

A Single Currency for the Pacific Countries?

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Introduction

Efforts towards the economic integration of Australia, New Zealand and the Pacific Island countries (PICs)¹ received a major boost in March 2003 when an Australian Senate Committee (2003) made a recommendation to usher in a Pacific Economic and Political Community. The Senate Committee, which studied Australia's relations with the PICs, specifically suggested adoption of the Australian dollar as the common currency. The inspiration behind a single currency came from the successful introduction of the euro in Europe, just a year before the new millennium.

The subject of the integration of PICs, most of them having been found to be less than viable, despite substantial decades-long aid inflows (Hughes 2003), has, however, been under consideration for a while. Trends in economic integration — ranging from preferential trade to free trade arrangements and to economic and monetary union, especially in developing regions² — have given further impetus to such attempts in the Pacific (Jayaraman 2001). Two major initiatives were launched in 2002, one towards achieving free trade by 2010 exclusively among PICs and free trade by 2015 with Australia and New Zealand.³ Gradual trade liberalisation in the next few years was considered as a stepping stone to promote regional economic integration.

Chand (2003) has noted that the response to the Australian proposal was not enthusiastic. It appeared that Australia was too quick to propose a currency union since a strong sense of regional solidarity, which evolved over 50 years in Europe, was singularly absent in the Pacific region. Aside from a political case, one has also to assess whether there is an economic case for a single currency. This chapter, which seeks to examine the feasibility of a common currency for the region as a whole, covering Australia and New Zealand and the PICs, as well as exclusively for the PICs, is organised into three sections: the first section provides a theoretical background of monetary integration; the second

investigates the readiness of PICs for a single currency; and the final section presents conclusions with policy implications.

A brief theoretical background

The economic integration of sovereign states usually begins with freer trade through the dismantling of trade barriers, with freedom to retain their existing but varying tariff and non-tariff barriers against imports from the rest of the world. The next step is agreeing to impose a set of common tariffs against imports from outside the region, an arrangement known as a customs union. If this arrangement were accompanied by perfect mobility of capital and labour, there would emerge a single economic space, known as a common market. The logical next step is monetary integration. Some member states might not proceed further and would prefer to postpone the decision on joining a single regional currency. In between these upward movements, the member states build up the required political will towards monetary integration. The evolution of the euro is a case in point.⁴

Institutional arrangements for monetary integration take different forms. The degree of rigour varies from highly restrictive to flexible (Masson and Pattillo 2001b). At one end, it is a *currency union*, in which a single currency, either through creation of a new currency or adoption of the existing national currency of a leading member country, prevails with a common monetary policy for all members. A common currency is the ultimate or the *nirvana* of the economic integration of states, without having to surrender their sovereignty. Known as a currency union, it is a zone of countries, 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.

An intermediate arrangement is known as *monetary union*. Under this, national currencies coexist with common monetary and exchange rate policies. However, under currency and monetary union arrangements, a supranational monetary authority is established for pursuing a common external exchange rate and monetary policy, with national central banks relinquishing individual control over international reserves by vesting them in the common monetary authority. The monetary union permits the possibility of an exit should a member country want to return to its previous regime, as it can easily fall back on its own currency. An exit from a currency union is far more difficult. It has to face substantial costs involved in restoring its discontinued national currency and reviving the central bank and related arrangements.

At the other end of the spectrum, there might be *pseudo exchange rate arrangements* of monetary integration. In a pseudo exchange rate union, a permanently fixed relationship between national currencies might be assured. There is, however, no explicit integration of economic policy, no common pool of foreign exchange reserves and no single central bank. In the absence of these mechanisms for maintaining fixed exchange rates, there are possibilities of member countries deliberately depreciating or appreciating their currencies against each other (Corden 1972).

Cohen (1998) emphasised the need for a strong bond of solidarity among the participating member countries. A long period of close cooperation as well as the continued

existence of regional institutions would contribute to the strengthening of such a bond. There should be at least one leading member, such as Germany in the case of the euro, having a good record of central bank independence. An independent central bank would not permit any fiscal expansion unsupported by domestic resources. Thus, it would act as an 'agency of restraint' to fiscal indiscipline (Masson and Pattillo 2001a). The 'agency of restraint' solution need not be in terms of a monetary union.⁵ In fact, no such country with fiscal indiscipline would be admitted to any union in the first place, unless some semblance of fiscal order is restored and maintained over a period. The prerequisites are known as convergence criteria,⁶ by which the country's suitability would be evaluated.

