# Money in a Sovereign Quebec

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*If Quebec were to separate, either amicably or acrimoniously, its chances of continuing to use the Canadian dollar are practically nil*

The likely monetary regime of a sovereign Quebec will be a key issue if there is a referendum on sovereignty. Judging from the 1980 referendum, the soundness of the currency could well be the make or break issue, and should be of keen interest to Canadian businesses. If Quebec were to separate, managers would find themselves in the difficult position of having to assess their exposure to currency risk in the uncertain environment of a country being split asunder. Consequently, for reasons of informed political choice and prudent business strategic planning, it is critical that all of the complex ramifications of money after sovereignty be fully understood.

### Quebec People Like the Canadian Dollar

Quebeckers have a deep attachment and high level of confidence in the Canadian dollar. Sovereigntist politicians recognize this fact and do their utmost to assuage worries that sovereignty might mean the establishment of a new, and likely shaky, Quebec currency. Jacques Parizeau, the leader of the Parti Québécois, was quoted in *Le Devoir* as saying that to create a Quebec currency would be to take a big risk and put in peril the economic levers of a sovereign Quebec. In early 1992 he told a group of institutional investors in Montreal that "Quebec as a sovereign nation would choose the Canadian dollar. That's absolutely certain."

Sovereigntists have not always voiced such strong support for the Canadian dollar. In a pamphlet released in 1990 the PQ stated that it advocates a monetary union with Canada, but if Canada refused, Quebec would adopt its own currency as has been done by almost all independent states.

More curiously, the most recent PQ program, which was prepared before Mr. Parizeau's latest utterings on the Canadian dollar, is relatively quiet on the PQ's plans for Quebec's monetary future. All it says is, "Quebec could accept under certain conditions to use the same money as Canada." Evidently, not everyone in the PQ shares Mr. Parizeau's total and unqualified commitment to the Canadian dollar.

The source of Mr. Parizeau's professed belief that Quebec can continue to use the Canadian dollar even without the agreement of Canada was the Bélanger-Campeau Commission. It took the position in its report that all that was required to maintain the Canadian dollar as the currency of a sovereign Quebec was the adoption of legislation declaring the Canadian dollar legal tender in Quebec. A simplistic position such as this can only be interpreted as a bargaining ploy intended to strengthen Quebec's hand in negotiations with the rest of Canada. It completely ignores the overriding importance of confidence in something as fragile as paper currency and the payments system.

### The Nature of the Breakup Would Affect the Currency

Critical to the issue of the continued use of the Canadian dollar and the maintenance of confidence in the currency would be the nature of the breakup. If the split were amicable, there would be a possibility that an agreement could be reached that would allow Quebec to continue to use the Canadian dollar. On the other hand, if the separation were acrimonious, an agreement would be very difficult if not impossible.

An acrimonious split would be the most likely outcome if the country were to break up. English Canadians love their country and are apt to react very emotionally to its destruction. Such a gut reaction is likely to be compounded by pocketbook disputes over the sharing of assets and the debt. The reception of the Bélanger-Campeau proposal for debt sharing shows how far apart the two sides would be and the hostility likely to be engendered.

The importance of rationality in determining economic institutions is overestimated. If it were

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the overriding factor, Canada would probably already be part of a U.S. dollar currency area. But the politics of Canadian nationalism makes such a development virtually anathema. Politics often takes precedence over economics.

The only possible reason that sovereigntists can be so insistent in claiming an agreement is not necessary for Quebec to continue to use the Canadian dollar is that they fear an acrimonious breakup. Otherwise they would argue for an agreement, because an agreement would unquestionably be essential to maintain confidence in the currency.

### Impossible for Quebec to Use the Canadian Dollar Without Agreement

Only the Canadian government can run a Canadian dollar monetary system. Without an explicit agreement with the Canadian government, the confidence that is so critical to the functioning of a financial system would be lacking.[1] The Canadian government alone can print the currency that people want to hold, and make the rules under which the payments system operates. While almost a quarter of the Canadian money supply is now in Quebec hands, these bills will wear out and must be replaced on a regular basis. The average life of $2, $5 and $10 bills is currently about a year, and the average life of a $20 bill around two years. Only the Canadian government can supply replacement currency. To keep an adequate supply of bills would require the regular delivery of truckloads of bank notes. This would be much more than the Quebec government could expect to obtain through normal balance of payments transactions, which are usually settled by bank drafts. While membership in the Canadian Payments Association for Quebec financial institutions would not be absolutely essential to clear Canadian dollar transactions, it would facilitate the clearings and would be critical in establishing the confidence so necessary for the functioning of the financial system.

