UNIT 19 REGIONAL FINANCIAL INSTITUTIONS

Structure

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19.0 OBJECTIVES

After going through the Unit, you will be able to:

- define and explain the working of customs unions currency areas;
- define and explain the working of optimum currency areas;
- analyse the growth of regional financial institutions; and
- describe and assess the development of the European arrangements regarding the evolution of customs union, and later, currency unions.

19.1 INTRODUCTION

You have read about regional international trading blocs in Block 5 Course MEC 007 International Trade and Finance. This unit deals with regional financial institutions which are institutions working in a group of nations. Regional financial institutions are institutions that have financial dealings in a certain region rather than at a global level. But we explore in a greater part of the unit how a group of nations comes together to engage in foreign trade and international financial dealings among each other using arrangements that may be thought to be substitutes for the fixed exchange rate system that you studied in Unit 17.

We will explain the theory of customs unions in the next section. These unions are basically arrangements where a group of nations do away with tariff and non-tariff barriers among themselves but apply these to countries outside the group. The subsequent section deals with currency unions and optimum currency areas. These are areas where the member countries agree to share a common currency. The monetary or currency union is an extension of the fixed exchange rate that seeks to avoid the instability associated with the fixed exchange rate system. The section after that deals with regional financial institutions, which are financial institutions that lend at the level of a few nations, or one continent. An example is the Asian Development Bank (ADB). The final section discusses the evolution of Europe in the post-World War II period from being a customs union to moving towards a monetary union with a common currency. This section is an application of sections 19.2 and 19.3 on customs union and currency unions, respectively.

19.2 THE THEORY OF CUSTOMS UNION

A customs union is an association of two or more countries to encourage trade. The countries making such an arrangement agree to eliminate tariffs and other restrictive regulations on trade among them. It is a discriminating trade arrangement since the liberalisation only includes the countries that are members of the customs union and they formulate and administer a common foreign trade policy in regard to tariffs and other trade restrictions against third countries.

The best-known customs unions have included the Zollverein, which was created by Bismark, Benelux and the EEC, which later came to be called the EU. The Zollverein was formed by German states in the 1830's. These states became the German nation in 1871. Belgium, the Netherlands and Luxembourg established Benelux in the 1940's. Belgium, France, Italy, Luxembourg, the Netherlands and West Germany set up the EU in 1957. We will discuss about the European case in greater detail in Section 19.5.

The first systematic analysis of customs union was provided by Jacob Viner. He looked at the situation for a group of countries before and after they joined the union. In what circumstances would countries gain by forming a customs union? How will trade patterns and resource allocation be affected? According to Viner, after the formation of the union, some member would be importing from others but which it formerly did not import because the price of the protected domestic price of the product was lower than the import price. With the formation of the union, protection to domestic industry would be removed. There will be a shift in the locus of production from a high cost to a low cost point. This would be appreciated by those who champion free trade. Viner called this outcome *trade creation*. There could be a second kind of effect of the formation of customs union, according to Viner. After the formation of the union, there may be commodities which a member would be importing from some other member, which it earlier used to import from a low-cost *third* country, because that was the cheapest source of supply, even after payment of duty. After the union, this same product may be purchased from another member of the union. The shift of production in this case is not now between two member countries but between a low-cost non-member country and high-cost member country. This kind of effect Viner called *trade diversion*.

According to Viner, when trade creation is dominant and trade diversion not so prominent, the formation of the union raises the collective welfare of its members. Some member may experience a loss, but the joint welfare of others will outweigh the loss. Moreover, the non-member countries may experience some welfare loss, but the welfare of the members will outweigh that loss. On the other hand, if trade diversion is dominant, a customs union may reduce the welfare of its members.

