

A Fixation with Floating
The Political Basis of Canada's
Exchange Rate Regime

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Abstract: Since the 1930s, Canadian policymakers have demonstrated an unusually strong commitment to a floating exchange rate regime. They embraced a fixed exchange rate for only two brief periods between 1939-50 and 1962-70. Even as the Canada's economic integration with the US has deepened over the past decade, this commitment has remained. This Canadian "fixation with floating" is surprising since it is often assumed that countries with very open economies will favor a fixed exchange rate regime. This article demonstrates that Canada's unusual commitment to floating has stemmed from a combination of distinct domestic private sector interests, the beliefs of state policymakers, and international influences. In addition to highlighting the usefulness of this kind of multi-level analytical approach to the study of exchange rate regime choice, the Canadian case also shows that many of the models recently developed to explain preferences at each level are not able to account for important nuances in the politics of Canadian exchange rate policymaking.

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The birth of the euro has been an important development not just for Europeans. It has also generated new interest in the idea of regional monetary unions in other parts of the world. Canada has been no exception to this trend. In 1999, an active and high level debate broke out in the country about the need for a North American monetary union (NAMU). Its supporters argued that the idea of NAMU made sense for a country with an economy so closely tied to that of the US; over 40% of Canada's GNP now consist of exports, and over 80% of these exports go to the US. NAMU was portrayed as an obvious next step in the process of North American economic integration that began with the introduction of the Canada-US Free Trade Agreement in 1989.

Although the debate attracted considerable public attention for a brief time, Canadian policymakers rejected the idea of NAMU and reiterated their commitment to the country's existing floating exchange rate regime. This decision was in keeping with a long tradition of Canadian exchange rate policymaking. Since the 1930s, Canadian policymakers have demonstrated an unusually strong commitment to a floating exchange rate regime.¹ Canada's exchange rate was fixed to the US dollar for only two brief periods: 1939-50 and 1962-70. During all of the rest of the time, the Canadian currency floated vis-à-vis the US currency (and all other currencies). Indeed, so strong was this preference for floating that Canada was the only major industrial country to demand and receive special exemption from the rules of the Bretton Woods system to pursue a float in the period 1950-62. 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

¹ Canada also adopted a floating rate between 1914-26. Because Canadian policymakers hoped to return to the gold standard throughout this period, that era is not discussed in this article.

(ultimately temporary) fixed rates agreed to in 1971. During the 1930s, the Canadian dollar was also one of the only currencies in the world to float almost completely freely.²

This Canadian “fixation with floating” is unusual not only in comparison to other industrial countries. It is even more surprising given the high degree of openness of the Canadian economy. It is commonly assumed that countries with very open economies will favour a stable exchange rate. Kate McNamara sums up this conventional wisdom well: “In general...the more open the economy in trade terms, the more governments prefer to fix their exchange rates because of concerns about the effect of exchange rate variability on trade and investment activity. Larger, more closed economies such as the United States and Japan have been less willing to fix their exchange rates than the smaller, more open countries of Europe”.³ The Canadian case is a clear anomaly in this respect. The country has long been one of the most open economies in the industrial world. Not only is its dependence on external trade unusually high, but the country has also long been a major recipient and source of foreign investment. Despite these features of the Canadian economy, the country’s policymakers have continued to demonstrate an unusually strong commitment to a floating rate regime.

What is the political foundation of this odd Canadian exchange rate preference? The Canadian case has received almost no attention within the growing literature on the politics of exchange rate regime choice.⁴ This neglect is unfortunate because, as I show in this article, the case highlights both some strengths and limitations of this literature. In the article, I explain the basis of Canada’s longstanding preference for a floating exchange rate regime through a study

² Plumptre 1941, 185.

³ McNamara 1998, 14.

⁴ It has also not received much attention from scholarship on Canadian foreign economic policymaking, which has been focused much more on trade and investment policy. The best existing works on the politics of Canadian exchange rate policymaking are Webb 1992 and Plumptre 1977. These two works do not attempt to address the broader analytical question of the political basis of Canada’s preference for a floating exchange rate.

of the politics surrounding moments when Canada's exchange rate regime changed - 1931, 1950, 1962, 1970 – as well as those associated with the recent NAMU debate. The usefulness of three sets of broader analytical claims about the political bases of exchange rate regimes is evaluated in the context of this history.

I draw first on the insights of Jeffrey Freiden's work which represents the most sophisticated analysis to link economic openness to a preference for stable exchange rates by examining the preferences of domestic business actors. He outlines an important caveat to his model that I argue helps to explain the anomalous nature of the Canadian case. At the same time, I show that even more qualifications are necessary to explain the exchange rate regime preferences of Canadian business. The second section highlights how a focus on business preferences does not provide a complete explanation of Canadian exchange rate regime choices. Also important are the preferences of state policymakers who have often had considerable autonomy from domestic interest groups to make policy in this area. I examine a number of analytical models that have been developed to explain state policymaker preferences towards exchange rate regimes, and conclude that the ideational basis of these preferences is more important in explaining the Canadian case than "partisan" concerns or the "survival maximization" strategies of politicians. The final section highlights that a third level of analysis - the international context facing Canadian policymakers - has also been significant in explaining Canada's exchange rate regime preference. Both heightened capital mobility and Canada's relationship with the US have played an important role in accounting for Canada's fixation with floating, although in ways that might surprise observers of European exchange rate politics. The conclusion sums up the political sources of Canada's exchange rate regime preferences and highlights the broader theoretical significance of this case.

Domestic Business Interests and Exchange Rate Regimes

Within the last decade, political economists have begun to focus considerable attention on the politics of exchange rate policymaking.⁵ Although scholars working in this field share the same substantive interest, they have developed quite different ways to analyze the topic. One difference is methodological; some of the literature employs a deductive and rationalist framework of analysis, while other writings – including this article – adopt a more historical approach. Another difference concerns the level of analysis chosen to explain exchange rate policymaking. Some analysts focus on the role of domestic interests; others concentrate on the preferences of state policymakers; still others examine the influence of the international context. As I will show in this article, all three of these levels of analysis are useful in explaining Canadian exchange rate regime choices.

Let us begin by examining the insights of the literature that focus on the importance of domestic economic interests. The most prominent analysis of this kind has been developed by Jeff Frieden.⁶ Frieden's work is particularly important for our purposes because it represents the most sophisticated attempt to model analytically why countries with more open economies will favor stable exchange rates. He argues that private actors involved in cross-border transactions – international merchants, multinational corporations, international investors, and banks - will generally press for a fixed exchange rate regime because it will reduce uncertainty and transaction costs for their internationally oriented activities. Those in the non-tradable sector will be less concerned about exchange rate instability, and they may in fact have strong reasons to oppose a fixed exchange rate regime in a context of financial openness. In such an

⁵ For a recent survey, see Broz and Frieden 2001.

