarching (supranational) central bank with a board of directors selected in part from the still-existing national banks” (Courchene and Harris 2003: 310). At the top of the edifice there would be a “Federal Reserve Bank of North America” where Canada would act as the thirteenth reserve bank in the system. Its institutional architecture would be similar to that of EMU in that it would be “governed by a constitution like that of the European Central Bank, which makes it responsible solely to maintain price stability” (ibid). The US dollar would continue to exist and the newly issued Canadian currency would exchange one-for-one with the US dollar in a similar way Eurozone members have undertaken the change-over.⁷

Transition Phase: The Maastricht Connection II

It is interesting to observe that commentators expect NAMU to be achieved through a process of fiscal and monetary convergence modeled after the Maastricht approach to EMU where a set of entry criteria were stipulated. Accordingly, membership to NAMU would necessitate the fulfillment of these eligibility requirements in order to ensure macroeconomic discipline in general and fiscal stringency in particular. In fact, the theoretical literature on currency unions emphasizes that sound public finances are crucial for preserving macroeconomic stability and as a means of strengthening the conditions for price stability.⁸ This is the underlying rationale for securing budgetary discipline for

⁷ See the official policy debate at the Senate (Government of Canada 1999) where Courchene and Grubel make similar arguments. As for the conversion rate, Grubel proposes the Canadian conversion might be .5 amero for every Canadian dollar with the US dollar set equal to one amero.

⁸ Monetary unions, it is argued, eliminate the possibility of using interest rate differentials to compensate for differences in inflation and depreciation risks between currencies that existed before. This makes borrowing an attractive option for financing outlays (especially for those states that had previously been penalized in the bond market) creating a deficit bias in the new currency area. Moreover, deficit-spending by a member state would lead to higher interest rates and financing the deficit would put upward pressure on the costs of long-term finance in the area as a whole. See, for example, Eichengreen (1998) who summarizes the theoretical discussion on the issue.

monetary unions. It has authoritatively informed the policy debate on EMU and is likely to shape the discussion on any future project for currency integration. In this context, the emphasis by the leading commentators in the policy debate on specifying a set of fiscal rules for NAMU's success is hardly surprising. In his proposal, Grubel (1999: 5), for example, claims that "[a]s in Europe, membership in the union will require that countries do not incur persistent budget deficits."⁹ At the same time, referring to the debt ceiling of 60 percent for EMU eligibility, Courchene calls on the Senate that "it is important that we do not go [into NAMU] with an inappropriate fiscal side" (Government of Canada 1999). In the light of this policy debate, Courchene and Harris (2003: 313) explicitly propose the introduction of a set of convergence criteria and argue that these would constitute "the NAMU equivalent to the Maastricht fiscal guidelines."

In anticipation of the incorporation of a set of Maastricht-like fiscal criteria for entry into NAMU, different sides of the policy debate hold differing views on the adoption of these. Advocates of NAMU welcome these criteria as an "enabling" source of "fiscal flexibility under the common currency" (Courchene 1999: 311; see also Courchene and Harris 2003) or a practical "institutional restraint on the ability of politicians to exploit monetary policy and fiscal policy for their short run gains" (Grubel's testimony to the Senate, Government of Canada 1999). In contrast, critics of the project such as Seccareccia (2002: 19) argues against these criteria as he depicts them merely as a "cacophony of fiscal rules which set binding constraints". These contrasting opinions in the policy debate on the structure and nature of the NAMU process mirrors the debate on the convergence criteria set out for joining EMU. The main question raised in the rest of the paper concerns the extent to, and the ways in, which a NAMU designed along the lines of EMU would impact the Canadian welfare state trajectories. In order to entertain this question the following section will introduce the debate on the social consequences of EMU.

EUROPEAN MONETARY UNION AND THE DEBATE ON ITS IMPACT ON EUROPE'S WELFARE STATES

The idea of establishing a monetary union in Europe is perhaps the most far-reaching, and hence, the boldest project in monetary history. As Benjamin Cohen

⁹ We find Grubel repeating the same argument at the Senate hearings: "the creation of the amero is likely to require that governments limit their deficits, much as happened in the European Monetary Union"(Government of Canada 1999).

(2003: 279) argues, “never before, in modern history, has a group of fully independent states voluntarily agreed to replace existing currencies with one newly created type of money.” After a relatively short transition period the project came to full fruition in 2002 with member states formally transferring their monetary sovereignty to a common authority, and with its single currency, the euro, circulating in twelve countries that make up the eurozone.

A Brief History of EMU

The project of EMU had been on the political economic agenda of Europe for a long time. Despite lack of a commitment in the Treaty of Rome (1957) to such a project, initiatives aimed at forming a monetary union have appeared on the agenda as early as the 1960s. By the end of that decade leaders of the original six commissioned the Werner Report and in 1970 the Werner Plan proposed that the member states of the European Community move in three stages to full monetary union as early as 1980. The ephemeral currency “snake” constituted the first and the only stage of this plan to be implemented and further integration had to wait until the economic turmoil of the 1970s came to an end. In order to stabilize exchange rates in Europe the French and the Germans created the European Monetary System (EMS) in 1979. This system was based on an Exchange Rate Mechanism (ERM) in which member currencies varied around others within agreed bands of fluctuation. The EMS played a crucial role in the re-emergence of EMU as well as building up support for the revival of the EMU project during second half of the 1980s. This culminated in the Delors Report (1989) which served as a blueprint for EMU laid out in the Maastricht Treaty.

The Maastricht Treaty called for EMU to be completed in three stages. Taking effect immediately, Stage I aimed at the dismantling of all internal barriers to the free movement of capital within the European Union. Closer coordination of macroeconomic (and in particular fiscal) policies and closer cooperation of central banks of member states were also called for. Stage II which began in 1994 was devoted to the transition process culminating in the completion of full monetary union. In this stage, the European Monetary Institution (the forerunner of the European Central Bank) was created in order to enhance coordination of national economic policies. This stage was also the decisive one for membership at the end of which member states were to be assessed for whether they have successfully satisfied a set of eligibility requirements known as the Maastricht convergence criteria. These criteria would serve to ensure price stability and sound public finances in the Eurozone: inflation and interest rate levels of

candidates had to be close to an average of those of the three best performing EU members, annual budget deficits and public debt had to remain lower than three percent and sixty percent of GDP respectively, and currencies had to have participated in the EMS for at least two years. According to this plan, only those member states which have completed the process of convergence on these fiscal and monetary fundamentals would participate in the Stage III of EMU, that is full monetary union. This final stage would involve the establishment of a European Central Bank, permanently fixing of exchange rates and the introduction of the single currency.

