A PACIFIC CURRENCY AREA: COMMENT

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In the February 1970 issue of this journal, Professor Kiyoshi Kojima has added to his previous imaginative schemes for regional economic co-operation among the developed countries of the Pacific a proposal for a Pacific Currency Area.[1] To at least one reader, the case he makes is unconvincing.

When Professor Kojima expounded his scheme for a Pacific Asian Free Trade Area, I confessed to doubts.[2] But these related merely to what seemed to me its excessively ambitious character. The PAFTA scheme clearly aimed in the right direction, freer trade among the countries of the Pacific. In the case of the new proposal for a Pacific Currency Area, I am not convinced that this would be a move even in the right direction, except possibly as a later step in a progression—if this can be realistically conceived—from a Free Trade Area towards federal union among the five countries he has in mind. It is the object of this note to set out some of my difficulties.

Professor Kojima's proposal prompts comparison with another scheme for a regional currency arrangement now under consideration, the scheme for a regional payments union for the ECAFE countries devised by Professor Triffin. This contains two elements: (a) a regional clearing arrangement involving some mutual short-term credit (swing) and (b) a regional currency reserve pool. Professor Kojima's proposal differs from this in that it makes no provision for a regional clearing arrangement—this, as we shall see, may be merely a matter of exposition—and that it includes an agreement on exchange rate policy whereby exchange rates among member countries would be fixed but vis-à-vis non-members flexible within a ±5 per cent band. It also differs from the ECAFE scheme much more fundamentally because, instead of being designed to facilitate payments among a relatively compact group of small less developed countries (with some help from one or two big neighbours), it relates to five disparate developed countries including the United States.

An Optimum Currency Area?

Perhaps somewhat unfortunately for the persuasiveness of his case, Professor Kojima begins by raising the question whether his five countries, the United States, Canada, Japan, Australia and New Zealand, can be regarded as an optimum currency area. He virtually (though not explicitly) concedes that they fail to qualify by any of the criteria he mentions. It can hardly be claimed that "commodities and factors of production... move much more freely within [the] area and that there [is] greater similarity in prices and the purchasing

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[1] Kiyoshi Kojima, "A Pacific Currency Area: A New Approach to International Monetary Reform", *Hitotsubashi Journal of Economics*, February 1970, pp. 1-17.

[2] "A Pacific-Asian Free Trade Area", *Intereconomics* (Hamburg), October 1967, reprinted in *A Small Rich Industrial Country*, Cheshire, Melbourne, 1968, Ch. 15.

power of currencies within it than outside" (p. 5). Still less can one conceive of these five countries forming in any foreseeable future "a well integrated monetary area which operates monetary-fiscal policy as if it were a single country. A successful currency area requires... such solidarity as is required [inter alia] for the pursuit of co-operative monetary-fiscal policies.... Only those countries which possess such solidarity could establish an effective currency area" (p. 6).

The prominence given at the outset to the notion of an optimum currency area is unfortunate because it tends to reinforce in the reader's mind the impression conveyed by such flat statements as "within the currency area, member countries would maintain fixed exchange rates in relation to the dollar" (p. 4). Actually, as we shall see, Professor Kojima is prepared to allow "the re-arrangement of par values among member-country currencies should fundamental balance of payments disequilibria appear" (p. 12). His proposal does not, in fact, demand anything as drastic and unrealistic of the five countries as behaviour proper to parts of an optimum currency area, though the demands it makes in other respects are not inconsiderable. The discussion of optimum currency areas proves to be something of a red herring.

Solution of International Monetary Problems?

Professor Kojima claims that the formation of a Pacific Currency Area "can buttress the international monetary system and contribute to the solution of international monetary problems" (p. 4). He admits that a regional currency scheme of this kind involves discrimination, but he justifies this, by analogy with the case for a free trade area, "as representing progress towards freer global trade" (p. 5). I would question the analogy. There is a strong, though not incontrovertible, "second best" case for a free trade area. There does not seem to be even such a case for the Pacific Currency Area.

