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Discussion

# The political economy of sequencing: Monetary versus trade regionalism

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## 1. Introduction

Regionalism has various components. These encompass both trade and monetary integration. Each component tends to involve a gradation running from “modest” to full integration. On the trade side, the gradation runs from preferential trade areas to common markets. On the monetary side, the gradation runs from exchange-rate coordination (including regional basket pegs or a regionally harmonized exchange-rate band) to full monetary and fiscal integration incorporating a single currency, common monetary policy and institutions, and coordinated tax and fiscal policies. However, not only are the components of regionalism graduated, regionalism itself is usually phased in terms of the sequence in which the components are introduced.

In Europe, an initial trade agreement tended to be followed by increasingly binding constraints on exchange-rate policy. These constraints began in terms of the “snake in the tunnel” and then the Exchange Rate Mechanism of the European Monetary System and eventual monetary integration with the adoption of a single currency, the euro, in 1999. In many other regional settings, most notably in Asia and Mercosur, there is some discussion of the possibility of moving beyond trade integration towards fuller economic and monetary union along the lines of the European model, but at present the discussions have led to little tangible forward movement.

What is the nexus between trade and monetary integration? Why has trade integration proved more attractive than monetary integration? Is there an economic explanation using conventional theory (Balassa, 1961), and is this reasoning still valid in the current global environment where

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28 cross-border capital and currency flows are as significant as real sector transactions and where  
29 capital-account crises have been the norm rather than the exception? To answer these questions,  
30 we examine the interactions between trade and monetary integration. Is the connection one-way  
31 or two-way? If the former, a specific sequence would suggest itself. In the latter, sequencing may  
32 become more complex.

## 33 2. Interrelationships between trade and monetary regionalism<sup>1</sup>

34 There has been a strong tendency in the literature to treat trade and monetary regionalism  
35 independently. Thus, the criteria for judging whether countries would be good partners within a  
36 customs union have focused on the size of the proposed union and the pre-union size of trade  
37 between potential partners (as indicating the likely extent of trade diversion), the degree over-  
38 lapping in production (as a measure of the potential gains from specialization) and the cost  
39 differentials between prospective partners, the size of pre-union tariffs, the price elasticities of  
40 demand and supply for traded goods and services, and the scope for dynamic gains. Meanwhile,  
41 optimum currency area (OCA) criteria have focused on the degree of factor mobility between  
42 partners, size and openness, trade diversification, dissimilarity of commodity composition of pro-  
43 duction and trade baskets, macroeconomic trends and the synchronization of business cycles, the  
44 degree of labor market flexibility, the scope for regional transfers and the strength of the finan-  
45 cial sectors of potential members. It is only more recently that the connections between trade  
46 and monetary integration have been examined, leading some analysts to claim, for example, that  
47 conventional OCA criteria are endogenous.<sup>2</sup> What are the connections?

48 First, if exchange rate stability encourages trade, the formation of an exchange-rate union will  
49 help establish the conditions for a welfare-generating trade agreement. By reducing transactions  
50 and information costs, a single currency may encourage further trade among partners in a regional  
51 trade agreement (RTA). By the same token, however, an RTA may be undermined by exchange-rate  
52 instability among members. Currency misalignment or competitive devaluations may generate a  
53 protectionist backlash which goes against the purpose of the RTA and possibly even threatens  
54 its existence, as the recent experience of the Mercosur seems to suggest. Most recently in South  
55 America, the Mercosur trading agreement designed to encourage trade between Brazil, Argentina,  
56 Paraguay and Uruguay has been severely undermined by uncoordinated exchange rate policy  
57 between Brazil and Argentina.<sup>3</sup> The devaluation of the Brazilian real in 1999 accentuated the  
58 overvaluation of the Argentine peso and contributed to the economic crisis in Argentina, which in  
59 turn had significant negative repercussions on the Uruguayan banking system.<sup>4</sup> Trading partners  
60 were in effect pursuing competitive exchange rate policy and, as noted earlier, the ramifications  
61 of exchange rate changes will be much greater for close trading partners – fellow members of an

<sup>1</sup> While this paper deals only with trade and monetary regionalism, Barry Eichengreen's comments in this volume focus on the issue of regional financial integration in Asia. Also, see Rajan (2005) and references cited there.

<sup>2</sup> Frankel and Rose (1998) suggest that intra-union trade is encouraged by reducing the risk of exchange rate changes and that this in turn increases the degree of synchronization between business cycles of countries comprising the union which is itself a criterion for an OCA. We return to this idea later.