Viner's analysis had three limitations. First, he did not show how to deal with a trade-off between trade creation and trade diversion. Secondly, he assumed a case of constant returns to scale. Finally, he considered only production effects, and did not analyse consumption effects which modern tariff analysis explicitly brings into the picture. Traditional customs union theory builds on relatively strict assumptions such as perfect competition in commodity and factor markets and hence it is often referred to as orthodox customs union theory. It also only deals with the static welfare effects of a customs union. It has both positive and negative welfare effects, compared to a situation in which every member state practices protectionism. Therefore no conclusion can be drawn in advance as to the net welfare result of a customs union. The term 'orthodox customs union theory' is due to the relatively strict assumptions of this theory, i.e., perfect competition in the commodity market and factor markets, perfect factor mobility within individual countries but not among the countries, foreign trade equilibrium and full employment. The opportunity cost in production is reflected in the relative commodity prices in each country and transport costs are not included since tariffs are assumed to be the only kind of international trade barrier.

Later theories have attempted to deal with these limitations of Viner's theories. Customs union theories can be analysed in the same way as partial equilibrium analysis of the effects of tariffs. We now compare customs union with free trade zones. Both customs union and free trade zones are examples of **preferential trading agreements** under which member countries apply lower tariffs on each other's goods than on the same goods coming from other countries. In a customs union, the countries must agree on the tariff rates. In a free trade area, on the other hand, each country's goods can be shipped to the other without tariffs, but in which each member country sets tariffs against the outside world *independently*. The North American Free Trade Agreement (NAFTA) is a free trade agreement between the US, Mexico and Canada. Canada and Mexico need not agree, for example, on tariff rate on electronics goods from Japan. The European Union is a customs union. Free trade area is politically simple but administratively complex while a custom union is the opposite. For example, tariff administration is easy in a customs union. Goods must pay tariffs when they cross the border of the union but can be freely shipped from there onward.

Check Your Progress 1

1) What is a preferential trading agreement?

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2) Explain the difference between trade creation and trade diversion effect of a customs union.

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3) Bring out the difference between customs union and a free trade area.

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19.3 CURRENCY UNIONS AND OPTIMUM CURRENCY AREAS

You have studied about the relative merits of fixed and flexible exchange rates in unit 17. One alternative to fixed exchange rates is for a group of currencies to form a common currency. This Section explains the working of monetary unions and common currency areas. The Section also examines the case for and against optimum currency areas. Countries are facing external economic shocks all the time. By changing its exchange rate, a country can lessen the disruptive effect on its economy. If the country has a flexible exchange rate policy, it can have some potentially harmful effects, like making prices volatile, and governments not being able to check inflation. So a country might like to get the same type of benefits that are conferred by the fixed exchange rate system, and avoid the rigidities at the same time. This is possible through an optimum currency area. The basic theory of currency unions was put forward by Robert Mundell, who later went on to win a Nobel Prize for his work

A country's costs and benefits from joining a fixed-exchange area depend on how well integrated its economy is with its potential partners. The theory of optimum currency areas suggests that fixed exchange rates are most appropriate for areas closely integrated through international trade and factor movements. A major benefit of fixed rates is that they simplify economic calculations and provide a more predictable basis for decisions that involve international transactions as compared to floating rates. The monetary efficiency gain from joining the fixed exchange rate system is the comparative saving from avoiding the uncertainty and transactions costs that arise from floating exchange rates. A high degree of economic integration between a country and a fixed-exchange rate area *amplifies* the monetary efficiency *gain* that accrues to the country when it pegs its exchange rate against the area's currencies. Another reason why high integration with a fixed exchange area increases a country's benefits from joining the area is economic integration leads to international price convergence and hence lessens the scope for independent variation in the pegging country's price level.

Membership in an exchange area may involve costs as well, even when the area has low inflation. These costs arise because a country joining an exchange rate area gives up its ability to use the exchange rate and monetary policy for the purpose of stabilising output and employment. This economic stability loss from joining like its benefits from joining is related to the country's economic integration with its exchange rate partners. Now, a basic result is that a high degree of economic integration between a country and the fixed exchange rate area it joins *reduces* the resulting economic stability loss due to output market disturbances. This finding as well as the previous one about high degree of economic integration increasing the benefits of a country joining a fixed-exchange rate area explains the existence of optimum currency area which is a region with economies closely linked by trade in goods and services and factor mobility.

