Ewart S Williams: From single market to single economy (*benefits and challenges*)

Address by Mr Ewart S Williams, Governor of the Central Bank of Trinidad and Tobago, at the Second Biennial International Conference on Business, Banking & Finance, Port of Spain, 2 May 2006.

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In January this year when six countries signed an agreement to initiate the Caribbean Single Market, it marked a milestone in a process that formally started in 1973 with the Treaty of Chaguaramas. The formal establishment of the Caricom Single Market heralded, inter alia, the removal of restrictions on the free movement of goods, skills, services, and capital and the rights of establishment of enterprises anywhere in the region.

The Single Economy, which as of now is tentatively scheduled to be in place by 2008, involves the adoption by Member States of harmonized macro-economic policies, coordinated development of productive sectors, the building of a regional capital market and arrangements for a common currency. In essence, the Treaty envisages the reconfiguration of the separate national economies into a truly Single Economy.

Over the last two decades or so, the world has witnessed increased economic and monetary integration efforts among developed nations. This fact has highlighted the case for greater economic cooperation among developing countries. Moreover, the success of the Euro, which has become the world's second leading currency, has heightened interest in monetary union among developing countries. I should note that it is not only in the Caribbean that the establishment of a common currency is under consideration. Indeed, the Economic Community of West African States (ECOWAS), a grouping that includes Nigeria and Ghana, along with four smaller states, has put the establishment of a monetary union at the top of its agenda.

In Asia, interest in the possibility of an Asian Monetary Union has resurfaced as part of the continuing dialogue on regional economic cooperation. In 2001, Asian Governments appointed a Currency and Exchange Rate Mechanism Task Force to examine the desirability and feasibility of regional exchange rate co-ordination.

What I would like to do is to address three related questions: What additional benefits would monetary union bring to our ongoing integration efforts? What are the main challenges involved in the establishment of a single regional currency? Can the European Union serve as a template for monetary union in the Caribbean?

Since the signing of the declaration giving force to the Caribbean Single Market, there has been much comment throughout the region **on the limited discussion that has taken place on the implications** of the Single Market. Sorry to say there has been **precious less** on the implications of the **Single Economy**, and on **Monetary Union**. I would hope to prompt more discussion on these issues.

What is a monetary union?

In a **monetary union** there is a common monetary policy in an environment free of capital controls. Such a union need not have a single currency, as member countries may continue to use their currencies but with a rigid fixing of exchange rates among them. In practice, however, a **monetary union** usually refers to a single currency area.

The main characteristics of a monetary union are:

- The existence of a regional central bank. As in the case of the EU, national central banks may remain, not to set monetary policy but for example, with responsibility for financial sector regulation.
- Only the regional central bank will be responsible for monetary policy, which will be directed to the region objectives and not to individual country circumstances. With the loss of monetary

and exchange policy autonomy, the main adjustment tools available to national economies would be fiscal policy as well as price and labour market flexibility.

- A Monetary Union assumes a pooling of external reserves, which are under the control of the regional central bank and are at the disposal of all the members of the union.
- A Monetary Union may require mechanisms for compensating participating countries that are disadvantaged by the creation of a single market. One such mechanism is the Development Fund to provide financial assistance to these disadvantaged countries.

Benefits of a monetary union

Economic theory cites several potential advantages to be derived from monetary union:

- First, a monetary union promotes intra-regional trade because it reduces transactions costs and eliminates exchange rate uncertainties. The relative value of this benefit depends on the share of intra-regional trade in total trade.
- Second, monetary union is expected to facilitate the process of price stability by strengthening macro-economic management through budgetary discipline and the elimination of deficit financing.
- Third, monetary union could encourage the enhancement of efficiency in domestic and regional capital markets as well as improved productivity through free factor mobility.
- Fourth, monetary union can deepen the sense of identity, with the single currency serving as a symbol of regional unity.
- Given all these benefits, a monetary union could provide the stimulus to regional growth and employment creation.

I should note that the indifferent performance of Eurozone economies since the adoption of the Euro has prompted much skepticism as to the direct relationship between monetary union and growth. Some critics suggest that there is a tendency for monetary union to have an inherent "**stability bias**" which can sometimes affect the growthenhancing aspects (unless special measures are taken).

