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The economics of regional monetary integration

Introduction

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In 2006, 185 countries in the world were members of the International Monetary Fund. But there were only 149 currencies in the international monetary system. Indeed, 41 countries either were part of regional monetary unions (the European monetary union, the CFA franc zone, the East Caribbean monetary union) or had abandoned monetary sovereignty by fully dollarizing (or euroizing) their economies.

Looking forward, the number of currencies in the world is likely to decline in the next decades. Indeed, several plans of monetary unions have flourished all around the world (see Hawkins and Klau, 2005, and Hawkins and Masson, 2003, for an economic assessment of these projects). While the jury is still out whether they will sustain, the international monetary system may evolve towards a "bloc-floating" system where a limited number of currencies would be floating against each other while monetary stability would be secured regionally through regional monetary unions or unilateral dollarization/euroization (see Collignon, 1999). Such movement would match with developments in goods markets provided that the many regional integration schemes would turn into a number of customs unions negotiating conditions of market opening with one another. It would also be consistent with ongoing efforts to develop regional financial markets in order to enable emerging countries to reap the benefits from international integration while protecting them from exchange-rate instability, sudden inflow reversals and the "original sin" problem. Due to their larger size, foreign exchange markets are expected to develop world-wide for regional currencies and to allow for cheaper hedges against cross-block exchange-rate fluctuations. Indeed, regional monetary integration could allow emerging countries to escape the "corner solution" dilemma – either float or fix the exchange rate for ever to one of the existing key currencies. Through regional monetary integration, they could find a way to reduce their vulnerability to currency crises while retaining some monetary independence which would be shared regionally (see Bénassy-Quéré and Cœuré, 2005).

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However, the road towards a "bloc-floating" international monetary system will take time and some regional initiatives may show up more successfully than others due to more economic rationale and/or political will. In September 2006, the Kiel Institute for the World Economy hosted a conference aiming at discussing the economic grounds for regional monetary initiatives all around the world. The conference was conceptually initiated by Herbert Grubel (Fraser Institute, Vancouver) and co-organised by Rainer Schweickert from the Beyond Europe Regional Integration Studies (BERIS) network of the Kiel Institute. The conference successively visited the Americas (NAFTA, the Caribbean), the resource-abundant economies of the CIS and the Gulf area, Sub-Saharan Africa (the CFA, the West and Central African monetary zones), Asia (the ASEAN-plus-Three initiative) and Oceania (Australia-NewZealand). At the Conference, this road-show benefited strongly from contributions given by Robert Mundell, the *spiritus rector* of regional monetary integration.

Économie internationale is pleased to publish a sub-set of the papers discussed during this conference. This special issue opens with a commissioned paper by Michael ARTIS summarising what has been learned about monetary unions since the three seminal papers by Robert Mundell (1961), Ronald McKinnon (1963) and Peter Kenen (1969). According to him, the case for endogenous optimum currency areas – i.e. monetary unions that become optimum *ex post*, if not *ex ante* – should not be taken for granted: a monetary union *per se* is unlikely to spur an important increase in intra-zone trade, nor is it instrumental to engineer business-cycle convergence. According to him, two criteria should be taken very seriously when considering a monetary union. First, in small and/or low-income countries, exchange-rate stabilisation relying on own anchors is often a mirage rather than a controlled policy outcome and the cost of abandoning monetary sovereignty is probably limited. Second, financial integration is key to allow for regional risk sharing, hence reducing the vulnerability of member countries to idiosyncratic shocks.

The optimum currency areas literature also stresses that wage and price flexibility reduce the costs of fixing the nominal exchange rate, because they allow for relative prices to adjust to idiosyncratic shocks without the help of the nominal exchange rate. Nevertheless, there is a case for discussing the relevance of reverse causality and endogeneity of the optimum currency areas criteria in the sense that the adoption of a given exchange rate regime may influence the pace of labour market reforms. To this aim, Ansgar BELKE, Bernhard HERZ, and Lukas VOGEL investigate the relationship between the monetary regime and the implementation of economic reforms. Using a panel data set of more than 100 countries observed over 30 years, they show that an exchange-rate commitment does not trigger labour and product market reforms. Here again, the case for endogenous optimum currency areas is relatively weak.