An **optimum currency area (OCA)**, also known as an **optimal currency region** (**OCR**), is a geographical region in which it would maximize economic efficiency to have the entire region share a single currency. It describes the optimal characteristics for the merger of currencies or the creation of a new currency. An optimal currency area may often be larger than a country. For instance, part of the rationale behind the creation of the euro was that the individual countries of Europe did not each form an optimal currency area, but that Europe as a whole does form an optimal currency area.

The main characteristics of an optimum currency area are:

1) Labour should have free mobility across the region. This includes physical ability to travel (visas, worker's rights, etc.), lack of cultural barriers to free movement (such as different languages) and institutional arrangements (such as the ability to have pension transferred and to the new region).

2) Openness with capital mobility and price and wage flexibility across the region. This is so that the market forces of demand and supply automatically distribute money and goods to where they are needed. In practice this does not work perfectly as there is no true wage flexibility.

There should be an automatic fiscal transfer mechanism to redistribute money to areas/sectors which have been adversely affected by the first two characteristics. This usually takes the form of taxation redistribution to less developed areas of a country/region. This policy, though theoretically accepted, is politically difficult to implement as the better-off regions rarely give up their revenue easily.

Additional criteria that have been suggested for a region to be called an OCA by some economists are: there should be (a) production diversification (b) homogeneous preferences and (c) commonality of objectives The classical case for optimum currency areas assumes not only a similarity among participating countries, but also a high level of economic integration among participating countries. This theory has been most frequently applied in recent years to the euro and the European Union. By the above criteria the European Union does not constitute an Optimal Currency Area and therefore the Euro should not be a successful union of currencies. Although the developing world's experience with monetary unions has been neither abundant nor successful, European monetary integration has led to some initiatives for forming monetary unions in the developing world. The initiative taken by the members of the Gulf Cooperation Council stands out in this regard.

Check Your Progress 2

1) Explain why country that is already closely economically integrated with a fixed-exchange rate area will gain from joining the area as a member.

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2) Explain what an optimum currency area means. How does it work?

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3) What are the two main characteristics of an optimum currency area?

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19.4 GROWTH OF REGIONAL FINANCIAL INSTITUTIONS

We find many levels of groupings of nations in the international arena. Groups of countries that share borders often have semi-permanent cooperation agreements on immigration and customs and possess institutions that implement these. Other groupings of countries come together on the basis of and to advance an ethnic, a geographical and or a cultural identity. Institutions like the UN, the World Bank and IMF are global institutions. You studied about global Bretton Woods institutions like the World Bank and IMF in the previous unit.

There is a particular type of grouping that is relatively large in terms of country coverage without being global, and one that deploys primarily financial instruments to advance its objectives. These are the Regional Financial Institutions (RFI's) Regional financial institutions are institutions that have financial dealings in a certain region rather than at a global level. For instance, the Asia Development Bank operates to assist financially countries in Asia and the Pacific. An important characteristic of these institutions is that both rich and poor countries are their members. The rich nations are usually donors and the poor the recipients. In other words, these institutions are primarily designed to be agents of development assistance. In some ways, the, RFI's are smaller scale versions of fully global financial institutions (GFIs), particularly the World Bank. The operations of the RFI's and GFI's may sometimes overlap in some countries.

There can exist, theoretically and actually, groups of firms, and groups of countries. There sometimes arise in these groupings, economies of scale as well as economies of scope. The size of the institutions will be determined by marginal costs and benefits of size, which will in turn depend on the specifics of the socioeconomic situation being discussed. Taking the perspective of costs and benefits, of scale and scope, we can ask as to the rationale for the co-existence of RFI's and GFI's, especially when 'development assistance resources' may be scarce. If there is such a rationale, is the current mix of RFI's and GFI's optimal? The issue is division of labour between RFI's and GFI's, and how both types of institutions can increase their effectiveness.