<sup>3</sup> The member countries of Mercosur also used economic integration to lock in structural reforms, which is an important political economy benefit of RTAs involving developing and transition countries. Concerns about the sustainability of Mercosur as only a regional trade agreement have given rise to suggestions in some policy circles that it be extended into a full-fledged regional monetary union (Fратиanni, 2004 and Levy Yeyati & Sturzenegger, 2000).

<sup>4</sup> A similar concern about competitive devaluations appears to exist in Asia.

62 RTA – than for other countries. A similar concern about competitive devaluations appears to exist  
63 in Asia.

64 Fernandez-Arias, Panizza and Stein (2002) present evidence based on 37 countries and 6 RTAs  
65 to suggest that the adverse effects of uncoordinated exchange rate policy may be more pronounced  
66 within the context of a RTA. These adverse effects can be expected to be greater the deeper the  
67 real sector integration as the cross-price elasticity of demand for similar goods and services  
68 produced within the integrated region may rise (so-called “knife-edge” comparative advantage).  
69 This is particularly so if, as Fernandez-Arias et al. (2002) suggest, intraregional FDI is especially  
70 footloose and sensitive to exchange rate changes and misalignments.

71 Second, the increased openness and intra-union trade encouraged by forming an RTA makes  
72 flexible exchange rates less appropriate and monetary integration more appropriate among partner  
73 countries.

74 Third, while the increased factor mobility that may be associated with forming a common market  
75 may substitute to some extent for trade among partner countries (as suggested by conventional  
76 trade theory), it may also substitute for exchange rate adjustment and therefore help to meet the  
77 criteria for an OCA.

78 Fourth, to the extent that a monetary union encourages intra-industry trade within the union, it  
79 may help not only to enhance the welfare gains from regional trade integration but also encourage  
80 the closer synchronization of business cycles that then helps retrospectively to justify the formation  
81 of the monetary union. This particular dimension of the relationship between trade and monetary  
82 regionalism has been empirically investigated by Frankel and Rose (1998) using 30 years of data  
83 for 20 industrialized countries. They acknowledge that if RTAs or monetary unions encourage  
84 industrial specialization and inter-industry trade according to comparative advantage, this could  
85 reduce the correlation between business cycles in the member countries, and this in turn could  
86 weaken the case for monetary integration since independent monetary tools, or a flexible exchange  
87 rate, may be needed to compensate for asymmetrical shocks (Krugman, 1993). It is therefore an  
88 empirical issue as to which of these effects – supply (asymmetry) or demand (symmetry) – will  
89 dominate.

90 Frankel and Rose (1998) claim that the empirical evidence that they examine suggests  
91 that closer economic integration has coincided with closer synchronization between business  
92 cycles—hence the argument that OCA criteria are endogenous. A study by Calderón, Chong,  
93 and Stein, (2002) of 147 countries over the period 1960–1999 using annual data finds that the  
94 impact of trade integration among industrial country pairs on output fluctuations is 0.092, significantly  
95 higher than the impact among developing country pairs (0.019) or between industrial and  
96 developing country pairs (0.037). The authors conjecture that this is due to higher IIT between  
97 industrial countries compared to inter-industry trade involving developing countries. More specific  
98 evidence to date for selected Asian economies suggests that the volume of intra-Asian trade  
99 does not necessarily lead to more symmetrical business cycles and could actually cause more  
100 idiosyncratic business cycles (Lee, 2004).

101 A number of implications follow from this analysis. If further EU enlargement encourages  
102 greater industrial specialization based on factor intensity-driven comparative advantage, it does  
103 not necessarily follow that the historical trend observed by Frankel and Rose will carry forward  
104 into the future. At the same time, however, the effects of industry-based asymmetrical shocks  
105 could be offset by the reduced incidence of demand-side shocks associated with the closer coordination  
106 of macroeconomic policy. The implication of this is that the effects of integration on the  
107 synchronization of business cycles within the integrated area are difficult to predict *a priori* and  
108 *ex ante*. Fortunately, our principal purpose in this brief paper is not to pursue this particular issue,

109 but merely to observe that there will be inter-connections between trade and monetary integration,  
110 and that the direction of these connections may run both ways. Trade integration and the forma-  
111 tion of a common market may help to create conditions more suitable for monetary integration.  
112 Meanwhile, monetary integration may help to facilitate trade integration. It is in this context that  
113 some political actors and independent observers have been suggesting that monetary integration  
114 can take place in conjunction with or even precede trade regionalism.

