"Is A Single Regional Currency A Viable Solution?"

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1. A single currency for the Pacific region was proposed by Australia at the annual Pacific Forum Leaders' meeting held in Auckland in August 2003, which was attended by the prime ministers and presidents of the 14 Pacific Island Countries[1] (PICs) and the prime ministers of Australia and New Zealand.

2. A common currency is essentially the ultimate of economic integration of states, known as currency union, without having to surrender their political identity as nations and their sovereignty. Known as currency union, it is a zone of countries or a region, where (i) a single currency circulates; (ii) a single monetary authority operates; (iii) a single exchange rate policy prevails; (iv) the single monetary authority maintains a common pool of reserves; and (v) free trade takes place within the region. The proposal of a single economic space for the South Pacific region is not new. It has been toyed with from time to time over the last two decades in one form or another, as part of promoting regional economic cooperation.

3. The timing of the proposal for a common currency this time was, however, triggered by certain developments. Besides the renewed impetus given by the emergence of the euro as a common currency in 1999 in Europe, deteriorating economic conditions in the last few years in some of the PICs due to their weak monetary and fiscal discipline and poor governance have been causing some concerns to the aid donors. These concerns came to be highlighted in a study by Helen Hughes, which prompted an Australian Senate Committee (2003) to come up with a strong plea for a *Pacific Economic and Political Community*. One of the suggestions for promoting regional stability was adopting a common currency, preferably the Australian dollar, replacing the existing national currencies.

4. In the event of the Australian dollar being adopted as the common currency of the region, the cost for Australia would be minimal since its central bank, the Reserve Bank of Australia (RBA) would continue with unfettered freedom to pursue its own monetary policy. Substantial benefits to Australia would consequently arise from increase in its volume of trade, since dollarisation of the region would lead to elimination of transaction costs and volatility in exchange rates between Australia and others in the region. Just as a common language promotes communication among people, a common currency could promote trade and investment among countries in the region. These benefits will have to be weighed against the likely costs that have to be incurred by New Zealand and the 14 PICs. These would involve the costs of discontinuing their own independent currencies by replacing with the Australian dollar and the loss of seigniorage revenue

[1] The 14 Pacific island countries, which are members of the Pacific Forum along with Australia and New Zealand are: Cook Islands, Fiji, Kiribati, Republic of Marshall Islands, Federated States of Micronesia, Nauru, Niue, Papua New Guinea, Samoa, Solomon Islands, Tonga, Tuvalu, Vanuatu.

from printing their own currencies. Further, all of them have to fall in line with Australian macroeconomic and exchange rate policies.

5. A common currency entails a single set of economic, monetary, financial and fiscal policies to influence the balance of payments of the region. Such a single set of policies can be justified only when there is a high degree of synchronization of business cycles for all prospective member countries of a currency union. According to optimum currency area (OCA) conditions, countries experiencing common external shocks would be better suited to form a currency union because it permits the use of union-wide policies to correct any imbalances, including the adjustment of the common currency. The OCA conditions have since been elaborated, refined and updated by growing literature on the subject.

6. The gains from a currency union, which are in terms of increase in efficiency, arise primarily from two sources. The first is that a common currency eliminates transaction costs usually incurred when trade and investment transactions need currency conversion. Secondly, a common currency eliminates risk from uncertainty in the movements of exchange rate between trading partners. One more gain is that a currency union provides a potential for reinforcing fiscal discipline and credibility of monetary policy.

7. The disadvantages are obvious. They relate to the loss of two important macroeconomic adjustment tools, namely independent monetary and exchange rate policies. The member country has to abide by common monetary policy for the union as a whole; and it has to relinquish its exchange rate, an instrument for protecting itself from economic shocks. However, the costs are less severe if the shocks affect all member countries in the union in a similar fashion, and a common monetary and exchange rate policy *vis-a vis* with the rest of the world would then be appropriate. On the other hand if the shocks were asymmetric in nature, affecting the countries in a dissimilar manner, due to reasons such as different industrial structures, a common policy would be the least desirable. In such cases, the inability to use the exchange rate for making necessary adjustments would result in greater volatility in output and employment. However, disadvantages of such a nature can be reduced to a great extent if prices and wages are flexible and if there is perfect labour mobility between member countries. Thus, downward flexibility of wages and prices and labour mobility will enable the member countries in a currency union to withstand shocks of asymmetrical nature.

8. The OCA literature identifies the following as key deciding factors for a currency union: openness, intra-trade volume, degree of product diversification, similarity in industrial structures, high correlation in economic activities, similar inflation rates, flexibility in wages and prices and factor mobility.

9. A comparative picture on regional trading patterns shows though PICs, as a group, are the second most open (trade openness being about 79 percent of GDP), next only to ASEAN. However, their intra-trade (12 percent of GDP) is lower than that of the Eurozone (25 percent) and ASEAN (24 percent).

10. On the other hand, PICs, except RMI, FSM and Palau, which have been closer to the USA because of the past political relations, have substantial trade with Australia and New Zealand. For example, Australia is the major destination for Samoa's exports (60 percent in 2002) and PNG's imports are dominated by Australian goods (49 percent in 2002. Similarly, Fiji exports one fifth of its goods to Australia and imports from Australia more than one third of its total imports.

11. A review of the patterns and trends of intra-trade among PICs shows that the volumes of trade in both absolute and percentage terms are very small. The major intra-regional trading partners among PICs are Fiji and PNG, which have relatively large manufacturing base. PICs lack product diversity. Consequently, all of them have had to depend upon Australia and New Zealand for other consumer products, and on Japan and the USA for machinery and transport vehicles and other intermediate products.

