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Pacific Island Countries: Possible Common Currency Arrangement

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Abstract

This paper examines the potential advantages and disadvantages of adopting a common currency arrangement among the six IMF member Pacific island countries that have their own national currency. These countries are Fiji, Papua New Guinea, Samoa, Solomon Islands, Tonga, and Vanuatu. The study explains that the present exchange rate regimes—comprising pegging to a basket of currencies for five countries and the floating arrangement for Papua New Guinea—have generally succeeded in avoiding inflationary, balance of payments, external debt, and financial system problems. The study concludes that adopting a common currency in the Pacific would require greater convergence of domestic policies and substantial strengthening of regional policies, which would take time to achieve.

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I. INTRODUCTION[1]

The increasing integration of the world's economies is a challenging policy environment for small states. On the one hand, they stand to gain through better access to export markets, the ability to exploit local economies of scale, and the opportunity to use foreign savings to develop their productive sectors. On the other hand, their increased exposure to international trade and financial flows may leave them more vulnerable to external shocks. How to increase the benefits from closer integration with the global economy, while minimizing the potential risks, is a topic under active discussion.

The Pacific island countries have historically followed an outward orientation and have sought to deepen the economic links among themselves and with their major trading partners. Two regional cooperation and trade agreements have come into force: the Pacific Agreement on Closer Economic Relations in 2002 and the Pacific Islands Countries Trade Agreement in 2003. Discussions on an Economic Partnership Agreement with the European Union began in 2004. The Pacific Plan was launched by the island governments in 2005 to explore ways to strengthen relationships among their economies. Several academics have suggested the region move beyond the initiatives already in place by adopting a common currency, citing its potential to enhance macroeconomic stability and further increase trade flows between member countries.

Against this background, the paper examines the potential advantages and disadvantages of adopting a common currency arrangement among the six countries that have their own national currencies, namely Fiji, Papua New Guinea, Samoa, the Solomon Islands, Tonga, and Vanuatu. It first reviews the main economic characteristics of the region and the history of its exchange rate policies, in order to set the discussion of a possible common currency arrangement in context. The actual experiences of countries in other regions that already participate in a common currency arrangement are then outlined. On the basis of these developments, and the economic circumstances of the six countries, the potential advantages and disadvantages and technical issues that would arise should they choose to adopt a common currency are assessed.

The main conclusions are as follows. While the Pacific island countries have faced considerable challenges arising from the small size of their economies, vulnerability to shocks, limited policy flexibility, and variable economic performance, the region has adopted a set of exchange rate policies that, differing between themselves and often within the same country over time, have generally succeeded in avoiding inflationary, balance of payments, external debt, and financial system problems. Yet, putting in place the fiscal and structural policies that are necessary to lift the sustainable rate of economic growth is a goal that has often proved elusive. The experiences of countries in other regions that have already adopted a common currency arrangement suggest that there is no assurance that economic growth will be higher, as a common currency, on its own, is not likely to promote the required degree of fiscal discipline and structural reform. Furthermore, adopting a common currency in the Pacific would require a substantial

[1] An earlier version of this paper was presented at the December 2004 meeting of the South Pacific Central Bank Governors, who, while not seeking a firm recommendation on whether to accept a common currency, requested an assessment that would outline the key issues.

strengthening of domestic and regional policies which would take time to achieve, and extensive technical issues would need to be addressed upfront to ensure its success.