I can see no way in which it could be said to represent progress towards a more satisfactory global monetary system. Although exchange rate adjustment among member countries in the event of fundamental disequilibrium would not be ruled out, the formation of a joint currency scheme among the five countries would clearly limit their freedom of action in exchange rate adjustment vis-a-vis one another and Professor Kojima in fact makes much of the benefits to trade and investment within the region that would flow from "stability in the value of currencies between them" (p. 13). Vis-a-vis the rest of the world, on the other hand, Professor Kojima proposes flexible exchanges (within a ± 5 per cent band) which in his opinion (which is debatable) "would tend to discriminate against extra-areal investment flows" (p. 13). 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. Unlike a free trade area, it does not, in itself, involve liberalisation of trade, even within a limited region. (The only qualifications to this relate to the argument that greater exchange stability among member countries would promote capital flows and that the grant of mutual overdrafts among members, if this is indeed proposed, would promote trade among them. To both these points I shall return later.) Nor is the case for such a regional currency scheme strengthened by treating it as open-ended. In the case of a free trade area, the accession of every additional member country involves some additional liberalisation of trade. In the case of a regional currency area, the effects of accession of additional members will vary greatly, depending on whether they are advanced debtor or creditor, lending or borrowing, reserve centre or outer member, deficit or surplus countries (such as the United Kingdom, West Germany, Australia or Switzerland) or less developed countries in varying financial circumstances.

Reserve Pooling

The Triffin scheme for the ECAFE region is designed to help a group of small LDCs in three ways. First, by pooling some part—initially 10 per cent—of their foreign exchange reserves, they would free for development investment some of the capital now immobilised in their individual holdings. Secondly, if Japan and Australia could be induced to join, the smaller member countries would benefit by a substantial enlargement of the reserves to which they would have access. Thirdly, under the proposed clearing arrangement member countries would grant one another limited overdraft facilities to finance temporary intra-area balance of payments deficits. There are obvious difficulties about such a scheme, especially in framing conditions under which Japan and Australia and potential surplus countries within the region would be prepared to join, but it has a solid rationale.

I can see no corresponding rationale in Professor Kojima's proposal for a currency reserve pool among the United States, Japan and the other three countries. It is seemingly much more far-reaching and certainly much less precise. The main differences between the two schemes are (a) that Professor Kojima appears to propose the pooling of the *total* gold and foreign exceange reserves of member countries, without limit or conditions; (b) that there is no explicit provision for a clearing arrangement although mutual overdraft facilities among member countries appear to be envisaged; and (c) that Professor Kojima's scheme includes the United States, the world's main reserve centre country.

(a) On the first point, Professor Kojima makes two statements. "All Pacific Currency Area members, including the United States, would sell monetary gold to [a newly established] Pacific Reserve Bank" in exchange for "deposit... receipts" (p. 6) and the scheme would "involve the pooling of gold and foreign exchange reserves" (ibid). Although he does not specifically say so, Professor Kojima's statistical estimates of the size of the reserve pool suggest that he expects member countries, including the United States, to sell to the Pacific Reserve Bank their total gold reserves, and that member countries other than the United States are in addition expected to pool their total foreign exchange reserves. Nothing is said about the extent to which, and the terms on which, member countries would be entitled to draw on the central reserve pool, in other words about the extent to which, and the terms on which, member countries would lend their international reserves to one another. Yet, it is surely obvious that the difficulty of defining acceptable limits and terms for such mutual lending of foreign exchange has been the crux of all past attempts to negotiate currency reserve pools. Until Professor Kojima is more specific on this point, he can hardly expect his proposal to receive serious consideration.