12. These characteristics render their economies more competitive than complementary to each other, resulting in a low volume of intra-regional trade. Further, there are other critical factors remaining to be examined. These include testing the existence of high correlation in economic activities between PICs and Australia as well as similar inflation rates so that a common set of union wide policies can be pursued.

13. Empirical analysis indicates that there was no convergence of macroeconomic policies pursued by PICs and Australia, since economic shocks hitting both sets of countries were dissimilar and there would be no gains for PICs agreeing to Australia's own set of monetary and exchange rate policies being adopted for the region as a whole. Since PICs and Australia have different levels of development, the growth and development challenges facing PICs are different from those of Australia. Union-wide policies at this juncture would not be suitable for PICs. The same conclusion is reached for the currency union among PICs themselves, without involving Australia, since there is considerable divergence in growth rates amongst themselves.

14. However, it is possible to argue for a currency union with Australia on the grounds that OCA criteria are to some extent endogenous and currency union might help make the shocks hitting member countries more symmetric in the future and might also expand intra-union trade. These arguments are not different from the observations made by theorists, when the European Common Market was born. It was felt that common currency arrangements would by themselves make the countries similar all along the way. However, it should be noted that the EU member countries did not plunge into a currency union arrangement, as they were aware of the pitfalls and insisted on fulfilling the convergence criteria[2] contained in the Maastricht Treaty of 1991 and the requirements under the Growth and Stability Pact of 1996.

[2] The Maastricht Treaty of 1991 provided a timetable, setting preconditions for the final stages of the process of currency union. The following five preconditions are known as convergence criteria. These are: (i) each country's budget deficit has to be below 3% of its GDP; (ii) each country's public debt, has to be less than 60% of GDP;(iii) countries should have an inflation rate within 1.5% of the three EU countries with the lowest rate; (iv) long-term interest rates must be within 2% of the three lowest interest rates in EU; and (v) exchange rates must be kept within "normal" fluctuation margins of Europe's exchange-rate mechanism. Greece was the only one member of the European Union which was told that it was not ready to join the single currency with the first wave of countries in 1999. It had to wait for two years before joining the Eurozone at the beginning of 2001.

15. Fulfillment of the convergence criteria is only a necessary but not a sufficient condition for ushering in a currency union. One has to clearly recognize the role of politics in monetary integration. As Mr. Padoa-Schioppa, a member of the Executive Board of European Central Bank recently observed, monetary integration requires strong political support from all the candidate countries[3]. As witnessed in the case of members of the Euro zone, besides the surrender of monetary sovereignty to a supranational authority, fiscal policy too was constrained first by the aforesaid convergence criteria and then by the Growth and Stability Pact of 1996. The members of EU were also required to open their capital and labour markets by implementing the policies towards harmonization of a wide range of commercial and legal standards.

16. If Australia were keen about dollarisation of Picks, the latter are likely to seek and secure some assurances from the former. Since dollarisation would result in discontinuance of their independent currencies, PICs would lose the current revenue flowing from the sovereign right of printing its own currency. The PICs would then like to have a share in the seigniorage revenue, which would accrue only to Australia. Secondly, since there would be only one common central bank in a currency union, a given PIC would not be able to support its domestic banks in the event of a bank crisis. In such circumstances, PICs would like to be assured of liquidity support from Reserve Bank of Australia, as a lender of last resort for rescuing their crisis-affected banks. Thirdly, if the Reserve Bank of Australia finds it inopportune to follow an expansionary monetary policy or would not like to use the exchange rate as the policy tool to fight unemployment in one or more of its member countries, PICs would prefer the mechanism of fiscal transfers to the needy member countries. Finally, a currency union without perfect mobility of labour and capital would be a failure since PICs would lose the exchange rate as a policy tool to effect corrections in domestic pricing of goods and factors. In the absence of downward flexibility in prices and wages in PICs, labour mobility is the only way to have a successful union.

17. The issues including labour mobility and fiscal transfers have far reaching implications. They have to be resolved at political levels. It is not yet clear whether these have been resolved even in Australia through a national consensus, let alone reaching an understanding with other Pacific Forum leaders or an agreement amongst the island countries themselves.

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[3] Gathering political support and securing consensus for achieving monetary integration in Europe took nearly five decades. There were several notable milestones. Setting up of the European Coal and Steel Community was the first one in 1950, which aimed at free trade in coal and steel by 1954. Establishing the European Economic Community under the Treaty of Rome signed in 1957; European Free Trade Association in 1960; and several regional institutions and harmonizing measures for facilitating movement of capital and labour under the Single European Act of 1987 followed these. The creation of a single market was achieved in 1992. Along with these measures, there were parallel efforts in monetary integration. These included introduction of the European Monetary System in 1979 for creating an area of exchange rate stability among members by ushering in the Exchange Rate Mechanism and the European Currency Unit, paving the way for Monetary Union within European Community. In 1989 the Delors Report recommended the introduction of a single currency by setting out stages including the establishment of the European Central Bank System. The stages included the signing of Maastricht Treaty of 1991, which laid down the criteria for reaching convergence and enactment of the Growth and Stability Pact of 1996. The latter levied a fine of 0.1 percent of GDP on members in case of fiscal deficits in excess of the 3% of GDP ceiling. These measures, which were introduced and implemented through political consensus, eventually prepared the members to become eligible for adopting the single currency. The Euro was ultimately born on Jan 1, 1999.

18. It is worth recalling the Caribbean experience in this regard. A single currency for the Caribbean region has yet to become a reality. The reasons are obvious. William Demos, a former Governor of the Central Bank of Trinidad and Tobago, who later became the first Secretary General of the Caribbean Community and Common Market (CARICOM) observed nearly two decades ago that a single independent currency, which entailed a single set of monetary and fiscal policies, was possible only with a high degree of economic union, tantamount to a political union.