There are mixed motives for the donor countries to provide development assistance to developing nations. While a desire for poverty alleviation may genuinely be present, there is also narrow self interest, as is sometimes seen in the case of tied aid. There are also foreign policy interests. But we can still look at the advantages and disadvantages of alternative institutional arrangements for development assistance. One case is bilateral assistance. In this case the donor country's 'taxpayers' can closely monitor their aid in the developing country. The disadvantages also arise from this same source—domestic political processes in the donor country, and domestic distributional struggles, affect and influence the nature and composition of development assistance. This is seen in the various pressures that come on a government to tie its aid to purchases from its own suppliers.

We turn to the issue of whether a group of donor nations should come together multilaterally. In principle, a pooling of resources in a rich donors' group should have considerable cost advantages. However, pooling of countries in turn introduces the problem of differences in preferences of the different members on how the resources should be used. Whatever consensus is reached, it will always be unsatisfactory to some countries' preferences as donors. The cost advantages therefore have to be balanced against this disadvantage. Therefore, a rational response for each donor country will be to diversify, to have some of its development assistance flow through bilateral channels and some through channels that group together rich country donors. This argument has not as yet provided a rationale for RFI's, since it discusses groupings of donors, not groupings of recipients. What are the costs and benefits of grouping recipients into groups that are defined by geographical region? The cleanest argument comes from a consideration of cross-border externalities and multi-country public goods. When development in or actions by one country have an impact on other countries, an impact that is not mediated by competitive markets, the presence of such an externality can lead to sub optimal policy outcomes for the group of countries encompassed by that externality.

The above argument suggests a demarcation of tasks: regional externalities to be dealt with by regional institutions, global externalities by global ones. In other words, RFI's should supply regional public goods (RPG's), and GFI's should supply global public goods (GPG's). Of course the division is not clear-cut.

There are five policy suggestions that have been made regarding regional financial institutions. First, the responsibility and resources for region specific public goods should be gradually and increasingly shifted to the RFI's. To the extent that the RFI's do not have the capacity to deliver on these just yet, a purposive programme of building up these capacities should be developed. Second, global issues such as green house gases, financial contagion, global spread of diseases, etc., should remain the domain of global institutions. But these may not be explicitly financial institutions.

Third, on country specific operations there should be a presumption in favour of donor resources flowing through RFI's rather than the World Bank. This does not necessarily mean that the World Bank end country-specific operations. Fourth, there should be a presumption that the lead role in interacting with a government in developing and monitoring conditionality should fall to the RFI's rather than the GFI's. And finally, in certain situations, a case could be made for *sub*-regional financial institutions for further improving the division of labour.

Regional development financing arrangements have been of three basic types.

The oldest and best-developed type is multilateral development banks and related multilateral financial institutions. These institutions are present in all regions, although with different coverage, structures, and priorities. A second type, which is usually used by the European Union, is fiscal transfers with explicit redistributive regional objectives. A third and more novel type is the development of regional bond markets; East Asian countries have taken the most significant steps in this regard.

Regional financial cooperation faces significant challenges, which must not be underestimated. They relate to the viability and long-term sustainability of the arrangements that are created, and involve three major issues: the capacity of a given group of developing countries to supply the relevant financial services; the need to guarantee that strong regional institutions are developed; and an equitable distribution of the benefits of regional integration.