### Even with an Agreement There Would be Difficulties

Even an agreement is not very strong glue for a monetary union. If a monetary union were established, there are grounds for pessimism about its durability, which would serve to undermine confidence. In the past, monetary unions without political unions have always eventually collapsed. Premier Bourassa recognizes this inconvenient fact that Mr. Parizeau has chosen to ignore. In a speech to the National Assembly on March 20, 1992, which was celebrated by federalists and deplored by sovereigntists, Premier Bourassa argued that a monetary union requires a political union and that the PQ's plan to separate but continue to use the Canadian dollar was unworkable. This has been Premier Bourassa's position since that fateful day in his basement in the early 1960s when he declined to join Réné Levesque in founding the Parti Québécois.

### The Canadian Government Could Block Quebec Use of the Canadian Dollar

If Quebec were to separate on acrimonious terms and were not to assume its fair share of the public debt, the reaction of the rest of Canada would be understandably hostile. In such a climate, there are some, admittedly extreme, steps that the Canadian government could take to prevent Quebec from using the Canadian dollar. Restrictions could be put on the export of Canadian currency. Existing Canadian currency could be recalled and new notes issued. Or regulations could be established to deny Quebec financial institutions direct access to the Canadian Payments Association. The mere threat of these measures would probably be enough to create a crisis of confidence that would knock Quebec right off the Canadian dollar.

The prospect of a crisis of confidence would have many of the aspects of self-fulfilling prophecy. If the holders of deposits of Quebec financial institutions denominated in Canadian dollars were to

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become worried that the Quebec government might pass a law changing the currency of the deposits into Quebec dollars, they would withdraw their money from Quebec financial institutions for redeposit in Canadian, or most likely U.S., institutions where it would be safe from devaluation. If the withdrawal of funds were sufficiently large, the Quebec financial institutions would quickly exhaust their liquidity reserves and would have to call their loans to honor their obligations. The resulting credit crunch would have a devastating impact on the non-financial sector of the Quebec economy, precipitating a collapse in asset values and investment. The solvency of Quebec financial institutions could even be jeopardized. The only way the Quebec government could relieve the building recessionary pressures and preserve the financial system would be to announce a separate Quebec currency and to devalue it sufficiently to establish confidence that no further devaluations were likely.

The resort to extreme measures by the Canadian government to block the use of the Canadian dollar by a sovereign Quebec would not be desirable and would undoubtedly only be taken if there was a complete breakdown of relations between Quebec and the rest of Canada.

A study by David Laidler and William Robson, published by the C.D. Howe Institute, has been cited by sovereigntists as evidence that there is nothing the Canadian government could do to prevent Quebec from using the Canadian dollar. A closer reading of this study reveals that what it actually says is, "The actions that the government of ROC (rest of canada) would need to take to prevent SQ (sovereign Quebec) from doing so – namely, the introduction of comprehensive foreign exchange controls – seem beyond the bounds of political possibility." Laidler and Robson never question that the government of Canada could stop Quebec from using the Canadian dollar if it was willing to take the necessary action, but question only that it would have the political will to do so. This should not provide much comfort to Quebeckers desirous of retaining the Canadian dollar. If the backlash in English Canada unleashed by the breakup were strong enough, the political will would be there to do everything necessary to ensure that Canada was not taken advantage of. Laidler and Robson are profoundly pessimistic about the long-term prospects for the continuing use of the Canadian dollar in Quebec for many of the same reasons discussed here.

**There are Many Advantages of a Monetary Union**

The advantages of the Canadian monetary union are great. It reduces transaction costs within the country and promotes the free flow of goods, services and capital, thus enhancing economic efficiency. The larger the size of the monetary union the more stable is the value of the currency and the better able it is to serve its function as a store of value. A larger monetary union and a more stable currency also lead to smaller risk premiums and lower interest rates. This has important implications for investment, longer term growth and standards of living.

The lack of a common currency between Canada and Quebec, if no agreement were reached on a monetary union, would be more troublesome for Quebec than Canada. The smaller and more open an economy is and the less diversified and the more variable economic activity is, the fewer the benefits from a floating exchange rate in fostering adjustment and the higher the costs in increased transaction costs and volatility. Bernard Fortin's estimate that a separate Quebec currency could cost Quebec $1 billion per year or 0.6% of Quebec GDP is illustrative. The costs to Canada would be comparable in absolute dollars, but, as a proportion of GDP, only one-quarter as much, taking into account Canada's higher GDP. This is a cost Canada could afford, either to avoid some of the disadvantages of a shared currency or, if separation brings

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out the worst in Canadians, simply to indulge its antagonism towards a newly sovereign Quebec.