Gains from a common currency, in addition to reinforcing fiscal discipline and strengthening the credibility of monetary policy, arise from elimination of (i) transaction costs involved in currency conversion, and (ii) risk from uncertainty in the movements of exchange rates between trading partners (McKinnon 1963). The disadvantages are the loss of two important macro-economic adjustment tools: independent monetary and exchange rate policies. The member country has to abide by a union-wide, common monetary policy. 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 a similar fashion. A union-wide, common set of policies would then be appropriate. If the shocks were asymmetric, common policies would be least desirable, as the inability to use the exchange rate for making necessary adjustments would result in greater volatility in output and employment. Disadvantages can be substantially reduced if there is perfect labour mobility between member countries (IMF 2001).

The literature on optimum currency areas (OCA) thus identifies the following as key deciding factors for a currency union: (i) openness, defined in terms of percentage of a country's total exports and imports to its gross domestic product (GDP); (ii) intra-trade volume; (iii) degree of product diversification; (iv) similarity of industrial structures; (v) high correlation in economic activities; (vi) similar inflation rates; (vii) flexibility in wages and prices; and (viii) perfect factor mobility (Mundell 1961; McKinnon 1963; Kenen 1969; IMF 1997).

If an economy is open, it is easier to enter into a currency union arrangement since the nominal exchange rate has already become a redundant instrument (McKinnon 1963). The higher the pre-union intra-regional trade, the greater the benefits. The composition of trade is another important factor. The higher the share of trade in manufactured goods, the greater the appeal of a currency union among trading partners, since their prices, unlike the prices of primary commodities being determined in world markets, are determined largely by producers (Bayoumi and Mauro 1999).

If an economy were more diversified, it would export a wider variety of products. If a fall in the demand for some of its products occurred, the effects of such external shocks would not create large-scale unemployment. On the other hand, if an economy depends on one or two export products, fall in demand would be more disastrous, needing exchange rate adjustments. In a more diversified economy, if independent shock affected each of its products, the law of averages would ensure that the economy remained stable. A more diversified economy is more suitable for a currency union than a less diversified

one (Masson and Pattillo 2001b). Similarities in industrial structures of the candidate countries would strengthen their eligibility, since they are likely to be affected in a similar way by sector-specific shocks.

Formal OCA criteria do not include the requirement of similarity in the levels of development in the candidate countries for a currency union. Similar levels of economic and financial sector development in the countries concerned would make it easier for them to enter into a union.⁷ Regardless of differences in their industrial structures, if the candidate states display a high degree of correlation in economic activities, they are likely to experience similar economic shocks. Similarity in inflation rates of countries would lead to an inference that they have been pursuing a similar set of economic policies and their economic structures are also similar. Such states are eligible candidates for a currency union (Bayoumi and Ostry 1997).

The next section examines how far OCA requirements, either for a currency union exclusively among PICs or a larger union with Australia and New Zealand with a common currency — say, a Pacific dollar or the adoption of the Australian dollar — have been fulfilled.

Empirical investigation

The PICs exhibit considerable diversity in physical endowments and human resources. Land area varies from country to country: 24 sq. km in the case of Nauru to 462,840 sq. km in the case of Papua New Guinea. So too does population (Table 1), the most populous nation being Papua New Guinea (5.1 million) and the least being Niue (2,000). While Kiribati and Tuvalu are atolls with poor soils and limited agricultural possibilities, Papua New Guinea, the Solomon Islands, Fiji, Samoa and Tonga have relatively large tracts of fertile land. However, the economic challenges before PICs are similar (Urwin 2004). They rely on a few exports, such as fish, copra, timber and tourism (Table 2) to finance their imports, which cover basic necessities and essential goods, including transport and capital and intermediate goods. Almost all PICs depend heavily on foreign aid and have large public sectors with weak private sectors. Further, most of the PICs are prone to natural disasters, including cyclones.