19.5 EUROPE: A CASE STUDY

Let us now see how events unfolded over the decades in Europe that led to monetary unification in terms of a single currency and single central bank. At the very beginning Europe undertook steps in this direction by forming a customs union. European attempts at regional integration started soon after the Second World War when there was a common realisation among these countries of the need to rebuild their war-affected economies. Moreover, the United States through the Marshall Plan for the reconstruction of Europe. The US urged the European governments to combine their economic and political resources. At first, Europeans adopted a sectoral approach. The European coal and Steel Community was created, freeing trade in coal and steel. Then efforts were directed towards the creation of a full – fledged customs union, an arrangement under which all trade barriers among these countries would be abolished, and a common external tariff for other countries would be adopted. In 1957, six countries (Belgium, France, Germany, Italy, Luxembourg and the Netherlands) signed the treaty of Rome, establishing the common market in 1958. Monetary cooperation in Western Europe began before the creation of the common market in 1958 but efforts in this direction were stepped up in the later period. The customs union was completed in 1968. in 1973, Britain was admitted to the EEC. The EEC adopted a Common Agricultural Policy (CAP) in 1968, setting uniform prices for farm products and imposing variable levies on imports.

Current account convertibility came early (in 1958, coinciding with the launch of the Common Market), capital account liberalisation came late, and was part of a gradual process that did not culminate in the collective removal of capital controls until 1990. This was soon followed by a major crisis in 1992. It thus became clear that exchange rate stability required a full-fledged movement toward monetary union. This was combined with the Stability and Growth Pact, which established explicit fiscal rules and convergence criteria.

Europe's move towards a common currency area started in the late 1960s when the Bretton Woods system started showing problems and there were currency crises. In 1969, European leaders met at The Hague and appointed Pierre Werner, Prime Minister and finance minister of Luxemburg to head a committee that would outline concrete steps for eliminating intra-Europe exchange rates, lowering trade barriers and centralising EU monetary policies. The Werner Report was adopted in 1971 . In March 1979 was formed the European Monetary System. It was a mutually pegged exchange rate system consisting of eight members originally: France, Germany, Italy, Belgium, Denmark, Ireland, Luxembourg, and The Netherlands. This system worked to restrict the exchange rates of participating currencies within specified fluctuating margins. The EMS went through periodic currency realignments. Eleven realignments occurred between 1979 and 1987. events of 1990 when reunification of eastern and western Germany took place. This led to huge spending and fiscal expansion by Germany as well as borrowing and there was high inflation in that country. The German Central Bank, the Bundesbank raised interest rates to stem inflation. Other EMS countries like France, Italy and Britain were not growing fast, and they did not want to raise interest rates as that might have lowered real investment and pushed their economies into recession. They also did not want to devalue their currencies. The result was a series of speculative attacks on the EMS exchange parities. By 1993 the EMS was forced to retreat to very wide bands which stayed till 1999.

The process of developing a common market that was started in 1957 when the EU (then called EEC) formed the customs union, was still incomplete in the late 1980s. There were government imposed standards and licence requirements in some countries. There were significant barriers to factor movements. In June 1985, the EU's executive body, the European Commission decided to work towards removing all barriers to trade and capital and labour movements by 1992.

The early EMS had frequent currency realignments and widespread government control over capital movements. This led to significant manoeuvring for national monetary policies. In 1989, a committee headed by Jacques Delors, president of EC, recommended a transition to an economic and monetary union (EMU) and eventually to a single currency. This was followed by a meeting of the leaders of the EU on December 10, 1991, at the Dutch city of Maastricht and a decision there to place the EU on the path to EMU.

The EU countries moved away from the EMS towards the more ambitious goal of a single shared currency for four reasons. First, it was believed that a single EU currency would produce a greater degree of European market integration than fixed exchange rates by removing the threat of EMS currency realignments and removing the costs of currency conversion. The single European currency was seen as a necessary complement to the 1992 plan for unifying EU markets into a single, continent-sized market. Secondly, Germany's actions after 1990 and its position made some countries feel that EU's goals were being substituted by Germany's goals at the cost of their benefits. They felt the need of a European Central Bank. Third, given the wide freedom of capital movements within the EU, it seemed not a good idea to keep national currencies with fixed parities; rather it was felt that a unified, single currency would be better. if the goal was to combine permanently fixed exchange rates with freedom of capital movements, a single currency was the optimal solution. Finally, it was hoped by leaders of EU, the participants in the Maastricht Treaty, that the Treaty's provisions would guarantee the political stability of Europe. A single currency was seen as signifying greater political cooperation as well.

