

**EXAMINING THE LINKS BETWEEN  
TRADE AND MONETARY REGIONALISM<sup>1</sup>**

**by**

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Economic regionalism encompasses both trade and monetary dimensions, with each component involving a progression from “shallow” to “deep” integration. On the trade side, the progression is from preferential and free trade areas to customs unions and common markets. On the monetary side, the gradation runs from exchange rate coordination (including regional basket pegs or a regionally-harmonised exchange rate band) to full monetary and fiscal integration incorporating a single currency and common monetary policy.

There has been a strong tendency in the literature to treat trade and monetary regionalism independently. Indeed, it is often lamented that there are few policy fora that allow for interactions and discussions between “trade specialists” who debate regional trade integration and “macro and finance specialists” who have views on monetary regionalism. The discussion on the two forms of integration, at least in Asia, has thus far taken place in parallel with, but largely independently of each other (we return to this point below).

According to conventional wisdom, the criteria for ascertaining whether countries would be good partners within a trade arrangement such as a customs union have focused on the pre-union size of trade between potential partners as indicating the likely extent of trade diversion, the degree of overlapping in production (as a measure of the potential gains from specialisation), the cost differentials between prospective partners, the size of pre-union tariffs, the price elasticities of demand and supply for traded goods and services, and the scope for dynamic gains.

The criteria for ascertaining the feasibility of a common or optimum currency area (OCA) have focused on the degree of factor mobility between partners, size and openness, trade diversification, dissimilarity of commodity composition of production and trade baskets, macroeconomic trends and the synchronisation of business cycles, the degree of labour market flexibility, and the scope for regional transfers of potential members.

*Nexus between Trade and Monetary Integration:* Scant attention has been paid to the connections between the two forms of economic regionalism. The conventional wisdom has been that trade integration must precede monetary integration. The broad reasoning is that trade integration leads to a convergence in aggregate demand patterns in the trade partners making them more likely to share common business cycles. However, this “trade-first” sequencing has recently come under scrutiny in Latin America and particularly in East Asia, which is actively considering if and how intra-regional monetary cooperation might be enhanced in parallel with ongoing steps towards trade integration<sup>2</sup>.

There are in fact some good reasons to question the “trade-first” conventional wisdom.

First, a regional trade arrangement could encourage industrial specialisation and inter-industry trade according to comparative advantage based on differences in factor endowments of countries (and factor intensities of goods). If the countries involved specialise in the production of products (or parts and components of a product) of different factor intensities, the countries’ production structures may actually become more dissimilar and thus more vulnerable to asymmetric supply shocks. This in turn could weaken the case for monetary integration since independent monetary tools, or a flexible exchange rate, may be needed to compensate for asymmetrical shocks<sup>3</sup>.

Second, by reducing transactions and information costs, a single currency may encourage further trade amongst partners in a regional trade arrangement. There is a large and growing body of evidence based on gravity models using both cross-sectional and time series data that suggests that a common currency stimulates trade<sup>4</sup>. As is common knowledge, proponents of European integration used such an argument extensively to justify the region’s Economic and Monetary Union. In other words, insofar as a monetary union encourages intraregional trade, especially of

the intra-industry variety, it may not only help enhance the welfare gains from regional trade integration but could also encourage the closer synchronisation of business cycles that then helps retrospectively to justify the formation of the monetary union. In other words, OCA criteria may be endogenous<sup>5</sup>.

Third, closely related to the above, a regional trade arrangement may be undermined by exchange rate instability amongst members. Competitive devaluations may generate a protectionist backlash which goes against the purpose of the regional trade arrangement and possibly even threatens its existence, as the recent experience of the Mercosur seems to suggest. The devaluation of the Brazilian real in 1999 accentuated the overvaluation of the Argentine peso and contributed to the economic crisis in Argentina which in turn had significant negative repercussions on the Uruguayan banking system. Trade partners were effectively pursuing competitive exchange rate policy. Indeed, recent evidence based on thirty-seven countries and six regional trade arrangements suggests that the adverse effects of uncoordinated exchange rate policy may be more pronounced within the context of a regional trade arrangements<sup>6</sup>. These adverse effects can be expected to be greater the deeper the real sector integration as the cross-price elasticity of demand for similar goods and services produced within the integrated region may rise (so-called “knife-edge” comparative advantage).

*Political Economy Factors:* The previous section identifies a complex and two-way nexus between monetary and trade integration. Since the analysis suggests that the nexus is bi-directional, why then do we observe a strong empirical tendency for trade agreements to come first? Why do exchange rate and monetary union not precede them; or why are regional trade and monetary arrangements not established simultaneously?

Regional trade arrangements and monetary unions are not just economic phenomena. Indeed, numerous studies emphasise the importance of political imperatives. For instance, a recent World Bank report has appropriately cautioned that trade regionalism “is good politics partly because it is ‘sound bite economics’ based on only those effects that are easiest to grasp...Regional integration may also be good economics, but the impetus for integration has usually not been the economics. Sometimes, good politics delivers bad economics”<sup>7</sup> (p.11).

Similarly, Charles Goodhart has argued persuasively that Economic and Monetary Union in Europe reflects a political desire for closer integration<sup>8</sup>. Strong and unambiguous justification is not to be found in the underlying economics. Emphasising the importance of politics, studies have generally found that from an economic standpoint East Asia may be as close to, or rather, as far away from being an optimum currency area (OCA) as Western Europe. However, most would concur with the conclusion that East Asia is unlikely to move towards a European-type union anytime soon as “there is little sign, comparable to the evidence which has existed in Europe for nearly 50 years, of a willingness to subordinate national prerogatives to some larger regional entity. There is no wider web of interlocking arrangements, as in the EU, which would be put at risk by a failure to follow through on promises of monetary and financial cooperation” (p.11)<sup>9</sup>.