The exchange rate arrangements of PICs differ, spanning the continuum, from the use of a foreign currency as legal tender to an independent and free-floating domestic currency (Table 3). Eight PICs have adopted the national currencies of Australia, New Zealand or the United States: Kiribati, Nauru and Tuvalu (the Australian dollar); the Cook Islands and Niue (the New Zealand dollar); and FSM, Marshall Islands and Palau (the US dollar). Five PICs (Fiji, Samoa, Solomon Islands, Tonga and Vanuatu) have independent currencies. Papua New Guinea, on the other hand, has a freely floating exchange rate regime. Rosales (2001) notes that inflation has been higher in Papua New Guinea and in the dollarised PICs. The PICs with independent currencies seem to have done better on the inflation front.

The PICs are open economies with large import flows. Their trade volumes in commodities (exports and imports) expressed as percentages of GDP are high. In 2000, they ranged from 120 per cent in Kiribati to 68 per cent in Marshall Islands. Exports are

Table 1: Key Indicators of Pacific Islands Countries

Country	Land Area (sq. km)	Population ('000) (2002)	Exclusive Economic Zone ('000 sq. km)	Total GDP (\$US mill) (2001)	Per capita GDP (\$US) (2001)	Aid per capita (\$US) (2000)	Aid as % of GDP (2000)	Human Development Index (HDI) (1999)	Global HDI Rank (1999)
Cook Islands	240	19	1,830	51	2,651	420	15.9	0.822	62
Fiji	18,272	799	1,260	1,605	2,008	46	2.3	0.667	101
Kiribati	690	85	3,550	45	530	203	38.4	0.515	129
Marshall Islands	170	51	2,131	102	2,008	1,438	49.3	0.563	121
Micronesia	701	114	2,978	213	1,864	1,010	54.1	0.569	120
Nauru	24	12	320	81	7,017	183	2.6	0.663	103
Niue	259	2	390	7	4,773	2,720	58.6	0.774	70
Palau	487	19	601	129	6,989	2,168	31.1	0.861	46
Papua New Guinea	3,120,000	5,099	468	4,232	830	82	8.5	0.314	164
Samoa	2,857	175	120	177	1,004	208	20.6	0.590	117
Solomon Islands	28,446	418	1,630	300	720	102	14.4	0.371	147
Tonga	699	98	700	173	1,763	252	14.3	0.647	107
Tuvalu	26	11	757	4	345	471	130.0	0.583	118
Vanuatu	12,189	183	680	241	1,319	223	16.8	0.425	140

Sources: US Central Accounting Office (2001); Australian Agency for International Development (2001); Asian Development Bank (2003)

Table 2: Main Merchandise Exports and Tourism Earnings of Pacific Islands Forum Countries
(Averages of 1996–99)

Country	Main Merchandise Exports (% of Total Merchandise Exports)		Tourism Earnings (% of Exports of Goods & Services)
	Export	Value	
Fiji	Sugar	27.1	25.1
	Garments	23.1	
Kiribati	Copra	52.1	14.2
	Seaweed	7.8	
Marshall Islands	Fish	66.1	8.3
	Coconut oil	12.1	
Micronesia	Fish	88.1	7.6
	Garments	6.2	
Papua New Guinea	Gold	30.1	-
	Copper	19.4	
	Crude oil	18	
Samoa	Coconut oil	28.1	51.3
	Copra	15.9	
Solomon Islands	Timber	51.1	-
	Palm oil	11.1	
Tonga	Squash	44.4	29.1
	Fish	19.6	
Vanuatu	Copra	40.2	41.7
	Beef	12.1	

Source: Asian Development Bank (2003)

limited in range. While Papua New Guinea's major exports are gold, petroleum, copper, timber and coffee, Fiji's main exports are sugar, garments and gold. For smaller island countries, which have negligible manufacturing capacity, reliance on primary exports is much greater. For Samoa, exports are fish, copra and related products; for Tonga, squash, fish and root crops; and for Vanuatu, beef, copra and cocoa.

Intra-PICs trade has been small (Table 4), with low product diversity. The major intra-regional trading partners are Fiji and Papua New Guinea, which are relatively more diversified because of their significant manufacturing bases. Fiji has been exporting to other PICs processed consumer goods, including wheat flour, cooking oil and biscuits. On the other hand, Fiji's imports from other PICs are confined to a very small volume of agricultural commodities. Papua New Guinea's exports are coffee and manufactured goods. In terms of percentages of GDP, intra-regional trade volume in 2000 varied from 59 per cent in Tuvalu, which imports substantial consumer goods from Fiji, to 0.01 per cent in FSM. In terms of percentages of total trade, intra-regional imports range from 56 per cent in the case of Tuvalu to 0.02 per cent in the case of FSM.