⁶ Frieden 1991, 1996a, 1996b, 2002, and 2003.

environment, a fixed exchange rate will undermine the ability of national monetary authorities to pursue an autonomous monetary policy. Because businesses in the non-tradable sector depend primarily on the health of the domestic market, this loss of autonomy will concern them much more than it concerns internationally-oriented businesses whose interests are spread across a number of markets. Based on these predictions, Frieden concludes: “the higher the level of international trade and payments, the more economic actors with existing or potential global activities want exchange rate stability”.⁷

The Absence of a Strong Business Lobby for a Fixed Exchange Rate

Although Frieden cites empirical evidence in Europe and Latin America to support his analysis, the Canadian case appears to be an anomaly. Throughout the period being studied, Canada’s dependence on external trade been unusually high and multinational corporations have played a larger role in the domestic economy than in any other Western country. In addition, it has maintained an open capital account regime for the entire period being discussed here, with the brief exception of the 1939-51 period. And yet, this highly open economic context does not seem to have generated political demands from domestic economic interests for exchange rate stability.

If we examine the influence of private sector preferences at each of the key moments when Canada’s exchange rate regime changed, it is indeed striking that internationally-oriented businesses have not displayed a great deal of concern about transaction costs associated with the country’s floating exchange rate. This has even been true in the current era. NAMU supporters have hoped that accelerating US-Canadian economic integration in the free trade era

⁷ Frieden 1996b, 111.

would encourage the business community to take a greater interest in the issue.⁸ But the business lobby group that represents the most internationally-oriented firms – the Canadian Council of Chief Executives (previously the Business Council on National Issues) – has continued to defend the floating exchange rate regime during the NAMU debate. So too have the Canadian banks. NAMU has also been opposed by other major business lobby groups such as the Canadian Chamber of Commerce as well as the business-linked Conference Board of Canada. A spokesperson for the Alliance of Manufacturers and Exports Canada (which includes biggest industrial exporters including Ontario’s auto sector) also said his members had little interest in the issue when the debate first broke out in 1999.⁹

Why are these businesses not more concerned about the uncertainty and transaction costs associated with a floating exchange rate? Frieden acknowledges that some firms may regard the benefits of reduced currency volatility as unimportant.¹⁰ In the Canadian case, this sentiment stems partly from the fact that many Canadian firms are very skilled at using currency hedging techniques to minimize their exposure to future currency movements.¹¹ Some Canadian firms also invoice suppliers in US dollars as an informal form of hedging, while others report their earnings in US dollars which helps them to avoid converting US revenue into Canadian dollars. In addition, firms with major parts of their operations in the US, such as Nortel, also do all of their accounting in US dollars, a development which Nortel’s top executive has said helps explain his lack of interest in NAMU.¹² One additional explanation for the relative disinterest is the fact that so much of US-Canada trade (about 60%) is within large

⁸ For example Grubel 1999, 38.

⁹ Author.

¹⁰ Frieden 2002, 840.

¹¹ For example “Mixed Blessings of Canada’s Currency” *New York Times*, 15 January 2002; “Debate over Canada adopting U.S. greenback rises to surface: Western Canada would be stable” *The Vancouver Sun* 26 May 2001. NAMU would of course eliminate the need for businesses to spend money and time on these techniques.

¹² *Ottawa Citizen*, 14 May 2001; *Macleans*, 5 July 1999, 14.

multinational corporations. This trade is priced simply as bookkeeping entries within a firm's overall accounting and the impact of exchange rate movements can be compensated for by adjustments in transfer pricing within the company.¹³

This disinterest in the potential benefits of a fixed exchange rate has also characterized the position of internationally-oriented Canadian businesses in the past. For example, the private sector did not play much of a role in pressing for a fixed exchange rate during the two moments when this exchange rate regime was introduced. They were uninvolved in the 1939 decision which was taken at the outbreak of World War Two and reflected the government's concern that a floating rate might become very volatile in wartime conditions.¹⁴ The 1962 decision primarily also reflected other concerns of the government outlined in the next section. To be sure, a comprehensive survey of members of the Canadian Manufacturers Association soon after the 1962 peg was announced confirmed that some members favored the fixed rate because it provided greater certainty in predicting costs and export receipts, both of which were also helpful for planning long-term investments in certain product lines. But the survey also revealed that a large percentage of the respondents had no strong opinion on the question.¹⁵ There was also no consensus among the financial community at the time on the desirability of a fixed or floating exchange rate.¹⁶

If Canadian business interests have played little role in pressing for a fixed rate, have they been significant in lobbying for a floating rate? As we have seen, many business groups have publicly supported the floating rate during the recent NAMU debate. As noted below, private sector pressure was also important in explaining the decisions to introduce a floating

¹³ Clarkson 2000, 159; Bowles 2003, 7; Sidney Weintraub and Christopher Sands, "Why dollarization is a Canadian affair" *Globe and Mail*, 21 February 2002.

¹⁴ Plumptre 1977, 92; Rasminsky 1941, 99-101.

¹⁵ Royal Commission 1962, 4916-8.

¹⁶ For example, Canada 1962b, 1295

exchange rate in the early 1930s, and especially in 1950. It played much less of a role in the decision to float in 1970, although some parts of the financial community did support the move at the time. Why would such an internationally-oriented business sector lobby for a floating rate in these instances?

The Complicated Link Between a Floating Rate and Competitive Concerns

The first clue comes from Frieden who offers an important caveat to his argument. He notes that producers in exporting and import-competing sectors may prefer a floating exchange rate if they manufacture goods for which price competitiveness is key and/or in which exchange rate changes can be easily passed through to the consumer. These businesses - such as those producing commodities and standardized manufacturers - may want to keep open the option of using exchange rate depreciation for competitive purposes. This preference will contrast with producers of “specialized product-differentiated manufactured goods” - such as automobiles – who favor a fixed exchange rate not just because of its stability but also because they do not want to carry the exchange rate risk.¹⁷ Although producers of this latter kind have been significant within the Canadian economy through the period being studied (e.g. the auto sector), commodity exports and standardized manufacturers have also been centrally important to the Canadian economy. Does their prominence help to explain Canada’s anomalous preferences?

Some of the business opposition to NAMU has certainly reflected the desire of export and import-competing Canadian firms to keep open the depreciation option. But the significance of this motivation should also not be overstated. Business spokespeople have highlighted that the dollar’s depreciation has sometimes been a double-edged sword in its

¹⁷ Quote from Frieden 2002, 840.

impact on their competitiveness. Many Canadian businesses rely very heavily on imported machinery and equipment whose costs rise with the depreciation of the dollar. They have also noted how depreciation can hurt the recruitment and retention of specialized experts as well as discourage foreign corporations from making new investments in their Canadian subsidiaries (because the dollar's depreciation lowers the value of the Canadian subsidiary from the head office's point of view).¹⁸ Because of these complicated effects of currency depreciation in the Canadian economy, it is very difficult to make generalizations about the impact of depreciation on the tradable sector. Indeed, Paul Bowles reports the Canadian Association of Manufacturers and Exporters found its member firms to be "all over the place" in terms of their view of how a depreciating dollar affected their competitive position.¹⁹

This complexity was also apparent at the time of the 1962 decision to fix the exchange rate. During the previous year, the government had been actively talking down the dollar in an effort to improve conditions in exporting and import-competing sectors that had been hurt by the high dollar of the late 1950s. Given this background, it is surprising that there were so few voices in the Manufacturers Association demanding the preservation of the floating rate in order to keep open the option of depreciation. But business leaders in tradable sectors noted that depreciation had not always helped them. One figure in the manufacturing sector noted that depreciation increased his costs of production because of his high dependence on imports. Another business leader in the pulp and paper sector noted that Canadian business dominated the world price in many sectors; as a result, the depreciating Canadian dollar only caused a decline in world prices.

