

THE POLITICAL ECONOMY OF SEQUENCING: MONETARY VERSUS TRADE REGIONALISM

by

Graham Bird* and Ramkishen S. Rajan**

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* Surrey Centre for International Economic Studies, University of Surrey, England. E-mail: G.Bird@surrey.ac.uk

** LKY School of Public Policy, National University of Singapore. E-mail: rrajan@nus.edu.sg

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 policy. 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 the case of Europe the pattern emerged where an initial trade agreement was 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 cross-border capital and currency flows are as significant as real sector transactions and where capital account crises have been the norm rather than the exception? To answer these questions, we examine the interactions between trade and monetary integration. Is the connection one-way or two-ways? In the former case a specific sequence would be suggested. In the latter, sequencing may become more complex.

2. Interrelationships Between Trade and Monetary Regionalism¹

There has been a strong tendency in the literature to treat trade and monetary regionalism independently. Thus, the criteria for judging whether countries would be good partners within a customs union have focused on the size of the proposed union and the pre-union size of trade between potential partners (as indicating the likely extent of trade diversion), the degree overlapping in production (as a measure of the potential gains from specialization) and 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. Meanwhile, optimum currency area (OCA) criteria 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 synchronization of business cycles, the degree of labor market flexibility, the scope for regional transfers and the strength of the financial sectors of potential members. It is only more recently that the connections between trade and monetary integration have been examined, leading some analysts to claim, for example, that conventional OCA criteria are endogenous.² What are the connections?

First, if exchange rate stability encourages trade, the formation of an exchange rate union will help establish the conditions for a welfare-generating trade agreement. By reducing transactions and information costs, a single currency may encourage further trade amongst partners in a regional trade agreement (RTA). By the same token, however, an RTA may be undermined by exchange rate instability amongst members. Currency misalignment or

¹ While this paper focuses only on trade and monetary regionalism, Barry Eichengreen's paper in this volume focuses on the issue of regional financial integration in Asia. Also see Rajan (2005) and references cited within.

competitive devaluations may generate a protectionist backlash which goes against the purpose of the RTA and possibly even threatens its existence, as the recent experience of the Mercosur seems to suggest. Most recently in South America, the Mercosur trading agreement designed to encourage trade between Brazil, Argentina, Paraguay and Uruguay has been severely undermined by uncoordinated exchange rate policy between Brazil and Argentina.³ 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.⁴ Trading partners were in effect pursuing competitive exchange rate policy and, as noted earlier, the ramifications of exchange rate changes will be much greater for close trading partners - fellow members of an RTA - than for other countries. A similar concern about competitive devaluations appears to exist in Asia.

Fernandez-Arias, Panizza and Stein (2002) present evidence based on thirty seven countries and six RTAs to suggest that the adverse effects of uncoordinated exchange rate policy may be more pronounced within the context of a RTA. 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). This is particularly so if, as Fernandez-Arias, Panizza and Stein (2002) suggest, intraregional FDI is especially footloose and sensitive to exchange rate changes and misalignments.

² 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.

³ 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 has given rise to suggestions in some policy circles that it be extended into a full-fledged regional monetary union (Fратиanni, 2004 and Levy Yeyati and Sturzenegger, 2000).

⁴ A similar concern about competitive devaluations appears to exist in Asia.

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

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

Fourth, to the extent that a monetary union encourages intra-industry trade within the union, it may help not only to enhance the welfare gains from regional trade integration but also encourage the closer synchronization of business cycles that then helps retrospectively to justify the formation of the monetary union. This particular dimension of the relationship between trade and monetary regionalism has been empirically investigated by Frankel and Rose (1998) using thirty years of data for twenty industrialized countries. They acknowledge that if RTAs or monetary unions encourage industrial specialization and inter-industry trade according to comparative advantage, this could reduce the correlation between business cycles in the member countries, and 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 (Krugman, 1993). It is therefore an empirical issue as to which of these effects – supply (asymmetry) or demand (symmetry) – will dominate.

Frankel and Rose (1998) claim that the empirical evidence that they examine suggests that closer economic integration has coincided with closer synchronization between business cycles - hence the argument that OCA criteria are endogenous. A study by Calderón et al. (2002) of 147 countries over the period 1960-99 using annual data finds that the impact of trade integration among industrial country pairs on output fluctuations is 0.092, significantly higher than the impact among developing country pairs (0.019) or between industrial and developing country pairs (0.037). The authors conjecture that this is due to higher IIT between industrial

countries compared to inter -industry trade involving developing countries. More specific evidence to date for selected Asian economies suggests that the volume of intra-Asian trade does not necessarily lead to more symmetrical business cycles and could actually cause more idiosyncratic business cycles (Lee, 2004).

