Central bank cooperation and coordination in the Pacific Islands

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Introduction

In the context of globalisation, among central banks the terms cooperation and coordination have come to be associated with maintaining exchange rate stability as well as fighting currency and financial contagion, and, more recently, preventing the spread of world recession. In the past, it was often considered that such concerted action was required only among the industrialised countries. For small economies, including the Pacific Island countries (PICs), individual country reforms were deemed to be more important.

Accordingly, reforms now being implemented in PICs were designed to promote economic openness and macroeconomic stability. These goals are promoted by formulating sound and transparent economic policies, and by providing a rational regulatory framework, appropriate incentives and robust financial systems. The latter are supported by effective banking and financial institution supervision, and competent governance in both public and private sectors.

It was expected that, if all PICs implemented these reforms, the region would develop faster and would overcome 'the Pacific paradox', namely poor growth in the midst of plentiful foreign aid (World Bank 1991). Apparently for this reason, the subject of central bank cooperation and coordination received much less attention than it deserved. The objective of this article is to examine the need for effective cooperation and coordination among the central banks of PICs, and to suggest measures to improve both in the future.

Globalisation, regional integration and the tasks ahead

Increased globalisation has conferred benefits on developing countries. In the last decade, world trade grew at an annual average rate of 6.8 per cent, more than double the annual world output increase of 3.2 per cent. For developing countries, the corresponding figures were much higher: trade increased at 8.3 per cent and output at 5.5 per cent. During the second half of the last decade, PICs in particular fared badly, with poor growth in real output and trade. The Caribbean islands, with which PICs share many features (Fairbairn and Worrell 1996), performed well. Among the Caribbean islands, eight island countries belonging to the Eastern Caribbean Currency Union, which has a single currency, have done far better.

Studies by Duncan et al (1999) and Knapman and Saldanha (1999) show that PICs have not been able to take full advantage of integration into the global economy. With low domestic saving rates, extreme dependence on primary exports and minimal manufacturing capabilities, PICs risk being marginalised. Leaders of PICs are aware that globalisation would draw in much-needed capital, facilitate private investment in key areas and help the transfer of technology, thereby increasing the access of local exports to world markets. Towards these objectives, aside from the requirement that governments must create a suitable environment to encourage domestic investment and attract foreign direct investment (FDI), regional integration is critically needed to overcome the obstacles created by the smallness of markets in each individual PIC.

A foreign investor would find it profitable to invest in producing goods for export in a given PIC only if the regional market is assured. The liberalisation of intraregional trade would present a bigger market, replacing small individual national markets. Referring to North Africa, Chabrier (2001) observed gravity models linking bilateral trade flows to the economic size of, and the distance between, trading partners, and showed that bilateral trade between, for example, Algeria and its neighbours, is substantially below its potential.

A European investor would prefer to set up business in Europe to produce goods for export to North African countries, rather than investing in Algeria. An Australian investor would be ready to invest in Vanuatu, for example, if his exports to other PICs are assured entry free of any impediments. The creation of larger markets also confers benefits on domestic investors by creating economies of scale in production and distribution, lowering transaction costs and increasing the reliability of market demand.

Regional cooperation, now being accelerated by the Pacific Island Countries Trade Agreement which promotes free trade among 14 PICs, should not be confined to trade alone. The establishment of regional infrastructures, both physical and financial, is also necessary. Physical infrastructures include regional transport and telecommunications. Financial infrastructures would cover payment systems, merging of stock exchanges, harmonising investment incentives and tax systems, and labour market reform.

PICs would do well to extend such cooperation to other areas as well: exchanging views on respective reform programmes, discussing common issues, sharing best practice standards, coordinating regulatory reforms and harmonising property rights and investment law. Such efforts would eliminate the market fragmentation that makes the region unattractive to investors. Further, the regional approach would enable PICs to pool their human resources to achieve greater technical and administrative competence.

