A PACIFIC CURRENCY AREA: REPLY TO PROFESSOR ARNDT'S COMMENT

By KIYOSHI KOJIMA

I am very grateful to Professor Arndt for the valuable comments he has made on my Pacific Currency Aaea scheme.[1] This scheme is still in the formulative stage and, of course, far from realization in the Pacific, but a similar scheme has every prospect of implementation in Western Europe. The development of monetary integration in Western Europe, and the reactions of the United States to European monetary integration, deserve serious study. Many of the technical problems which, as Professor Arndt pointed out, remain somewhat ambiguous in my paper also deserve further study. Some of the issues that have been raised should become clearer in the course of European monetary integration. Thus, in this context, I would prefer to concentrate on exploring the two main purposes of the Pacific Currency Area proposal which Professor Arndt seems to have misunderstood.

I. *Strengthening the Dollar as an International Currency*

Firstly, my proposal aims at supporting the United States dollar, at buttressing the dollar as an international currency, and thus strengthening the present international monetary system. A PCA dollar should replace the US dollar as international currency. US dollars held by US residents would not constitute part of the supply of PCA dollars. Only dollars earned and held as foreign exchange reserves by other PCA countries would be deposited with the PCA reserve centre and comprise PCA dollar supplies. Professor Arndt seems to be mistaken when he says: "The United States, as the reserve centre country, could contribute its total gold reserves but beyond this she would be contributing her own currency and this is to her in unlimited supply." (p. 70). The PCA dollar, an international currency, should be distinguished conceptually from the US dollar, a national currency, although practically they may have equivalent values.

The PCA dollar would be held as international liquidity not only by Pacific countries but also by other countries outside the region. There would be more confidence in the stability of its value than in the stability of the US dollar since PCA dollars would be backed by a larger pool of gold reserves, combined with PCA dollars and other reserves, and drawing rights on the International Monetary Fund. In addition, fluctuations in the balance-of-payments position of PCA countries as a whole vis-à-vis the outside would—or imbalances in the

[1] Kiyoshi Kojima, "A Pacific Currency Area: A New Approach to International Monetary Reform," *Hitotsubashi Journal of Economics*, February 1970, pp. 1-17. H.W. Arndt, "A Pacific Currency Area: Comment," *ibid.*, February 1971, pp. 67-72.

demand for and supply of PCA dollars in the world market—would be minimized by the mutually offsetting element in member country's balance-of-payments.

What was explained in Table 2 (p. 7) of my paper is important:

1) Suppose the United States fell into overall balance-of-payments deficit and into deficit with Japan. Japan would increase her dollar deposits with the PCA reserve centre.

2) In the reserve situation, if the United States had an overall balance-of-payments surplus and a surplus vis-à-vis Japan, Japan's dollar deposits with the PCA reserve centre would fall.

3) Also, the United States overall deficit might be offset by an overall Japanese surplus, and *vice versa*, even when there was no imbalance between the two countries.

4) Only when the balance-of-payments of each and every PCA countries on balance was in deficit (or surplus) would there be flows of reserves from (or to) the region or pressure on the rate at which PCA dollars were exchanged for other countries.

If the US dollar is supported in this way by a larger pool of reserves and the inter-relationships between reserve holdings are as I have observed them to be empirically, the dollar would become a stronger currency. The Pacific Currency Area would supersede the United States alone as a reliable centre in the world monetary system.

Professer Arndt appears to suggest that the PCA scheme would have benefits for all member countries (especially Japan) other than the United States, and seems disturbed that the function of the US dollar as an international currency might be reduced.

"The scheme would pre-empt the international reserves of the United States for a limited regional currency reserve pool, an arrangement which could hardly be anything but an obstacle to further advance towards a more satisfactory world-wide system for adequate international liquidity." (p. 68)

"Professor Kojima expects the world's main reserve centre country, the United States, to place her total gold reserves at the disposal of the four proposed partner countries in the Pacific Currency Area." (p. 70).

"No doubt Japan would be happy to swap her present holdings of dollars for deposit receipts which would give her unlimited access to the United States' gold reserve, and perhaps this is what Professor Kojima means by saying that his scheme would have the effect of putting existing gentlemen's agreement on a sounder institutional footing." (p. 70).