Completion of these stages for EMU candidates was vexed by an environment of ever-increasing economic adversity during the early 1990s. Apprehensive of an unstable and weak euro, the Germans insisted on the Stability and Growth Pact which would extend Maastricht's fiscal stringency beyond the transition phase well into the final stage. Despite all the hardship, eleven member states qualified for EMU in May 1998. Britain and Denmark had already obtained an opt-out of the third stage of EMU at Maastricht, and, in 2003, Sweden decided not to join. Greece which had not yet qualified for membership during the 1998 assessment joined the Eurozone by 2002. During the same year the process culminated with the circulation of euro notes and coins simultaneously in twelve member states.

Conventional Wisdom on EMU's Impact on Europe's Welfare States

With its re-launch during the late 1980s, the process sparked a lively public debate in all policy areas. One major question concerned the impact of monetary integration on the main pillar of the "European Social Model": the welfare state. From the early 1990s onwards virtually every study on European welfare states had something to say about the possible impact of European monetary integration on national social policies. The conventional wisdom shared by both *Euro-skeptics* and *Euro-philes* on this issue was that furthering monetary integration would lead to the "downsizing" of the European welfare state. While disagreeing on the precise consequences, the most frequent outcome predicted was that EMU would breed a host of structural constraints on the welfare state (Jenson and Pochet 2002), and that these would effectively lead to "tying the hands" of policymakers (Giavazzi and Pagano 1988), or put differently, "strapping them to the mast" (Dyson, Featherstone and Michalopoulos 1995).

The point of departure of *Euro-skeptic* arguments is that the convergence criteria regarding fiscal balances were the most direct and pressing constraint on Europe's welfare states. Some argued that, given the high level of budget deficits and public debt during the early 1990s, the convergence process within the context of the transition phase would require radical fiscal retrenchment for EMU membership. Since social security programs are largely publicly funded and they constitute the bulk of total public expenditures, restricting deficit and debt levels would ordain diminishing resources at the disposal of the welfare states. The Stability and Growth Pact which would take effect once the third stage of EMU begins would only exacerbate all these processes (Bonoli, et al. 2000; Delsen, et al. 2000; Ferrera and Rhodes 2000; Huber and Stephens 2001: 206, 234-5, 319; Martin 1996; Pierson 1999; Pierson and Leibfried 2000; Rhodes 1996; Scharpf 2000; Teague 1998). Others added that EMU, as a recessionary "macroeconomic policy regime", has broader implications than exerting pressures on social expenditures through the fiscal criteria alone. The Maastricht austerity, in their view, would put sustained pressures on total output and employment, and the eventual falling incomes would lead to declining tax revenues translating into a smaller spending budget out of which social expenditures are financed. This, they conclude, would lead to a crisis of welfare state financing with severe implications for social protection (Begg, et al. 1994; Begg and Nectoux 1995; Burkitt and Baimbridge 1995; Grahl and Teague 1997; Leibfried 2000; Martin 1996; Pierson 1999; Rhodes 1996, 1997). On top of these mechanisms, still others add that EMU would ultimately institutionalize a "neoliberal" policy paradigm which would impose minimalist welfare states.¹⁰ Underlying many of these accounts, there is the expectation that EMU would unleash fiercely competitive market forces and make social benefit costs more transparent across the eurozone. This would result in what is commonly called "social dumping" by putting producers in high social protection jurisdictions in a disadvantaged position vis-à-vis their competitors from locations with lower social standards. In order not to lose competitiveness welfare states would face a downward spiral in social provision – a "race-to-the-bottom" – leading eventually to rudimentary welfare states with minimal social provision. (Leander and Guzzini 1997; Martin and Rose 1999; Pierson 1998; Rhodes 1997; Ross 2000; Tsoukalis and Rhodes 1997). As such, these commentators inauspiciously predicted that EMU would either

¹⁰ These accounts view EMU as "a neoliberal construction" (Wylie 2002) a "default neoliberalism" (Hay 2000), "a costly neoliberalism" (Grahl and Teague 1989), 'subversive liberalism' (Rhodes 1998), or even a "disciplinary neoliberalism" (Gill 1995, 1997, 1998).

itself “spell the death-knell” of Europe’s welfare states (Martin and Ross 1999: 171) or would ultimately become “the altar upon which the European social model is ultimately sacrificed” (Hay 2000: 521).

In parallel, *Euro-philes*, too, view EMU in general and the fiscal convergence criteria in particular as breeding a host of inexorable structural constraints on European welfare systems. Mainly emanating from the writings of experts working with international organizations such as the Organisation for Economic Cooperation and Development (OECD) and the International Monetary Fund (IMF) (see, for example, Bovenberg and de Jong 1997; Dohse and Krieger-Boden 2000; Kopits 1997; Mussa 1997; Soltwedel, Visco 1999), these scenarios link fiscal rectitude imposed by monetary integration and welfare state “rightsizing” through a policy imperative: fiscal (and monetary) discipline required for EMU would prove ineffective in addressing economic policy goals in the absence of welfare reform (OECD 1999, 2000).

Therefore, the conventional wisdom shared by both supporters and critics of EMU expected that it would result in downsized welfare states with lower levels of social protection. Two elements of this body of literature are particularly noteworthy. First although there was no provision in the convergence criteria that compels budget cuts to be concentrated on welfare state expenditures, given the centrality of social spending within the public budgets in European countries, these commentators assume that subsequent cuts in budgets would lead to disproportionate cutbacks on social expenditures resulting in leaner welfare states. Second, it is widely argued that policymakers would *use* EMU in justifying their efforts at putting their domestic financial houses in order by curtailing the welfare state: external discipline imposed by monetary integration on public balances would have provided policy makers with a powerful argument for a *vincolo esterno* (external link) in implementing policies otherwise unpalatable such as welfare reforms (Dyson and Featherstone 1996 and 1999).¹¹

The Austerity Hypothesis: EMU, Convergence Criteria and Retrenchment

According to the conventional wisdom the most direct and significant mechanism through which monetary integration is expected to pressure welfare states is the stringent fiscal rules governing the transition period imposed by the

¹¹ See, for example, Delsen et al. 2000; Dyson 2002; Leibfried and Pierson 2000; Pierson 2001; Ross 2000; Verdun 2002 for parallel arguments.

Maastricht Treaty which are extended to the final stage of EMU through the Stability and Growth Pact. What unites Euro-skeptics and Euro-philes alike in this respect is the very hypothesis that EMU will downsize/rightsize Europe's welfare states through imposing macroeconomic *austerity* by means of its fiscal restraints. As such, the *austerity hypothesis* underlying the foregoing literature implies that the extent to which welfare states change depends on the level of the *need* to reduce deficits and public debt. Therefore, the *farther* a state is (in terms of its public balances) from meeting the criteria by the time the criteria was announced, the larger fiscal cutbacks it will have to realize for EMU membership. Moreover, the larger the fiscal cutbacks required, the larger the effects expected on the welfare state. As a corollary, if there would be *any* welfare retrenchment in Europe, it would have to occur in those countries that would have to face the *largest* budget/debt cutbacks throughout the convergence process to meet the Maastricht criteria. Thus countries which would have to undergo radical fiscal surgery would constitute ideal test cases – in other words, “crucial cases” *a la* Eckstein (1975) – where, under the austerity hypothesis, conventional wisdom would expect welfare state downsizing.