Table 3: Growth Rates, Fiscal and External Current Account Balances and Inflation

Category	Average GDP		Average Growth		Average Overall Fiscal Balance		Average Inflation		Average						
	(1995-99)	(1995-99)	(1995-99)	(1995-99)	(1995-99)	(1995-99)	(1995-99)	(1995-99)	2000	2001	2002	2003			
A. Countries with no separate legal tender															
Cook Islands	-1.2	13.9	4.9	3.9	3.1	-4.2	-1.9	1.5	0.2	-3.2	0.1	1.7	9.5	3.9	2.4
Kiribati	4.3	1.6	1.8	0.9	2.5	-3.4	-26.4	7.6	21.4	-13.4	2.0	0.4	6.0	3.2	2.0
Marshall Islands	-2.1	-2	-1.5	4.0	3.0	11.8	8.7	2.2	14.8	14.1	4.9	1.6	1.7	2	2.5
Micronesia	-0.5	9.3	0.5	0.8	0.1	-0.9	-6.9	-6.2	2.5	1.9	5.6	2.1	1.3	-0.2	-0.2
Nauru	NA	NA	NA	NA	NA	-41.8	NA	NA	NA	NA	8.9	NA	NA	NA	NA
Niue	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Palau	4.7	NA	NA	NA	NA	17.5	NA	NA	NA	NA	3.5	NA	NA	NA	NA
Tuvalu	5.3	3.0	4.0	2.0	3.0	4.1	15.4	-54.3	76.5	-16.3	2.8	5.3	1.8	2.6	2.6
B. Countries with currencies pegged to a basket															
Fiji	2.1	-3.2	3.0	4.1	5.0	-3.5	-3.4	-6.6	-5.6	-6.1	3.2	1.1	4.3	0.8	4.1
Samoa	4.7	6.9	6.2	2.8	3.5	1.1	-0.7	-2.7	-2.1	-0.6	2.2	1.0	3.8	8.1	0.1
Solomon Islands	2.3	-12.3	-10.1	-4.0	3.8	-3.4	-4.2	-11.5	-11.1	0.9	9.8	7.3	6.8	7.3	8.3
Tonga	2.3	6.5	0.6	1.6	1.9	-1.2	0.5	-0.9	-1.6	-3.1	3.3	5.3	6.9	10.4	11.1
Vanuatu	1.7	2.7	-2.1	-2.8	1.6	4.7	-6.8	-3.7	-3.2	-1.1	2.5	2.5	3.7	2.0	3.0
C. Countries with flexible exchange rate															
Papua New Guinea	0.2	-1.2	-2.3	-0.8	2.0	-2.1	-2.0	-3.6	-4.1	-1.7	12.9	15.6	9.3	11.8	11.8

Source: Rosales (2001); Asian Development Bank (2003); United Nations ESCAP (2004)

