

Prospects for a currency union in the Pacific

A preliminary assessment

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Abstract

The paper presents some preliminary findings of a study on the prospects for a currency union among the Pacific Island countries. In addition to drawing upon extensive theoretical literature, the study utilises the experiences of currency unions among the developing countries in the West African and Caribbean regions. As ill-thought out and ill-planned monetary and currency unions might end in disaster, certain prerequisites suggested in the literature are carefully evaluated. These include an examination of the pre-union trade patterns, asymmetric economic shocks, labour mobility and possibilities of fiscal transfers, as well as institutional strengths of the existing central banks with regard to their monetary policy formulation and implementation. The indications are that the Pacific Island countries would prefer to await the outcome of a free trade area before forging higher forms of integration.

Keywords

currency union; Pacific Islands; monetary policy

Introduction

With the signing of two agreements in August 2001 on promoting free trade in the Pacific under the auspices of the Pacific Islands Forum (the Forum), expectations are on the rise about the beneficial effects of regional economic integration. The Forum comprises 16 countries (FCs: Forum countries) in the region. They include 14 developing island countries, known as FICs (Forum island countries)—Cook Islands, Federated States of Micronesia, Fiji, Kiribati, Nauru, Niue, Papua New Guinea (PNG), Republic of Palau, Republic of Marshall Islands, Samoa, Solomon Islands, Tonga, Tuvalu and Vanuatu—and two developed countries—Australia and New Zealand. The two agreements are the Pacific Agreement on Closer Economic Relations (PACER) signed by all 16 FCs, and the Pacific Island Countries Trade Agreement (PICTA) signed by the 14 FICs.

While PACER sets out the basis for future development of trade among all FCs, PICTA provides for the progressive phasing out of tariffs by 2010 for all FICs except the identified least developed and small island states. These include the Cook Islands, Kiribati, Nauru, Niue, Samoa, Solomon Islands, Republic of Marshall Islands, Tuvalu and Vanuatu, for which the deadline is 2012 (Qalo, 2001). When implemented, economic integration in terms of free trade between the developing FICs, and eventual trade and economic cooperation between the FICs and the two developed member countries, are likely to generate greater volumes of intra-FIC trade. Although various studies sponsored by the Forum (Scollay, 1998; Centre for International Economics, 1998) have indicated that the potential economic gains from PICTA would be minor, the FICs have decided to take a small step first before opening their markets to other partners. Thus, PICTA is seen as a small component in their overall strategy of gradually liberalising their trade, as well as a way of encouraging greater cohesion among the FICs in trade policy matters.

Worldwide trends in economic integration—beginning from preferential trading arrangements and moving to free trade arrangements and to ultimate economic and monetary union in both the developed and developing regions—have given an impetus to similar attempts in the South Pacific. The birth of the euro in 1999, as a single currency first for 11, later 12, member-countries¹ in the European Union's Economic and Monetary Union (EMU), began with similar efforts in 1958 towards free trade amongst themselves and with common tariffs against third countries. It was the first step,

known in 1958 as customs union, towards a common market with full factor mobility in labour and capital.

In the developing world, there have been some notable integration efforts as well. These include:

1. Communauté financière africaine (CFA), consisting of two zones,
 - a) West African Monetary Union,² and
 - b) Central African Economic and Monetary Union in Africa³ (Hernandez-Cata et al., 1998; Cobham & Robson, 1994; Collier, 1991);
2. the rand zone;⁴
3. the Eastern Caribbean Currency Union (ECCU)⁵ within the Organisation of Eastern Caribbean States (OECS);⁶ and
4. the Caribbean Community and Common Market (CARICOM)⁷ in the Caribbean region (Samuel, 2001; Hilaire, 2000, 2001; Van Beek, 2000; Hilaire et al., 1994; Blackman, 1998; Demas, 1974), with which FICs share many commonalities (Fairbairn & Worrell, 1996).

These efforts have also inspired some notable studies in the Pacific (de Brouwer, 2000; Duncan et al., 1998). The exchange rate arrangements of FICs vary, spanning the continuum from the exclusive use of a foreign currency as domestic currency through to a free-floating domestic currency. Eight FICs do not have any independent domestic currency of their own, using instead the national currencies of Australia, New Zealand or the United States as legal tender. These are: Kiribati, Nauru and Tuvalu (using the Australian dollar); the Cook Islands and Niue (the New Zealand dollar); and Marshall Islands, Micronesia and Palau (the United States dollar). A further five FICs (Fiji, Samoa, Solomon Islands, Tonga and Vanuatu) have their own national currencies, which are pegged to baskets of currencies whose composition and weights are generally kept confidential. Only one FIC, Papua New Guinea, has an independently floating exchange rate regime. The objective of this paper is to undertake a preliminary assessment of prospects of monetary integration, including establishment of a currency union in the Pacific region. The paper is divided into four sections, the first of which briefly deals with various forms of monetary integration. The second section examines the FCs' preparedness in the light of various

criteria required for monetary integration, while the third reviews trends in monetary cooperation in the region and future directions. The final section presents a summary and conclusions.

Forms of monetary integration

Institutional arrangements for monetary integration among sovereign countries take different forms. The degree of rigour varies from the highly restrictive arrangements to the flexible (Masson & Pattillo, 2001b). At the one end, it could be a *currency union*, in which a single currency, either through creation of a new currency or adoption of an existing national currency, prevails with a common monetary policy for all union members. As an intermediate arrangement, it could take the form of a *monetary union* with national currencies coexisting along with a common external exchange rate policy, flexible or pegged to an external currency or a basket of currencies. At the other end, there might be 'pseudo—exchange rate arrangements' of *monetary integration* (Corden, 1972). However, under currency and monetary union arrangements, a supranational monetary authority is established and a single external exchange rate policy is pursued, with national authorities relinquishing their individual control over international reserves by vesting them in a common central authority.