¹⁸ For example, "Weak loonie seen to offset lumber duties" *Globe and Mail*, 29 January 2002; "Mixed Blessings of Canada's Currency" *New York Times* 15 January 2002; *Ottawa Citizen* 14 May 2001.

¹⁹ Bowles 2003, 26fn13.

Even those in the tradable sector who benefited from the depreciation had been forced to recognize that Canada's floating exchange rate could cut both ways. While it made possible the depreciation in 1961-2, the floating rate had left them vulnerable to a sudden appreciation of the currency, as had occurred in the late 1950s. This exchange rate movement had been caused by tight monetary policies the Bank of Canada had pursued at the time. With a floating exchange rate, the burden of this policy fell heavily on the tradable sector as the nominal value of the Canadian dollar rose more quickly than domestic wages and prices declined. The resulting appreciation of real value of the dollar generated widespread business protests at the time, protests which had prompted the government to begin talking down the dollar.²⁰ The association of a floating exchange rate with an appreciating currency also helps to explain why there was not much support from price-sensitive exporting industries for the 1970 float. The introduction of the floating rate at the time produced an *upward* move in the currency which hurt the competitiveness of many businesses – especially those in the commodity sector.²¹ Although business pressure did not play a significant role in explaining the decision to float at the time, businesses successfully lobbied the government to curtail the appreciation of the currency once the float was introduced.

Floating Rates and Concerns about Exchange Controls and Macroeconomic Outcomes

The move to a floating rate in 1950 also generated an appreciation of the currency, but in this case the decision was widely *welcomed* by the business community at the time, as well as by the business-backed Conservative Party (which had campaigned in favor of a floating rate

²⁰ For example, Fleming 1985, 174; Plumptre 1977, 165.

²¹ For example Webb 1992, 167; Wonnacott 1971, 72-6.

in the 1949 election).²² Indeed, this moment was the one when the business community displayed its most consistent and strong preference about Canada's exchange rate regime. How do we explain this odd result? The rationale for their support of a floating rate was the new exchange rate regime would enable the government to eliminate foreign exchange controls. These controls had been introduced in 1939 and had defended by the government since the end of World War Two as necessary to defend the currency's fixed value. But the internationally-oriented Canadian business community considered them a nuisance and also worried that they discouraged US investment. Leading the business opposition was the financial sector whose cross-border securities trading and ability to attract international money market business was also inhibited by the controls.²³

The association of fixed exchange rates with foreign exchange controls was particularly salient at the time of the 1950 decision. The country was experiencing massive inflows of short-term capital which threatened to reinforce existing inflationary pressures in the Canadian economy if the country maintained its currency peg. One way of handling the crisis – which IMF officials strongly advocated - was to tighten capital controls. But faced with domestic business opposition to such controls (as well as their own preferences, as noted below), Canadian policymakers made clear that they had little interest in even retaining – let alone tightening - the country's wartime capital control regime any longer than was absolutely necessary.²⁴ By floating the Canadian dollar instead, they allowed the currency to appreciate in a way that discouraged further inflows and maintained Canada's monetary policy autonomy. Indeed, some policymakers made it clear that a key motivation for floating the Canadian dollar

²² For example Muirhead 1999, 139.

²³ For example Plumptre 1948, 9; Canada 1947, 3048

²⁴ IMF 1950, 6-7.

was that the move would make it easier to abolish foreign exchange controls altogether.²⁵ The abolition came the next year, making Canada the very first IMF member to eliminate existing foreign exchange controls since 1945. In this episode, internationally-oriented businesses – particularly in the financial sector - had made clear that they judged capital controls to be more disruptive to their economic activities than floating rates would be.

Although this rationale for supporting floating rates does not appear in Frieden’s model, C. Randall Henning anticipated it in his important work on the mapping of business actors’ preferences towards external monetary policy. In discussing bank preferences, he argued that they may advocate floating exchange rates because this exchange rate regime supports their “clear interests in low inflation, minimizing government interference, and *freedom from domestic and international capital controls*”.²⁶ He suggests that banks are more likely to view their exchange rate preferences in light of these broader objectives – rather than concerns about industrial competitiveness - when they do not have a close relationship to the manufacturing sector. He cites Britain and the US as countries where this situation exists - Canada is another.

Henning’s predictions about the significance of banks’ preferences for low inflation have also been borne out. Some of them supported the 1970 decision to float on the grounds that it would insulate the country from US inflation that was accelerating at the time and enable the Bank of Canada to control inflation more effectively with tight monetary policies.²⁷ In explaining their support for the float today, Canadian banks have also noted how it preserves the ability of the Bank of Canada to continue the low inflation policy it adopted in the late 1980s.²⁸

²⁵ Muirhead 1999, 137

²⁶ Henning 1994, 26. Emphasis added.

²⁷ For example Johnson 1970, 8.

²⁸ Author.

The Floating Rate as a Tool for “Depoliticizing” the Exchange Rate

There is one final and more indirect way that private sector preferences influenced Canada’s preference for floating that appeared at the very outset of Canada’s floating exchange rate regime. In the early 1930s, the issue of the appropriate level for the exchange rate was an enormously controversial one within Canadian domestic politics. On the one side were many businesses in the tradable sector that pushed for Canada to leave the gold standard and devalue the currency as a means of bolstering their competitive position at home and abroad in the context of the Great Depression.²⁹ As Frieden predicts, this preference was particularly strong among commodity exporters - especially wheat farmers in the West of the country. Many of these groups hoped that a devaluation might also be soon accompanied by a re-linking of the Canadian dollar to sterling as a means of bolstering trade with the UK and the Empire. On the other side of the debate were private sector groups with debts payable in foreign currency who worried that a devaluation would increase their debt service costs.³⁰ Also favoring the maintenance of the gold standard were many banks – though not all – whose primary concern appeared to be a fear of the inflationary consequences of a devaluation and more activist domestic monetary policy.³¹ Some analysts also noted that a devalued currency might hurt businesses with close ties to the US – Canada’s other major commercial partner at the time – since the US dollar remained on gold until 1933.³²

Given these diverse exchange rate preferences, the government of the day faced an enormous political dilemma. Its position was made more difficult by the fact that the debate

²⁹ See for example, National Archives of Canada, MG-27 III B9 v.16 and File 30-1, “Difficulties Experienced by Canadian Firms in Export Trade Due to the Exchange Situation” RG-33-17 v.6.

³⁰ For example Clark 1932; Bennett 1932, 197126.

³¹ Brecher 1957, 110-14; Towers 1932.

³² For example Clark 1932, 188-90.

was inflaming already-existing regional tensions in the country. While the supporters of devaluation were concentrated in the west of the country, the opponents tended to be in central Canada where the bulk of manufacturing and financial interests existed.³³ The fact that the federal government – as well as many provincial and municipal governments – also held foreign currency denominated debt complicated its decision-making further.

In the end, the government found it politically expedient simply to allow the market to determine the Canadian dollar's value in 1931. When the rate settled roughly halfway between pound and the US dollar, this choice was particularly useful in a political sense; as the Minister of Finance put it in 1933, the floating exchange rate “may be working out a not unsatisfactory compromise between groups who have different exchange rate preferences”.³⁴ Although competing domestic groups continued to demand various exchange rate policies throughout the 1930s, the government continued to resist the calls, fearing that it might ignite another domestic political controversy.