FROM FISCAL CONSOLIDATION TO DISMANTLING THE WELFARE STATE?

This section briefly reviews the fiscal consolidation process as induced by the Maastricht Treaty. It provides an overview of welfare state trajectories of those EMU-candidates that were expected to face dramatic fiscal challenges. In order to do so it relies on an analysis of social protection expenditures and a review of existing comparative research on relevant cases.

Since the criteria for accession to EMU had been officially announced in December 1991 affecting fiscal and social policy decisions as of 1992, the analysis below will mainly focus on the extended transition period 1992-1998 with a brief discussion of the third and final stage.¹² Moreover, in addition to the announcement of the criteria, this period saw the strengthening of macroeconomic policy coordination especially in the budgetary field. In order to monitor policies

¹² While the convergence criteria were to enter into effect as of January 1994 according to the Treaty, they had already been decided and made public in the Monetary Committee earlier (Bini-Smaghi et al. 1994, Italianer 1993; Verdun 2001: 92-93 and 2000: 215 fn. 14). Therefore European governments (as the authors of the criteria together with the

within the context of the multilateral surveillance procedure national convergence programs were to be presented to the Commission detailing the policies being followed in order to achieve convergence for participating in EMU.

Table 1: EMU Convergence Criteria: public finance during the extended transition period (Deficit (-) or surplus of general government as % of GDP)

| | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 |
|-----|-------|-------|-------|-------|------|------|------|
| B | -7.1 | -7.1 | -4.9 | -3.8 | -3.1 | -1.6 | 1.9 |
| DK | -2.2 | -2.8 | -2.4 | -2.4 | -0.9 | 0.4 | 1.0 |
| D | -2.6 | -3.2 | -2.4 | -3.3 | -3.4 | -2.7 | -2.0 |
| EL | -12.3 | -13.8 | -10.0 | -10.3 | -7.5 | -4.0 | -2.5 |
| E | -4.1 | -7.0 | -6.3 | -7.1 | -4.5 | -2.5 | -1.7 |
| F | -3.8 | -5.8 | -5.8 | -4.9 | -4.1 | -3.0 | -2.9 |
| IRL | -2.5 | -2.4 | -1.7 | -2.1 | -0.2 | 1.0 | 2.4 |
| I | -9.7 | -9.6 | -9.2 | -7.7 | -6.6 | -2.7 | -2.7 |
| L | 0.8 | 1.7 | 2.8 | 1.8 | 2.8 | 3.8 | 2.5 |
| NL | -3.9 | -3.2 | -3.8 | -4.1 | -1.8 | -1.0 | -0.7 |
| A | -1.9 | -4.2 | -5.0 | -5.1 | -3.7 | -1.8 | -2.2 |
| P | -3.6 | -6.1 | -6.0 | -5.7 | -3.3 | -2.5 | -2.2 |
| FIN | -5.9 | -8.0 | -6.4 | -4.6 | -3.1 | -1.2 | 0.9 |
| S | -7.7 | -12.2 | -10.3 | -6.9 | -3.5 | -0.7 | 1.9 |
| UK | -6.3 | -7.9 | -6.8 | -5.7 | -4.4 | -1.9 | 0.5 |

Source: Eurostat Yearbook (2000)

The general framework for assessing fiscal convergence was delineated with the criteria for government budgetary discipline in the Maastricht Treaty: *i)* the (actual or planned) budget deficit of each country must be no more than three percent of Gross Domestic Product (GDP), unless the ratio has been declining and is close to the reference value, or any excess is exceptional and temporary, and *ii)* gross general government debt must not exceed sixty percent of GDP, unless the ratio is declining towards this reference value at a satisfactory rate. Compliance with the fiscal criteria was instrumental not on a once-and-for-all basis only for the final assessment of eligibility in 1998 but also it was regularly monitored through the Excessive Deficit Procedure (EDP) throughout the convergence

Commission) were fully aware of the terms and conditions of the criteria during the fiscal year of 1992.

process.¹³ Thus European governments were required to remain committed to the fiscal rules incessantly throughout the 1990s.

Run-Up to EMU: Slashing Budget Deficits and Retrenching Public Debt

One would expect European governments to have engaged in fiscal consolidation efforts in the aftermath of the announcement of the convergence criteria in late 1991. Deficit figures for the initial years reveal that a striking majority of the members were far from the specified upper limits (see Table 1). At the onset of the official transition stage in 1994 when candidates would officially enter the Commission's surveillance for convergence, only Ireland and Luxembourg were able to satisfy the criterion for budget deficits with others exceeding the deficit ceiling with varying levels. In terms of the austerity hypothesis, those cases that were farthest from the criteria in the early 1990s thereby requiring largest cutbacks throughout the transition process were primarily Greece, Italy, and Belgium. Accordingly, if there would be any EMU-induced pressures for meeting the deficit criterion they would have to be visible most extensively on these cases. Therefore, the scale and urgency of the need to slash budget deficits in these cases qualify them as primary candidates to undergo welfare state downsizing.

As for debt-to-GDP ratios, Table 2 shows that for the period between the announcement of the criteria and mid 1990s debt levels in virtually every EU member displayed a rising trend except for Ireland and Germany. At the onset of the extended transition stage in 1992, only half of the EU members were able to satisfy the government debt requirement. Most relevant cases for analyzing the impact of the debt criterion, again, would be those which were farthest from the requirement hence calling for largest debt retrenchment among the candidates. Belgium, Italy and Greece, again, exceptionally stand out as countries whose total stock of government debt in a given year exceeded even their yearly national income throughout the transition period. Therefore, under the austerity hypothesis, these countries would constitute critical cases for examining the impact of EMU-induced pressures on welfare states resulting from the need to comply with the debt ratio criterion.

¹³ The EDP was designed to operationalize the binding Treaty principle that excessive deficits should be avoided. The procedure identifies whether there is an excessive deficit, and defines the mechanism through which pressures are imposed on the member state concerned.