(b) Professor Kojima makes no mention of any clearing arrangement, though his reference to deposit receipts suggests that the mechanism for settlement of intra-area claims he has in mind would work in much the same way. He does seem to envisage mutual overdraft facilities to enable member countries to finance balance of payments deficits among one another: "Within a Pacific Currency Area, adjustments in the balance of payments between member countries should rely upon sound monetary-fiscal policies and the improvement of productivity in the long run, *supplemented by short run accommodation from pooled reserves* and short-term capital movements" (p. 12). But here again, all the detail remains to be filled in.

(c) While the Triffin scheme aims, so far with little prospect of success, to improve the liquidity position of the less developed countries of the ECAFE region by inducing two advanced countries with ample resources, Japan and Australia, to make a substantial though strictly limited contribution to the currency reserve pool, 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.

As Professor Kojima concedes, the total gold reserves of the pool would not be much larger than those of the United States alone. He attributes this in part to the gentlemen's agreement under which Japan and Canada have been willing to hold dollars instead of gold. This surely points to a crucial difference between the United States and the other proposed member countries. The international liquidity position of Japan or Canada depends on its holdings of gold or dollars, and so long as there is confidence in the dollar it does not matter which. That of the United States depends on its gold reserves and on the willingness of the rest of the world to hold dollars. Canada or Japan therefore could pool their international reserves of gold and foreign exchange, and the limit to the credit facilities they could grant in this way to other member countries would be the total of their reserves. 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. The distinction between lending foreign exchange and granting overdrafts in domestic currency which is clear-cut for Japan and Canada does hot exist for the United States.

Japan and Canada have been willing to continue to hold dollars under gentlemen's agreements basically because they share the interest of the whole trading world in keeping the existing world monetary system, centred on the dollar, in working order until a better system can be devised. No doubt Japan would be happy to swap her present holdings of dollars for deposit receipts wsich 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. 7). But it is difficult to believe that even in Japan such a swap is regarded as a realistic proposal.

Whether or not it is conceivable that Japan, Canada, Australia or New Zealand might be willing to throw in their lot with one another to the extent required by Professor Kojima's scheme, it is surely quite impossible to imagine that the United States should for one moment consider doing so. Far from strengthening confidence in the dollar, as Professor Kojima claims his scheme would do, the mere suggestion that the United States might contemplate vesting her total gold reserves in a Pacific regional institution would surely provoke incredulity and, if taken at all seriously, profoundly shake confidence in the dollar where it matters—in Zurich, Frankfurt, Paris and even in Washington and New York.

Exchange Rates

With respect to exchange rate policy, Professor Kojima makes two proposals: (a) "Member countries would maintain fixed exchange rates in relation to the dollar". (b) Exchange rates vis-a-vis all other currencies should be allowed to float within a narrow band, say 5 per cent above and below par.

(a) On the first point, as has already been suggested, Professor Kojima's position is somewhat ambiguous. On the one hand, he implies that the present degree of freedom of proposed member countries to adjust exchange rates would remain unimpaired—in the event of fundamental disequilibria exchange rate adjustment between members would be permitted (p. 12). On the other hand, he regards the promise of greater exchange stability among member countries than at present as one of the major advantages of the scheme (p. 13). Two comments suggest themselves. Member governments, though generally still wedded to stable exchange rates, will want to be sure that membership of such a regional currency area would not inhibit them unduly in adjusting exchange rates when the need arises and thus force them into more "solidarity" in domestic monetary-fiscal policies than they would be prepared to swallow. Those economists, on the other hand, who favour flexible exchanges would want more evidence than Professor Kojima has provided that greater exchange stability among the five countries would promote the mobility of capital among them. I doubt whether fear of exchange rate changes among the five countries constitutes in practice a significant obstacle to capital flows among them, nor are there any convincing theoretical reasons why it should.