The initial choice of the freely floating exchange rate regime, thus, reflected private sector preferences, but in a rather unique way. The very openness of the Canadian economy, combined with its diversity in a regional and sectoral sense, generated an incoherent set of exchange rate preferences among private economic actors. The choice to float reflected the government's efforts both to reach a compromise among these competing interests and to insulate itself from the political struggles that would be unleashed by deliberate exchange rate adjustments. Interestingly, when the Canadian government reestablished a fixed exchange rate at the start of the World War Two, its concerns about politicizing the exchange rate question remained. Although private sector lobbying played little role in the decision, policymakers

³³ Plumptre 1977, 23.

³⁴ Canada 1933, 3208.

remained acutely aware of the danger of “politicizing” the exchange rate question and they carefully chose a rate halfway between the pound and the US dollar. When questions were raised about changing the exchange rate in 1943, the idea was opposed on the grounds that it “would lead to sectional difficulties”. Policymakers worried about “the possible political debate between East and West which would follow; and the dangers involved in letting the exchange rate become a political football”.³⁵

The decision to float the exchange rate in 1950 was then driven partly by a similar motivation to “depoliticize” the exchange rate issue (in addition to the concerns about capital controls noted above). The government had already adjusted the currency twice since the war in response to changing international conditions: a revaluation in 1946 and then devaluation in 1949. These decisions had once again encountered much domestic criticism and, in the words of one key policymaker, “introduced the exchange rate into the field of domestic controversy”.³⁶ When faced with the need to revalue the currency once more in 1950, the finance minister introduced a floating rate partly in order to avoid choosing a specific rate that might again meet criticism.³⁷ This motivation continued to act as an important justification for the freely floating exchange rate throughout the 1950s, as one internal 1957 memo within the Bank of Canada made very clear:

there can be no rate of exchange which can simultaneously satisfy the requirements of all the separate economic groups in the country. No given rate of exchange could be regarded as ‘ideal’ to such separate groups as: exporters, importers, industries meeting foreign competition, consumers, tourists, shipping interests, firms borrowing abroad or investing abroad, institutions paying interest on debt held abroad or redeeming foreign

³⁵ Rasminsky 1943, 10.

³⁶ Rasminsky 1950b, 4.

³⁷ IMF 1950, 4; Fullerton 1986, 243; Muirhead 1999, 137.

debt, etc., etc. The choice of any specific rate of exchange, or the decision to raise or lower the market rate must mean a decision to favour or discriminate against some of these groups.... The appropriate character of the chosen rate [if a fixed rate was adopted] would be a matter of public and Parliamentary concern and discussion. Conflicting representations would probably be put forward as to the rightness and wrongness of the target rate, based upon the separate interests of various regional and other economic groups concerned. Exchange rate policy might well become a matter of public controversy, as it was between 1946 and 1950. There is nothing wrong with this, of course, but the disadvantages are obvious.³⁸

What do we learn, then, about the political foundations of Canada's exchange rate policymaking from this brief historical survey of private sector preferences? Because of the prominence of intra-firm trade and hedging mechanisms, internationally-oriented Canadian businesses have been less concerned by the uncertainty and transaction costs associated with the country's floating exchange than we might have expected. Some commodity exporters and standardized manufacturers – both of whom have a prominent role in the Canadian economy – have sometimes supported the floating rate for the competitive reason Frieden highlights, although their interests have been complicated by their high import-dependence, their status as foreign subsidiaries, their price-making position in some world markets as well as their recognition that a floating rate can also produce an appreciation. The preferences of some businesses – especially financial interests - have also been influenced by broader concerns identified by Henning such as their desire to abolish exchange controls and their macroeconomic preferences. And finally, the diversity of private sector preferences – a product

³⁸ Parkinson 1957, 9-10, 14-15.

of the openness and diversity of Canadian economy – has at times played a role in encouraging the government to embrace a “free float” as the way to depoliticize the exchange rate question.

State-Level Explanations: Interests, Institutions, and Ideas

Although private sector preferences help to explain Canadian exchange rate regime choices, their role should not be exaggerated. Canadian policymakers have often had considerable autonomy from private interests in deciding the exchange rate regime at various moments. This situation is not an unusual one in a comparative context. A number of scholars have noted that exchange rate policymaking is also often quite autonomous from specific private interests. Some attribute this autonomy to the technical complexity of the issues involved. Others highlight the fact that the distributional effects of exchange rate regimes are often small or unclear from the standpoint of private interests. Even when these effects are substantial and clear, they are focused at the macroeconomic level in ways that undermine effective collective action by private actors.³⁹

The Usefulness of “Partisan” and “Rationalist” Models?

If Canadian policymakers have sometimes had considerable autonomy in choosing exchange rate regimes, it is important to analyze why they have generally favored a floating exchange rate regime. How can we best analyze their preferences? The growing literature on the politics of exchange rate regimes offers a number of answers to this question. One approach suggests that preferences will be determined by the “partisan” leanings of politicians. This analysis assumes that left-of-center policymakers will favor growth and income distribution,

³⁹ McNamara 1998; Gowa 1988; Andrews and Willett 1997; Broz and Frieden 2001, 328.

while those on the right will be more concerned with price stability. Unfortunately, this approach does not generate consistent hypotheses about how these preferences translate into exchange rate regime preferences. While left-of-center policymakers might be expected to favor floating exchange rates to maximize policy autonomy, they may also see a fixed exchange rate as a way to establish credibility in the eyes of global financial markets.⁴⁰ In addition to this theoretical problem, empirical evidence from OECD countries after the early 1970s does not provide any clear link between partisan leaning and the choice of exchange rate regimes.⁴¹

Canadian exchange rate regime choices also do not appear to have been influenced by a clear pattern by partisan preferences. A Conservative federal government introduced the floating rate in the early 1930s, while a Liberal government re-introduced it in 1950 (albeit with strong Conservative support). When the exchange rate was fixed in 1962, a Conservative government was in power. The Conservative party was also initially skeptical when a Liberal government brought in the floating exchange rate once again in 1970. After this point, both Liberal and Conservative governments have endorsed the floating exchange rate regime.

A second approach has been a “rationalist” one that assumes policymakers are driven primarily by the goal of holding office. This literature examines how the preferences of these “survival-maximizing politicians” are then influenced by different institutional and political environments.⁴² For example, Bernhard and Leblang suggest that policymakers may prefer a fixed exchange rate regime in contexts where there is intense intra-party or intra-coalitional conflict over monetary policy. In their view, such a regime may help to manage this conflict.⁴³

⁴⁰ Simmons 1994; Broz and Frieden 2001, 328.

⁴¹ Bernhard and Leblang 1999.

⁴² Quote from Clark 2002, 743.

⁴³ Bernhard and Leblang 2002.

Interestingly, however, we have seen how the opposite has been true in the Canadian context: a floating exchange rate has been seen as a way to defuse intense domestic political conflict over the exchange rate question.