Table 2: EMU convergence criteria: public finance during the extended transition period (Gross debt of general government as % of GDP)

| | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 |
|-----|-------|-------|-------|-------|-------|-------|-------|
| B | 129.2 | 135.1 | 133.3 | 132 | 128.8 | 123.4 | 118.2 |
| DK | 68.6 | 80.7 | 76.5 | 72.1 | 67.7 | 63.9 | 58.0 |
| D | 44.1 | 48.0 | 50.2 | 58.3 | 60.8 | 61.5 | 61.1 |
| EL | 89 | 111.6 | 109.3 | 110.1 | 112.3 | 109.5 | 106.3 |
| E | 48.1 | 60.1 | 62.6 | 64.2 | 68.5 | 67.1 | 65.1 |
| F | 39.7 | 45.3 | 48.5 | 52.8 | 55.7 | 58.1 | 58.8 |
| IRL | 92.3 | 96.3 | 88.2 | 78.4 | 68.6 | 59.9 | 49.5 |
| I | 108.7 | 119.1 | 124.9 | 125.3 | 124.6 | 122.4 | 118.7 |
| L | 5.1 | 6.1 | 5.7 | 5.8 | 6.3 | 6.4 | 6.9 |
| NL | 80.0 | 81.2 | 77.9 | 77.9 | 76.1 | 70.8 | 67.5 |
| A | 58.0 | 62.7 | 65.4 | 69.4 | 69.8 | 64.1 | 63.0 |
| P | 63.0 | 63.1 | 63.8 | 65.9 | 64.9 | 61.7 | 57.8 |
| FIN | 41.5 | 58.0 | 59.6 | 58.1 | 57.6 | 55.0 | 49.7 |
| S | 66.8 | 75.8 | 79.0 | 77.6 | 76.7 | 76.1 | 74.2 |
| UK | 41.8 | 48.5 | 50.3 | 52.5 | 53.1 | 51.5 | 48.7 |

Source: Eurostat Yearbook (2000)

The “Maastricht Effect”: The Role of EMU in Fiscal Consolidation in Europe

Although some authors have argued that constraints on public finances would still exist in a world without EMU (see, for example, Pierson 2001: 92) many empirical studies document that there was an explicit “Maastricht effect” on fiscal behaviors of EMU-candidates during the transition phase.¹⁴ These authors claim that the process of fiscal consolidation in the 1990s in Europe owes its thrust to the member states’ convergence efforts for EMU eligibility. This holds true even

¹⁴ Chasing after the “Maastricht effect” and especially demonstrating it empirically during the period in the run-up to the third stage of EMU seems to have evolved into ‘growth industry’ among economists and political economists. For a sample of this research, see Briotti (2004); Busemeyer (2004), Buti and Giudice (2003), ECB (2004); Freitag and Sciarini (2001), Hughes-Hallett, Lewis and von Hagen (2004), Rotte (1998), Rotte (2004), Rotte and Zimmerman (1998), von Hagen, Hughes Hallet and Strauch (2001). While the effect was more observable in the second half of the 1990s and it was expected that the Stability and Growth Pact would further strengthen it, this research suggests that it seems to have lost its steam once the third stage began.

more so especially in those member states whereby fiscal imbalances were the largest. In their econometric analysis on the probabilities of initiating fiscal consolidation, von Hagen, Hughes Hallet and Strauch (2001), for example, found that fiscal consolidation that began after the early 1990s in the Eurozone are not predicted by a model of budgetary behavior estimated over past data. This finding led them to conclude that it was in effect the Maastricht process with its attendant rule-based framework that created an independent political pressure on the governments to undertake fiscal consolidation. Moreover, this pressure was most effective mainly in the first half of the 1990s – the high time of the convergence process. Similarly, in his case studies of budgetary policy making of different European governments Hallerberg (2004: 8) concludes that “there is a Maastricht effect”, albeit uneven, among different EMU members. In particular, Hallerberg observes that Belgium, Italy and Greece were among the prime cases whereby pressures to comply with the Maastricht criteria explain in large part subsequent changes in the fiscal behaviors during the 1990s.¹⁵ Therefore this empirical literature shows that the Maastricht process brought about a structural break in the fiscal policy and performance of prospective Eurozone members especially in those with a history of “fiscal profligacy”.

The budget deficit and public debt figures for the early 1990s show that Greece, Italy and Belgium were the cases that remained the *farthest* from meeting the EMU criteria on public balances - the criteria that *de facto* determined whether an EMU-candidate would enter into the final stage.¹⁶ Accordingly, the austerity hypothesis expects to find the most pressing fiscal constraints to center on these cases. Moreover studies cited above on the Maastricht effect assign an independent causal impact to EMU underlying the fiscal consolidation process in Europe in the 1990s. The urgency of the need to realize the EMU objective in these cases, therefore, would translate into downsized welfare states hence reduced levels of social protection.

¹⁵ See also Sbragia (2001), Croci and Picci (2002), and Chiorazzo and Spaventa, for example, for the role of EMU in facilitating fiscal retrenchment in Italy.

¹⁶ The other criteria remained in the background for the assessment for eligibility in 1998. For interest rates and price stability, Maastricht did not really “bite” as conversion to monetary discipline already had taken place in the 1980s throughout the Community. The requirement of membership in the EMS for at least two years was effectively dropped in large part after the currency upheavals of the early 1990s. The only set of real hoops member states had to jump through, therefore, remained the fiscal criteria.

From Fiscal Surgery to the Altar? An Analysis of Social Protection Expenditures

This section will focus on the effects of EMU-induced fiscal consolidation on welfare state trajectories through data on social protection expenditures reported by EUROSTAT.¹⁷ In our discussion social expenditures will be taken as a proxy of “welfare effort” – the percentage of national income (GDP) a nation devotes to social expenditure. From the pioneering works in welfare state research in the 1950s and 1960s to the state-of-the-art studies, welfare effort has been repeatedly used since the 1960s to the extent that it has now become the “gold standard” of this body of literature (Amenta 2003: 118).¹⁸

For our purposes the operationalization of welfare state change by social protection expenditures is obvious. As we attempt to link fiscal policies with welfare state trajectories social expenditures constitute a valid measure of welfare state generosity (Green-Pedersen, 2004: 6). Since welfare states – as an immense cost item in public budgets– are largely financed publicly especially in tax-financed social insurance countries, social spending can successfully gauge the extent of cuts in entitlements and therefore can reflect retrenchment strategies. At the same time, this measure remains certainly the most appropriate indicator of welfare state change in our study as the conventional wisdom on the social consequences of EMU flatly predict across-the-board cutbacks in social expenditures.¹⁹

An overview of social protection expenditures across the EU for the extended convergence period (Table 3) shows that with the exception of a few cases (i.e. Ireland, the Netherlands and Finland), trajectories of European welfare states are

¹⁷ Social protection, as reported by EUROSTAT’s *European System of Integrated Social Protection Statistics* (ESSPROS) encompasses “all action by public or private bodies to relieve households and individuals of the burden of a defined set of risks or needs associated with old age, sickness, childbearing and family, disability, unemployment, etc.”

¹⁸ See, for example, Wilensky and Lebeaux, 1958; Cutright, 1965; Jackman, 1972; Wilensky, 1975; Cameron, 1978; Korpi, 1983 and 1989; Heidenheimer, Hecllo and Adams, 1990; Hicks and Swank, 1992; van Kersbergen, 1995; Garrett 1998; Stephens, Huber and Ray 1999; Huber and Stephens 2001; Swank 2002; Castles, 2001, 2002, 2004.