Another advantage Professor Kojima attributes to exchange stability is that "the cost of exchange transactions would be reduced since within the currency area fixed exchange rates would be maintained between member country currencies" (p. 11). However, his argument here seems to rely not on fixity of exchange rates but on a change in the payments mechanism involving replacement of dollars and sterling by member countries' own currencies in bilateral payments between them. The cost to traders of bankers' commissions and of the margin between buyers and sellers' rates "could be eliminated if a foreign exchange market were organised... so as to allow direct clearing between the Japanese yen and Australian dollar or between any pair of member country currencies. It might also be feasible to eliminate the marginal fluctuations of member country exchange rates around their par values, and implement a rigid fixed exchange rate system within the currency area" (p. 11).

The desirability or otherwise of replacing dollars or sterling by yen or other national currencies in bilateral international transactions and of eliminating day-to-day fluctuations in exchange rates is well worth discussing, but it raises entirely different issues. The issue essentially is that of import substitution in international banking services. As in other cases of import substitution, the pros and cons need to be assessed in terms of gross and net foreign exchange savings and of static and dynamic efficiency.

(b) Professor Kojima argues that "flexible exchanges [within a ± 5 per cent band around par] would present an effective means whereby a Pacific Currency Area could adjust its balance of payments vis-a-vis the rest of the world" (p. 10). The apparent contradiction between advocacy of stable exchange rates between members but floating exchange rates with the rest of the world is resolved by the proposition that exchange rate changes would be more effective for balance of payments adjustment "for a Pacific, or any such large, currency area [than] for a single country" (p. 9). On the face of it, this proposition contradicts the usual assumption 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. Professor Kojima advances three arguments for his proposition all of which puzzle me.

The first argument I cannot follow at all. Intuitively, I doubt whether anything definite can be said in general terms about the relative price elasticity of demand for total imports in large and small countries. The relevant demand and supply elasticities are those not for imports but for importables. Everything will depend on the commodity structure of imports and domestic production, so that determinate solutions presumably require a general equilibrium approach. Even his "obvious" proposition that "the ratio of production to imports for the area as a whole will be larger than for each member country separately" (p. 9), while probable, does not necessarily hold.

The second argument, that if accompanied by progress towards a free trade area the formation of a Pacific Currency Area would be associated with relative growth of intra-area trade and that this would involve "increased price elasticities of import demand" (p. 10), also strikes me as unconvincing. Diversion of imports towards intra-area trade is most likely to occur in products which the area member countries can relatively easily produce themselves. For the remaining imports, the domestic elasticity of supply of importables and therefore the elasticity of demand for imports would, for that reason, tend to be lower.

The third argument, that the effect of a devaluation in reducing domestic real wages is, because of "money illusion", less likely to provoke countervailing increases in domestic money wages in a large than in a small country, is plausible as it stands. But even here care needs to be taken in extending it to a currency area so large that its total trade may approach that of the rest of the world. For in that case, the repercussions of a simultaneous devaluation of all member currencies on prices throughout the world will be so great that partial equilibrium analysis is no longer an adequate guide.

Relations with Asian and Latin American Countries

On this aspect I have no comments but one might reasonably ask Professor Kojima for some clarification.

He says that "neighbouring less developed countries in Asia and Latin America would almost certainly become interested in a Pacific Currency Area" (p. 13). Does he envisage all or most of them joining the area? If so, would they all be required to assume the commitment to maintain fixed (or at least stable) exchange rates with all other member currencies and to move towards concerted domestic monetary-fiscal policies?

He says that, in that case, the original members could co-operate in the business of "aid creation" (p. 13). Does he mean anything more by this than that the advanced member countries would increase their aid to the LDCs? Does the formation of a regional currency area have any specific implications for this?

Finally, Professor Kojima claims that a Pacific Currency Area, including the United States, Canada, Japan, Australia and New Zealand, which would invite Asian and Latin American participation would be better than an ECAFE region scheme on Triffin lines. Would he argue that a scheme embracing all the five advanced and all Latin American countries would have advantages to the Southeast Asian countries over the much more modest Triffin scheme?

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