Regional cooperation would also contribute to macroeconomic stability. Such cooperation comes in the form of regional peer group surveillance, which would help reduce the risks of macroeconomic slippage. Surveillance tasks would include laying down convergence criteria, targets and a time schedule (Jayaraman 2001a). In particular, the focus would be on exchange rate stability in the region as a whole, which certainly hinges on domestic fiscal and monetary discipline in each country. Aiming at exchange rate stability indirectly brings to attention issues of technical and administrative competence in the central bank of each PIC in the areas of liquidity management and autonomy, which is referred to as central bank independence (Jayaraman 2001b). Participating in a structured program of central bank cooperation would permit national authorities to pursue reforms in regard to central bank independence that aim at eliminating the fiscal abuse of central banks (Fry 1993), and other politically difficult measures at home.

An active program of central bank cooperation would be a precursor to monetary integration, including the formation of a currency union, once intraregional trade volume has reached a high level. Experiences in Africa and the Caribbean have shown that it is worthwhile pursuing ways and means of encouraging greater central bank cooperation.

Experiences from other regions

Regional integration measures in Africa and the Caribbean present contrasting experiences. Africa has many different, overlapping regional arrangements, particularly in eastern and southern Africa. On the other hand, in the Caribbean there is one single regional organisation, the Caribbean Community and Common Market (CARICOM), which has now been in existence for more than 40 years. CARICOM, which evolved as a free trade area, finally emerged as a customs union (Hilaire et al 1994).

A commitment to integration efforts provided an impetus to central bank cooperation efforts in Africa and the Caribbean. Consequently, a conscious decision was made to rationalise existing arrangements (Gondwe 2001) and to resort to peer group surveillance of national macroeconomic policies, including the adoption of convergence criteria (Worrell 2001, Hilaire et al 1994, Masson and Pattillo 2001). As a result, the political leadership in the Economic Community of West African States in 2000 adopted criteria along the lines of the Maastricht accession criteria in Europe, which revolved around fiscal deficits, inflation and external debt.

In the Caribbean, the governors of central banks in CARICOM decided in 1992 on a phased approach to monetary union, which depended upon the observance of qualifying or convergence criteria. These criteria were that the countries should have had: foreign reserves equivalent to three months' import cover for at least 12 months; a stable exchange rate for three years; and a debt–service ratio of less than 15 per cent.

The observance of convergence criteria, and their monitoring through peer group surveillance, help the cause of integration. The central banks in the Caribbean set up a think tank research institution known as the Caribbean Center for Monetary Studies (CCMS). The CCMS, manned by personnel drawn from the region's central banks and the University of the West Indies, undertakes periodic reviews and provides information on economic and monetary developments in the region.

Central bank cooperation among PICs

The PICs have varied currency and exchange rate regimes. There are five countries which have no currencies of their own, having adopted the currencies of major developed countries as legal tender: Kiribati and Tuvalu use the Australian dollar; and the Republic of Marshall Islands, the Federated States of Micronesia and Palau use the American dollar. While Papua New Guinea (PNG) has a flexible exchange rate, there are five countries that have their currencies pegged to a basket of currencies of their major trading partners. Since regional integration efforts do not cover monetary integration, there is no pressure on PICs to push beyond free trade.

There are other reasons they have not done this: despite poor growth with stagnant per capita incomes, the macroeconomic performance of PICs has not caused any serious concern. Inflation has been generally low, as imports have been from Australia and New Zealand, whose central banks have been targeting inflation. Fiscal deficits are also low because of substantial external aid. Further, inflows of private remittances help to balance the external payments.

Reforms, however, are not sufficient to attract FDI to supplement domestic savings and to upgrade managerial and technical expertise. The FDI inflows of PICs have been much lower than those of the Caribbean islands. It is important to present the region to overseas investors as stable, growing and solid so that foreign businesses can become competitive by overcoming the handicaps imposed by PICs — small markets, weak basic infrastructure and limited financial and human resources. The monetary authority of each PIC should coordinate and cooperate with each of the others to promote macroeconomic stability in the region as a whole.

