The Relationship Between Trade and Currency Zones

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The subject under consideration, the relationship between trade and currency zones lends itself to a variety of interpretations. When I was asked to speak on this subject, I wondered what kind of interpretation I should discuss, not knowing the contributions of the other speakers. After all, one can historically observe the relationship as going from a trade zone to a currency zone or from a currency zone to a trade zone. Given the various configurations of this relationship, I decided to speak briefly about what I still consider to be a core issue of this economic debate: must a trade zone inevitably evolve into a currency zone? Also I will touch upon some previous remarks concerning such an evolution in the context of the European Economic Community.

First, we must recognize that exchange rate policy can be used as a tool for trade protection. We are not in a system of fixed parities with specified rules for exchange rate flexibility and adjustment. Rather, we are in a system of floating exchange rates. This floating is not a free floating or a clean floating. It is a sort of managed floating--one without a clear set of guidelines that are internationally agreed upon and enforced for the purpose of regulating exchange rate management, preventing "beggar-thy-neighbor" policies and spurring a country to enact measures for macroeconomic and structural adjustment as soon as imbalances begin to emerge.

The basis of a trade zone is that the exchange of goods, services, and, under certain conditions, factors of production is free not only from tariff bamers but also from other protectionist maneuvers such as exchange rate manipulation. Countries in a trade zone cannot disregard what happens on the exchange rate policy front. Trade policy does not take place in a vacuum. Trade policy is one component of a whole set of policies that have to be considered altogether.

Some argue that, apart from considerations related to the safeguard of the attributes of national sovereignty, it is essential for countries participating in a trade zone to retain autonomy and flexibility in exchange rate management in order to minimize the economic costs of dealing with demand or supply shocks. Excluding this policy tool would lead, in their opinion, to higher output losses and unemployment. But those who argue in this sense fail to explain the reasons why in several countries, regions that are not endowed with the power to adjust the exchange rate of the currency used in their territory, and that face downward rigidity in nominal wages, have nontheless been successful in minimizing the costs of dealing with demand or supply shocks. Why should it be preferable for these regions to have at their disposal the possibility of varying their exchange rate? Does such flexibility allow a given country to lessen or avoid the need for structural adjustment?

Taking an historical perspective, there were significant supply shocks in the Organization for Economic Cooperation and Development (OECD) area during the 1970s, but exchange rate flexibility did not provide a lasting solution for dealing with these shocks. For instance, in the European Community, some currencies floated downward for a number of years in the 1970s, but the resulting sizable depreciations did not eliminate the need for sizable adjustments in both macroeconomic management and economic structures. Although policies accommodating depreciations appear an easy solution to macroeconomic or structural imbalances, in fact they are a deceptive solution because they do not eradicate the root cause of the problem but end up only in buying time.

At the same time, such policies tend to shift, via corresponding currency appreciations, adjustment costs onto countries that have applied financial discipline and/or achieved structural productivity advances. Unless countries participating in a trade zone are willing to accept such an unfair sharing of the costs, a free trade zone with countries pursuing independent exchange rate policies cannot survive. Over the long term, in order to prosper, a trade zone inevitably has to lead to some form of currency zone.

The next issue is what type of currency zones might emerge in this process. Miguel Mancera has given a good account of the various possibilities, ranging from a loose pegging policy to some form of monetary union. How can one identify what could be a viable solution? To this end, one has to take into account the differences in policy objectives and economic conditions among the various countries participating in the trade zone.

First, one objective in moving toward a currency zone could be to prevent any participating country from easily accommodating failures in domestic policy by making its exports cheaper and its imports less competitive.

Second, another objective can be derived from the recognition that the free movement of goods and factors of production within a trade zone tends to reduce the degrees of freedom that a member country has in policy orientation. In such a context, it is preferable for a participating country to aim at the introduction, within the zone, of some rules for exchange rate policy, and possibly for macroeconomic management, rather than being subject to the policy discretion of the major partner countries.

Third, member countries might find it in their mutual interest to reach a common policy, vis-à-vis major currencies of the rest of the world so as to command some degree of seigniorage in international monetary relationships.

Fourth, some participants in a trade zone might belong to the category of small, highly open economies. Such an economy is actually highly dependent on other economies' policy orientations and its ability to pursue divergent policies is very limited, if not nonexistent. Under these conditions, this country has a clear interest in extending the trade zone arrangement to a binding exchange rate arrangement in which it can have some say.

Of course, the range of options in currency zones is large and there is no reason to assume that the free trade zone is bound to evolve into a currency unit. Whether this does occur will depend on the characteristics of the participating economies, such as economic, geographic, or cultural contiguity, and on additional objectives these countries might have. There are at least four additional objectives.

First, member countries might share as a common goal not just the establishment of a free trade zone, but a complete integration of their economies. This is now the case of the European Economic Community.

Second, these countries could consider it important to reduce the uncertainty stemming from the fact that even in a system of permanently fixed exchange rates, currency realignments are still possible. Such an uncertainty can stand in the way of maximizing trade opportunities within a zone and can distort capital movements. To obviate these effects, it is not sufficient to resort to futures or forward markets for foreign exchange. With the exception of a few major economies such as the United States, these markets are generally thin and not well developed. Since they cover only a limited range of maturities and currencies, they do not offer hedging facilities to investors interested in long-term investment or in investing in countries lacking such markets for their currency.