Table 4: Intra-Regional Exports and Imports of PICs

Countries	Intra-Reg. Exports		Imports		Intra-Reg. Trade		Exports to Australia		Imports from Australia		Exports to NZ		Imports from NZ		Total Trade (% of GDP)
	(% of Total Exports)	Total Exports	(% of Total Imports)	Total Imports	(% of Total Trade)	Total Trade	(% of Total Exports)	Total Exports	(% of Total Imports)	Total Imports	(% of Total Exports)	Total Exports	(% of Total Imports)	Total Imports	
Cook Islands	-	Average of 1994-97	-	Average of 1994-97	-	Average of 1994-97	-	Average of 1994-97	-	Average of 1994-97	-	Average of 1994-97	-	Average of 1994-97	-
1998	-	10.26	-	10.26	9.52	4.9	21.07	7.19	25.51	70.94	51.43	-	-	-	-
1999	-	11.76	-	11.76	10.83	5.6	28.3	9.75	10.4	68.2	52.45	-	-	-	-
2000	-	10.44	-	10.44	9.82	5.2	9.32	8.2	25.2	68.94	54.85	-	-	-	-
2001	-	18.49	-	18.49	15.68	12.03	33.91	5.97	25.13	60.58	76.73	-	-	-	-
2002	-	11.12	-	11.12	9.74	6.77	22.08	6.1	8.2	74.83	74.4	-	-	-	-
Average of 1994-97	-	5.2	-	5.2	5.6	3.41	22.08	6.85	13.9	79.07	61.5	-	-	-	-
Fiji	0.31	0.07	0.38	0.38	0.505	0.505	26.67	39.86	6.99	15.50	76.87	-	-	-	-
1998	4.73	0.12	2.13	0.12	2.13	0.73	33.79	44.84	4.31	15.11	86.84	-	-	-	-
1999	6.84	0.1	2.81	0.1	2.81	0.64	33.02	41.09	4.47	13.10	90.62	-	-	-	-
2000	7.11	0.14	3.35	0.14	3.35	0.94	25.67	48.71	3.53	13.04	89.62	-	-	-	-
2001	8.33	-	3.7	-	3.7	0.07	19.74	44.26	3.46	14.88	82.5	-	-	-	-
2002	7.21	-	3.02	-	3.02	0.06	19.43	37.31	3.76	17.15	89.26	-	-	-	-
Average of 1994-97	-	7.8	-	7.8	5.15	11.67	3.02	18.11	-	3.94	88.78	-	-	-	-
1998	-	10.01	-	10.01	8.7	17.06	4.05	21.82	-	1.69	102.74	-	-	-	-
1999	-	14	-	14	11.37	16.31	2.59	33.08	-	3.02	98.02	-	-	-	-
2000	-	14.21	-	14.21	10.7	22.26	0.24	34.12	-	4.75	80.98	-	-	-	-
2001	-	20.8	-	20.8	11.87	21.53	0.39	37.16	-	2.91	91.87	-	-	-	-
2002	-	12.67	-	12.67	9.14	20.69	0.38	26.6	-	3.58	124.74	-	-	-	-
Average of 1994-97	-	0.97	-	0.97	0.71	0.46	-	1.31	-	1.01	83.41	-	-	-	-
1998	-	0.78	-	0.78	0.7	0.35	-	2.01	-	0.71	67.93	-	-	-	-
1999	-	1.16	-	1.16	1.02	0.5	-	1.42	-	0.85	68.94	-	-	-	-
2000	-	1.25	-	1.25	1.05	0.54	-	1.46	-	0.89	68.33	-	-	-	-
2001	-	NA	-	NA	NA	NA	NA	NA	NA	NA	61.3	-	-	-	-
2002	-	NA	-	NA	NA	NA	NA	NA	NA	NA	67.62	-	-	-	-

continued over

Table 4: continued

Countries	Intra-Reg. Exports		Imports		Intra-Reg. Trade		Exports to Australia		Imports from Australia		Exports to NZ		Imports from NZ		Total Trade (% of GDP)
	(% of Total Exports)	Total Exports	(% of Total Imports)	Total Imports	(% of Total Trade)	Total Trade	(% of Total Exports)	Total Exports	(% of Total Imports)	Total Imports	(% of Total Exports)	Total Exports	(% of Total Imports)	Total Imports	
ESM	0.01	Average of 1994-97	0.01	Average of 1994-97	0.01	Average of 1994-97	NA	Average of 1994-97	2.62	Average of 1994-97	-	Average of 1994-97	-	Average of 1994-97	65.61
1998	0.19	-	0.02	-	0.01	-	NA	-	4.02	-	-	-	-	64.71	
1999	0.2	-	0.02	-	0.01	-	NA	-	19.79	-	-	-	-	64.39	
2000	NA	-	NA	-	NA	-	NA	-	NA	-	-	-	-	73.07	
2001	NA	-	NA	-	NA	-	NA	-	NA	-	-	-	-	53.05	
2002	NA	-	NA	-	NA	-	NA	-	NA	-	-	-	-	52.01	
Average of 1994-97	0.03	0.03	0.06	0.03	0.11	0.11	27.68	51.43	1.39	4.01	88.89	-	-	-	
1998	0.21	0.24	0.45	0.24	0.21	0.21	18.72	52.41	0.69	4.12	94.70	-	-	-	
1999	0.18	0.30	0.44	0.30	0.23	0.23	26.29	53.01	0.16	4.1	114.12	-	-	-	
2000	0.21	0.36	0.57	0.36	0.29	0.29	29.98	49.54	0.73	3.8	116.45	-	-	-	
2001	0.1	0.21	0.25	0.21	0.2	0.2	24.62	51.29	1.35	4.02	94.42	-	-	-	
2002	0.10	0.13	0.31	0.13	0.18	0.18	23.74	49.26	1.32	4.4	95.81	-	-	-	
Average of 1994-97	-	10.49	-	10.49	7.70	6.50	84.18	19.18	6.17	35.15	47.89	-	-	-	
1998	-	18.08	-	18.08	11.9	11.6	48.96	16.23	2.74	22.59	51.74	-	-	-	
1999	-	16.67	-	16.67	12.27	11.52	58.95	14.59	3.68	23.01	57.34	-	-	-	
2000	-	9.48	-	9.48	13.02	9.48	57.36	27.31	2.37	13.89	38.69	-	-	-	
2001	-	12.6	-	12.6	9.98	13.64	60.98	13.12	1.42	17.32	59.9	-	-	-	
2002	-	20.33	-	20.33	14.17	13.43	59.5	15.75	2.05	4.25	56.2	-	-	-	
Average of 1994-97	0.38	0.66	1.04	0.66	1.92	1.92	1.38	40.92	0.26	7.43	94.27	-	-	-	
1998	1.07	4.3	5.1	4.3	2.66	2.66	1.97	42.96	0.35	5.26	108.46	-	-	-	
1999	1.29	3.7	4.36	3.7	2.81	2.81	1.34	38.53	0.47	6.29	110.78	-	-	-	
2000	2.1	6.1	8.2	6.1	3.7	3.7	2.79	27.5	0.74	5.63	85.89	-	-	-	
2001	-	7.46	-	7.46	4.4	NA	1.69	29.27	0.28	5.0	NA	-	-	-	
2002	-	9.1	-	9.1	5.10	NA	0.88	31.31	0.25	5.02	NA	-	-	-	