The central banks in the region have no doubt in the past been in touch with each other. Notable among such meetings are the annual meetings of central bank governors, which are held in different capitals of the region. Although there is no fixed agenda for such annual meetings, and no minutes are kept to enable a follow-up of subjects discussed, personal contacts have proved helpful. The subjects covered in annual meetings since the mid-1990s include banking supervision, training and legislation for better monitoring, and controlling illegal money flows to financial centres under tax haven status in various PICs. Other cooperative activities include staff development in PIC central banks, arrangements for staff visits to other central banks to gain work experience and improve the profile of the country.

In this regard, efforts by the International Monetary Fund (IMF) in the Pacific region deserve mention. Regional organisations such as the Asian Development Bank are able to monitor macroeconomic performance by using the IMF mission reports. These reports provide the necessary information to compare countries' performances and stimulate discussion.

Further, the IMF set up a Pacific Financial Technical Assistance Center (PFTAC) in Fiji in the mid-1990s, to provide technical assistance and training to PICs in selected areas. These included budget management, tax administration and policy, banking regulation and supervision and statistics. The PFTAC has, however, avoided sensitive areas such as the harmonisation of monetary and exchange rate policies.

Because of this, critical components of central bank cooperation are missing in the region. There is no requirement on the part of central banks to pursue targets similar to the convergence criteria pursued by CARICOM. Consequently, the maintenance of exchange rate stability in the region as a whole is missing: such strategies as bilateral/multilateral currency swap arrangements and improvements in liquidity management, including open market operations and debt management, would contribute to making the region stable.

There is no institutional support to monitor the conditions in the region corresponding to that of the CCMS in the Caribbean region. The absence of mechanisms to achieve peer surveillance of macroeconomic stability has forced PICs to rely on multilateral organisations, which at times have been found by the PIC concerned to be too critical and less constructive on sensitive aspects.

A lack of policy commitment on the part of governments with regard to economic integration beyond trade does not mean that PICs cannot explore further avenues of central bank cooperation. Past experience indicates that central banks in PICs did have some understanding with each other, especially in regard to bilateral/multilateral currency swap arrangements. In times of foreign exchange crisis, when a country's exchange rate is under severe stress, the central banks of the PICs could come to the rescue of others in the region by establishing a network of swap and repurchase agreement facilities among themselves.

It is understood that, in the mid-1980s, an informal swap and repurchase arrangement was executed successfully by Samoa and Fiji, when Samoa was awaiting the finalisation of an IMF program of assistance. At that time, Samoa's reserves were at critical levels, its currency was under stress, and essential imports, such as fuel, were found to be very difficult to finance.[1] It would be worthwhile formalising such arrangements.

Further, the central bank governors in the region may consider meeting more than once a year and extending their meeting agenda to cover new subjects that, until now, have been considered fairly independent and sensitive. These would include providing training in financial supervision and regulation to achieve a more collaborative stance. Considering the acute shortage of expertise in the region, it would pay not only to harmonise the appropriate legislative measures, but also to pool the available expertise and resources into a regional effort that would deal specifically with financial supervision and regulation.

Conclusion

More concerted efforts are needed to assure international investors that the region is stable, which would contribute to overcoming the handicaps imposed by the smallness of national markets and inadequate human resources. In such an enabling macroeconomic environment, factories and businesses can be located within in the region to serve the regional market as a whole, without any impediments to the movement of goods or services utilising regional resources. Only under such circumstances can the benefits of globalisation, which have eluded PICs so far, be obtained.

Now that free trade has become a distinct possibility, central banks should explore together areas of coordination and cooperation. One step that is within their capacities is setting up a Pacific Island centre for monetary studies, with expertise drawn from the region's central banks and the University of the South Pacific, which could function as a think tank for the region.

Note

1. We owe this information to Mr S Siwatibau, a former governor of the Reserve Bank of Fiji, now vice-chancellor of the University of the South Pacific, Suva, Fiji.

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