Restrictive conditions

The monetary union arrangement is a looser concept than currency union, as it allows the circulation of individual national currencies without need for a common currency. However, there are restrictive conditions (Allen, 1976):

1. the currencies of member countries should be fully convertible at immutably fixed exchange rates;
2. there should be a single monetary policy, which is determined at the union level, allowing no autonomy at national levels; and
3. there should be a single external exchange rate policy.

The monetary union permits the possibility of an exit from the monetary union should a member country want to return to its previous regime, as it can easily fall back upon its own currency. Such an exit from a currency

union is far more difficult, since the exiting member country has to face substantial costs involved in restoring its discontinued national currency and reviving the central bank and related arrangements.

In a pseudo—exchange rate union, a permanently fixed relationship between national currencies, and absence of exchange controls on current and capital transactions within the area of its jurisdiction, might be assured. There is, however, 'no explicit integration of economic policy, no common pool of foreign exchange reserves and no single central bank' (Corden, 1972: 3). Because of the critical absence of these mechanisms to maintain exchange rates rigidly, there is the possibility of a member country deliberately depreciating or appreciating its currency against those of others. Such monetary unions are not credible and lack the rigour of formal unions (Cobham & Robson, 1994).

Institutional safeguards

The need for institutional safeguards is stressed in monetary union arrangements to bestow much needed credibility. Aside from a single monetary policy and permanency in the fixation of exchange rates, which are the basic ingredients for a monetary union, the purists underscore the absence of national banks and pooling of international reserves as the fundamental requirements. For a currency union, in particular, a common currency cannot coexist with any national currencies and national central banks.

Masson and Pattillo (2001b: 14) and Cohen (1998: 87) also emphasise the need for a strong bond of solidarity among the participating member countries. A long period of close cooperation as well as continued existence of institutions would contribute to the strengthening of such a bond, as witnessed in the case of the euro zone. It would assure some degree of permanency under certain circumstances. There should be at least one member exercising hegemonic power and it should have a good record of price stability, with sound financial and monetary institutions having an impeccable record of central bank independence. The prospective members would then feel assured of gains arising out of union arrangements with the leadership role assumed automatically by the dominant member (Cohen, 1998).

External convertibility is not an essential requirement for either a currency or a monetary union. Developing countries in the initial phase of monetary integration efforts may still prefer to retain exchange controls. However, internal convertibility within a currency union is fundamental to maintain credibility. This is especially so if national currencies are allowed to coexist for a while along with the common currency. In the long run, external convertibility, if introduced and maintained, would eliminate any incentives to hold foreign currencies, either legally or illegally (Masson & Pattillo, 2001b).

For a successful operation of integration arrangements, the common central bank in a currency union should enjoy full autonomy in establishing and implementing appropriate monetary policy to maintain price stability and value of currency. As a corollary to this rule, no individual member government is permitted any fiscal expansion unsupported by domestic resources. Certainly, the common central bank is not expected to bow to pressures to accommodate such deficits. Some governments may not follow prudent fiscal policies but rather may indulge in monetisation of their fiscal deficits by steamrolling the pliable central banks. For a wayward individual member government of this kind, monetary integration would result in the creation of a supranational institution in terms of a common central bank. Such a common central bank is expected to act as an 'agency of restraint' (Collier, 1991).

Two fire-fighting solutions

The 'agency of restraint' solution for an individual country with a tendency to run into fiscal deficits year after year over a period, thereby giving rise to uncontrolled inflation and external deficits, need not necessarily be in terms of a monetary union with neighbouring countries. In fact, such a country with poor fiscal discipline would not be admitted to an existing currency union or be considered for forming such a union with other similarly placed countries, unless some semblance of fiscal order is restored and maintained over a period. These conditions would fall under the description of convergence criteria by which the country's membership application would be evaluated.

On the other hand, a solution now being suggested more and more is a currency board arrangement (CBA). Under CBA, the national currency

would continue to exist. The monetary authority, though, would be required to hold reserves in a foreign currency (the anchor currency to which the national currency will be firmly pegged) sufficient at least to cover the entire narrow money supply. In this way, the financial markets and the public are assured that every domestic currency bill is backed by an equivalent of foreign currency. The central bank can increase money supply only by adding to the international reserves through external borrowing or building trade surplus (Balino & Enoch, 1999; Gulde, 1999; Ghosh, Gulde & Wolf, 1998; Enoch & Gulde, 1997, 1998; Henke & Schuler, 1994). The voluntary surrender of monetary sovereignty brings its own advantage in terms of:

1. assured convertibility;
2. macroeconomic stability;
3. guaranteed balance of payments adjustment mechanism;
4. low inflation; and
5. confidence in the monetary system, thereby promoting trade, investment and growth.

Another variant of a firmly fixed exchange rate arrangement is 'dollarisation' (Eichengreen & Hausmann, 1999). Under this arrangement, there could be either full or partial dollarisation. In the case of the first, the national currency would be discontinued and replaced as legal tender by a currency of a country, usually the United States or a major economic power, with which trade and economic relations have been close in recent years. Under the second, the residents are permitted to hold bank deposits, both checking and long term, in dollar and national currency. Thus, the two currencies would circulate side by side. The transitional economies, especially some of the former Soviet republics, are notable examples.