Others working in this tradition have argued that the existence of majoritarian (single-member plurality) electoral systems will encourage policymakers to favor a floating exchange rate regime. Because the costs of losing office are very high in this kind of system, they argue that ruling politicians will place a high value on the role of discretionary monetary policy in generating support in advance of elections.⁴⁴ This preference may be reinforced by the fact that they are held more directly accountable for economic performance.⁴⁵ In federal political systems, Mark Hallerberg also argues that the desire for floating exchange rates will be reinforced because fiscal policy is less useful as a form of national macroeconomic management given that the fiscal policies of subnational governments can not easily be controlled by the federal government.⁴⁶

Hallerberg in fact cites Canada as an example of how “one party player, federal” political systems generate a desire for a floating exchange rate for these reasons.⁴⁷ The causation he draws is deductive rather than one drawn from inductive research about the sources of Canadian exchange policymaking. My own analysis of the reasons why floating exchange rate regimes were chosen in the early 1930s, 1950 and 1970 does not provide much support for this causal link. Policymakers did not discuss their choice of exchange rate regimes in the kind of electoral terms that Hallerberg suggests, and none of these decisions were taken in the immediate lead-up to an election. Interestingly, the only change of exchange rate regime

⁴⁴ Berhard and Leblang 1999.

⁴⁵ Hallerberg 2002.

⁴⁶ Hallerberg 2002.

⁴⁷ Hallerberg 2002.

to take place in this context was the choice to *fix* the exchange rate during the 1962 federal election campaign. In the context of making these various decisions, policymakers also did not discuss how Canadian federalism was complicating their ability to use fiscal policy as a macroeconomic tool.

Federalism arose as an issue only in the context of discussions about implementing controlling capital inflows at the time of the 1970 decision to float the currency. At that time, the IMF and many foreign officials asked the Canadian government to consider such controls as a way of preserving a fixed exchange rate.⁴⁸ Canadian officials rejected the idea, as they had in 1950, but the key reason they cited this time was the fact that the major Canadian borrowers were provincial governments. Controlling their foreign borrowing raised issues that were particularly delicate at the time of considerable federal-provincial tension.

The Role of Ideational Factors

My reading of the historical evidence suggests that the more useful approach for examining the preferences of state policymakers is an “ideational” one that examines their ideologies and beliefs.⁴⁹ Throughout the period we are examining, key policymakers favored a floating exchange rate because it served two macroeconomic purposes: 1) it helped the Canadian economy adjust to external shocks, and 2) it provides a degree of monetary policy autonomy in an environment of financial openness.

Each rationale was clearly outlined for the first time when Canadian policymakers initially embraced a floating exchange rate in the early 1930s. This was a time when professional economists first began to play a significant role in setting Canadian monetary

⁴⁸ Muirhead 1999, 235-40; De Vries 1976, 478-81.

⁴⁹ Freeman 2002, 902; McNamara 1998; Andrews and Willett 1997; Woods 1995; Odell 1982.

policy. One of the most influential was Clifford Clark who had been an economist at Queen's University before he assumed the post of deputy finance minister in 1932 (a position he then held without interruption until 1952). Just before assuming this post, Clark drafted a 196 page memo for the government about Canada's exchange rate options after soliciting comments from economists across Canada. The document provides the first detailed outline of these arguments for a floating exchange rate that I have found in government archives.

In the document, Clark noted that a fixed exchange rate could be very "difficult and painful" for a country such as Canada which was subject to frequent balance of payments fluctuations as a result of its heavy reliance on commodity exports. Here is his reasoning:

under a policy of fixed exchanges, an upset in the country's balance of payments due to a crop shortage, or a change in foreign demand for one or more of the country's important products may have to be corrected by the painful process of restricting credit and reducing prices and personal incomes. This process appears the more ruthless when it is realized that many of the disequilibria in international balances of payments are of a temporary nature.

The question may be raised whether the policy of exchange stability in some case does not involve the payment of too high a price for the advantage gained.⁵⁰

For this reason, he supported the decision to leave the gold standard in 1931. In his view, currency depreciation had been necessary to help domestic actors adjust to the severe external shocks that Canadian economy had experienced at the time.

The second reason he favored a floating exchange rate was that it would insulate Canada from monetary instability abroad. If the country re-pegged to the US dollar after 1931, he noted that "we will subject our Canadian economic structure to all the oscillations of a

⁵⁰ Clark 1932, 145-6.

monetary unit which has shown no capacity for stability”.⁵¹ Pegging to sterling also contained risks because the commitment of British authorities to price stability was not clear. The best course was an independent one, he argued:

The arguments against a tie-up with New York and with London constitute the case for retaining our national autonomy in monetary matters for the present at least. In particular, neither alternative offers any real assurance of price stability or the restoration of our prices to a level at which the burden of fixed debt resting upon the industrialist and taxpayer will be appreciably mitigated. Either would subject our economic system to the possibility of external shocks that might conceivably be sudden and violent.... There is much to be said against entering into hard and fast monetary agreement in the present state of uncertainty. If we retain our independence, we may choose our own objectives and plot our own course towards them.⁵²

These macroeconomic rationales for a floating rate reemerged in the postwar period. By this time, the objectives of Canadian policymakers had shifted to include not just price stability but also full employment. This new focus only strengthened the case for a flexible rate since Canadian policymakers were unwilling to sacrifice either of these domestic macroeconomic objectives to the goal of maintaining exchange rate stability.⁵³ We have already seen how the 1950 decision to float the currency reflected this commitment to sacrifice exchange rate stability to monetary autonomy; the goal was to prevent capital inflows from generating domestic inflationary pressures. A very similar situation prompted the move to floating in 1970. This decision was taken when the country was once again experiencing large inflows of short-term capital. Because inflation was already rising, the government did not want to lower

⁵¹ Clark 1932, 188-9.

⁵² Clark 1932, 195.

⁵³ For example Rasminsky 1944, 10,

interest rates to defend the currency peg. The floating of the currency provided a way to discourage the inflows and preserve policy autonomy.

The preference to preserve monetary autonomy in 1950 and 1970 need not have ushered in a floating rate if policymakers had been willing to use capital controls to curtail financial inflows. As noted already, however, they rejected this option in both cases. This decision partly reflected private sector opposition to controls but it also stemmed from their own opposition. In 1950, key policymakers such as Louis Rasminsky worried that controls on capital inflows “might place Canada in a position of creating an atmosphere of hostility toward American capital through administrative action.”⁵⁴ This concern not to alienate American investors had been very prominent throughout the short history of Canada’s exchange control regime and it reflected postwar Canadian policymakers’ view that US investment was critical to Canadian economic growth.⁵⁵ In 1970, Canadian officials also worried that controls would be extremely difficult and disruptive in the context of the close US-Canadian economic relationship (in addition to their concerns about provincial-federal relations noted above).⁵⁶

The choice of an exchange rate regime in these episodes was thus clearly linked to a broader set of preferences about the desirability of financial openness and monetary policy autonomy. Canadian policymakers recognized that they could only ever achieve two of the three goals within the “impossible trinity” of open macroeconomics at the same time: financial openness, monetary policy autonomy and a stable exchange rate. In these episodes, they

⁵⁴ IMF 1950, 6-7. See also Rasminsky 1950a, 2.

⁵⁵ For example Rasminsky 1943, 5; Clark 1940, 3,6.

