IS IT TIME FOR A COMMON NAFTA CURRENCY?

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ABSTRACT

Should the NAFTA (North American Free Trade Agreement) nations adopt a common currency? Using the European Monetary Union (EMU) as a model, this paper seeks to address the feasibility of implementing a common currency in North America. A general evaluation of obstacles and rewards will be made, followed by an assessment of the need for a common currency. An assessment of the three NAFTA countries and the global advantages accruing to each will be discussed.

INTRODUCTION

A common currency is a form of money used universally by a group of political bodies (countries). It is designed to replace existing currency and is intended as a tool to level the economic playing field. The European Community has moved through the many stages of implementation of its common currency after years of negotiation and planning and controversy. The issues have revolved around the realizable advantages and more recently, methods of implementation. Since so much monetary autonomy is transferred from the individual countries to the community, there must be a consensus for economic policy. As a result, a fairly formidable political power has come into existence (Volcker, 1997). This paper seeks to explore the advantages and disadvantages of a common currency for the three countries that comprise the NAFTA. Studies have been done by Bayoumi (1997), Eichengreen (1994) and Masson (1997) regarding the comparable strengths of various economies needed to share a common currency. The concept of a common currency is not new. In 1961, Robert Mundell's theory of optimum currency areas suggests that a common currency is possible in the right regional environment with the right economic conditions. More recently, Eichengreen goes further; he suggests that not only is it possible but it may be inevitable (Eichengreen, 1997).

The decision to issue and use a common currency presents a multifaceted dilemma for any group of countries. The common currency affects not just economic issues but also social concerns and political events and decisions. The dilemma is particularly complicated for the NAFTA nations, (Mexico, the United States, and Canada) because there is a dramatic difference among their social, economic and political levels.

THE MODEL

Before contemplation of a common currency, the countries should be evaluated using Mundell's 'optimal currency area' as outlined in the *American Economic Review* (Mundell, 1961). The theory of optimum currency area examines the advantages and disadvantages of different regions adopting the same currency. Mundell notes that adopting a uniform currency has both advantages and costs, with the advantages stemming from the lower costs of changing money, and its greater value as a medium of exchange. He essentially simplifies common currency into two qualities, operating internally and externally. Externally, it is a regulator of exchange rates. Internally, it is a regulator of interest rates. Prior to addressing the technical details of issuance, implementation and function, a nation must carefully examine the short - and long-term rewards and benefits for its citizens that could result from a common currency. Most importantly, countries must recognize that a wide range of decisions currently made within one country would now be made by a group of countries. In fact, although each region considering the common currency will do so individually, an aggregate decision must be made to accept or reject.

If it is determined that a common currency is acceptable, necessary, and will benefit the countries involved, an implementation structure can be examined. These are the steps that the European Community took, leading up to the Maastricht Treaty of 1991.

As a model for common currency, the European Community can be compared to the NAFTA nations. Both enjoy working trade agreements that seek to facilitate inter-regional exchanges be they social, economic or political. One may assume that structural similarities in the individual trade agreements will behave similarly in practice. Therefore where similarities exist, one might conclude that a common currency could be utilized in the same way for both conglomerates. Where there are differences, one might expect enhanced effectiveness or ineffectiveness with a common currency.

COLLECTIVE EVALUATION

Returning to Mundell's theory of optimum currency, we examine the likely fit of the NAFTA nations with his criteria. A fit is directly related to the costs and benefits of adopting a common currency with costs being of initial concern. Areas that face similar economic disturbances will face low costs related to a common currency. Regions with dissimilar economic disturbances will face higher costs because their monetary policy responses will be different.

The combination of 12 countries into the European Monetary Union (EMU) may differ from the three NAFTA nations. For instance, France, Belgium, and Germany faced very similar economic situations making them likely candidates for Mundell's optimum currency. The common currency was seen as a means to facilitate economic assistance when economic disturbances did occur.

NAFTA does not enjoy the same economic parity. Canada and the United States have very similar strengths and would most likely encounter similar economic disturbances; this is not yet the case with their partner to the south. Mexico is financially weaker and has historically been in a position to encounter extreme economic disturbances. Therefore, the assistance required by Mexico as a part of a monetary union may create high costs for the other nations. In addition to the nature of underlying disturbances, three other broad considerations affect the costs of adopting a single currency. The efficiency of alternative mechanisms for using the exchange rate to alleviate economic disturbances is the first. The effectiveness of the exchange rate as a method of alleviating economic disturbances and finally the desired path for monetary policy can also vary regionally.