¹⁹ Since EMU is argued to impose stringency on public finances under the austerity hypothesis, curtailing the level of total social expenditures as part and parcel of a ‘cost-containment strategy’ should constitute *an immediate aim in itself* for policymakers for fiscal consolidation required for EMU.

characterized by continued stability.²⁰ Although the rate at which social expenditures grew decelerated in the 1990s when compared with their growth rates during the golden age of welfare capitalism and soon after, the current picture is certainly not one of downsizing. This holds true, even more so, in those countries facing immediate EMU-induced fiscal pressures. In Greece there seems to be an ever-rising trend in expenditures despite the hypothesized negative effects of dramatic fiscal consolidation in terms of both the deficit and debt ratios. While the welfare state was consuming just a bit more than a fifth of Greece's national income during the early 1990s, this ratio has exceeded a quarter of GDP towards the end of the decade showing signs of further expansion. Although Belgium faced the urgent need to control her mounting budget deficits coupled with intense pressures from an exceptionally high debt ratio, social expenditures continued to rise until 1994 returning to a level that is slightly higher than its base level in 1991 thereafter. Despite strenuous efforts at fiscal consolidation through slashing deficits and addressing exceptionally high debt ratios under the Maastricht ordeal, Italian social expenditures, too, seem to have remained rather stable. During the convergence period Italian social protection levels saw a slight upward trend which was followed by a mild decline. At the end of the 1990s, however, Italy continues to devote more than a quarter of her national income to her welfare state. Most interestingly, while there was a striking decline in the deficit in 1997 (from 6.6% in 1996 to 2.7% in 1997) social expenditures for the period registered an increase, however modest.

Trends in real social spending levels and benefit replacement ratios confirm these results. Spending trajectories measured at constant prices for the convergence period show a marked increase across the EU even in the most heavily indebted states. Likewise, the rate at which incomes are replaced in case of inactivity show a high degree of stability confirming the above observations (see also, Rhodes 2002: 44). Furthermore, once the third stage of EMU began on 1 January 1999 and in spite of heightened apprehensions over the impact of the Stability and Growth Pact, social protection expenditures in these cases continued

²⁰ It would be analytically and empirically difficult to attribute the changes in social expenditures in Ireland, the Netherlands and Finland to EMU. Although these candidates had public imbalances to varying degrees during the early 1990s these were never too severe so as to necessitate immediate budgetary action for EMU membership and they were not exposed to comparable EMU-related fiscal pressures. Accordingly, efforts at cutting back social expenditures could not have been part of an EMU-induced cost containment strategy. Whatever changes took place in these cases, they are the result much less of externally imposed fiscal constraint than of internal fiscal restructuring.

to display patterns that are no different than those in the extended transition period.

The welfare state panorama delineated here, therefore, does not point to a clear association between fiscal convergence and levels of social protection in these cases in the run-up to EMU.²¹ It is interesting to note that the end-of-period figures remain always higher than their base levels in early 1990s when countries increasingly came under EMU pressures. Where and when welfare state spending did decline, they did not systematically reflect the dramatic pattern of fiscal consolidation: where social expenditure levels displayed a decline, these reductions in spending have *always* remained at a substantially lower rate than those in deficits throughout the convergence process and also after the introduction of the euro.

**Table 3: Social Protection Expenditure as a % of GDP
(Extended Transition Period and Stage III)**

| | Extended Transition Period of EMU (Stage I– II) | | | | | | | Stage III | | | |
|-----|---|------|------|------|------|------|------|-----------|-------------------|-------------------|-------------------|
| | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
| B | 27.0 | 27.3 | 29.5 | 29.0 | 28.2 | 28.8 | 28.1 | 27.5 | 27.3 | 26.8* | 27.5* |
| DK | 29.7 | 30.3 | 31.9 | 32.9 | 32.2 | 31.4 | 30.5 | 30.0 | 30.0 | 29.2 | 29.5 |
| D | 26.2 | 27.6 | 28.4 | 28.4 | 28.9 | 30.0 | 29.5 | 29.3 | 29.6 | 29.6 | 29.8 ^P |
| EL | 21.9 | 21.5 | 22.3 | 22.3 | 22.6 | 23.1 | 23.6 | 24.5 | 25.5 | 26.3 | 27.2 |
| E | 21.8 | 23.0 | 24.7 | 23.5 | 22.7 | 22.5 | 22.0 | 21.6 | 20.2 ^P | 20.2 ^P | 20.1 ^P |
| F | 28.4 | 29.3 | 30.9 | 30.4 | 30.7 | 31.0 | 30.8 | 30.5 | 30.2 | 29.8 | 30.0 ^P |
| IRL | 19.8 | 20.5 | 20.5 | 20.3 | 19.6 | 18.5 | 17.2 | 16.1 | 14.7 | 14.2 | 14.6 ^P |
| I | 24.8 | 26.0 | 26.2 | 26.0 | 24.6 | 25.2 | 25.7 | 25.2 | 25.2 | 25.2 | 25.6 ^P |
| L | 23.5 | 23.7 | 24.5 | 24.1 | 24.9 | 25.2 | 24.8 | 24.1 | 21.7 | 20.3 | 21.2 ^P |
| NL | 32.5 | 33.0 | 33.5 | 32.4 | 30.9 | 30.1 | 29.4 | 28.5 | 28.0 | 27.4 | 27.6 ^P |
| A | 27.0 | 27.6 | 28.9 | 29.8 | 29.7 | 29.6 | 28.8 | 28.4 | 28.9 | 28.4 | 28.4 |
| P | 17.0 | 18.9 | 21.3 | 21.4 | 21.3 | 22.0 | 22.5 | 23.4 | 22.6 | 23.0 | 23.9 ^P |
| FIN | 29.8 | 33.6 | 34.6 | 33.8 | 31.8 | 31.6 | 29.3 | 27.2 | 26.8 | 25.5 | 25.8 |
| S | 34.3 | 37.1 | 38.6 | 37.2 | 35.2 | 34.5 | 33.6 | 33.3 | 31.8 | 30.7 | 31.3 ^P |
| UK | 25.5 | 28.0 | 29.1 | 28.4 | 27.9 | 28.0 | 27.3 | 26.8 | 26.4 | 27.1 | 27.2 ^P |

Source: *European Social Statistics – Social Protection* (2001) for the period 1991-1998, and (2004) for the period 1999-2001.

Abbreviations “^P” and “*” stand for “provisional” and “estimated”, respectively.

²¹ Greece was an exception where fiscal consolidation was associated with a continuous rise in social protection both in the extended transition phase and in the final stage of EMU.