Full dollarisation offers greater gains than does CBA, including:

1. absence of speculative attacks on the domestic currency, as there is none;
2. no possibility of sharp depreciation and no sudden capital flows;
3. no possibility of inflationary finance; and hence strict financial discipline; and
4. closer integration with the country whose currency has been adopted as legal tender.

Disadvantages, besides the loss of a national symbol (as a domestic currency tends to be) include:

1. loss of support for the domestic banking system in times of crisis;
2. loss of seigniorage revenue; and
3. difficulty in exiting from dollarisation compared to other regimes.

The need for an 'agency of restraint' was the main reason behind suggesting monetary integration in Africa, where several countries, because of their contiguity, have been drawn into the experience of inflation as a result of running into fiscal deficits with balance of payments crises over years. The FICs (table 1) are different. A comparative picture of the macroeconomic performance of FICs (table 2) shows that although their growth rates in recent years have been modest, fiscal deficits have been manageable, with comfortable levels of international reserves, and inflation has been generally low. The sole exception has been Solomon Islands, which continues to go through an extended period of inter-island rivalry and ethnic strife and its aftermath. Rosales (2001) notes that no single exchange rate or monetary arrangement is superior to the other, as inflation in those FICs with the Australian or the United States dollar as legal tender is not always lower than that observed in other FICs under other exchange rate regimes.

The African context is not applicable to FICs. The fire-fighting solutions in terms of CBA or dollarisation are not warranted (Jayaraman, 2001). Nor should they form the basis for advocacy of the idea of monetary integration. Rather, an appreciation of potential long-term gains such as increases in trade, growth in output and welfare should provide the motivating force for striving towards greater integration beyond PICTA.

Table 1 Pacific Island Countries: basic indicators

Country	Population ('000)	Per Capita		Life Expectancy (Years)	Adult Literacy (%)	Human Development		External Aid		Structure of the Economy	
		GNP (US\$)	1999			Index	Rank	Per Capita (US\$)	Average of 1996-98	Agriculture	Industry	Services	(% of GDP)
Cook Islands	17.9	5020	71	100	0.822	62	490.9	-	16.6	7.8	75.6
Fiji	811	2310	65	92	0.757	101	46.1	2.2	18.4	2.5	56.6
Kiribati	89.6	910	59	97	0.515	129	200.8	17.6	18.6	7.6	73.8
Marshall Islands	51.6	1950	63	91	0.563	121	811.3	60.5	13.5	14.9	71.5
Micronesia	118.5	1830	64	81	0.569	120	705.6	44.5	-	-	-
Nauru	11.8	2900	55	90	0.663	103	182.7	-	-	-	-
Palau	19	6448	66	98	-	46	4814.1	45.9	-	-	-
Papua New Guinea	4,400	810	58	72	0.534	-	78.5	-	28.7	38.1	33.2
Samoa	170.7	1070	65	98	0.701	117	215.3	17.7	16.2	26.5	57.3
Solomon Islands	459	750	64	62	0.603	147	102.4	12.5	22.1	15.4	62.5
Tonga	100.3	1730	65	96	0.647	107	259.6	15.7	28.5	15.1	56.4
Tuvalu	10.5	1360	64	99	0.583	118	472.7	-	25.6	14.5	59.8
Vanuatu	187.7	1180	64	70	0.633	140	221.8	14.4	15.8	10.5	73.7

Source: Asian Development Bank, *Key Indicators 2001*

Electronic databases of World Bank, UNESCAP, UNESCO, UNICEF, WHO

Table 2 A Comparative picture of Pacific Islands' economic performance (average of five years: 1995-1999)

Category	Average GDP Growth Rate (%)	Overall Fiscal Balance excluding grants (% of GDP)	Overall Fiscal Balance including grants (% of GDP)	Inflation (%)	External current account (% of GDP)	Growth in M2 (%)	Foreign reserves in terms of import cover (in months)
A. Countries with no separate legal tender							
Kiribati	4.3	-37.6	-3.4	2.0	17.1	-	-
Marshall Islands	-5.1	-31.8	11.8	4.9	-0.7	-	-
Micronesia	-0.5	-46.4	-0.9	5.6	7.9	-	-
Palau	4.7	-30.8	17.5	3.5	22.2	-	-
Tuvalu	5.3	-15.2	4.1	2.8	5.8	-	-
B. Countries with currencies pegged to a basket							
Fiji	2.1	-3.7	-3.5	3.2	0.9	-0.1	6.1
Samoa	4.7	-10.7	1.1	2.2	6.3	12.3	7.4
Solomon Islands	2.3	-16.2	-3.4	9.8	2.4	8.7	2.2
Tonga	2.3	-2.4	-1.2	3.3	-5.0	11.3	5.1
Vanuatu	1.7	-5.6	4.7	2.5	2.1	5.0	5.8
C. Country with flexible exchange rate							
Papua New Guinea	0.2	-6.6	-2.1	12.9	3.9	11.9	3.2

Source: Rosales (2001)
Asian Development Bank, Key Indicators (2001)

A case for monetary union among FICs

The idea of monetary integration generally gathers support after a period of sustained free trade, as witnessed in the EMU and in the ultimate birth of the euro. Monetary union requires a gradual build up of certain factors, which get accentuated because of more intimate trade relations. Falling under the description of optimum currency area conditions (Mundell, 1961; McKinnon, 1963; Kenen, 1969), these relate to similarities in pre-union trade patterns and adjustment policies as well as similarity in economic structures but with sufficient diversity to sustain trade. Once a free trade area is created giving rise to a flourishing inter-country trade, the next apparent and logical step for consideration is formation of a customs union and a common market with full factor mobility. Although the European Union is cited as an example for emulation, one does not see it as an inevitable step to eventuate in other parts of the world. However, growing appreciation of the benefits of freer trade does lead to consideration of forging a monetary union, as witnessed in the Eastern Caribbean States.