Necessary pre-conditions

Of course the attainment of these benefits is dependent on certain pre-conditions and these include:

- Firstly, the existence of similar or complementary production structures in the participating economies. This is broadly the case in the European Union as well as in our Eastern Caribbean Currency Union (ECCU).
- Secondly, Monetary Union works best when, among the participating territories, there is a high level of intra-regional to total trade – in the case of the EU, for example, intraregional trade accounts for an average of 60 percent of total trade. The higher the level of intra-regional trade, the greater the gains from the elimination of transactions costs.
- Thirdly, a successful monetary union requires a high degree of monetary and economic convergence between the participating members. This convergence facilitates the establishment of common economic goals, to be pursued by common macro-economic policies.
- A fourth pre-condition for monetary union is a high degree of factor mobility, particularly labour and capital.

Challenges of a monetary union

A monetary union also carries certain costs and challenges.

By far, the most important cost is the loss of national sovereignty over the use of monetary instruments – particularly the exchange rate and the interest rate. This could be a serious limitation and as you may know, even with the success of the euro, Great Britain has yet to reconcile itself with this reality.

Another issue could be its inflexibility, in the following sense. Given its size, the European Union adopted a floating exchange rate regime. The conventional wisdom is that in a monetary union involving small developing countries, the regional currency should be pegged to a major currency. This however, could create serious challenges when there is need to adjust the parity of the regional currency due to a misalignment. The challenge comes from the need for consensus among all the participants of the currency union – that is the case now with the Eastern Caribbean Currency Union.

A more important problem, inherent in a monetary union is the difficulty with dealing with what the theorists call "asymmetric shocks". This is the case where the members in the union are affected differently by the same exogenous event. Such a situation creates a major challenge for the regional central bank, which must devise a single monetary policy for the entire region.

Without the ability to use the exchange rate or an independent monetary policy, fiscal adjustment becomes the main policy instrument and since some developing countries have limited fiscal space, they are at the mercy of resource transfers from the stronger member countries.

Fourth, the establishment of a regional central bank robs national economies of **revenues from seignorage**, which could be sizable in fiscal terms. This loss is in addition to the revenue loss from trade liberalization.

The Caribbean reality

Let me briefly apply some of these general principles to the Caribbean situation. Let me address the question whether, based on these principles, **we are ready for monetary union of the EU variety**. **Are the preconditions there,** and **more importantly, are we ready for the type of commitments that may be necessary**?

First the preconditions: although the level of intra-regional trade has been increasing in recent years. the share in total trade remains relatively small, at an estimated 8 to 10 percent, compared with (as I said before) 60 percent in the EU. And this ratio is heavily influenced by oil exports from Trinidad and Tobago to the rest of the region; if these are excluded (and who knows what Petro-Caribe will imply), the ratio is more in the region of 3 to 5 percent. This low ratio of regional to total trade reduces the potential benefit from the reduction in transactions costs that could derive from the establishment of a single currency.

Still in terms of pre-conditions, one area in which we have been making important progress is towards **intra-regional capital mobility**. Integration of the regional capital market is being enhanced through the proliferation of financial conglomerates operating throughout the CARICOM area.

Some progress has been made as regards **the elimination of capital controls** though two countries still maintain restrictions. There is a significant amount of **informal collaboration in the area of financial sector regulation** while work proceeds on the formulation of a CARICOM Financial Services Agreement.

An important aspect of the intra-regional capital mobility challenge which is receiving attention is **the integration of the regional stock markets**. The standardization of regulations among the various national stock exchanges, as well as regional connectivity, would go a long way towards creating a **larger market for regional government securities and increasing the liquidity of the equity market**. Obviously, the creation of a single currency would facilitate capital market mobility though we would still have to deal with issues such as the standardization of settlement systems.

As indicated above, **regional labour mobility** is an essential precondition to monetary union since it could be an important factor in cushioning exogenous shocks. Initial steps towards the promotion of labour market mobility have been taken with the elimination of work permit requirements for specific skills. **In a monetary union, labour mobility needs to go much further if it is to be an instrument for raising regional economic efficiency and export competitiveness**.