II. Economic Characteristics and Exchange Rate Policy in the Pacific Region

A. Economic Characteristics

The six island countries under review broadly share many economic and physical characteristics. These include: smallness in terms of GDP and population; geographic isolation; narrow productive sectors; limited export diversification; high trade penetration shares; vulnerability to terms of trade fluctuations; frequent natural disasters; and large public sectors. Some of these features are consistent with the standard prescriptions for the formation of a successful common currency arrangement, but others are not. Overall, since independence, these countries' economic development and performance has fluctuated widely, and the challenges they face remain diverse, although for reasons that have little to do with the particular type of exchange rate policy each has adopted:

- *Narrow productive sectors and low growth rates:* The private sectors focus on the production of just two or three primary commodities, which vary between the countries, as well as mineral and oil output in Papua New Guinea and tourism in Fiji and Vanuatu. Growth of real GDP has generally been disappointing. With the exception of Samoa, which since the mid-1990s has benefited from steadfast implementation of a strong economic reform agenda, and the growth in tourism in Fiji following the 9/11 events, average annual real GDP has increased by only about 3 percent since 1990. While specific factors in each country are in part responsible for this result, the low rate of private investment and employment is linked to the absence of wide-ranging structural reforms focused on improving the private sector regulatory environment and the quality of public enterprises. Furthermore, the production of higher quantities of marketable agricultural output in the rural sector, where the bulk of the citizens work, has often been impeded by complex tribal-based claims for land that is communally held, lack of financing opportunities, the poor state of infrastructure and transportation services, and labor market rigidities. Law and order difficulties in Papua New Guinea and political instability in Solomon Islands and Vanuatu have also been factors. These issues cannot be resolved simply by adopting a common currency.

- *Openness and inflation:* The trade shares of the islands are high, with the export share typically around one-third and import share around one-half of GDP. However, most of the foreign trade is concentrated on just a few regional countries, with Australia and New Zealand the main trading partners for Fiji, Papua New Guinea, Samoa, and Tonga, and Japan for the Solomon Islands and Vanuatu. The low volume of trade amongst the countries themselves reflects the similarity of their exports. Furthermore, while the open trade regime has helped to keep the inflation rate down, macroeconomic policy instability has been a source of inflationary pressures in some cases. In Fiji, Samoa, and Vanuatu, which on balance have had the most stable macroeconomic policies, and more recently in Papua New Guinea, the annual inflation rate has averaged around the same level as that of their major trading partners. In contrast, the Solomon Islands, and recently Tonga, inflation has been higher, primarily reflecting weaker fiscal performance. The inflation performance in these countries might improve under a different currency arrangement.

- *Fiscal pressures:* Over the past decade, the fiscal sector came under stress, especially in Papua New Guinea and the Solomon Islands. Further, most countries have budgets that suffer from structural rigidities. Annual revenue collections fluctuate in line with commodity-linked revenue that cannot be easily replaced with higher receipts from other sources. The quality and flexibility of budget expenditure is generally weak, with large civil service wage bills that cannot be adjusted quickly in response to economic shocks and revenue shortfalls, and development programs that are often poorly focused. More recently, fiscal developments have shown a substantial improvement in Papua New Guinea and the Solomon Islands in response to the strengthening of government policy. External debt burdens vary widely, although most debt is contracted with the World Bank, Asian Development Bank, and bilateral donors on favorable repayment terms.

- *Limited effectiveness of monetary policy:* Several factors compromise the effectiveness of monetary policy as an adjustment tool. First, due to the presence of large nonmonetized subsistence and informal sectors, financial systems are shallow, and the ratios of currency in circulation and of M2 to GDP are low. Second, high levels of excess bank liquidity at commercial banks—which reflects the lack of local investment opportunities, large mandatory savings in the provident funds, and restrictions on outward investment—weaken the impact that changes in official interest rates have on the interest rates faced by the private sector. Third, fiscal dominance over monetary policy decisions is prominent in some countries due to large budget financing needs. Addressing this issue would be important to achieve the aims of a currency union.

- *High vulnerability to shocks but rare balance of payments crises:* The island countries are highly vulnerable to commodity price fluctuations due to the heavy reliance on primary exports, weather-related shocks, and, in some cases, internal political unrest. These types of shocks affect different islands at different times, although their overall impact on the balance of payments has been moderated, to varying extents, by workers' remittances, fish license fees, aid flows, and emergency disaster assistance. Furthermore, since the region is not closely integrated with international capital markets, speculative attacks have been limited. As a consequence, official reserves have generally remained above three months of imports despite the vulnerabilities. In the face of the fiscal and monetary policy rigidities noted earlier, the exchange rate has been used as an adjustment tool to offset the impact of the exogenous shocks and internal demand pressures, as described in the next section.