Researchers using social expenditures as a proxy for welfare effort point to several problems in their use. First, rising numbers of the unemployed and the aged (as beneficiaries) would push up welfare need which in turn would inflate spending levels even if there is no change in the levels of entitlements in real terms. Second, social expenditures (as counter-cyclical stabilizers) are sensitive to cyclical changes in economic activity as cycles in the economy affect the denominator (GDP) they are measured against. Third, it is argued that these gross figures mask differences in the tax treatment of transfers. Finally, since social expenditures are reported at the aggregate level, they might conceal programmatic changes in different policy areas.

While addressing all these problems in detail would fall beyond the confines of this paper, some observations are in order. First, as for welfare need, rising levels of compensatory spending in response to demographic and labor market changes might have contributed only modestly to aggregate social expenditures which were stable or rising during the 1990s. For unemployment benefits, unemployment levels across Europe were already very high to begin with during the early 1990s. This was true for especially Belgium and Italy and to a lesser extent for Greece. Although unemployment levels increased in the first half of the 1990s, they have declined to their initial (early 1990s) levels at the end of the decade. Thus while at the root of the initial expansion of social expenditures might lie pushing up unemployment benefits, the stability of or increases in social expenditures in the second half of the 1990s cannot be attributable to these trends where welfare need (unemployment benefits) would only have decreased. For old age benefits, while the share of pension benefits in *total benefits* have slightly risen in response to the gradually ageing population across Europe (and markedly in Belgium, Italy and Greece)²², these processes have added up to marginal increases in the shares of pension expenditures as percent of *GDP* thereby having a minor effect in pushing up total social expenditures. Therefore while shares of unemployment and old age benefits were rising within total benefits as welfare states have responded to rising needs by rechanneling resources to these sectors which might hint at a benefit restructuring, their impact on aggregate social spending remains modest. Thus aggregate social expenditures reported in Table 3 have risen or remained stable to a large extent independent of increases in welfare need due to changes in demographic trends and labor markets.

²² In Greece, the increase in pension expenditures in large part reflects the newly introduced benefits in 1997-1998. Therefore, rising spending is not merely a result of expanding welfare need.

Second, while decelerating economic activity would, *ceteris paribus*, make welfare effort appear increasing as might have been the case in the early 1990s, the second half of the decade saw strengthening of economic activity throughout Europe. Thus although part of the rise in social expenditures could be attributed to declining denominator of the indicator (GDP) in the early 1990s, the second half of the 1990s (which saw increasing GDP levels making welfare effort appear lower than it actually is) recorded either stable or increasing levels of the indicator in the three cases against a rising denominator. These patterns could only be interpreted as real increases in welfare effort as the rate of growth of spending has exceeded or has at least kept pace with rising GDP. Moreover, since we compare changes in deficit and debt levels with those in social expenditures (which are all measured against the same denominator – GDP), our comparison would implicitly take into account the impact of changes in the denominator.

Third, it might be the case that gross social expenditures may mask differences in the tax treatment of benefits: governments may, for example, claw back spending on benefits through the tax system (through direct taxation of benefit income and indirect taxation of consumption by benefit recipients) and/or provide tax advantages for social purposes (e.g. child tax allowances). Thus *net* social expenditure levels might be lower than what gross spending indicators suggest if there would have been a change in taxation. Researchers with the OECD have devised ways to calculate spending net of the impact of tax systems. Recent studies suggest that while there remains enormous differences in the tax treatment of benefits across countries, levels of *net* social spending have remained stable in the 1990s which is consistent with our findings for gross levels (Adema 1999 and 2001).

Finally, it is argued that spending aggregates may conceal “compensatory movements” where one program may expand at the expense of the other. An overview of the benefit programs measured as a portion of total benefits during the 1990s show that while there has been some fluctuations in some programs over the years which might indicate piecemeal restructuring, these certainly did not add up to a radical overhaul of any given program in any of the cases studies. Although a mild common downward trend in employment protection is observed in Greece and Italy, the shares of unemployment benefits in total benefit structure were very low to start with constituting only one percent to three percent of total spending. The figures remain stable especially in those cases which had larger employment protection programs such as Belgium. This draws our attention to another observation that the basic programmatic structure of these welfare states, too, seems to have remained rather stable during the convergence period. Thus

social protection data points to a remarkable stability not only in terms of levels of spending but also the distribution of such spending across different program areas.

The foregoing discussion, therefore, suggests that the European welfare state panorama has fundamentally remained unchanged throughout the 1990s. It did so, however, by standing up against immense pressures emanating from EMU. Contrary to the expectations of both sides of the EMU debate, therefore, fiscal consolidation efforts undertaken during the 1990s and early 2000s have not come to translate into outright, systematic welfare state downsizing. Moreover, while there might be several concerns regarding the use of social expenditure figures, none of these criticisms, whatever their validity, undermines the finding of remarkable social spending stability in the face of not only strong pressures but also practically unanimous predictions to the contrary.

European welfare states, however, are not permanently immune to pressures. Since 1999, the European Central Bank has assumed the responsibility of designing and implementing the single monetary policy. At the same time, the Stability and Growth Pact governing the final stage has not only sustained the Maastricht criteria for the present but also made it even more stringent with its “close to balance or in surplus” requirement for budget deficits. This should not imply, however, that there was a radical change in the macroeconomic policy template from the transition stage to the final stage. The monetary regime had already undergone a process of conversion to macroeconomic discipline during the 1980s and early 1990s which was already complete at the onset of the transition phase. The additional budgetary effort required during the present stage is certainly not as high as was the case in the 1990s implying lower fiscal pressures than before. Moreover, there are strong signals that some political discretion will be used in interpreting the Pact which might afford social budgets some room for maneuver.²³ Thus although the jury is still out for the overall future impact of such policy template, it is highly unlikely that it would trigger an overall dismantling of European welfare states.

Survival of the European Welfare State in the Face of EMU Pressures: Insights from Comparative Case Studies

The lack of *significant* and *systematic* social expenditure retreat demonstrated above is broadly consistent with research that examines welfare state reform

²³ Faced with intense political pressures during 2002-2003, the Pact with the November 2003 decision of the Ecofin Council remains suspended *de facto*.

processes in cases with severe budgetary disequilibria during the early 1990s and EMU's impact on them (see Featherstone, Kazamias and Papadimitriou 2001 on Greece; Ferrera and Gualmini 2000, and Radaelli 2002 on Italy; Hemerijck, Unger and Visser 2000 on Belgium). To be sure, this case-study literature tends to emphasize the sheer variety of actors, institutional settings, historical trajectories, and policy styles in the EMU candidates. Thus politics of welfare reform involved: addressing diverse problems with varying urgency; targeting different programs within diverse welfare regimes crystallizing around dissimilar historical-structural features, organizational characteristics, and policy styles; co-opting, giving side payments as *quid pro quos* to different societal actors, or acquiescing to their demands within different institutional contexts of interest intermediation; and appeasing or capitalizing on varying levels of public support for the European unification project. In short, all this means is that "varieties of welfare capitalism" implied "varieties of reform politics". Nevertheless, on closer inspection, for all their variety there are some remarkable similarities between these cases which go a long way in explaining the results reported in this paper. All governments that came to power in the 1990s – where ever they were, or what ever political coloring they bore – intended to reform their welfare states. In domestic public debates welfare programs were commonly indicted as the main culprit for the severe financial problems that could forestall EMU entry.²⁴ Successive attempts at welfare reform were continuously justified by reference to the very constraints EMU criteria pose. In the area of fiscal policy and politics, structural pressures and discursive opportunities of EMU appear to have led governments to institute some "Copernican revolutions" in some cases. Eventually the 1990s witnessed a phenomenal convergence with respect to the level of budgetary deficits enabling EMU-candidates passing the Maastricht test eventually.