⁵⁶ Throughout the period of the fixed exchange rate regime between 1962-70, they had also rejected the option of using capital controls to defend the peg. They had also objected vigorously when the US applied its own controls on US capital outflows to Canada in 1963. The US relented only when Canada agreed to subordinate its monetary policy to the goal of exchange rate stability by accepting ceilings on its foreign exchange reserves (a measure that would guarantee that Canadian capital imports would not contribute to US balance of payments problems). In addition, Canada accepted “pass-through” guidelines that discouraged Canadian firms from re-lending their US borrowings to third countries. See Wright and Molot 1974; Muirhead 1999, 254-5; Plumptre 1977, 207-9.

demonstrated a consistent preference to preserve monetary policy autonomy and financial openness and sacrifice a fixed exchange rate.

In light of this pattern of policymaking, the decision to fix the exchange rate in 1962 requires explanation. We have seen already how this decision came after a period in which the Bank of Canada pursued an aggressive anti-inflation policy. This policy marked the first time that Canadian monetary authorities had pursued this kind of policy with a floating exchange rate and open capital account regime. The result was one familiar to students of economic theory today: effectiveness of the tight monetary policy was reinforced as capital inflows drove up the currency's value. But these causal links were less familiar to observers in the late 1950s, and the central bank governor in particular – James Coyne (who had little formal training in economics) - appeared not to recognize them. Because of his determination to control inflation, Coyne refused to consider lowering interest rates, and he also opposed the government's decision in 1961 to talk down the dollar, arguing that it would simply fuel inflation. The conflict between Coyne and the government produced a major political crisis in the country which ended with Coyne's resignation in 1961.

It was in this unstable context that opposition to the floating exchange rate grew. Policymakers now saw that the monetary policy autonomy provided by a floating exchange rate was not always desirable for those committed to full employment goals. They also recognized that a floating exchange rate did not always work to correct the country's trade imbalances; in this episode, it had worsened an existing trade deficit. Most importantly, in the climate of political and economic uncertainty, key officials within the government began to believe that a fixed exchange rate was necessary to reestablish a more stable macroeconomic environment for

Canadian business.⁵⁷ This sentiment was reinforced when the government's strategy of talking down the dollar generated a currency crisis in the midst of an election campaign in May 1962. To restore the confidence of financial markets, a fixed rate was hurriedly adopted, with very little discussion about its consequences.⁵⁸ The rationale was summarized well by the new head of the Bank of Canada, Louis Rasminsky: "the best way to eliminate uncertainty was to declare a par value and create a situation where government was formally committed".⁵⁹

This idea that a fixed exchange rate could cultivate financial market confidence is one that has become popular in many countries since the 1970s. In Europe and many Southern countries, national governments have increasingly embraced a fixed exchange rate – and eventually monetary union in the European case – because they have seen it as a kind of "credibility" mechanism. Because a fixed rate precludes discretionary monetary policy in conditions of capital mobility, it is used as a signal to financial markets that politicians will not tamper with the monetary system in inflationary ways. The goal of directing monetary policy solely to the objective of price stability is not just supported by financial markets. It has also gained in popularity because policymakers after the 1970s have embraced the "neoliberal" view that price stability – rather than full employment - should be the key goal of monetary policy.⁶⁰

If the decision to fix in 1962 represented an early example of this kind of policy, it seems odd at first sight that Canadian policymakers have not returned to the idea more recently. Beginning in mid-1970s and then especially after the mid-1980s, they followed their counterparts in other countries in embracing the idea that the sole objective of monetary policy should be price stability. This sentiment has not, however, been accompanied by a desire for a

⁵⁷ Muirhead 1999, 195-6; Plumtre 1961, 2.

⁵⁸ Smith 1995, 438; Fleming 1985, 495-6; Granatstein 1986, 86-7.

⁵⁹ Rasminsky 1962, 2.

⁶⁰ For example McNamara 1998.

fixed exchange rate. Instead, it in fact generated support for a *floating* rate that would give the Bank of Canada enough autonomy to pursue a vigorous anti-inflationary program.⁶¹

This preference has emerged once again in the NAMU debate.⁶² Some NAMU supporters have argued that this monetary regime could act as an important institutional mechanism guaranteeing price stability. But NAMU opponents – including those in government and the central bank – have argued that the Bank of Canada already provides price stability; indeed, it has been mandated to pursue a low inflation target since 1991. Some have gone further to argue that a monetary link with the US might generate a higher inflation rate since the US monetary policy has been less anti-inflationary since the late 1980s than Canada's. Whereas regional monetary union is seen as a “hard currency” option in Europe because countries are essentially importing the Bundesbank's monetary objectives, NAMU is portrayed as a soft currency option by these opponents. As we have seen, this goal of avoiding the importation of US monetary instability has in fact been an important rationale for a floating exchange rate in Canada since the 1930s.

The other argument raised against NAMU by government policymakers is the one Clark cited in 1932: a floating exchange rate helps Canada adjust to external shocks. Drawing on optimum currency area (OCA) theory, they argue that the need for such a shock-absorber would be less if these shocks were correlated with those experienced by the US. But Canada's status as a major commodity exporter ensures that it experiences different shocks than the US. They also highlight how the OCA case for a floating exchange rate is also reinforced by the inflexibility of Canadian wages and prices, and the absence of US-Canada labor mobility.⁶³

⁶¹ Crow 2002, 219; Laidler and Robson 1993, 120-21; Webb 1992, 180.

⁶² Author.

⁶³ For a summary of these arguments, see Author.

In sum, an important source of political support for Canada's floating exchange rate has come from policymakers who have seen it as a useful tool for both easing adjustment to external shocks and strengthening monetary policy autonomy. Interestingly, it is also worth noting how the case for monetary autonomy has reflected a longstanding distrust of US monetary policymaking. In the early 1930s, Canadian policymakers saw a currency float as a way to insulate Canada from the deflationary trends in the US. In 1950, 1970 and today, the floating exchange rate was seen as a tool to avoid importing US inflation. These latter cases reveal an important limitation in contemporary analyses that suggest anti-inflationary goals or "neoliberal" monetary thinking will lead to a preference for a fixed exchange rate.⁶⁴ This suggestion rests on an often unstated assumption – drawn largely from the EU context - that the country to whom one fixes has firm anti-inflationary policies. As Freeman puts it, analysts must recognize that "the 'strength' of inflation-averse parties in the country to which one pegs is a key element of the decision to fix one's own exchange rate."⁶⁵ In the Canadian context, the anti-inflationary goals of policymakers produced a desire for a *floating* exchange rate because of a distrust of anti-inflationary credentials of US monetary authorities.

The International Context: Regimes, US Preferences and Capital Mobility

In addition to the role of domestic interests and the preferences of state policymakers, some literature on the politics of exchange rates also highlights the significance of the international context in which national exchange rate policymaking takes place. At first sight,

⁶⁴ For example Bernhard, Broz, and Clark 2003.

⁶⁵ Freeman 2002, 896. More generally, as Frieden (2002: 837fn12) notes, these analyses do not explain why a fixed exchange rate regime is any more "credible" than inflation targets. As noted above, Canadian policymakers have committed themselves to inflation targets since 1991.

this approach seems less relevant to the Canadian context since international regimes do not appear to have played a major role in Canada's exchange rate choices. In particular, it is striking that the Canadian decisions to adopt a floating exchange rate in both 1950 and 1970 contravened the IMF's Articles of Agreement (which had endorsed an adjustable peg exchange rate system). In both cases, the Canadian decisions provoked very strong opposition from IMF officials and many foreign governments for this reason. Foreign critics demanded to know why Canada had not maintained a fixed exchange rate by simply tightening its capital controls. Why did this international pressure not have more of an impact on Canadian policymaking?