Third, participating countries might aim at counterbalancing their loss of autonomy in macroeconomic policymaking, a loss which is due to the presence within the area of partner countries with an overwhelming economic weight. In this context, it is appropriate for these countries to pursue the establishment of institutions and mechanisms for deciding jointly, that is, with the participation of all member countries, common policies that apply across the entire zone. Thereby, they could share some influence in shaping monetary or financial policies for the area, or could obtain a less uneven distribution of the benefits resulting from freedom of movement of goods and capital by means of a system of fiscal federalism.

If the set of objectives and conditions that have been described are met within a free trade area, then the single currency approach is preferable to a looser exchange rate arrangement, even if it is not a necessary complement to the freedom of trade. It is actually hard to see the advantages of a permanently fixed exchange rate system over a single currency area, because in the latter context, all member countries can have the opportunity of sharing responsibility for the common monetary policy within an appropriate institutional framework.

A single currency will also do away with the costs of currency conversions and, by reducing transaction costs, will maximize the potential of trade liberalization to promote trade. Moreover, in a currency union it would no longer be necessary for a country to curb domestic absorption in order to meet the constraint of balancing the external deficit to a financeable position. In this respect there would be only one currency and only one monetary policy for the whole area, and savings and credit would flow freely across countries within the area, responding mainly to differences in productivity and after-tax profitability among regions. As a result, the notion itself of balance of payments inside the zone would lose policy relevance.

Of course, not all these objectives and conditions that have been mentioned are present in all free trade zones. For instance, there is good reason to doubt whether these elements are present in the North American free trade area. Even in the EEC, one can doubt that all participating countries share these objectives or conditions.

Before concluding, some comments are needed on three points that were raised by previous speakers. One is related to the argument that a European currency union would reduce the scope for potentially good monetary policy in member countries. This argument appears rather unreasonable since it assumes that some countries would always gear their monetary policy to only one objective, namely, price stability, therefore downgrading or excluding other traditional objectives such as to allow their economy to reach a sustainable rate of growth. That argument also appears excessive because it implicitly assumes that in the future European currency union, the model of monetary policy management that will prevail will be too lenient toward member countries with a high inflation propensity. It is actually too early to assert which institutional model for monetary policymaking will be established in this union as well as which country, or group of countries, that have specific policy objectives will prevail in the management of the new monetary institutions.

The second point is related to the discussion concerning first-class/second-class citizens in the evolution of the European Community. It is clear that a number of EC countries are not ready to undertake all the obligations of a currency union. They need a longer time to prepare themselves to fulfill these requirements and responsibilities. But this should be seen as a purely transitory phenomenon, not a permanent one. This transitory stage does not necessarily have to lead to discrimination or separation among member countries since there are no institutional hindrances to prevent some economies from catching up with the leaders. Such a difference among countries is a matter of economic reality that must be overcome rather than accommodated. In particular, it must be overcome through the determination of first-class and second-class countries to cooperate in raising the second-class countries to the same level of economic development and price stability achieved by the first-class countries at an earlier date.

The third point concerns the contention that "half a loaf" is not better than "no loaf"—namely, that the diffusion of free trade regions is inimical to further progress toward full, multilateral trade liberalization. Although under certain conditions such a conclusion might be warranted, these conditions do not correspond to the reality of today's world economy. Today, as a result of several rounds of multilateral tariff reductions that have taken place in the last three decades, the average level of tariffs is quite low, at least among the advanced, industrial countries. Consequently, there is relatively little room left to bring the average tariff level close to zero.

The majority of the remaining trade barriers or obstacles is thus concentrated in the nontariff areas. They stem from regulations that are justified on grounds extending far beyond the economic domain. These regulations may reflect public safety concerns, social factors, or cultural aspects. In order for such nontariff barriers to be lower, they must first be identified, and this requires deeper and longer examinations than in the case of tariff barriers. Second, their reduction requires intervening in areas much broader than tariffs, thereby introducing far-reaching limitations to the powers of national sovereignty of each country. An illustrative example ,of the complexities involved in curtailing nontariff barriers to trade is provided by the Structural Impediments Initiative that was agreed upon by the United States and Japan in the 1980s.

Most of the current difficulties in reaching a successful conclusion of the Uruguay Round are due to the same complexities. In the face of these difficulties, the creation of new, large free trade areas such as in North America might be seen as a step forward in multilateral trade liberalization, provided that these zones do not raise trade barriers and continue cooperating for the success of multilateral trade negotiations. After all, the articles of the GATT agreement include in some cases (Articles XXIV and XXVIII) a commitment to avoid raising tariffs. An enforcement of such a commitment would suffice to ensure compatibility of regional trade agreements with worldwide trade liberalization. By another token, it could eventually be easier to negotiate a very high degree of trade freedom on a global scale if all the countries of the world were to belong to very few regions with no inside trade barriers. In ,conclusion, under these conditions it can be said that "half a loaf is much better than no loaf at all."