Despite all these radical changes in fiscal behavior, when governments attempted to reform welfare programs their reform capacities in this field were in large part effectively demarcated by an alliance of entrenched interests. The convergence period is marred with successive episodes of mass mobilization of unions against pension reforms which ended up being diluted at best. Opposition parties (or even partners making up ruling coalitions) reined back governments

²⁴ With its deadlines looming large, monetary integration, of course, was not the only spur to the reform processes. Several other factors have indeed come into play including specific problems of adjustment, financial sustainability, labor-market and post-industrial adaptability, susceptibility to national social conflict. Even without the Maastricht conundrum reforms in several areas (especially pensions) would have been part of the political agenda.

from pushing forward with far-reaching reform or by completely blocking cutbacks in social protection. Middle classes took to the streets in protest against reform plans to scale down (mostly) pension programs in order to meet the fiscal criteria. In some cases reform initiatives in the realm of social protection were shelved and proposals never saw the light of day. In others, governments' ambitions were scaled down and the results of these reforms turned out to be much more modest than had originally been planned.

Notwithstanding the sheer difficulty of reforming the welfare state, some of the reforms were passed which could in fact be considered as retrenchment. These were carried out, however, almost always within a consensual context resulting in negotiation of new social pacts with organized actors. More often than not, the trade-off faced by reformers in most of these cases was to either scrap the proposals or to postpone their impact to later decades falling well beyond the Maastricht time horizon.²⁵ Thus although EMU with its most impending strictures was expected to have immediately called for a major overhaul of welfare programs, almost all of these attempts stumbled on the politics of welfare reform to have resulted in only piecemeal, incremental retrenchment.

Underlying these developments was the fact that although rule-based EMU exerted immediate fiscal pressures, there was nothing in its structure that specified the strategy for correcting the existing fiscal imbalances. Evidence from processes of fiscal consolidation and welfare reform of the 1990s indicate that even in most problematic cases welfare states remained as generous as they were at the onset of the transition phase.²⁶ Such empirical landscape, therefore, rests far from confirming the expectations of the conventional wisdom – that the burden of fiscal adjustment for fitting into the Maastricht straitjacket would fall onto social welfare budgets eventually compromising Europe's welfare states. Members of the Eurozone, however, found alternative ways to deal with fiscal austerity while sustaining their social protection levels.²⁷ To the extent that deficit reductions

²⁵ For reasons of space, it is beyond the scope of the present paper to identify specific policy changes in each of these countries. For details, see the case studies referred to above.

²⁶ See also Jenson and Pochet (2002) and Rhodes (2002) who reach similar conclusions.

²⁷ Fiscal politics of the 1990s has reconfirmed the view that convergence in fiscal outcomes (level of deficits and debt) do not necessarily presuppose convergence in fiscal policies. In this context, the "Maastricht effect" had its own limits. While 1990s saw efforts at genuine consolidation, EMU-candidates have devised different strategies to deal with the fiscal pressures emanating from EMU. In addition to cutting back public expenditures, among the strategies pursued were increasing public revenues including raising taxes and one-off measures (McNamara 2003) and some accounting tricks which were facilitated by the EUROSTAT (Savage 2001: 50). A degree of

were realized through curtailing total outlays, these reductions mainly centered on *non-social* expenditures with a de-emphasis on industrial policy, reduced subsidies, declining defense expenditures, and declining spending on other items such as general public services leaving considerable leeway for welfare state-related portfolios (Castles 2004). Thus, although European welfare states underwent some re-adjustment some of which resulted in cutbacks (mainly with medium- and long term consequences), we do not observe the dismantling of European welfare states as a result of EMU expected by both Euro-skeptics and Euro-philes.

WOULD NAMU UNDERMINE THE CANADIAN WELFARE STATE? INSIGHTS FROM THE EUROPEAN EXPERIENCE

How would a future NAMU impact the Canadian welfare state, and in this regard, what could the EMU experience tell us? This section addresses these questions by putting the issue of social consequences of NAMU into comparative perspective. It is highly likely that this issue will spark a lively debate alongside other contested issues if and when the political initiative is taken for a currency union. The incipient debate at least among the ranks of academia surveyed below is a sign in this respect.

Expectations about NAMU's Social Consequences

As mentioned above, the way the debates on the question of adopting a common currency are cast in both Europe and North America are remarkably similar. Participants in the Canadian debate draw parallels with EMU as they expect NAMU to resemble its European variant with respect to its governance structure and its transition phase. Moreover, similar to the EMU debate, NAMU-skeptics and NAMU-philes alike seem to share the view that advancing monetary integration would downsize the Canadian welfare state. On the one hand, skeptics argue that NAMU, by imposing excessive macroeconomic discipline through a set of ill-conceived budgetary rules, would lead to a major overhaul of Canada's welfare programs. Proponents, on the other hand, view NAMU as a source of

flexibility employed in the performance assessment of the debt criterion, too, helped heavily indebted members states qualify. At the same time, the economic upturn in the second half of the 1990s facilitated the process.

external discipline which would provide a window of opportunity for “rightsizing” the overly-burdened, inefficient welfare system through reforms that are long-overdue.

In particular, skeptics such as Parguez, Seccareccia and Gnos (2001: 12) articulate a series of concerns: “[T]he new Federal Reserve would be granted the same power of monitoring domestic legislation by attacking employment and welfare programs that would be inconsistent with neoclassical precepts.” Furthermore, the new Fed “would have to be protected by more stringent fiscal rules than in Europe because neither Mexico nor Canada have passed through the same degree of fiscal austerity as in Europe during the twenty years prior to the official implementation of the single currency”. Echoing their EMU-skeptic counterparts they also expect that the required fiscal surpluses for consolidation “would be exacted primarily from the social program envelopes of government budgets” (ibid: 13). At the same time, evoking a North American *vincolo esterno*, Seccareccia (2001: 2) claims that NAMU would bestow upon conservative policymakers in Canada a discursive instrument to retrench the Canadian Social Model as was in the case of EMU: “the Canadian Right sees [NAMU] as one additional opportunity to curtail the power of the state and further dismantle the Canadian welfare state”. Parguez, Seccareccia and Gnos (2001: 15) thus add that “[a]ll those advocates in Canada pushing for dismantling the old Canadian welfare state ought to be the first to applaud for the adoption of the NAMU”. In this context they warn that NAMU would destroy the Canadian Social Model through providing “a frontal attack not only on the presumed fiscal “excesses” of the member states” but also on all of the alleged “disincentives to work and obstacles to productivity” that are associated with the welfare state.