### 115 3. The political economy of sequencing regional trade and monetary arrangements

116 If the connection between regional trade agreements and regional monetary arrangements was  
117 simply that RTAs resulted in trade creation with partners and helped to establish the OCA criteria,  
118 it would be relatively easy to explain why historically RTAs tend to come first. But the previous  
119 section identifies a much more complex and two-way relationship within which it is as easy to  
120 argue that exchange rate and even monetary union will help to maximize the benefits from RTAs.  
121 If there is this two-way relationship between trade and monetary integration, why is it that we  
122 observe a strong empirical tendency for trade agreements to come first? Why are they not preceded  
123 by exchange rate and monetary union; or why are regional trade and monetary arrangements not  
124 established simultaneously?

125 Conventional economic considerations on their own struggle to explain the observed trade-  
126 first strategy. One possibility is that the answer lies in the dynamics of integration, but this seems  
127 unlikely. As noted earlier, the dynamic effects of integration are difficult to pin down and quantify.  
128 In any case, there is a reasonable presumption that the dynamic effects of monetary integration on  
129 trade expansion will exceed the dynamic effects of trade integration on securing the conditions  
130 most suited for monetary union. At the very least, the dynamics do not conveniently explain the  
131 tendency for a ‘trade first’ strategy towards integration. In terms of the economics of integration,  
132 it would be as easy to argue for a ‘monetary first’ or a concurrent approach. So, again, why is this  
133 not what we observe?

134 RTAs and monetary unions are not just economic phenomena. Indeed, numerous studies empha-  
135 size the importance of political imperatives. [Krugman \(1996\)](#), for example, argues that many of  
136 the issues surrounding NAFTA at the time of its inception were of little quantitative significance.  
137 From the viewpoint of the U.S. there were never likely to be large gains in terms of increased trade  
138 or large costs in terms of unemployment among unskilled U.S. workers or environmental degrada-  
139 tion. Subsequent empirical studies appear to confirm this ([Krueger, 1999](#)). Instead, NAFTA  
140 offered the U.S. a way of assisting Mexico at a time when it was anxious to strengthen Mexican  
141 democracy, encourage policy reform in Mexico and help Mexican economic development.

142 Similarly, [Goodhart \(1995\)](#) argues cogently that Economic and Monetary Union (EMU) in  
143 Europe reflects a political desire for closer integration. Strong and unambiguous justification is  
144 not to be found in the underlying economics. Emphasizing this point about the importance of  
145 politics, [Eichengreen and Bayoumi \(1999a,b\)](#) have concluded that from an economic standpoint  
146 East Asia may be as close to, or rather, as far away from being an optimum currency area (OCA)  
147 as Western Europe.<sup>5</sup> However, the authors go on to conclude that Asia is unlikely to move towards  
148 a European-type union anytime soon as “there is little sign, comparable to the evidence which  
149 has existed in Europe for nearly 50 years, of a willingness to subordinate national prerogatives

<sup>5</sup> This conclusion is based on an OCA index that takes into account the costs associated with asymmetric region-wide shocks as well as the benefits from stabilizing exchange rates with trading partners.

150 to some larger regional entity. There is no wider web of interlocking arrangements, as in the EU,  
151 which would be put at risk by a failure to follow through on promises of monetary and financial  
152 cooperation” (Eichengreen & Bayoumi, 1999b, p.11).<sup>6</sup>

153 If politics lies behind both trade and monetary agreements, it may be reasonable to assume that  
154 politics also helps explain the sequence in which RTAs and exchange rate and monetary unions  
155 occur. The short answer may simply be that the political rate of return to RTAs is higher than it  
156 is for monetary unions, so that it is rational for governments to pursue trade regionalism first.

157 Let us consider the options facing governments of geographically proximate states that are  
158 anxious to develop a closer relationship for political (military or security) reasons. A closer  
159 relationship can, in principle, extend to a full economic union but can be sub-divided into trade  
160 integration and monetary integration. Economic analysis suggests that there are probably small  
161 welfare benefits from trade liberalization within the context of an RTA. But the domestic political  
162 costs are probably even smaller and may indeed be outweighed by domestic political benefits.  
163 There are a number of elements to this.

164 First, the gainers will be those sectors of the economy that benefit from trade expansion and  
165 trade diversion. In the case of the European Union, for example, it has been the manufacturing  
166 sector that has gained from trade creation and the politically powerful agricultural sector that  
167 has gained from trade diversion (Sapir, 2000). An analytically strategic component of a customs  
168 union is the common external tariff. It is this tariff on imports from the rest of the world that  
169 generates trade diversion and the protectionism involved in RTAs (Krueger, 1999, 2000). The  
170 domestic political importance of trade diversion is revealed by the preference governments often  
171 show for RTAs as opposed to multilateral free trade. In the latter case, trade creation would be  
172 greater and trade diversion (except via non-tariff barriers) would be eliminated. In terms of basic  
173 economic analysis, the gains from multilateral trade integration would generally be higher. It is  
174 therefore, the domestic politics of protectionism that tends to get in the way.