If politics is the driver in the decision whether or not to establish trade and monetary agreements, it may be reasonable to assume that politics is also the driving force determining the sequence of trade versus monetary integration. In particular, monetary integration gives rise to the whole notion of “national sovereignty” over domestic macroeconomic policy culminating in the abandonment of national currencies. This will carry a particularly high cost for countries that possess a strong feeling of national identity or whose monetary authorities are concerned about forsaking hard-earned credibility.

Such concerns are far less apparent in the case of trade integration, which therefore offers governments the closer regional relationships that they are anxious to establish at relatively little, if any, net domestic political cost. In this context, it is easy to see why trade pacts have been so widely pursued<sup>10</sup>. Conversely, a rather dramatic alteration in the socio-political dynamics in East Asia following the regional crisis of 1997-98, and in particular, heightened concerns of economic vulnerability to the forces of financial globalisation, explains in part the new-found enthusiasm to explore the possibility of closer monetary *cooperation* if not *integration* in parallel with regional trade integration.

*Implications for India:* There has also been a renewed interest by ASEAN members in integrating India more closely with the Southeast Asian region in the trade sphere, due probably to changing regional and geopolitical circumstances as well as because of a paradigm shift in Indian business and economic mind-set. It is essential that Indian policymakers and leaders seize this opportunity by giving renewed diplomatic and political impetus to the country's "Look East" policy and consciously work towards engaging with all of East Asia in the trade as well as the monetary areas. Business associations, diplomatic missions and the Indian diaspora can and must be used much more effectively to promote commercial diplomacy between India and its East Asian neighbours. If India is ever to be considered a globally relevant power, it must first be accepted as one by the whole of Asia and particularly East Asia.

## Endnotes

<sup>1</sup> This commentary draws on G. Bird and R. Rajan (2002). “The Political Economy of a Trade-First Approach to Regionalism”, September (mimeo). Available on: [www.economics.adelaide.edu.au/rrajan/rajan.html](http://www.economics.adelaide.edu.au/rrajan/rajan.html)

<sup>2</sup> For instance, see G. Bird and R. Rajan (2002). “The Evolving Asian Financial Architecture”, *Princeton Essays in International Economics No.226*, International Economics Section, Princeton University, March and R. Rajan (2002). “Coping with Capital Account Crises: Financial Cooperation in East Asia”, *Economic and Political Weekly*, 37 (8), pp.704-706.

<sup>3</sup> This reason was initially presented by P. Krugman (1993). “Lessons of Massachusetts for EMU”, in F. Torres and F. Giavazzi (eds.), *Adjustment and Growth in the European Monetary Union*, Cambridge, UK: Cambridge University Press and B. Eichengreen (1992). “Should the Maastricht Treat Be Saved?”, *Princeton Studies in International Finance No.64*, International Economics Section, Princeton University.

<sup>4</sup> See J. Frankel and A. Rose (2001). “An Estimate of the Effect of Common Currencies on Trade and Income” (mimeo, April); R. Glick and A. Rose (2001). “Does a Currency Union Affect Trade?: The Time Series Evidence”, mimeo (April); A. Rose (2000). “One Money, One Market: Estimating the Effect of Common Currencies on Trade”, *Economic Policy*, 15, 7-46; and A. Rose and C. Engel (2000). “Currency Unions and International Integration”, *Working Paper No.7872*, Cambridge, MA: NBER.

<sup>5</sup> This particular dimension of the relationship between trade and monetary regionalism has been empirically investigated by Frankel and Rose (1998) “The Endogeneity of the Optimum Currency Area Criteria”, *Economic Journal*, 108, pp.1009-1025.

<sup>6</sup> See E. Fernandez-Arias, U. Panizza and E. Stein (2002). “Trade Agreements and Exchange Rate Disagreements”, (mimeo, March).

<sup>7</sup> M. Schiff et al. (2000), *Trade Blocs*, Washington, DC: The World Bank.

<sup>8</sup> C. Goodhart (1995). “The Political Economy of Monetary Union”, in P. Kenen (ed.), *Understanding Interdependence: The Macroeconomics of the Open Economy*, Princeton, NJ: Princeton University Press.

<sup>9</sup> B. Eichengreen and T. Bayoumi (1999). “On Regional Monetary Arrangements for ASEAN”, paper presented at an International Conference on Exchange Rate Regimes in Emerging Market Economies (December 17-18, Tokyo).

<sup>10</sup> Of course, the suggestion that trade arrangements 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 do admittedly play a significant role. See Rajan, R. and R. Sen (2002). “Singapore’s New Commercial Trade Strategy: Examining the Pros and Cons of Bilateralism”, in Chang L.L. (ed.), *Singapore Perspectives 2002*, Singapore: Times Academic Press; R. Rajan, R. Sen and R. Siregar (2001). *Singapore’s Attraction to Free Trade Areas: Bilateral Trade Relations with Japan and the US*, Singapore: Institute of Southeast Asian Studies and R. Rajan and R. Sen (2002). “Bilateralism versus Multilateralism: Singapore’s New Commercial Trade Strategy”, *Economic and Political Weekly*, 37 (6), pp.534-536.