Prerequisites

If the volume of intra-area trade among the members of a free trade area is substantial, a monetary union with a fixed internal exchange rate relationship with each national currency and full convertibility between them would bring in greater benefits. This is because of reduction in transaction costs and exchange rate fluctuations. In a currency union, adoption of a common currency totally eliminates transaction costs between different agents and hence raises the static efficiency of the regional economy (Soltwedel, Dohse & Krieger-Boden, 2000). As well, elimination of exchange rate risks and costs of currency exchange and hedging would result in the saving of real resources, which can be shifted to other productive uses (Kenen, 1997). Furthermore, greater transparency would increase the intensity of competition, raising the dynamic efficiency of the economy (Soltwedel, Dohse & Krieger-Boden, 2000).

In addition to the prerequisite of a substantial volume of trade between the prospective member countries of a monetary union, symmetry in external shocks facing the countries is considered an important factor. The larger and more asymmetric the shocks, the greater the risk to the stability of the union. The member countries might be tempted to switch to

an independent monetary and exchange rate policy. Countries are less likely to face large asymmetric terms of trade if they have similar but more diversified structures. For example, a country exporting mineral resources and importing manufactures is likely to face more different movements in its terms of trade than a country exporting coffee and importing oil (Masson & Pattillo, 2001a, 2001b).

Most of the adverse effects of asymmetric shocks, including rise in unemployment and fall in income, would be reduced if there is downward flexibility in prices and wages (Soltwedel, Dohse & Krieger-Boden, 2000). In the absence of such downward flexibility, presence of considerable mobility of labour between member countries would be a great help. Additionally, if the monetary union can build in some provision of a mechanism of fiscal transfer to redistribute or compensate for differences in unemployment between member countries, the asymmetry of shocks will be less of a problem (Masson & Pattillo, 2001a, 2001b; de Brouwer, 2000; McKinnon, 1963; Kenen, 1969).

Optimum currency area

It has already been noted that there were no immediate concerns—such as runaway inflation and related balance of payment crises—giving rise to serious monetary and currency instability in the Pacific region, such as would merit an ‘agency of restraint’ solution. Therefore, an appreciation of long-term gains and costs would alone determine the case for monetary union or currency union. Such an appreciation requires an evaluation in the light of optimum currency area conditions.

The FICs’ exports of goods and services are dominated by tourism earnings and by a limited number of commodities. While Papua New Guinea’s main exports are gold, petroleum, copper, timber and coffee, Fiji’s exports are sugar, garments and gold. For smaller islands, which have negligible manufacturing capacity, reliance on primary exports is much greater. For Samoa, it is fish, copra and related products; for Tonga it is squash, fish and root crops; and for Vanuatu, beef, copra and cocoa (table 3). The FICs, however, import a wide range of goods and services. Their key trading partners are Australia (one of the two developed FCs) for both exports and imports; Japan for exports and France for imports (table 4). New Zealand (the other developed FC) is a significant source for imports, next in importance to France.

Table 3 Main merchandise exports and tourism earnings of FICs (averages of 1996–1999)

Country	Main Merchandise Exports (% of Total Merchandise Exports)	Tourism Earnings (% of Exports of Goods & Services)
Fiji	Sugar	27.1
	Garment	23.1
Kiribati	Copra	52.1
	Seaweed	7.8
Marshall Islands	Fish	66.1
	Coconut oil	12.1
Micronesia	Fish	88.1
	Garment	6.2
Samoa	Coconut oil	28.1
	Copra	15.9
Solomon Islands	Timber	51.1
	Palm oil	11.1
Tonga	Squash	44.4
	Fish	19.6
Vanuatu	Copra	40.2
	Beef	12.1

Source: World Bank (2000)

Table 4 FICs: Exports to and imports from main trading partners (averages of 1996–1999)

To	Exports (% share)	From	Imports (% share)
Australia	22.5	Australia	34.4
Germany	6.5	France	18.1
Japan	27	Japan	8.5
UK	8.1	N.Zealand	7.8
USA	7.5	USA	7.6

$56.9 = 29$
 $= 24.6 = 13$
 $= 35.5 = 18$
 $= 15.9 = 8$
 $= 15.1 = 7$

Source: IMF, *Directions of Trade* (various issues)

Intra-FIC trade has been small (tables 5 and 6). The major trading partner among FICs is Fiji because of its significant manufacturing base. Its chief exports to other FICs are wheat flour, cooking oil, and biscuits and other processed foods. On the other hand, Fiji's imports from other FICs are confined to a very small volume of agricultural commodities. Only under exceptional circumstances, such as cyclones or poor agricultural seasons, do FICs import staples such as root crops from other FICs. For instance, in the early 1990s, when coconut palms in Tonga were uprooted by cyclones, coconuts were imported from Samoa. Likewise, in the mid 1990s when the taro leaf blight severely damaged the root crops in Samoa, with poor yield for a continuous period of three years, large volumes of taro were imported from Tonga and other FICs to meet domestic requirements. Thus, any commodity trade between FICs in similar and competitive crops has been exceptional. Since Australia and New Zealand—the two major sources of imports in food and live animals, and beverages and tobacco—do not grow root crops, trade in these staples exists only among the FICs. Furthermore, FICs export root crops to Australia and New Zealand for meeting the consumption requirements of the Pacific Islanders resident there.