The issue of **asymmetric shocks** could provide serious challenges for a regional Central Bank in the formulation of a common monetary policy in the Caribbean because some of the economies are particularly vulnerable to natural disasters, the vagaries of tourism demand and sugar and banana prices while the movement of international oil prices has a differential impact.

Take the simple example of a **precipitous decline in oil prices**. In the case of Trinidad and Tobago, this could lead to a decline in growth and employment and perhaps call for a lowering of interest rates to boost domestic demand. However, lower oil prices will benefit the other Caribbean countries and could spur faster growth and employment creation, a situation that may call for an increase in interest rates – thus the dilemma for the regional central bank. Dealing with asymmetric shocks will require **some kind of stabilization fund** to provide temporary financial assistance to the more vulnerable economies.

Earlier I mentioned the need for a Development Fund and now I am talking about a Stabilization Fund. As a practical matter though, most of the Caribbean countries are not in a position to contribute to these regional funds. Trinidad and Tobago, as the economically strongest regional partner, will need to bear a significant part of this burden. **There is an argument that since Trinidad and Tobago has the most to gain, given its dominance in intra-regional trade**, this is how it should be.

Since 1994 CARICOM countries have been involved in a regime to achieve **macro-economic convergence**. The regime incorporates targets for **low inflation** and **exchange rate stability**, a **fiscal deficit** of no more than 3 percent of GDP, a ceiling on **external indebtedness**, and a floor for **external reserves**.

Unfortunately since 1994, many countries in the region have gone through a series of adverse external shocks including a slowdown in the global economy, a number of natural disasters, 9/11, and a phasing out of the preferential arrangements for sugar and bananas.

In these circumstances, the rate of macro-economic convergence has been much less than expected as several countries have found difficulty in meeting, in particular, the fiscal and external debt targets. **The slippage has highlighted a marked difference in our approach towards a monetary union compared with that of the EU**.

In the case of the EU the convergence criteria were taken as a basis for policy action, a disciplining device. Thus, for instance, if a country was not likely to meet the fiscal criterion, **strict monitoring as well as peer pressure** forced the country to take measures to come back on track. You would also remember that under the exchange rate mechanism (ERM), countries were required to intervene in foreign exchange markets to keep their floating currencies within the agreed band. In short, the convergence criteria had "teeth" and carried sanctions.

In the case of the Caribbean, the convergence criteria seem to be purely for information purposes; they have certainly not been seen as a guide to policy; there is no official monitoring; there are no sanctions; and none of the participating countries seem anxious to yield sovereignty over economic policy.

On this issue, Prime Minster Arthur of Barbados who has lead responsibility for the implementation of the CSME commented as follows:

"*Our Caribbean Community has been conceived to be a comm unity of Sovereign States. Each sovereign state in such an arrangement retains exclusive powers in relation to the implementation of community decisions. There is also no provision for the transfer of sovereignty to any supranational regional institutions and there is no body of community law that takes precedence over domestic legislation*".

Consequently, Prime Minister Arthur noted (in a speech to the Trinidad and Tobago Chamber of Commerce in June 2005) "*the convergence project" will go nowhere unless there is substantial political engagement on the matter of monetary convergence. This is precisely because the issue of sovereignty hangs over the subject of monetary cooperation and the adoption of a regional currency. The matter* (he continued) *therefore has to be addressed also as a political issue requiring as much political commitment as it does a technical and economic foundation*".

In addition to political will and commitment, the literature on monetary union also emphasizes the importance of communication with the various publics who need to be weaned off the uncertainties and apprehension about relinquishing their national currency. Another major challenge could be the distrust and suspicion between member states – the smaller states fearing domination by the larger states or the richer states concerned about bearing too much of the financial burden.

Monetary Union or some kind of intensified monetary co-operation may indeed be the way of enhancing integration of the Caribbean region. However, we need to re-examine our approach and in particular, we need to summon up the political will and achieve public buy-in to make this initiative a success.