What does the EMU Experience Reveal?

It will be recalled from the above discussion on Europe that both sides of the EMU debate had similar predictions for Europe’s welfare states. Since the primary mechanism through which EMU was expected to have its negative impacts was the convergence criteria these predictions were all the stronger for the “fiscally profligate” Italy, Greece and Belgium who came under immense retrenchment pressures. Contrary to the shared expectations, however, these pressures fell short of speaking for themselves in that the urgency of cost-containment in order to meet the fiscal criteria have not directly translated into reduced levels of social protection. Moreover research tracing the episodes of successive welfare reforms in cases where cost-containment pressures were the

strongest show that these attempts, while carried out in the name of EMU almost in all cases, resulted in welfare reforms that were far more modest were planned. Even if governments view welfare reforms imperative, retrenching social programs prove to be extremely difficult to calculate, program and achieve. The persistence of welfare provision within the context of what constitutes the European Social Model in the face of EMU pressures stands out as some powerful evidence for the enduring primacy of politics of reform over economics of rule-based constraints. Moreover, while some welfare states or programs might have undergone some degree of surgery for a host of factors, EMU does not seem to be directly related to these. If there is a lesson to be drawn from the European experiment, therefore, it is the observation that Europe's welfare states enjoyed a considerable degree of freedom through which a welfare overhaul was averted even in the face of pressing fiscal constraints. Although the evidence in this paper can not resolve the policy debate definitively, lessons from the European experience at least draw our attention to alternatives to deterministic scenarios of welfare state dismantling. A future NAMU designed along the lines of EMU would certainly exert pressures on the Canadian Social Model should Canadian fiscal balances require a substantial corrective. Even in the face of these constraints, however, currency unification *need not* necessarily lead to welfare state downsizing. Besides, in the NAMU case, the country with the larger welfare state – Canada – *also* happens to be the one that has tamed her deficit and debt. This implies that if there would be any currency partner to undergo radical fiscal surgery during a Maastricht-style convergence period, it simply would not be Canada. Taken altogether, to the extent that NAMU resembles EMU, this suggests that apprehensions over Canadian welfare state futures seem to be doubly unfounded.

Concluding Remarks: EMU, NAMU and Some Limitations to Comparison

There are a series of caveats to analyses attempting to draw lessons from historical experiences. As one historian and policy practitioner put, “history is not, of course, a cookbook offering pre-tested recipes. It teaches by analogy, not by maxims.” (Kissinger 1979: 54). Such cautionary remark certainly speaks to the present endeavor. Although the academic literature and the public debate often make parallelisms between EMU and NAMU, it is nevertheless a daunting task to make predictions for the North American case in light of the evidence from an

incomparably profound experience of Europe. In this regard, our conclusions are guarded for at least two reasons.

First, case studies that discuss the impact of EMU on European welfare states draw our attention to the centrality of “politics of reform” in mitigating against retrenchment pressures on welfare states. Welfare reform processes took different paths in Europe by and large reflecting their specific regime characteristics. The degree of freedom in these processes – even under stringent external constraints – was largely determined by the level of commitment to welfare state goals each society holds and the strength of the coalition of its societal actors aligned against reforms. The extent to which pressures may be modified, muted or even fully mitigated by counter-tendencies was, therefore, contingent on the very politics of reform. It depends on political choices and processes whether pressures are successfully resisted, or enthusiastically embraced and taken advantage of discursively. This implies that should the constellation of the Canadian public in general, its organized societal actors, and its government remain committed to their welfare programs as was the case in most of the EMU candidates, NAMU’s seemingly inexorable strains could be largely warded off. Should this not hold, however, NAMU can impart some significant pressures, and at the same time, may very well serve as a pretext (a North American version of *vincolo esterno* in this case) for structural change, and consequently, there might arise some significant risks with respect to the fate of the Canadian Social Model.

A second reason for a cautious conclusion concerns the qualitative differences between the currency unions in Europe and North America in terms of their origin and evolution. EMU, above all, was seen as a powerful means to a political end rendering it historically unique (Cohen 2003; Eichengreen 2002; Laidler 2002). In this respect, should it come to pass, NAMU as an economic project is no match to the political EMU project as Canadians (leave aside their American neighbors) do not fancy any kind of social or political integration with the US (McCallum 1999). Especially from the end of the 1990s which corresponds to the launching of EMU’s final stage, the social and political context within which EMU and Europe’s welfare states are embedded has started to evolve in a direction many had not foreseen only a few years ago. As the boundaries of EMU-*cum*-economic governance with other policy sectors have become “more permeable” (Dyson 2002: 22), efforts at further integration have come to involve the incorporation of means addressing social protection alongside efforts at integration exclusively in the economic realm (de la Porte and Pochet 2002). Although these mechanisms are still relatively loosely anchored within the European institutions and their standing in the Treaty structure remains rather weak, they attest to common political vision of social protection in the EU (European Commission 1999) with

a view to embedding EMU increasingly in social integration.²⁸ Such openings in the field of social protection show a stronger commitment to social protection and signal some guarantees afforded at the supranational level which NAMU would certainly lack. This implies that the future of EMU will serve increasingly less as a reliable basis of comparison for NAMU as the North American project is likely to remain exclusively as an economic project with no political and social spill-overs. As monetary unions in these two regions would be embedded in very different contexts, only insights we draw from the transition period and early years of EMU (covering the decade between early 1990s up until the present) seem to be the appropriate time frame for a comparison with NAMU. That is what we aimed at in this paper. The European experience with the most impending constraints during this period shows that even in the face of these pressures European political economies were still able to command a significant degree of freedom with respect to their welfare state decisions. Thus the conventional scenario of dismantling the European welfare state is largely averted. This paper attempted to drive home the lesson from this very experience. To the extent that politics of welfare reform in Canada parallels those in the EMU-candidates during the transition period, and to the extent that NAMU's governance structure follows that of EMU's in its transition and early years there seems no substantive ground for Canadian apprehensions over the futures of their social model should the NAMU decision is taken.

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²⁸ This common vision reflected in the Commission's earlier White Paper on *European Social Policy* (1994) holds that while Europe's welfare programs are to be 'restructured' for long-term 'sustainability' of the programs, social protection levels should be 'maintained'. These efforts have amounted to the institutionalization of what is now called in Euro-speak the 'open method of coordination'. The aims of this method include establishing social protection benchmarks, fixing guidelines for social policy and translating them into national and regional policies by setting targets and measures, using periodic monitoring, assessment, and other strategies of 'naming and shaming' (de la Porte and Pochet 2002).

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