A number of implications follow from this analysis. If further EU enlargement encourages greater industrial specialization based on factor intensity-driven comparative advantage, it does not necessarily follow that the historical trend observed by Frankel and Rose will carry forward into the future. At the same time, however, the effects of industry-based asymmetrical shocks could be offset by the reduced incidence of demand-side shocks associated with the closer coordination of macroeconomic policy. The implication of this is that the effects of integration on the synchronization of business cycles within the integrated area are difficult to predict *a priori* and *ex ante*. Fortunately, our principal purpose in this brief paper is not to pursue this particular issue, but merely to observe that there will be inter-connections between trade and monetary integration, and that the direction of these connections may run both ways. Trade integration and the formation of a common market may help to create conditions more suitable for monetary integration. Meanwhile, monetary integration may help to facilitate trade integration. It is in this context that some political actors and independent observers have been suggesting that monetary integration can take place in conjunction with or even precede trade regionalism.

3. The Political Economy of Sequencing Regional Trade and Monetary Arrangements

If the connection between regional trade agreements and regional monetary arrangements was simply that RTAs resulted in trade creation with partners and helped to establish the OCA criteria, it would be relatively easy to explain why historically RTAs tend to come first. But the previous section identifies a much more complex and two-way relationship within which it is as easy to argue that exchange rate and even monetary union will help to maximize the benefits from RTAs. If there is this two-way relationship between trade and

monetary integration, why is it that we observe a strong empirical tendency for trade agreements to come first? Why are they not preceded by exchange rate and monetary union; or why are regional trade and monetary arrangements not established simultaneously?

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

RTAs and monetary unions are not just economic phenomena. Indeed, numerous studies emphasize the importance of political imperatives. Krugman (1996), for example, argues that many of the issues surrounding NAFTA at the time of its inception were of little quantitative significance. From the viewpoint of the US there were never likely to be large gains in terms of increased trade or large costs in terms of unemployment amongst unskilled US workers or environmental degradation. Subsequent empirical studies appear to confirm this (Krueger, 1999). Instead, NAFTA offered the US a way of assisting Mexico at a time when it was anxious to strengthen Mexican democracy, encourage policy reform in Mexico and help Mexican economic development.

Similarly, Goodhart (1995) argues cogently that Economic and Monetary Union (EMU) in Europe reflects a political desire for closer integration. Strong and unambiguous justification is not to be found in the underlying economics. Emphasizing this point about the importance of politics, Eichengreen and Bayoumi (1999a,b) have concluded 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.⁵ However, the authors go on to conclude that 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” (Eichengreen and Bayoumi, 1999b, p.11).⁶

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

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

First, the gainers will be those sectors of the economy that benefit from trade expansion and trade diversion. In the case of the European Union, for example, it has been the manufacturing sector that has gained from trade creation and the politically powerful agricultural

⁵ 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.

⁶ 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.

sector that has gained from trade diversion (Sapir, 2000). An analytically strategic component of a customs union is the common external tariff. It is this tariff on imports from the rest of the world that generates trade diversion and the protectionism involved in RTAs (Krueger, 1999 and 2000). The domestic political importance of trade diversion is revealed by the preference governments often show for RTAs as opposed to multilateral free trade. In the latter case, trade creation would be greater and trade diversion (except via non-tariff barriers) would be eliminated. In terms of basic economic analysis, the gains from multilateral trade integration would generally be higher. It is therefore the domestic politics of protectionism that tends to get in the way.

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

The matrix of costs and benefits is much different for monetary unions. Here there is less unanimity of view about the benefits. At least in the case of trade integration there is a consensus around the view that there will be some small benefit via trade creation. Not so in the case of monetary unions. Governments therefore encounter significant uncertainty surrounding the benefits from a full-fledged monetary union. The claim that monetary unions will exert a counter-inflationary effect also becomes less compelling in an environment in which

⁷ 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 and Sen, 2002).

inflation is no longer perceived as a problem.⁸ Moreover, while monetary unions may offer a pro-trade benefit, they do not offer the protectionist pay-off which is a feature of many RTAs.

Lodged against the uncertain benefits from regional monetary arrangements is an array of potential political costs. First, there is the implication that exchange rate unions require enhanced labor market flexibility or intraregional labor mobility. Establishing this risks domestic political opposition if powerful trades unions are to be confronted. Second, exchange rate unions imply a need for fiscal transfers within the union and this may encounter political resistance especially amongst the probable creditor nations. Third, and perhaps most significantly, there is the whole notion of 'national sovereignty' over domestic macroeconomic policy culminating, in the context of Euroland, 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. Clearly from a political perspective it is irrelevant whether there is a real loss of sovereignty or not. It is the perception that counts. In addition to the above, the political benefits from incremental regional integration may be subject to diminishing returns. What is the political value-added from the greater integration that monetary union brings? Against this background it is easy to see why governments may pursue regional trade integration but may pause before they embark on monetary integration.

4. Concluding Remarks

The analysis in this paper suggests that the path towards regional integration and its 'trade first' orientation is the outcome of a combination of politics and economics. But, it is the politics that dominates. There is increasing evidence from an economic perspective that trade and monetary integration is closely connected. Indeed, it is plausible that monetary integration

⁸ 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

encourages trade and that trade integration leads to the closer synchronization of business cycles and produce other economic spillovers that facilitates monetary integration.⁹ This implies a complex set of positive causal interconnections between trade and monetary integration. Overall, while it is unclear why a trade first strategy should be favored on the basis of economic considerations alone, it becomes much easier to understand the preferred approach when political considerations are added.

1990s.

⁹ 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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