B. Exchange Rate Policies

Notwithstanding the economic similarities, the island countries in the Pacific have adopted a variety of exchange rate regimes. Among the ten IMF members, the current spectrum runs from dollarization (Kiribati, Marshall Islands, Micronesia, and Palau), pegging to a basket of currencies that may be supported by capital controls (Fiji, Samoa, Solomon Islands, Tonga, and Vanuatu), and a floating regime (Papua New Guinea). This mix of regimes reflects the inherent trade-offs involved in trying to simultaneously stabilize the nominal exchange rate to promote trade and investment, maintain a degree of policy independence, and retain an ability to offset the balance of payments and inflationary implications of unfavorable external and political developments and bouts of weak fiscal policies. The countries have sought different ways to balance these trade-offs based on their own preferences and circumstances, and the type of exchange rate regime they have selected has therefore varied, both between themselves and even over time within the same economy (Box 1). They have, however, broadly managed to use their exchange rate policies to offset external imbalances, and the use of IMF credit has been limited.

In providing advice to these island countries, the IMF has taken the position that the selection of a particular exchange rate regime is the prerogative of the authorities, and its role has primarily been to advise on whether the country's economic circumstances and its policy stance are consistent with the exchange rate regime that has been selected. Initially, there was little conflict between the authorities' external and domestic policy goals, and exchange rate policies were similar in all the six countries under review in this study. Specifically, at the time of independence, there was a strong consensus in the region that fixing the exchange rate to that of a major regional currency would boost credibility in their new national currencies and lower inflation expectations. Devaluations were perceived as having limited usefulness in the face of the prevailing strong link between wages and prices which has been subsequently modified, and the potential increase in transaction costs that would arise from exchange rate volatility. The authorities accepted that choosing a fixed exchange rate regime would place a heavy premium on fiscal discipline and flexibility, and budget deficits around that time were contained. Over the years, as major world currencies began to fluctuate against each other, the island countries switched from pegging to just one major currency to pegging to a currency basket in order to reduce the fluctuations in their effective nominal exchange rates against major trading partners. The weights of the currency basket were based on the trade shares with each country, and the currency's value was generally allowed to fluctuate only within a very narrow band.

Pressures on the exchange rate pegs started to grow in the early 1980s, because of the world recession, weaker export demand, higher cost of energy and other imports, and weakening fiscal discipline. The countries retained their fixed exchange rate regimes, but step devaluations were required and their currencies depreciated in real effective terms. Papua New Guinea, Samoa, the Solomon Islands, and Vanuatu depreciated their currencies during 1982–86. In the second half of the 1980s, political instability in Fiji and Papua New Guinea added to balance of payments pressures and contributed to exchange rate devaluations. In the 1990s, most countries showed an unwillingness to exit from their pegged exchange rate regimes, reflecting in part a view that floating rates were more accommodative to inflation. The main exception was Papua New Guinea which, following a period of fiscal indiscipline, introduced a floating rate system in 1994, which remains in effect.

Most of the region weathered the Asian crisis without major exchange rate adjustments, except for the Solomon Islands, although their currencies depreciated gradually in real terms. Subsequently, the IMF encouraged the authorities that maintained a pegged exchange rate to adopt slightly more flexible regimes to protect competitiveness, avoid reserve losses, and provide a buffer against external shocks. Consistent with this position, the IMF endorsed the actions of Samoa and Tonga to permit greater monthly rate adjustments by their central banks and suggested that this might also be appropriate for other countries. The IMF also subsequently accepted the use, for a limited period, of exchange controls by Fiji and the Solomon Islands in light of severe shocks to their economies due to military coups and internal conflict, respectively. However, the varying growth performance does not appear to have been closely associated with the choice of exchange rate regime.