My intentions in putting the PCA proposal forward were quite the reverse. Japan and Canada have been holding large dollar reserves partly for interest-earning purposes but more importantly, in circumstances of uncertainty about the US dollar, because of United States' persuation to refrain from gold conversion under a 'gentlemen's agreement'. Such a gentlemen's agreement is not entirely capable of preventing Japan or Canada from converting dollar reserves into gold in the United States, the IMF, or in free gold markets. This makes the United States' gold reserve position somewhat more precarious. It would seem better for the United States to put the existing gentlemen's agreement on a sounder institutional footing through the establishment of PCA in which member countries would not request gold-convertibility but merely a gold-guarantee to the value of PCA dollar reserves.

II. *Relations with Asia and Latin American Countries*

As Professer Arndt suggests (pp. 67–68) it would have probably been better not to emphasise the connection between the theory of optimum currency area and the characteristics of the Pacific Currency Area in my exposition. Only relaxation of the connections for an optimum currency area allows the useful application of theory to Pacific area problems, and I did not specifiy fully the less rigid model which I had in mind. This objection is even more valid when Asian and Latin American countries are taken into consideration. Asian and Latin American countries would, in my scheme, be granted associate membership of PCA. They would not have all the obligations of full membership, but they would receive benefits from membership—similar to the "one way free trade" benefits which would derive from implementation of the UNCTAD principles. For example, they would not be required "to maintain fixed (or at least stable) exchange rates with all other member currencies and to move towards concerted domestic monetary-fiscal policies." (Arndt, p. 72).

Associate members would be obliged to use the PCA dollar as a common unit of account and instrument of settlement. Their dollar reserves may or may not be deposited with the PCA reserve pool and gold-guarantee would be assured, but conversion into gold would not be allowed.

There is no doubt in my mind that trade, aid, and investment in the Asian-Latin American region would increase more rapidly in consequence of the dynamic effects of the formation of a Pacific Free Trade Area and Pacific Currency Area. However, these dynamic effects are difficult to measure. Originally I argued that as a direct effect of the establishment of PCA, a 'Lent Currency Scheme' could be initiated. This would facilitate the untying of aid in the Pacific-Asian-Latin American region without inducing balance-of-payments difficulties and a drain on American gold reserves. The idea behind my Lent Currency Scheme is developed into a more concrete proposal for a "Revolving-Aid Fund" in a report presented to the Asian Development Bank.[2] With the successful implementation of such a scheme, the advanced countries within PCA would be able to provide more aid to neighbouring less developed countries without having to "tie" aid individually. "Untied" aid not only allows more efficient aid allocation, but also increased offshore purchases among less developed countries themselves.

The Asian Payments Union scheme devised by Professor Triffin for the ECAFE region should be compared with the Lent Currency Scheme or Revolving-Aid Fund scheme, not with the Pacific Currency Area scheme as Professor Arndt suggested. Under our Revolving-Aid Fund scheme, regional settlements and clearing among less developed countries would be facilitated by the provision of short-term credits from accumulated aid-money in the Fund. The limitation of the Triffin Plan is that its successful operation would probably require year by year increases in the contribution of surplus countries to the regional surplus reserve pool. Our scheme would seem more acceptable to the advanced country participants as well as less developed country participants.

[2] Kiyoshi Kojima, Saburo Okita and Peter Drysdale, "Foreign Economic Relations," in *South-East Asia's Economy in the 1970's*, Asian Development Bank, 1 November, 1970, pp. 401–5.

There are a number of technical issues which Professor Arndt raised but it is better to limit the discussion at this point. The PCA scheme has a more complicated mechanism than I originally imagined and I am grateful for Professor Arndt's making me aware of this. However, there is one theoretical issue which should be clarified.

Professor Arndt is doubtful that exchange rate changes would be more effective for balance-of-payments adjustments for a Pacific Currency Area, or any such large currency area, than for a single country. He says that "a small country is more likely to benefit from a devaluation than a large one, for the same reason that the demand curve confronting an individual firm is more elastic than that confronting the industry as a whole." (p. 71).

The formula which I used to show the effect on the price elasticity of import demand in my paper (p. 9) is well known. Guy H. Orcutt[3] established clearly that "the effectiveness of depreciation by a small economic area is accepted, but a model is developed which supports the view that the effectiveness will be even greater for the case of depreciation between two existing large blocs." There is now an extensive literature incorporating this principle.[4]

[3] Guy H. Orcutt, "Exchange Rate Adjustment and Relative Size of the Depreciating Bloc," *Review of Economics and Statistics*, February 1955, pp. 1-11.

[4] Bela Balassa, "Tariff Protection in Industrial Countries: An Evaluation," *Journal of Political Economy*, December 1965.