These general results are illustrated in the regional papers presented in this special issue. As evidenced by Michael G. PLUMMER and Ganeshan WIGNARAJA, Asia has adopted an "integrate first" view, with a rather disparate mushrooming of trade agreements and the more recent political will to develop a regional financial market. Hence, Asian governments seem to hold that monetary integration will complement real integration rather than foster it. Recent monetary tensions in Asia, for instance, with Korea suffering from strong currency appreciation against both China and especially Japan, may, however, pave the way towards more activist approaches in accelerating the process of monetary integration in this region.

In contrast, Paul R. MASSON shows that the lack of effective regional integration in Africa is a serious impediment to more monetary integration. He further suggests that some African countries could incur a high cost due to lack of fiscal discipline in other countries triggering a loss in monetary credibility. This mitigates the idea that less-developped countries would not suffer much from abandoning monetary sovereignty. However, this argument is less stringent when considering the CFA zone which has special arrangements with the French Treasury. As evidenced by Etienne B. YEHOUE, the CFA zone performed better than non-CFA countries in terms of price stability and fiscal discipline over 1960-2004. Furthermore, CFA countries benefited from an additional shock absorber provided by a counter-cyclical disbursement policy in French development aid. From these two papers on Sub-Saharan Africa, one might infer that regional monetary integration may be less costly under a special arrangement with a foreign anchor such as in the CFA case, than with independent, regional projects such as the West-African Monetary Zone (WAMZ), the South-African Development Community (SADC) monetary union, the East-African Community project or the remote ambition of a single, pan-African currency.

The other regional papers presented in this special issue focus on cases where one or several small countries consider forming a monetary union with a large neighbouring country. The most well-known case is that of NAFTA. Dominick SALVATORE argues that, although there is a high level of trade integration between Canada, Mexico and the United States, the costs of permanently fixing the exchange rates are probably too high due to very different economic structures and the lack of coordination of other policies. For instance, a couple of Canadian provinces are specialized in the production of primary goods and thus face different conditions with respect to exogenous shocks than industrialised provinces (see Beine and Coulombe, 2003). In addition, according to Dominick Salvatore, there would be a high political cost for Canada and Mexico because the United States would not accept a common central bank with Canadian and Mexican governors at the board. Hence the only way for the two countries would be unilateral dollarization. This might explain why the NAFTA project does not have a monetary counterpart. The same kind of dilemma is described by Peter J. LLOYD and & Lei Lei SONG in the case of New Zealand *vis-à-vis* Australia with the latter country denying an active part in the process. While the New Zealand economy (as the smaller partner country) is expected to collect some gains from a monetary union, Australia's own gains are seen small due to the much more important economic links with the US, Japan and China. As a result, Peter Lloyd's outlook appears sceptical, although a genuine monetary union may be more feasible in this case than in that of NAFTA.

Finally, the case of Belarus, Kazakhstan and Ukraine engaged in monetary integration *vis-à-vis* Russia is discussed by David G. MAYES and Vesa KORHONEN. Interestingly, these countries used to be part of a single currency area that collapsed in the 1990s. This last case raises the problem of hegemony, not just because Russia is by far larger than the three regional partners, but also due to the direct (Belarus, Ukraine) or indirect (Kazakhstan) dependence of the three smaller countries on energy links with Russia. Substantial differences in economic structures between Russia and the three economies do not constitute a text-book case for a monetary union (based on the position of each one as an oil and gas producer/consumer/transit country). However, the authors argue that a co-movement towards fiscal federalism with transfers from Russia could make a monetary union sensible for the three smaller countries. Nevertheless they stress that the other option of separate currencies is equally founded and that in the end, political considerations both in Russia and the three countries are likely to dominate the debate on monetary integration. Perhaps the general conclusion of this *tour d'horizon* across regional monetary plans is that, although economic rationale and political will are both needed for a monetary union to succeed, some substitutability between these two factors is possible.

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