Table 5 FICs: Direction of trade: exports to: (averages of 1996—1999)

Country	Australia	NZ	Japan	UK	US	Other FICs	Rest of the World
Cook Islands	26.5	22.3	31.5	nil	0.1	..	19.6
Fiji	31.2	4.4	4.8	15.3	15.9	4.9	24.8
Kiribati	2.6	..	39.1	..	11.3	..	47
Marshall Is	..	..	..	..	..	..	..
Micronesia	..	..	69.2	..	11.9	0.05	18.9
Nauru	..	..	..	..	..	..	..
Palau	..	..	..	..	..	..	..
PNG	25.4	..	13.1	3.5	3.3	..	54.7
Samoa	65	3.6	0.6	..	15.6	..	15.2
Solomon Is	..	..	37.7	8.8	..	..	53.5
Tonga	2.9	5.8	51.9	..	20.9	3.2	7.1
Tuvalu	..	..	..	..	..	8.8	91.2
Vanuatu	..	..	24.4	0.8	14	..	61.2

Source: Asian Development Bank, *Key Indicators 2001*

Table 6 FICs: Direction of trade: imports from: (average of three years 1997–2000)

Country	Australia	NZ	Japan	UK	US	Other FICs	Rest of the World
Cook Is	7.5	67.3	2.9	..	4.7	13.3	4.3
Fiji	44.4	14.2	5.3	..	7.1	..	29
Kiribati	23.6	2.9	13.1	..	6.4	..	51
Marshall Is	..	..	..	..	..	..	..
Micronesia	6.9	..	13.7	..	45	..	34.4
Nauru	..	..	..	..	..	..	..
PNG	51.5	4.2	7.1	..	4.8	..	32.4
Samoa	22.1	19.1	11.6	..	14.9	14.8	17.4
Solomon Islands	37.5	5.6	8.6	1.8	2.1	2	42.4
Tonga	25.1	33.7	8.7	0.6	14.1	9.2	8.6
Tuvalu	20.3	5.3	5.1	2.2	..	58.5	8.6
Vanuatu	21.2	4.9	32.4	..	8.9	4.1	28.5

Source: Asian Development Bank, *Key Indicators 2001*

The preferential trading arrangements under the Melanesian Spearhead Group (MSG) Agreement covering Fiji, Papua New Guinea, Solomon Islands and Vanuatu and now in place since 1993, have encouraged trade in specified commodities such as coffee, kava and beef. There has not, however, been a remarkable rise in trade volumes. The revival in October 2001 of the Sugar Agreement between Fiji and other FICs—which was suspended in 1998 due to supply and production difficulties in Fiji, the only sugar producing FIC—would enable sugar trade to resume. Effective 1 November 2001, the agreement, under which Fiji is committed to supply up to a maximum of 20,000 metric tonnes, is expected to last until May 2005. The FICs' economies—with the exception of two major ones, Papua New Guinea and Fiji—are much less diversified and as a result, they lack product diversity. Australia and New Zealand, the advanced FCs, are far more diversified as well as being dissimilar in other respects in comparison to the FICs.

Impact of Shocks

As regards the impact of shocks, one would prefer to go by a study of past movements in their real effective exchange rates. The latter happen to be endogenous prices, the outcome of the structure of the economy as well as

domestic and external shocks. If a given set of countries is similarly placed in terms of both economic structure and external and domestic shocks, their real effective exchange rate movements would have common trends. In his study on real effective exchange rate movements in all FCs, though, de Brouwer (2000) has shown that there has been substantial divergence from each other, indicating that FCs are prone to asymmetric shocks.

In the absence of downward flexibility in prices and wages, which is compounded by the presence of relatively strong trade unionism in the formal sectors in FICs and the two developed partner countries, unhindered labour mobility between them can be relied upon to reduce the adverse impact of asymmetric shocks. However, this is not the case. There are legal hurdles to free labour mobility. Past trends in migration indicate a much lower rate of labour mobility amongst Melanesian countries (Fiji, Papua New Guinea, Solomon Islands and Vanuatu) and from the Melanesian countries to Australia and New Zealand, in comparison to the high mobility rate amongst Polynesian countries (Cook Islands, Samoa and Tonga) and from the Polynesian countries to Australia and New Zealand. There are presently no indications to suggest any likelihood of a change in the near future in the migration policies in the region.

Australia and New Zealand, the two developed FCs, are two major providers of aid to FICs (table 7). Besides, there have been steady flows in annual remittances to FICs from the resident Pacific Islander families in both Australia and New Zealand. However, the declining trend in remittances needs to be recognised. So FICs would prefer a commitment in regard to official transfers. Most of the official transfers, which until the mid-1990s were earmarked for budgetary support to FICs, are presently given in terms of tied grants to either projects or programmes. Though no firm pre-union commitment to instal a fiscal transfer mechanism can be expected (de Brouwer, 2000), the possibility is not ruled out. Present aid policies and programmes can be brought under fiscal transfer arrangements in the event of a monetary union comprising all FCs. However, in a monetary union without Australia and New Zealand, no such fiscal transfer mechanism can be visualised until such time as all FICs are able to raise sufficient domestic resources to pool in a fund earmarked for helping member countries in distress.