US Tolerance of Canada's Float

The answer is that another external factor – US preferences - insulated Canada from the pressure. In 1950, US officials played a key role in securing formal IMF approval for the Canadian decision. In explaining their support for Canada's float, US policymakers noted that they shared the reluctance of the Canadian government to tighten capital controls given the close financial ties of the two countries.⁶⁶ They also endorsed Canadian arguments that the decision to float would allow Canada to loosen both capital and import controls in ways that supported the broader IMF goal of creating a world of convertible currencies and multilateral trade. In 1970, US officials were initially less sympathetic to the idea of a floating Canadian currency. They were concerned that it would produce renewed pressure on the US dollar and help to undermine the stability of the broader Bretton Woods exchange rate regime. In the end, however, they endorsed the move, accepting Canadian arguments that the maintenance of a fixed rate exchange would require an unacceptable introduction of capital controls, a position

⁶⁶ IMF 1950, 8; Rasminsky 1950b, 9-10.

that voices in the US business press also put forward.⁶⁷ At the 1971 Smithsonian meetings where a new set of fixed exchange rates were established and throughout 1972, the US continued to defend Canada's float against foreign and IMF criticism.⁶⁸

In these instances, US sympathy for a floating Canadian dollar was likely augmented by the fact that the float produced an upward, rather than a downward, movement in the currency. Indeed, the one instance when the US pushed Canada towards a fixed exchange rate regime took place in the opposite context: the 1961-2 period when the Canadian government launched its strategy of deliberately devaluing the Canadian dollar to gain competitive advantage in international markets. While the US had supported Canada's "free float" of the 1950s, this Canadian new policy quickly generated strong US opposition. Not only was the Bretton Woods exchange rate system explicitly designed to prevent this kind of behavior, but Canada's action also affected US domestic firms directly and worsened the already-deteriorating US balance of payments situation. When the Canadian government moved to a fixed rate in 1962, there is no question that US pressure had some influence in encouraging the move.⁶⁹

The only other instance when US policymakers have shown some interest in pushing Canada towards a fixed exchange rate came during the 1985-7 negotiations that led up to the US-Canada Free Trade Agreement (FTA). These negotiations took place at a time when the exchange rate of the US dollar vis-à-vis other leading industrial countries had become highly politicized within the United States. Large US current account deficits were blamed partly on the fact that the US dollar had appreciated substantially against the currencies of the US's major trading partners from 1980 to 1985. Throughout the FTA negotiations, various members of Congress and some US business leaders suggested that the FTA should be accompanied by

⁶⁷ Muirhead 1999, 237-9.

⁶⁸ Plumtre 1977, 253; De Vries 1985, 40-1.

⁶⁹ Canada 1962a, 4; Muirhead 1999, 194-6; Plumtre 1961, 1-2.

an agreement that would establish some kind of link or target zone for the Canada-US exchange rate. According to key Canadian policymakers of the time, however, US administration officials did not take press the issue very strongly when they encountered Canadian resistance.⁷⁰ The fact that the Canadian dollar began to rise in value during the negotiations in response to the Bank of Canada's tightening of monetary policy also may have influenced US policy.⁷¹ Since this time, the issue of Canada's exchange rate has attracted little attention in the US, despite the substantial depreciation of the Canadian dollar after 1991.

Given its significance, the US acceptance of Canada's floating exchange rate for most of the postwar period needs to be explained. We have seen how it was linked in 1950 and 1970 to the fact that US policymakers shared the Canadian government's dislike of capital controls between the two countries. More generally, Henning shows how US policymakers have consistently shown less interest in limiting the exchange rate fluctuations of their trading partners' currencies than have other leading monetary powers such as Germany. He attributes this behavior primarily to the weaker voice of US manufacturing firms (who often have an interest in this issue) in US exchange rate policymaking.⁷² The fact that so much of US trade with Canada is intra-firm has also reduced US business interest in the competitive implications of the Canadian exchange rate.

Heightened Capital Mobility and the Choice to Float

One last international influence on Canada's exchange rate choices deserves mention: the role of heightened international capital mobility. We have already seen how Canada has

⁷⁰ Hart 1994, 162; Crow 2002, 97-101

⁷¹ Because the Canadian dollar rose during the negotiations and the first few years of the FTA, some have speculated that an informal target zone was secretly established (e.g. Laurie 1993). But this claim has not been substantiated and the dollar's path can be explained by the Bank of Canada's anti-inflationary policy in this period.

⁷² Henning 1994.

been subject to a high degree of capital mobility for almost all of the period we have examined. And it has had the effect predicted in the literature of forcing Canada to choose between monetary autonomy and fixed exchange rate long before other countries faced this choice.⁷³ As global financial flows have grown dramatically in recent years, however, many analysts have suggested that the choice facing countries has become even narrower. Given the power of speculative financial flows, governments find it increasingly difficult to maintain a fixed exchange rate. If a stable exchange rate is the goal, some argue that governments must embrace new monetary arrangements – such as monetary unions, currency boards or dollarization - as a way of signaling to the markets the seriousness of their commitment. The only other option is said to be a floating exchange rate.

The increasingly unsustainable nature of fixed exchange rates has had an important impact on Canadian exchange rate politics. While it encouraged the creation of the euro in Europe, it has strengthened the case for a floating exchange rate in Canada. This is because the likelihood of North American monetary union assuming a form that was attractive to Canadians is considered very low. In Europe, the national central banks of each of the participating countries have each been given an equal voice within the new European central bank. This has made it much easier for EMU supporters to argue that sovereignty is not being abandoned, but simply pooled at the EU-wide level. Supporters in smaller countries have in fact been able to argue that their central banks have acquired more say over monetary developments affecting their country than they had in the German-dominated European Monetary System.

Some supporters of NAMU hope that the US, like Germany, might agree to abandon its currency in favor of a new North American currency managed by a new North American central bank in which Canada has a significant decision-making role. But this argument has not

⁷³ For example Andrews 1994.

persuaded many people, especially given the US dollar's global role. Most analysts have concluded that the much more likely scenario is one in which Canada adopts the US dollar and tries to negotiate a position as a 13th Federal Reserve district within the Federal Reserve System. If this came to pass, Canada would still not in fact have acquired much influence over US monetary policymaking since only five of the existing twelve district presidents are voting members at any one time on the key policymaking body – the Federal Open Market Committee – and US presidential appointees outnumber these district bank presidents. Moreover, some Canadian analysts worry that the US might press Canada to transform the Bank of Canada into a private bank-owned institution to parallel the nature of the other district banks. In that case, the Bank's ability to be a conveyor of Canadian public preferences would be further undermined.⁷⁴

More importantly, it is unclear whether the US would agree to give Canada even this limited decision-making role. As we have seen, US policymakers are not terribly inclined to see Canada's fluctuating exchange rate as something they hope to "fix".⁷⁵ They also have shown considerable resistance to the idea of sharing decision-making powers in a North American context. During the FTA negotiations, Canadian policymakers faced enormous difficulties in their efforts just to create the binational dispute settlement process. Granting Canada a place in the Federal Reserve System would be a much more significant step and would likely require large concessions from Canada in other areas that could easily outweigh the perceived benefits. US policymakers have recently debated the question of whether they should encouraging foreign countries to adopt the US dollar, and these debates have shown the extent to which US politicians are not willing to consider incorporating the concerns of these countries in the Fed's

⁷⁴ Robson and Laidler 2002.