175 Trade policy tends to be more heavily driven by producer interests that may benefit from  
176 protectionism than by consumer interests where there would be a gain from cheaper imports,  
177 since producers represent a more coherent and better organized political lobby. Consumers are  
178 probably ill-informed about the effects of protectionism and are, in any case, poorly organized.  
179 Against this background, RTAs offer governments the closer regional relationships that they are  
180 anxious to establish at relatively little, if any, net domestic political cost. They may also offer the  
181 prospect of higher tax revenue than multilateral free trade. In this context, it is easy to see why  
182 they have been so widely pursued.<sup>7</sup>

183 The matrix of costs and benefits is much different for monetary unions. Here, there is less  
184 unanimity of view about the benefits. At least in the case of trade integration there is a consensus  
185 around the view that there will be some small benefit via trade creation. Not so in the case  
186 of monetary unions. Governments therefore encounter significant uncertainty surrounding the  
187 benefits from a full-fledged monetary union. The claim that monetary unions will exert a counter-

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<sup>6</sup> In addition, substantial asymmetries in the sizes and levels and stages of economic development of the countries in Asia, on the one hand, and the *de facto* policy of strict non-intervention in one another's affairs (economic and particularly political), on the other, makes it extremely difficult to envisage the successful introduction of 'tie-in' clauses to create punishment mechanisms to ensure conformity of economic policies as done in Europe.

<sup>7</sup> Of course, the suggestion that RTAs are pursued as a protectionist device is less relevant to some recent enthusiasts of regionalism like the small city state of Singapore which is already highly open to trade and investment flows. Pursuit of trade agreements by such economies is driven by other economic considerations, though security and political also play a significant role (Rajan & Sen, 2002).

188 inflationary effect also becomes less compelling in an environment in which inflation is no longer  
 189 perceived as a problem.<sup>8</sup> Moreover, while monetary unions may offer a pro-trade benefit, they do  
 190 not offer the protectionist pay-off which is a feature of many RTAs.

191 Lodged against the uncertain benefits from regional monetary arrangements is an array of  
 192 potential political costs. First, there is the implication that exchange rate unions require enhanced  
 193 labor market flexibility or intraregional labor mobility. Establishing this risks domestic political  
 194 opposition if powerful trades unions are to be confronted. Second, exchange rate unions imply a  
 195 need for fiscal transfers within the union and this may encounter political resistance especially  
 196 amongst the probable creditor nations. Third, and perhaps most significantly, there is the whole  
 197 notion of ‘national sovereignty’ over domestic macroeconomic policy culminating, in the context  
 198 of Euroland, in the abandonment of national currencies. This will carry a particularly high cost  
 199 for countries that possess a strong feeling of national identity or whose monetary authorities  
 200 are concerned about forsaking hard-earned credibility. Clearly from a political perspective it is  
 201 irrelevant whether there is a real loss of sovereignty or not. It is the perception that counts. In  
 202 addition to the above, the political benefits from incremental regional integration may be subject to  
 203 diminishing returns. What is the political value-added from the greater integration that monetary  
 204 union brings? Against this background, it is easy to see why governments may pursue regional  
 205 trade integration but may pause before they embark on monetary integration.

#### 206 4. Concluding remarks

207 The analysis in this paper suggests that the path towards regional integration and its ‘trade first’  
 208 orientation is the outcome of a combination of politics and economics. But, it is the politics that  
 209 dominates. There is increasing evidence from an economic perspective that trade and monetary  
 210 integration is closely connected. Indeed, it is plausible that monetary integration encourages trade  
 211 and that trade integration leads to the closer synchronization of business cycles and produces other  
 212 economic spillovers that facilitate monetary integration.<sup>9</sup> This implies a complex set of positive  
 213 causal interconnections between trade and monetary integration. Overall, while it is unclear why  
 214 a trade first strategy should be favored on the basis of economic considerations alone, it becomes  
 215 much easier to understand the preferred approach when political considerations are added.

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<sup>8</sup> It was possibly the attractions of the counter-inflationary effects of an exchange rate union that encouraged the UK to join the Exchange Rate Mechanism of the European Monetary System in the early 1990s.

<sup>9</sup> See Eichengreen and Taylor (2003) for a critique of this argument. They find that the political context matters far more in determining if and when closer trade integration leads to enhanced monetary integration.

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