Table 7 Aid flows to FICs from donors: 1998
(total aid and percentages)

Recipient Country	Total Aid (US\$m)	Australia (US\$m)	NZ (US\$m)	Australia (%)	Japan (%)	EU (%)	NZ (%)	France (%)	USA (%)
Cook Islands	8.1	1.2	4.3	14.8	4.9	..	52.4	..	..
Fiji	36.5	11.2	4.4	30.7	52.6	..	12.1	1.6	0.5
Kiribati	17.3	5	2	28.9	49.1	3.5	11.6	..	3.5
Marshall Islands	50.3	0.3	0.1	0.6	18.7	..	0.2	..	64.4
Micronesia	80.1	0.8	0.2	1.1	9.9	..	0.2	..	80.8
Nauru	2.1	1.8	..	85.7	9.6	..	..	..	..
Niue	4.1	0.5	3.4	12.2	2.4	..	82.9	..	..
Palau	89.1	0.2	..	0.2	11.8	..	..	..	87.9
Samoa	36.3	8.2	5.6	22.6	40.8	11.1	15.4	0.3	1.9
Solomon Islands	43.3	8	4.5	18.5	23.3	5.1	10.4	..	1.8
Tonga	25.6	6.3	4.3	24.6	19.5	11.3	16.8	2.3	2.3
Tuvalu	5.2	1.9	1.6	36.5	19.2	1.9	30.8	5.8	..
Vanuatu	40.6	9.1	4.4	22.4	9.3	5.5	10.8	19.9	1.7
French Territories	756	1.1	0.6	0.1	..	0.6	0.1	99.1	..
Regional	91.9	25.6	19.6	27.9	9.4	0.2	21.3	6.6	5.1

Source: AusAid (2001) Pacific: Program Profiles: 2000-01

In a union with Australia and New Zealand, settling on a fiscal transfer mechanism may not pose much of a problem in the long run. However, a FC currency union brings in further dimensions. There have been some (mostly inconclusive) discussions at policy levels as to which currency, the Australian or New Zealand dollar, should be adopted—although present indications are that the Australian dollar would be preferred to the New Zealand one. For such a wider union with all FCs participating, the choice of currency will also have some implications in regard to FIC solidarity and cohesion objectives. The three Micronesian FICs, which presently use the United States dollar, might prefer neither of the other two currencies. On the other hand, the Cook Islands, Fiji, Papua New Guinea, Samoa, Solomon Islands, Tonga and Vanuatu might not be averse to the adoption of the Australian dollar. The whole question will have to be decided upon the basis of cost-benefit analysis using the balance of payment arguments.

Thus, some of the traditional optimum currency area conditions do not hold for a monetary union of all 14 FICs. Such conditions would include a high degree of factor mobility—especially in labour (Mundell, 1961) and product diversification (Kenen, 1969)—and fiscal transfers. And quite apart from barriers to capital and labour mobility, intra-FIC trade has been small. The principal export products are dissimilar across countries, making FICs prone to asymmetric impacts of common shocks.

Mundell's seminal article referred to Canada and the United States (1961). The literature on optimum currency area conditions—relating to similarity in economic structures and adjustment policies adopted, fiscal and debt position, and inflation—was all written in the context of European monetary integration. It is increasingly argued that these optimum currency area conditions do not have much predictive power when applied to actual exchange rate regimes. Masson and Pattillo (2001b) refer to a recent study by Frankel and Rose (2000). Their findings are that optimum currency area criteria are to some extent endogenous and that monetary union might help make the shocks hitting member countries more symmetric and may also expand intra-union trade. These findings echo the same view expressed by Scitovsky (1958), just around the time when the European common market was born, that the common currency arrangements would by themselves tend to make countries more similar.

Future directions

The discussion on the applicability of optimum currency area conditions to FICs would be incomplete without a reference to the long running debate between two schools of thought—'the economists' and 'the monetarists'—on economic and monetary union. 'The economists' saw the need for prior convergence on economic policy and performance before proceeding to fixed exchange rate parities. 'The monetarists', on the other hand, stressed early action on locking exchange rate parities into place so as to impose monetary discipline upon member states and herd them towards convergence of their economic policies (Blackman, 1998). Temporarily, the debate seemed to have been settled in favour of 'the economists' when, after four decades, the euro, the common currency for the 12-nation euro zone in the European Union, was finally born on 1 January 2001.⁸

Courtney Blackman devoted his 15 years of leadership as the founding governor of the Central Bank of Barbados to spearheading a vigorous campaign for a Caribbean monetary union. He never felt discouraged by the non-convergence of criteria for monetary union based on optimum currency area conditions for all the CARICOM countries. In his writings and public addresses, he used to refer to the performance of two groupings within CARICOM:

- (a) the smaller and less developed countries (LDCs) in the Organisation of Eastern Caribbean States (OECS) comprising Antigua and Barbuda, Dominica, Grenada, St Kitts and Nevis, St Lucia, St Vincent and the Grenadines; and
- (b) the larger and more developed countries (MDCs) in CARICOM, which included Barbados, Guyana, Jamaica, and Trinidad and Tobago.

The OECS, having adopted a common currency under ECCU, recorded a far more impressive growth with low inflation because of a single monetary policy pursued by their common Eastern Caribbean Central Bank (ECCB), which imposed fiscal discipline on member states. On the other hand MDCs, which have their own currencies with individual central banks pursuing different monetary policies, experienced low growth rates and high inflation. In his famous 1992 public address on 'Economic and

Monetary Union in the CARICOM Caribbean', which was delivered under the auspices of ECCB in St Lucia, Blackman attributed the weak growth of MDCs to poor fiscal discipline and pleaded for a monetary union on the basis of the 'monetarist' approach rather than on the 'economist' approach, on the ground that convergence criteria are the outcome of an endogenous process.