⁷⁵ See also Sidney Weintraub and Christopher Sands, "Why dollarization is a Canadian affair" *Globe and Mail* 21 February 2002.

monetary policymaking. US officials have also ruled out the extension of lender-of-last-resort activities to dollarized countries and could not even agree on the principle of sharing some seigniorage revenue with them. In Cohen's view, only a significant threat to the dollar's global position from the euro might begin to change American opinion on this question.⁷⁶

For these reasons, many analysts have concluded that the Canadian debate about NAMU is really a debate about whether Canada should unilaterally adopt the US dollar. When the question is posed in this way, many Canadians who might have been more sympathetic to NAMU on economic grounds have turned against the idea on nationalist grounds. Monetary union in these "quasi-colonial" circumstances, they argue, would not be worth it.⁷⁷ Leaving aside the question of lost seigniorage and the need to develop new ways of providing lender-of-last-resort activities, the central cost is seen to be that Canadians would be left with no say over monetary policy. This has been one of the most powerful arguments against NAMU to date. Even business executives who oppose NAMU have cited this nationalist reason as the most important one – much more important than economic reasons – for why they opposed NAMU.⁷⁸ If heightened capital mobility has increasingly forced governments to choose between floating exchange rates and arrangements such as currency unions, currency boards, and full dollarization, floating rates look to many Canadians to be the much more attractive option on political grounds.

⁷⁶ Cohen 2002.

⁷⁷ Laidler and Poschmann 2000, 18.

⁷⁸ *National Post* 16 July 2001.

Interestingly, in Quebec, nationalist sentiments have encouraged support for – rather than opposition to – NAMU. Indeed, Quebec sovereigntists have emerged as one of the lead supporters of NAMU because they believe that Quebec sovereignty would be perceived as a less risky option from a monetary point of view by the Quebec population if it were in place. They also dismiss concerns about the likelihood that Quebec would have little voice with the US central bank by arguing that the Quebec government already has no formal say over Bank of Canada policies (Author).

Conclusion

What explains Canada's "fixation with floating" since the 1930s? It is partly attributable to the absence of a strong business lobby for fixed exchange rates of the kind one might anticipate in such an open economy as Canada's. I have suggested that this situation reflects the large presence of TNCs and intra-firm trade as well as the widespread use of various hedging mechanisms by Canadian businesses. As Frieden suggests, the prominent role of commodity exporters and standardized manufacturers has also created a business constituency favoring a floating exchange rate for competitive reasons, although their interests are not always consistent because of their high import-dependence, their status as foreign subsidiaries as well as their fear of appreciation. Some businesses – particularly in the financial sector - have also favored a floating rate at key moments on the grounds that it would accelerate the elimination of capital controls or help to maintain low inflation. In addition, the diversity of the Canadian economy has produced enormously varied business preferences regarding the exchange rate's most appropriate level, a variance which has in turn encouraged policymakers at times to embrace a floating rate as a way of "depoliticizing" the issue.

The preference for floating has also reflected the macroeconomic preferences of state policymakers. Within the "impossible trinity", state policymakers have shared the business sector's opposition to capital controls and have valued monetary policy autonomy very highly. The rationale for monetary policy autonomy has changed over time, but one fairly consistent argument in its favor has been a distrust of US monetary policymaking among Canadian policymakers. Canadian officials have also often supported a floating rate because it can help ease adjustments to external shocks.

Finally, the distinct nature of the US-Canada relationship has also been important in explaining Canada's choice of exchange rate regime. US tolerance of the Canadian preference for floating – even Canada broke the rules of the Bretton Woods system - has made this exchange rate choice easier to implement. In the current era, the asymmetric nature of US-Canadian power relations has also been significant in reinforcing the Canadian preference for floating. As heightened capital mobility has made the maintenance of a fixed exchange rate more difficult, Canadian policymakers have faced a more stark choice of exchange rate regimes: monetary union or floating. Since the US is unlikely to offer Canada a significant voice in a monetary union, the latter choice has seemed the more attractive.

What lessons does the unusual Canadian “fixation with floating” provide for the broader literature on politics of exchange rate policymaking? Three can be briefly noted. First, the Canadian case supports the thesis that private sector preferences play a significant role in determining exchange rate regime choices. But it also highlights that these preferences are not easily modeled in an abstract and deductive manner. As we have seen, the choice of an exchange rate regime has implications not just for the kinds of transaction costs and competitive concerns that Frieden highlights, but also for macroeconomic outcomes and the use of capital controls (not to mention other factors such as labor market regulation). The relative weight that private actors place on these various implications is obviously very hard to model since it will likely be, as Henning puts it, “highly situationally dependent”.⁷⁹ The Canadian case thus reinforces that argument that the domestic politics of exchange rate regime choice are best characterized by what McNamara calls a “highly unstable societal preference structure”.⁸⁰

⁷⁹ Henning 1994, 26.

⁸⁰ McNamara 1998, 35. See also pp. 7-8, 32-41 and Giovannini 1995. Frieden (2002, 839fn20, 840) too notes that deductive models which attempt to predict private sector preferences with respect to exchange rate regimes will inevitably require “some heroic assumptions” which mask “much nuance and complexity”.

Second, the Canadian case also provides evidence that state policymakers do often have a considerable degree of autonomy from domestic interests in choosing exchange rate regimes. The preferences of these policymakers are, however, not always so well explained by “partisan” concerns or rationalist models that assume politicians to be primarily “survival maximizing”. Instead, the more important explanation in the Canadian context is an “ideational” one that examines the influence of beliefs about the value of monetary policy autonomy and the use of the exchange rate to adjust to external shocks. As we have seen, these ideational factors are also highly context-specific; for example, whereas neoliberal economic ideas encouraged support for monetary union in Europe, they were associated with a preference for floating in Canada.

Finally, the Canadian preference for floating also highlights the role of international influences on national exchange rate policymaking. Once again, however, it suggests that their influence must be seen in a very context-specific way. Heightened capital mobility is often cited to explain the growing interest in monetary union in Europe. But I have outlined how it has reinforced the case for floating in the Canadian context because of the nature of US-Canada relationship. Similarly, regional monetary unions are often seen to be encouraged by the existence of a dominant or hegemonic state. In the North American context, the US certainly fits the description of being a hegemonic state, but we have seen how it has encouraged Canada’s *float* not just by “tolerating” it for most of the post-war period but also by offering very little encouragement to NAMU supporters in Canada.

In sum, the Canadian case highlights well that the task of explaining exchange rate regime choices involves much more than an evaluation of the degree of openness of a country’s economy. It suggests the usefulness of a multi-level analytical approach that examines the

preferences of both domestic economic interests and state policymakers, as well as the influence of the international environment. Within the growing literature on exchange rate politics, a number of interesting models have been put forward to explain preferences at each level. While many of these are helpful, we have seen how they do not always account for important nuances in the politics of Canadian exchange rate policymaking. In this way, the unusual Canadian fixation with floating also provides an important reminder that abstract modeling-building must never become too divorced from the specific historical context in which exchange rate policymaking takes place.

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