For the NAFTA nations, these questions can be restated. Based on history, it can be expected that Mexico is more likely to experience economic turbulence. What technique (beyond the fluctuation of exchange rates) do the U.S. and Canada have to assist Mexico in an economic disturbance?

It is also important to consider the regional path for monetary policy. This can cause conflict in establishment of policies for the common currency. When and if an economic disturbance occurs, what direction will be taken to rectify the situation? Are all regions contemplating similar growth or reduction plans? Will their responses be the same to each event? Again, it seems Canada and the U.S. might respond similarly but Mexico would not.

REWARDS AND LOSSES

In 1973, Einzig described a comprehensive list of pros and cons to the common currency in his book *The Eurodollar System*. These characteristics of common currency remain the same in the new millennium. In the examination of the list and its application to the NAFTA countries, one must determine the degree of balance between positive and negative. The balance must be sufficient to outweigh the risk of the disadvantages as a result of an acute crisis (economic disturbance).

The common benefits and problems can be grouped into three general categories: physical, economic and functional. The physical process benefits include the simplification of all money matters. The amount of record keeping and calculations for losses and gains resulting from exchange rates would be significantly reduced as would the need for hedging against such losses and gains. The physical process problems are related to the actual implementation plans. During the gradual phase-in, the economic situation becomes fragile. This transition period can be very rocky which may cause a loss of political support for the common currency.

The economic benefits include international payments between neighboring countries, reduction of border tariffs, and joint efforts in mutual support by governments, as well as bargaining power with non-common currency nations. Economic problems are related to the use of monetary policy (tax rates, inflation, interest rates) as a stabilizing tool for the economy. Constraints on the ability of a government to use these tools may accelerate a precarious situation.

Functional benefits are generally related to the everyday use of the common currency. Key benefits include the ability of governments to freely support each other in minor economic disturbances. The expected lack of monetary fluctuation should also result in improved overall economic strength. From a functional standpoint there are nationalistic issues tied to protectionism. Currency has been strongly related to identity. Countries do not wish to be dependent on foreign suppliers for security reasons. Therefore, the replacement of an individual currency with a common currency creates a unique identity crisis.

INDIVIDUAL EVALUATION

Beyond the general examination of strengths and weakness of a common currency, each nation should evaluate its usefulness on an individual basis. The strengths and weaknesses of each nation vary markedly and it is quite likely that the benefits for one country may cause problems for another. The cultural differences combined with economic, social and political differences, can make alliances difficult, if not impossible. (Trevino, 1998).

Some argue that economic benefits are accrued only to members of an economic union and non-members accrue high levels of economic costs as a direct result of being outside. This serves to entice members into a currency union.

MEXICO

Mexico's economic history has followed the boom-bust cycle. Expansions have led to high trade deficits, inflation, and economic crises (Rovelo, 2001). In the past 20 years, Mexico has moved toward trade liberalization, privatization, and other market-oriented reforms. However, during these past two decades, Mexico has suffered through dramatically fluctuating economic performances (Kaufman, 1998). The over-borrowing and over-lending has tainted Mexico's track record. Events such as the devaluation of the peso made foreign investors less enthusiastic and borrowing difficult. The prospect of a common currency would, it seems, be tempting for Mexico.

A survey on attitudes towards NAFTA in Mexico in 1992 reported 75% of the respondents favored NAFA. Even with Mexico's economic downturn in 1994, a majority (55%) favored this agreement (Kaufman, 1998). But, small businesses have been unable to capitalize on this agreement due to the resources needed to compete globally. Conducting international market research and locating foreign buyers can prohibitively increase the production overhead (Case, 1999). Although Mexico's economy is performing well overall, the number of people living in poverty rose more than 40% in four years, from 1994-1998 (Leiken, 1998). This contrasts sharply with the fact that Mexico is currently the leading commercial power in Latin America (Cassidy, 1999).

THE UNITED STATES

The United States enjoys a position of economic strength. If the NAFTA nations were to consider a common currency the United States would be the dominant party. The growth in the other two countries though may be helping to close the gap. In March 2000, for the first time in history, Mexico received investment-grade status from an international ratings agency. Moody's raised its rating of Mexico's sovereign debt (Waters, 2000). Mexico's economy has continued to strengthen. By October 2000, it was reported that Mexico could cover 90% of its current account deficit without assistance from international creditors (Sissell, 2000). However, since the economic disturbances at this time are still likely unequal, the costs of an economic currency would be high.

