# The Tradeoffs of Alternative Exchange-Rate Regimes

The absence of a common currency has adversely affected cross-border integration of agricultural commodity, product, and factor markets in North America. Empirical evidence shows a high degree of cross-border price transmission for specific commodities, suggesting strong spatial linkages between countries in North America (Vollrath and Hallahan). But this research also shows that the exchange rate inhibits continental integration.

The fact that changes in exchange rates cause U.S.-dollar denominated prices for the same good to diverge in the United States, Canada, and Mexico raises the question of whether a common currency might be advisable for North America. Quantitative analysis supports the view that a single currency generates substantial gains to the traded sectors (Frankel and Rose), and that a common currency in the three North American countries would increase intra-NAFTA trade by 50 to 70 percent (Hufbauer).

The increase in the post-CUSTA U.S. agricultural trade deficit with Canada has, in large part, been attributable to the appreciation of the U.S. dollar vis-à-vis the Canadian dollar from October 1991 to December 2002. Econometric analysis shows that a 1-percent exchange-rate shock (due to a disturbance in either the U.S. or Canadian economy) affects the U.S.-Canadian agricultural trade balance between 5 and 9 percent and that such a shock takes almost 2 years to work itself through the system before a new equilibrium is achieved (Kim et al.). Given that the U.S. dollar increased in value against the Canadian dollar 33 percent during the 1990s, the U.S.-Canadian exchange rate may be the dominant factor affecting post-CUSTA U.S.-Canadian agricultural trade.

NAFTA-induced tariff reductions increased U.S. access to the Mexican market and, therefore, fundamentally altered the nature of U.S. trade with Mexico; but the changing value of the peso was also a very important determinant of U.S.-Mexican trade. The expansion of U.S. agricultural exports to Mexico lost momentum immediately after Mexico devalued the peso in December 1994. Krueger contends that significant realignment of the U.S.-Mexican exchange rate has and will have a much larger influence on trade than Mexico's entry into NAFTA "because the total reduction in tariffs at the end of 15 years would average only 10 percent, in contrast with the 50 percent real depreciation."

It may be useful to examine the desirability of alternative exchange-rate regimes given the drag that current exchange rates impose upon the integration of agricultural markets in North America. What are the options? At one end of the spectrum is the hard-fixed exchange rate; at the other end are completely flexible rates. A whole host of managed (or pegged) exchange-rate regimes exist between these extremes. Currently, flexible rates characterize U.S., Canadian, and Mexican currency regimes.

Most theoretical and applied macroeconomists no longer favor managed exchange rates (Hufbauer). Milton Friedman views pegged rates as "ticking bombs." He explains why: "A central bank controlling a currency that comes under downward pressure does not have to alter domestic monetary policy. It can draw upon reserves of foreign currency or borrow foreign currency to meet the excess demand for foreign currency. Such a policy can smooth over minor and temporary problems, but lets minor problems that are not transitory accumulate. When that happens the minor adjustments in exchange rates that would have cleared up the initial problem will no longer suffice. It now takes a major change."

Obstfeld and Rogoff point out that sustaining official pegged rates has become more difficult in recent years due to the deregulation of world financial markets. Large swings in international capital flows can put pressure on the balance of payments, making it difficult to sustain a fixed peg. The integration of global financial markets explains why pegged exchange rates are rarely found today.

Historically, the Mexican peso has experienced periods of appreciation followed by financial crises that have required corrective devaluation. Devaluations of the Mexican peso, which have occurred under both nominal- and crawling-pegged exchange-rate regimes, lend credence to the view that managed exchange rates are not viable in the long run. This leaves two options for the North American countries-either commitment to the current system of flexible bilateral exchange rates or adoption of a hard-fixed regime.

The U.S. dollar would likely form the foundation of any *hard-fixed* regime established in Canada and/or Mexico because the United States is by far the largest economy in NAFTA. The U.S. real (1995) GDP is more than 13 (24) times greater than that in Canada (Mexico). Hence, a shift to a hard-fixed regime in

North America would likely result in the adoption of U.S. dollar.

Use of the U.S. dollar as the single currency in North America would have far-reaching implications. Continental adoption of the U.S. dollar would mean the loss of the Canadian dollar and Mexican peso as policy instruments. This would prevent Canada and/or Mexico from being able to adjust domestic interest rates and/or alter money supplies in order to cushion domestic economic shocks. But adoption of the U.S. dollar would increase price transparency, lower transaction costs, and virtually eliminate exchange-rate risk. It would also advance the cause of commodity and factor market integration by facilitating cross-border transactions. Moreover, eradication of volatile bilateral exchange rates would remove a source of uncertainty that inhibits trade and investment within NAFTA.

Mexico could conceivably benefit from either dollarization or being a member of a North American monetary union. Membership would impose fiscal discipline and contain domestic inflation. It would also mitigate exchange-rate volatility problems that have plagued Mexico's international economic relationships. A more stable exchange rate, such as that provided by use of the U.S. dollar, would be conducive to Mexico's trade and development. The economic payoffs would increase as Mexico's economy became more open to the international market and as its trading sector grew relative to the size of its domestic economy.

The use of the U.S. dollar could, however, pose major problems for Mexico. Mexico is a developing country, and its economy is structurally dissimilar from that of both the United States and Canada. One reflection of this difference is that Mexico and its NAFTA partners specialize in the production and export of goods from different industries. Such differences mean that the suitability of macroeconomic policies, at any given point in time, could differ between Mexico and its NAFTA neighbors. Given its relative size, Mexico might have to bear a disproportionate share of adjustment costs to the adoption of a uniform NAFTA monetary policy.

Similarities in the structures of the U.S. and Canadian economies mitigate concern about Canada's adopting the U.S. dollar. Consider, for example, that both are developed countries and that much of U.S.-Canadian trade is of the intra-industry type. Intra-industry trade means that each partner produces and trades goods with each other that come from the same industry but that are from different product niches. Interestingly, research conducted in the early 1990s showed that Canada and the United States were more suitable to the creation of a currency union than Europe, where shocks were likely to generate "non-negligible regional problems" (Eichengreen). But concerns remain over whether the United States would allow Canada a voice at the monetary table and provide Canadian financial institutions with access to the services rendered by the U.S. Federal Reserve (Robson and Laidler).