Role of politics

Blackman acknowledged that a mere optimistic 'monetarist's' approach alone would not be sufficient. In his writings and speeches, he recognised the role of politics as the most critical factor by quoting from William Demas, a former Governor of the Central Bank of Trinidad and Tobago, who later became the Secretary General of CARICOM. Demas articulated thus:

A single independent currency entails a single set of economic, monetary, financial and fiscal policies designed to influence the balance of payments. Such a single set of policies is possible only with a high degree of economic union tantamount to a political union. (1974: 54)

Hilaire (2001) refers to the recent case of Germany. Initial economic conditions for a currency union between the two regions, East Germany and West Germany, which were at different stages of development, were apparently found unsuitable in 1988. However, the political imperative dominated and resulted in a common currency between them in a very short period.

The Asian situation has been described as particularly difficult. Eichengreen and Sussman (2000) referred to special circumstances in Asia of trade and financial flows being regionally diversified, with neither the American dollar nor the Japanese yen as an attractive anchor currency for most of the smaller countries of the region. They observed that currency board or monetary union arrangements would be elusive; and that the required degree of political comity did not exist.

Political commitment among the Pacific Island countries has been lacking until very recently. The signing of the agreements on PACER and PICTA in 2001, therefore, assumes great significance. There is an increasing

realisation that regional integration would be beneficial. With growing support in favour of integration efforts, one does not have to wait for the deadlines 2010 or 2012 to arrive. If a high degree of political solidarity could be marshalled earlier than these deadlines, it would be useful to plan certain measures in advance. These would include paying attention to observance of the much required policy constraints and the undertaking of some preparatory exercises. Premature linkage of dissimilar economies could create stresses that would endanger stability of the union.

A warning

A note of caution sounded by Masson and Pattillo (2001a, 2001b) in regard to setting up a monetary union for all countries in the Economic Community of West African States (ECOWAS) seems relevant here. The leaders of six states—Ghana, Nigeria and Guinea, and representatives of Liberia, Sierra Leone and Gambia—showed considerable solidarity in their historic meeting in April 2000. By taking a decision in favour of a monetary union among non-CFA franc countries by January 2003, they took the first step toward a wider monetary union for ECOWAS by 2004. The time frame was considered short by experts, as there still remained a number of outstanding issues revolving around a certain set of principles, as demonstrated in the adoption of the Maastricht accession criteria in Europe for joining the euro. These criteria involved some stringent conditions on fiscal deficits, inflation and debt.

The message is clear: each country in the ECOWAS has to 'put its house in order' first before considering a monetary union. The goal of monetary union should not be allowed to distract attention from addressing certain serious domestic issues faced by countries in the region. These include opening up their economies by dismantling restrictive tariff regimes and removing obstacles to development, such as poor transportation infrastructure and divergent regulations and codes. Masson and Pattillo (2001b) stressed that instead of trying to meet a very short deadline, the ECOWAS countries should invest their energies in reinforcing convergence on low inflation, sustainable deficits and structural policies necessary for growth. Any hasty and ill-prepared monetary union could, if the monetary union proved not to be a success, set it back rather than helping the cause of regional integration.

The FICs at their present stages of development are no different from their African counterparts. They have similar sets of critical and urgent domestic issues to be resolved before plunging into monetary integration. Aside from the ethnic strife and tensions to be tackled in Fiji and Solomon Islands, there are basic structural and macroeconomic policy issues to be faced and dealt with in all FICs. In the meanwhile, the present loose form of monetary cooperation among the FICs should proceed and gain strength. Before discussing these aspects, we may examine whether there is a case for more formalised arrangements of monetary integration in regard to three subsets of FICs that have adopted the currencies of Australia, New Zealand and the United States.

Three subsets

Although a monetary union for all the FICs does not appear to be an immediate possibility, a stepwise approach could be considered. It could be possible for the 'dollarised FICs' to think in terms of forging such a union with the countries whose respective currencies they are using, and by extension, with the other countries who use that currency as sole legal tender. As noted in the introduction, three subsets of FICs—(i) Kiribati, Nauru and Tuvalu; (ii) Cook Islands and Niue; and (iii) Marshall Islands, Micronesia and Palau—are in a way in monetary union respectively with Australia, New Zealand and the United States. Thus their policy makers can enter into formal arrangements with the country concerned. It is an interesting question similar to the one posed by Eichengreen and Sussman (2000) in the context of the recent developments in Europe and the Americas.

In Europe, where integration is a political as well as an economic and financial phenomenon, monetary integration with deepening and widening possibilities is likely. When the eastern European countries and Turkey expressed a desire to join, there were indications of every willingness and receptivity on the part of EMU to consider. No doubt, the membership is not automatic, for stringent criteria are to be fulfilled, with some waiting period attached. In the Americas, in contrast, the United States is not willing to consider formation of an EU-style monetary union (Eichengreen & Sussman, 2000). The reasons are obvious: the United States is not willing to enter into institutional complications involving fiscal transfer mechanisms

and the like. The political driving force behind the formation of such a grand union as observed in Europe is just simply absent. So only unilateral dollarisation remains an option, as happened in the case of Ecuador early in 2000, when it experienced high inflation and there was loss of confidence in the domestic currency as store of value.

In 2000, negotiations between Argentina and the United States on the subject of dollarisation revealed that the United States was not keen to part with a portion of seigniorage revenue. Similarly, neither the Treasury nor the Federal Reserve Bank was willing to act as the lender of last resort or to provide liquidity in support of the banks in dollarised countries. Against this background, Latibeaudiere, the Governor of Jamaica's Central Bank, clearly ruled against unilateral dollarisation of his country (2001). He has stronger reasons as well: Jamaica's own good record of monetary stability; effective monetary and fiscal policy coordination; and improved functional autonomy of the central bank.