The Euro is the name that has been given to common official currency unit of 12 European countries, namely, Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxemburg, Portugal, Spain, and The Netherlands. These 12 countries along with the three other counties who are not part of the official currency unit of the euro, namely, Britain, Denmark and Sweden as you know constitute the European Monetary Union. These three countries are not part of the euro. The euro was formally introduced on January 1, 1999. At that time Greece was not a member, and joined two years later. During the period between January 1, 1999 and December

31, 2001, the respective national currencies of these countries continued to be legal tender, but their governments issued debt in euro.

The birth of the euro resulted in fixed exchange rates between all European Monetary Union nations. Not only did the countries have a fixed exchange rates system; they even had a common currency and a common Central bank. They thus gave up more sovereignty than a normal fixed rate regime entails. The European Central Bank was inaugurated on June 30, 1998, with its headquarters in Frankfurt. This Bank replaced the European Monetary institute.

Check Your Progress 3

1) What is the basis you would suggest to get the optimal mix of activities between Regional Financial Institutions and Global Financial Institutions?

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2) What have been the basic types of regional financial arrangements?

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3) Briefly state the basic reasons why the EU nations decided to move away from the EMS to the goal of a shared single currency?

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19.6 LET US SUM UP

In this unit, we continued our discussion of international financial relations that we had started in Unit 17. The unit discussed trading and financial relations for a group of nations who trade together as a block. The unit began with the theory of customs union. The basic assumptions were clearly stated and the workings of these unions were discussed. The advantages and disadvantages of these unions were assessed. Subsequently the unit went on to discuss the theory of optimum currency areas. The economic gains for the members were discussed and the political implications were touched upon.

The unit then discussed in great detail the history of the European experience, how Europe experienced a common market, a customs union, and later made moves towards an optimum currency area, and subsequently, made a move towards a common currency and common central bank. Various evolving arrangements and agreements in this regard were described. Finally, the unit did a regional version of the analysis of the previous unit. While Unit 18 talked of Bretton Woods institutions, the present unit talked of regional financial institutions. We saw why they exist and what functions they perform, and to what extent they are able to help nations that deal with these institutions.

19.7 KEY WORDS

Currency Area : An area where a group of countries share the same currency.

Customs Union : A customs union is an association of two or more countries to encourage trade through an arrangement by which they agree to eliminate tariffs and other restrictive regulations on trade among them.

Free Trade Area : in a free trade area, each country's goods can be shipped to the other without tariffs, but in which each member country sets tariffs against the outside world independently.

Monetary Efficiency Gain : it is the gain arising from joining the fixed exchange rate system. The gain is in the comparative saving from avoiding the uncertainty and transactions costs that arise from floating exchange rates.

Monetary Union : an arrangement where a group of countries agree to conduct monetary policy through a common central bank, and have a single currency.

19.8 SOME USEFUL BOOKS

Coyle, B.(2001) *Foreign Exchange Markets*, Glenlake Publishing Company, Chicago.

Kenen, Peter B. (1994) *The International Economy*, Cambridge University Press, Cambridge.

Levin, Jay H. (2000) *A Guide to the Euro*, Houghton Mifflin, Boston

19.9 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) See Section 19.2 and answer
2) See Section 19.2 and answer
3) See Section 19.2 and answer

Check Your Progress 2

1) See Section 19.3 and answer
2) See Section 19.3 and answer
3) See Section 19.3 and answer

Check Your Progress 3

1) See Section 19.4 and answer
2) See Section 19.4 and answer
3) See Section 19.5 and answer