continued over

Table 4: continued

Countries	Intra-Reg. Exports		Imports		Intra-Reg. Trade		Exports to Australia		Imports from Australia		Exports to NZ		Imports from NZ		Total Trade (% of GDP)
	(% of Total Exports)	(% of Total Exports)	(% of Total Imports)	(% of Total Imports)	Total Trade (% of GDP)	(% of GDP)	Total Exports (% of Total Exports)	(% of Total Exports)	Total Imports (% of Total Imports)	(% of Total Imports)	Total Exports (% of Total Exports)	(% of Total Exports)	Total Imports (% of Total Imports)	(% of Total Imports)	
Tonga	3.08	7.65	6.97	4.72	3.76	4.72	33.56	9.66	38.47	51.67					
Average of 1994-97	6.12	7.41	7.26	4.04	4.04	4.53	24.68	13.98	36.17	52.4					
1998	2.0	9.96	8.79	3.21	4.98	3.21	19.98	8.74	37.22	65.7					
1999	1.65	12.2	9.73	1.98	6.65	1.98	10.27	3.68	23.99	79.2					
2000	2.55	19.73	17.1	1.56	12.98	1.56	11.24	4.41	33.21	102.9					
2001	2.14	21.42	17.0	1.44	13.61	1.44	13.2	3.55	30.83	133.7					
2002	1.04	30.49	45.5	-	29.23	-	39.41	-	6.31	81.63					
Average of 1994-97	1.61	59.81	58.39	41.24	41.24	-	20.21	-	6.31	70.06					
1998	5.14	63.84	57.18	45.67	45.67	-	18.1	-	5.27	79.87					
1999	11.39	58.58	56.01	58.77	58.77	-	19.57	-	4.57	104.93					
2000	13.92	65.19	62.48	69.7	69.7	-	16.28	-	7.68	52.10					
2001	9.16	54.32	51.1	NA	NA	-	12.9	-	5.21	NA					
2002	0.01	0.93	0.94	2.67	2.67	4.05	21	0.47	5.19	85.58					
Average of 1994-97	1.41	5.67	7.08	3.92	3.92	0.60	21.67	0.39	4.76	92.32					
1998	1.19	4.12	5.31	3.98	3.98	0.68	17.95	0.44	4.13	122.87					
1999	4.84	8.55	13.39	5.75	5.75	0.54	25.08	0.44	6.93	79.24					
2000	-	4.72	3.17	3.58	3.58	3.01	25.37	1.12	6.57	53.72					
2001	-	7.11	1.88	4.13	4.13	3.20	23.48	0.64	10.69	52.41					
2002	-	-	-	-	-	-	-	-	-	-					