In the Pacific context, there are at present no indications of any political commitment to forge a union of European proportions. Further, there is no clear preference as to whether the Australian, the New Zealand or the American dollar would be the choice of currency for all the three subsets to form a currency union. It appears the preferable way would be for each independent subset to pursue monetary union with the respective country whose currency is now being used as legal tender and by extension, with the other countries who use that currency as sole legal tender.

As for other FICs, whose currencies, albeit independent, are pegged to baskets of currencies of undisclosed weights, the decision for any monetary union between them will have to depend on whether these baskets are identical or how close they are. The basic idea would be to assess how far FICs are from potential monetary union with each other. Another related issue is whether FICs coming together would prefer to have a common currency pegged to the American, Australian or New Zealand dollar, or to have a common currency that is independent and floating. Presently, Papua New Guinea's kina is the only FIC currency floating, and time alone will tell whether it will emerge as a strong common currency for adoption by all FICs.

Monetary cooperation

The central banks in the region have been in touch with each other through various forms of communication. Notable among them are the annual meetings of central bank governors, which are held in different capitals of the FCs. Although there is no fixed agenda for these annual meetings, such face-to-face contacts have proved helpful. Further, the middle-level staff gain opportunities to meet with their counterparts at various training programmes and seminars offered by the IMF and other organisations, including central banks of Australia and New Zealand. However, coordination or harmonisation of monetary and exchange rate policies among the FICs has yet to emerge as a significant step towards monetary integration.

In this regard, the initiatives undertaken by the IMF's regional Pacific Financial Technical Assistance Centre (PFTAC) deserve mention. The centre was set up in Fiji in the mid-1990s to attend at short notice to the regional needs of advice and consultation. Supported by Australia and New Zealand as well as by multilateral organisations, including the Asian Development Bank and the United Nations Development Programme, through funds as well as provision of technical expertise, PFTAC has been assisting FICs in select areas of economic and financial management. The latter include budget management; tax administration and policy; banking regulation and supervision; and statistics. In recent years, PFTAC has also been assisting the FICs in regard to strengthening their legislative provisions towards better monitoring and controlling the illegal money flows to financial centres operating under tax haven status in various FICs. However, while generally promoting 'best practices' in economic and financial management, PFTAC has made no effort towards harmonisation of monetary and exchange rate policies. These, considered sensitive areas, are left to individual FICs, an approach consistent with that of the Forum.

The central banks in the region, however, can themselves plan to initiate action in certain spheres of upgrading capacity management. Training programmes, including secondment to central banks within FCs, can be considered, under which middle-level staff can be exchanged for a fairly extended period of two to three years in key departments such as statistics, research, financial markets and banking supervision. Such secondment programmes can, to a large extent, mitigate the problem in regard to relative scarcity of qualified staff.

Another area of monetary cooperation relates to bilateral/multilateral currency swap arrangements. In times of foreign exchange crisis when a country's exchange rate is under severe stress, central banks of the FICs can come to the rescue of others in the region by establishing a network of swap and re-purchase agreement facilities among themselves. It is understood that Samoa and Fiji successfully put through an informal swap and repurchase arrangement in the mid-1980s, when the Government of Samoa was awaiting the finalisation of a programme with the IMF. 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.⁹ It would be worthwhile to devote attention to formalising such arrangements, which may be useful in the future. Further, the central bank governors in the region may consider meeting more than once a year and their meeting agenda can be extended to cover many new subjects, particularly ones that were heretofore considered fairly independent and sensitive.

Summary and conclusions

A preliminary assessment of monetary union, among either the 14 FICs or all 16 FCs including Australia and New Zealand, indicates the absence of a strong case for forming such a union at the moment. It would also be premature to suggest any deadline for a monetary union among either grouping, since neither PICTA (signed by FICs) nor PACER (signed by FCs) has yet been completed. The concept of a free trade area has yet to become a reality. Aside from the need for stepping up efforts to achieve greater political solidarity for an economic union, there is a need for 'putting one's own house in order'. This will include implementing macroeconomic policies and structural adjustments and removing hurdles to competition, which have been inhibitors in domestic investment behaviour.

In the meanwhile, until such time as the economic environment has improved, central banks should strive towards greater coordination and cooperation in critical areas. They can look forward to advice and guidance from the IMF's PFTAC and seek bilateral support.

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Notes

- 1 Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain, which were joined by Greece in 2001.
- 2 West African Economic and Monetary Union: Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal and Togo.
- 3 Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea and Gabon.
- 4 South Africa, Namibia, Lesotho and Swaziland.
- 5 Anguilla, Antigua and Barbuda, Dominica, Grenada, St Kitts and Nevis, St Lucia, St Vincent and Grenadines, and Montserrat.
- 6 All members covered by ECCU minus Anguilla and Montserrat, which are British territories.
- 7 All the OECS countries plus the Bahamas and Belize in Central America, Guyana and Surinam in South America, and Barbados, Trinidad and Tobago, and Jamaica.

8 This extended period included 40 years of common market operations since 1958. It included a gradual transition period from 1979, when the European Monetary System was installed by eight member countries (Belgium, Denmark, France, Germany, Ireland, Italy, Luxembourg and the Netherlands). They were later joined by Spain in 1989, the United Kingdom in 1990 and Portugal in 1992, under which they agreed to fix their exchange rates vis-à-vis one another and float jointly against the American dollar. A further 7 years of transition elapsed from the signing of the Maastricht Treaty in February 1992, imposing stringent convergence criteria.

9 I owe this point of information to Mr Savenaca Siwatibau, a former governor of Reserve Bank of Fiji, now Vice-Chancellor, the University of the South Pacific, Suva, Fiji.

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