There is political support for a common NAFTA currency. USA Today reported survey results indicating that 43% of Americans favor a NAFTA currency. This finding was surprising in light of the nationalistic identity expected from the power of the U.S. dollar.

CANADA

Canada is the single largest trading partner of the U.S. and the second-largest trading partner with Mexico. NAFTA's effect on Canadian companies has been positive, though not to the extent experienced in Mexico. Canada enjoys many of the economic freedoms that exist with a common currency. In fact, Blank and Haar suggest that Canada, Mexico, and the United States' economies are becoming one; that NAFTA simply reaffirmed an ongoing trend (Blank and Harr, 1998). In 1995 Canada was on the edge of a political upheaval. The potential for this sort of disbanding would have tremendous ramifications for a common currency. That aside, Canada has a heavy outstanding debt that would be assimilated with the American debt and the Mexican debt. Although it may not be monumental in and of itself, consideration must be given to the true amount of debt the NAFTA nations could handle with a common currency.

FINAL ASSESSMENT

It's been seven years since Eichengreen (1994) questioned why NAFTA did not need a common currency to support a fully-integrated marked if the EMU did. He answered his own question by responding that the tension caused in the U.S. by the peso exchange rate swings were negligible because of the small size of the Mexican economy relative to that of the U.S. economy. As long as this relative size remained constant, the problems caused by a change in the peso-dollar rate would be small compared to fluctuations experienced in Europe (Eichengreen, 1997).

He concluded the economic integration caused by NAFTA would remain limited for some time. This would be the result of NAFTA scheduling reductions of tariffs and barriers to foreign investments to be phased in gradually over the next ten to 15 years. He also concluded that the pressure for exchange rate stabilization would grow. (Eichengreen, 1997) Volcker (1997) in his speech *An American Perspective on EMU*, explains the desire of the European Community for close economic union and the logic of wanting to maintain exchange rate stability seems compelling. With floating exchange rates, large fluctuations of 20%-30% or more can be anticipated. With such fluctuations, a common market cannot become a true single market. Therefore, if an overriding exchange rate was decided upon to avoid the fluctuation, a common currency would become imperative.

Eichengreen (1997) claims there may be evidence that within NAFTA the shift from fixed to floating currencies has increased the volatility of exchange rates. However, there may be no practical alternative but to allow the currency rate to float subject to central bank management, in the hope that the market pressures do not imply exchange rate fluctuations on an intolerable order. However beyond some point, commercial integration without monetary integration may not be politically feasible (Eichengreen, 1997).

Using optimum currency area theory, diversified economies like those of the NAFTA can afford to continue floating against one another. However, the very different economic conditions that prevail in the three countries imply that significant compromise of domestic economic objectives would be entailed in any effort to stabilize exchange rates. With new presidents in both the U.S. and Mexico, the potential for this compromise now seems more possible. During George W. Bush's visit to Mexico in February 2001, President Bush discussed energy concerns with a broad statement. "What is important is to have a common policy whereby no one takes advantage of the other." During the Canadian Prime Minister Jean Chretien's visit to Washington, D.C., Bush asserted that a good foreign policy "is a vision that goes both north and south" (Roth, p. 17A).

The static analysis of gains and losses of a common currency indicates the pros to include reducing inflation and interest rates, thereby promoting economic stability. A common currency will reduce the risk of devaluation, which will in turn boost foreign investor confidence. A third benefit is the simplification of trade by eliminating the exchange rate transaction costs.

The loss from adopting a common currency includes the political loss of control over monetary policy. The economic loss would be in the elimination of the interest income from holding currency reserves. Additionally, the common currency adoption does not address the origin of economic crises and therefore cannot solve them (*Business Week*, 2000).

SUMMARY AND CONCLUSION

It is possible for a group of countries with relatively equal potential for economic disturbances to create a monetary union using a common currency. The countries must be willing and able to sacrifice monetary autonomy in return for gains in economic stability. Without common economic, social and political frameworks, a common currency will take longer to reap benefits and will certainly lose critical political support. With a common framework, benefits may be attained at a lower cost. There is evidence to suggest that economic integration through trade can create a more equal framework and lead inevitably to a common currency.

However, Mexico's economic and political systems are immature relative to the United States and Canada even with the substantial improvements over the past decade. Since Mexico's economic size is quite small relative to the United States, the shared need for a common currency is not yet realized. Eventually, pressure for a common currency will grow as the barriers to full commercial integration of NAFTA are eliminated and the globalization of the economy expands.

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