NA: Not available

- : Negligible

Source: Asian Development Bank (2003)

On the other hand, PICs' major trading partners in the region have been Australia and New Zealand and outside the region are the EU and Japan. Imports cover a wide range of commodities, inclusive of basic necessities and capital and intermediate goods. The PICs' imports from Australia were about 34 per cent of their total imports and their exports to Australia were 23 per cent of their total exports. The rest from the various other partners were well below the Australian percentages. On the basis of present pre-union trade volume, a currency union exclusively among PICs would not result in as much gain as would result from a larger sized union with Australia and New Zealand (de Brouwer 2000; Jayaraman 2003).

The next aspect for examination is whether the growth rates experienced by PICs and the two advanced countries have been similar. The evidence is to the contrary. Studies of simple correlation of growth rates of Australia and New Zealand and 11 PICs, over two decades, reveal that there is far greater divergence than convergence.⁸ The growth rate of Australia is significantly correlated only with that of Samoa, while New Zealand's growth rate is not significantly correlated with any country. Similarly, the growth rates of Fiji, Kiribati, Papua New Guinea, Marshall Islands and Solomon Islands are not correlated with any country. Correlation exists only between the growth rates of the following pairs of countries: Cook Islands and FSM, Cook Islands and Tonga, FSM and Tonga and Tuvalu and Tonga. The results indicate the absence of any coherent pattern in growth performance between PICs and the two advanced countries (Jayaraman 2004a).

Our attention now turns to real effective exchange rate (REER) indices. The REERs are endogenous prices, since they are the outcome of the structure of the economy as well as of domestic and external shocks (de Brouwer 2000). If countries were similarly placed in terms of their economic structure and if they had experienced similar external and domestic shocks, movements in their REERs would display common trends. The study results indicate that the co-movements in REERs are confined to two sets of countries: Australia and New Zealand; and Australia and Papua New Guinea. New Zealand's REER is not correlated with the REER of any PIC. Thus, there is substantial divergence, indicating that PICs do not share any common pattern in REER movements with Australia and New Zealand.

The conclusion is that in the absence of convergence in key indicators, a currency union either among 14 PICs or all 16 countries, including Australia and New Zealand, would be premature.

Summary and conclusions

The case for a single currency for PICs was examined on the basis of OCA criteria. Empirical analysis indicates that lack of product diversity has led to low intra-trade volumes in absolute and percentage terms. On the other hand, trade with the two other forum partners, Australia and New Zealand, is substantial. However, the PICs and Australia have different levels of development. Growth and development challenges facing the PICs are different from those of Australia. Further, there was no convergence of macro-economic policies pursued by PICs, and Australia and New Zealand. Since economic shocks hitting both sets of countries were dissimilar, there would be no gains for PICs agreeing to Australia's set of monetary and exchange rate policies being adopted for the region as a

whole. Union-wide policies, which are likely to be dictated more by Australian growth priorities than by those of New Zealand, would not be suitable for PICs.

A former governor of New Zealand's central bank went on record as saying that the time for adopting the Australian dollar as a common currency by New Zealand was not ripe. Arguing on the basis of OCA conditions, Governor Brash (2000) observed that there had been a lack of synchronisation of business cycles between Australia and New Zealand during the recent past.⁹ For the same reasons, one can conclude that there is also no case for a currency union among the PICs.

However, one can argue for a currency union with Australia on the grounds that OCA criteria are to some extent endogenous and a currency union might help make the shocks hitting member countries more symmetric in the future and might also expand intra-union trade. This is similar to an argument put forward by Scitovsky (1958) when the European Common Market was born. However, EU member countries did not plunge into a currency union arrangement until after nearly four decades of common market experience and fulfilment of convergence criteria (Padoa-Schioppa 2004).

In the alternative, a stepwise approach could be suggested. The dollarised PICs might consider a currency 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. Three subsets of PICs — (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, these eight PICs might consider entering into formal arrangements with the above named developed countries.

If Australia was keen about the dollarisation of PICs, 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 their own currencies. The PICs would then like to have a share in the seigniorage revenue, which otherwise 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 the Reserve Bank of Australia (RBA), as a lender of last resort for rescuing their crisis-affected banks. Thirdly, if the RBA 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, the 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 other factors of production (Jayaraman 2004a, 2004b).