Two separate currencies would lead to disputes over the appropriate exchange rate. While it is evident from Quebec's weak current account position that a Quebec dollar would have to trade at a significant discount to the Canadian dollar, the precise magnitude of the discount would be far from obvious. If the Quebec dollar sank to too deep a discount, or if the Quebec government was perceived to be trying to use an undervalued dollar to engineer a competitive advantage, serious conflicts could arise that could threaten trade relations. Neither Quebec nor Canada should expect to determine unilaterally the appropriate exchange rate between the Quebec and Canadian dollar if it were fixed, or expect to conduct a market intervention strategy without consulting the other if it were allowed to float. An exchange rate is a two-way thing.

The value of the Canadian dollar after separation is a related issue. In the ensuing financial chaos, down would be the predicted direction; how far is anybody's guess. For example, Premier Bourassa, a man of legendary caution, has speculated it could go to 75 cents, which must be acknowledged as a real possibility. Once the dust settled, however, the Canadian dollar would firm up, and, when the market finally came to register the implications of Canada's strengthened balance of payments without Quebec, the Canadian dollar would probably be pushed above its pre-separation value.

An additional advantage of a monetary union is that it would make it easier for Quebec to assume its fair share of the government debt. Since this debt is denominated in Canadian dollars, Quebec could be expected to bargain harder for a lower share if it were to have its own currency. Obviously, Quebec would experience more difficulties in carrying its share of the debt load denominated a foreign currency. If Quebec, counting on a monetary union, were to assume a larger share of the debt counting on a monetary union, however, and were eventually to be forced off the Canadian dollar by market forces or policy decisions and end up burdened with a large foreign currency debt anyway, gaining a temporary monetary union would turn out to be a pyrrhic victory.

**Canada Might Not Want Quebec to Use the Canadian Dollar**

Sovereigntists argue that it would be in Canada's interest to have Quebec continue to use the Canadian dollar. Whereas it is true that a wider common currency area would have certain advantages in facilitating trade and contributing to a more stable dollar, there would also be some definite problems that would arise for Canada if Canada were to allow Quebec to use the Canadian dollar. It would be extremely difficult, if not impossible, for the Canadian regulatory authorities to guarantee the solvency of the Canadian financial system if Quebec financial institutions could clear through the Canadian Payments Association and the Office of the Supervisor of Financial Institutions (OSFI) did not have supervisory authority over them.[2]

The bankruptcy of a major Quebec institution could occur without warning and could bring down the Canadian financial institution with which it had clearing arrangements. This would be a particular risk during the transition period to Quebec independence when the Quebec financial system would be subject to extraordinary strains. It would be in the interest of Canada to try to insulate itself as much as possible from the likely post-sovereignty disruptions of the Quebec financial system.

One of the great strengths of the current Canadian economic union is the national financial system with country-wide branching, which transfers savings from surplus areas to deficit areas and contributes to the efficient allocation of resources. Canada's system has worked much better than its U.S. counterpart, which is now mired in crisis.

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Over the past 20 years only two small regional banks and 20 near banks have failed in Canada, compared to hundreds in the U.S.

The breakup of the country would also fragment the current Canadian financial system on Canada-Quebec lines. There would no longer be a single regulatory authority and legislative framework. After Quebec independence, OSFI would continue to have responsibility for overseeing the global operations of financial institutions licensed in Canada. In Quebec the mandate of the Inspecteur général des institutions financières would have to be expanded to include the regulation of the formerly federally regulated institutions operating in Quebec. As a result of the likely efforts of both Canada and Quebec to regulate the same financial institutions, the individual institutions would have to be reorganized along Canada-Quebec national lines. Foreign ownership restrictions are already in existing Canadian financial institution legislation. The PQ program says it will adopt appropriate means to protect Quebec financial institutions from foreign (including presumably Canadian) ownership. It would be very difficult for the Canadian and Quebec regulatory agencies to coordinate their activities in the wake of the breakup, given the inevitable frictions that would arise.

Quebec sovereignty would sound the death knell of Canada's current financial system *a mari usque ad mare*. The splintering of the current Canadian financial system at the Canada-Quebec border would reduce the efficiency of financial markets and raise the cost of funds to borrowers. It would also reduce the stability of the financial system, particularly in Quebec, by reducing the extent to which financial institutions could diversify the risks of their loans and deposits across the whole country.