The issues including labour mobility and fiscal transfers have far-reaching implications, which can be resolved only at political levels. The Caribbean experience (Farrell and Worrell 1994; Worrell 2003) is relevant in this regard. A single currency for the Caribbean region has yet to become a reality for obvious reasons. Three decades ago, William Demas, 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, articulated it 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)

Notes

- 1 The 14 PICs are: Cook Islands, Fiji, Kiribati, Republic of Marshall Islands, Federated States of Micronesia (FSM), Nauru, Niue, Palau, Papua New Guinea, Samoa, Solomon Islands, Tonga, Tuvalu, Vanuatu. These 14 PICs and the two metropolitan powers in the region, Australia and New Zealand, constitute the Pacific Islands Forum, which is the major regional organisation.
- 2 These include: Communauté Financière Africaine (CFA), consisting of two zones, West African Monetary Union and Central African Economic and Monetary Union in Africa, the rand zone; the Eastern Caribbean Currency Union (ECCU) within the Organisation of Eastern Caribbean States (OECS); and the Caribbean Community and Common Market (CARICOM) in the Caribbean region.
- 3 The initiatives are the signing of two agreements in 2002, known as the Pacific Agreement on Closer Economic Relations (PACER) and the Pacific Island Countries Trade Agreement (PICTA). The PACER was signed by all 16 forum countries, including Australia and New Zealand, for starting negotiations by 2011 aimed at freer trade among all. The PICTA was signed by only 14 PICs for setting up a free trade area among themselves by 2010. PACER and PICTA received the necessary number of ratifications and became duly effective in late 2003.
- 4 Gathering political support and securing consensus for achieving monetary integration in Europe took nearly five decades. There were several notable milestones. The 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 harmonising 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 the 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 the Maastricht Treaty of 1993, 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 per cent of

- GDP on members in case of fiscal deficits in excess of the three per cent 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 1 January 1999.
- 5 There are two alternative solutions: (i) currency board arrangement (CBA); and (ii) dollarisation. Under CBA, while the national currency would continue to exist, the monetary authority 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. Thus, 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. Under 'dollarisation', the national currency would be replaced by the currency of a country with which trade and economic relations have been close in recent years. Advantages of dollarisation are: (i) absence of speculative attacks on the domestic currency; (ii) no possibility of inflationary finance; and (iii) closer integration with the country whose currency has been adopted as legal tender. Disadvantages of dollarisation are: (i) loss of a national symbol; (ii) central bank of the country of anchor currency might not support the domestic banking system in times of crisis; (iii) loss of seigniorage revenue; and (iv) difficulty in exiting from dollarisation compared with other regimes.
 - 6 In the case of the euro, the following five preconditions, which are known as convergence criteria, were provided under the Maastricht Treaty of 1993: (i) each country's budget deficit has to be below three per cent of its GDP; (ii) each country's public debt has to be less than 60 per cent of GDP; (iii) countries should have an inflation rate within 1.5 per cent of the three EU countries with the lowest rate; (iv) long-term interest rates must be within two per cent of the three lowest interest rates in the EU; and (v) exchange rates must be kept within 'normal' fluctuation margins of Europe's exchange-rate mechanism. Greece was the only member of the EU that 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.
 - 7 It makes sense to look at the nearly five-decade-old progress made towards economic integration in Europe, where the process of forming a currency union was associated with a significant degree of economic convergence in real GDP per capita over the years. This process was further supported by steadily growing intra-trade and labour mobility, culminating in the formation of a common market. These efforts were also accompanied by attempts to effect fiscal transfers to the poorer members (Greece, Ireland and Portugal) of the EU. In this connection, one might refer to a parallel in the developing world. India, with a federal constitution, is also a currency union of 22 states with varying levels of development. A combination of free interstate trade in goods and services, together with factor mobility and constitutional provision of federal fiscal transfers to economically backward states, has kept the Indian union going (Fabella 2002).
 - 8 Results will be made available on request.

- 9 The most recent study by Crosby and Otto (2003) has concluded that (i) Australia and New Zealand were not suitable candidates for the currency union; (ii) benefits of a currency union for Australia would be small; and (iii) it would be worthwhile for Australia to consider currency union with the United States rather than with New Zealand.

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