In addition, the Bank of Canada's conduct of monetary policy would be made more difficult if a large proportion of Canadian currency and Canadian dollar bank accounts were outside its control. Quebec financial institutions could not be compelled to report regularly to the Bank of Canada as are Canadian financial institutions. This would make it more difficult for the Bank of Canada to rely on current monetary indicators to gauge the stance of monetary policy. More importantly, monetary policy would have to be altered in response to changes in the money supply caused by inflows and outflows of Canadian dollars from Quebec resulting from among other things different macroeconomic policy stances in Quebec and Canada. This could conflict with the domestic objectives of monetary policy such as the pursuit of price stability.

### Quebec Could Decide to Abandon the Canadian Dollar on its Own

From Quebec's point of view, there would be disadvantages as well as advantages in continuing to use the Canadian dollar. For one, Quebec would not be able to conduct an independent monetary policy and would have to accept a Canadian monetary policy developed with little regard for economic conditions in Quebec. Some might say that this would be little worse than the *status quo*, but Quebec has no less voice at the Bank of Canada than other regions of the country. Even if English Canada were to go along with a monetary union with Quebec, it would not be likely to yield any significant say in the formulation of monetary policy to a sovereign Quebec. Other provinces would find it very difficult to accept Quebec representation on the central bank from which they were excluded.

There are strong forces at work that would make it almost inevitable that a sovereign Quebec would devalue and seek to pursue an independent and more inflationary monetary policy. There is dissatisfaction with the current relatively tight stance of monetary policy, and a naïve belief in some quarters that easy money could promote full employment. For instance, the PQ's program is very critical of the current monetary policy, and argues

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that measures taken to reduce overheating of the Ontario economy have often aggravated what was considered too high unemployment in Quebec. The PQ claims that it would put an absolute priority on full employment and is silent on the objective of price stability. It is understandably vague on how it might seek to achieve full employment, but an inflationary monetary policy is a nostrum that it would probably find hard to resist.

An independent Quebec would have serious current account and fiscal deficit problems. In 1990 Quebec had a deficit of merchandise imports over exports of $4.2 billion or 2.7% of GDP, according to the Quebec Bureau of Statistics. In the same year, Canada as a whole had a surplus of $10.9 billion or 1.6% of GDP. If Quebec's share of the deficit on non-merchandise transactions were estimated using its share of GDP, it would add another $7.6 billion or almost 5% of GDP to Quebec's deficit on merchandise trade to yield an estimate of $11.8 billion or 7.6% of GDP for Quebec's current account deficit.[3] This is a deficit that is three times higher than Canada's deficit of 2.4% of GDP in the same year and an order of magnitude higher than in the other G-7 countries. The situation has deteriorated in 1992 and it could turn out even worse if, as appears likely, a large risk premium gets built into the interest paid on Quebec's expanded external debt. A sovereign Quebec would be as close to a balance of payments basket case as could be found among the major industrialized countries.

**Poor Prognosis for the Canadian Dollar in a Sovereign Quebec**

With so much that could go wrong and confidence so fragile, the odds are very much against a continued monetary union if Quebec were to separate. Sooner or later, and most likely sooner, the government of a sovereign Quebec would abandon the Canadian dollar and establish a devalued Quebec dollar. Managers certainly need to factor this risk into their business calculations, but, most importantly, Quebeckers need to take this into account in deciding on whether to put nationalism ahead of their economic interest and opt for sovereignty. BQ

**Notes**

[1] The Bahamas and Panama currently use the U.S. dollar without a formal agreement, but these countries are very small relative to the U.S., have its acquiescence and have access to adequate currency brought in by the tourist trade and the Canal Zone.

[2] The Caisse de dépôt et placement du Québec, which is not subject to OSFI, currently clears through the Canadian Payments Association. This does not pose a threat to the solvency of the payments system, however, because the Caisse's liabilities are long-term pension contracts that, unlike short-term deposits can not be withdrawn quickly.

[3] While information is not available on Quebec's non-merchandise trade balance, there is no reason to believe that Quebec's share of Canada's balance would be less than its GDP share. Quebec has one of the highest provincial-local debt to GDP ratios. Its larger relative current account deficit could be expected to lead to a higher ratio of external debt. In addition, if Quebec were to assume its per capita share of federal debt, its share of federal debt as a proportion of GDP would increase.