III. Common Currency Areas: Experience in Other Regions

Membership in a regional currency area and the use of another nation's currency as legal tender is quite common. At present, over 50 countries participate in such arrangements, some for more than 50 years. Those in a currency union include countries in the euro zone, islands in the Eastern Caribbean Currency Union, and countries in the two African currency zones. The number of countries that are members of a currency union is expected to increase in the future, as European Union accession countries are expected to eventually adopt the euro. The Gulf Cooperation Council states have committed to form a currency union by 2010. In addition, more than 20 other independent countries use the currency of a major trading partner as legal tender.

The arguments for and against entering a currency arrangement with another country have been extensively studied in the academic literature. In broad terms, the key issue is whether the potential advantages of joining, in terms of greater macroeconomic stability and lower trade transaction costs, outweigh the loss of discretion to use monetary and exchange rate policies to respond to domestic and external shocks. In weighing these potential advantages and disadvantages, the literature has identified several conditions that, if fulfilled, may boost the benefits and hence the long-term sustainability of a country's participation. Specifically, the net benefits of membership are likely to be greater when: the productive sector is diversified so that the impact of shocks in one sector will be minimized for the country as a whole; shocks are similar across the countries in the common currency area so that the desirable monetary and exchange rate policy response is also similar; the trade sector is open and large with the partner countries; and fiscal policy, prices, and wages are flexible to compensate for the loss of monetary discretion.

The countries in existing regional currency unions have not fully shared these characteristics (Box 2):

- *Historical as well as economic factors:* While economic criteria have certainly been important factors, political and institutional factors—notably historical relationships with an anchor country, close geographic proximity, and a desire for regional integration, including in the formulation of monetary and exchange rate policies—have played a critical role in establishing and maintaining a regional currency union.

- *Undiversified economies:* In contrast to the criteria outlined in the literature, with the exception of the euro zone, the countries in a common currency arrangement typically have an undiversified production sector, narrow export concentration, economic shocks that vary across the region, and shocks that are very different from those that affect the anchor country. Further, on average, the rate of economic growth in these countries has not been higher than in countries that are not part of a currency union.

- *High trade shares but mainly with the anchor country:* The literature suggests that members of a common currency arrangement are more likely to gain if they have a high trade share, and that trade volumes could increase further due to the decline in transaction costs as exchange rate volatility is reduced. Countries in common currency arrangements have indeed tended to be very open. However, while trade shares with the anchor country are typically large, often over half of all exports and imports trade shares among the countries within a regional currency union have tended to remain small, often due to the heavy reliance on the production of similar primary products and/or tourism services.

- *Inflation and fiscal discipline:* By limiting the ability to finance budget deficits through printing money, and thereby effectively increasing the independence of the central bank, a common currency arrangement can underpin low inflation. The average inflation rate in members of a common currency arrangement has been lower than in other similar countries. However, budget deficits have often remained high, financed from the regional central bank itself, domestic and foreign borrowing, and/or aid transfers. Further, there is little evidence that the currency arrangement has prompted its member countries to take steps to enhance the flexibility of fiscal policy.

- *Financial integration and investment:* A currency union could in principle boost domestic and foreign direct investment by reducing exchange rate uncertainty, as well as eliminate the devaluation risk premium in local interest rates, and it may assist development of the financial sector by providing an opportunity to exploit economies of scale. In practice, the evidence suggests that financial integration among countries in a common currency arrangement can still be hampered by investment restrictions imposed on domestic financial institutions and on foreign ownership. Furthermore, domestic interest rates in these countries have not necessarily converged with each other or with those in the anchor country, due to ongoing repayment risk concerns, capital controls especially for large saving institutions like pension funds, and interest rate ceilings.

- *Seigniorage distribution:* A common currency arrangement could prevent a country from receiving interest on its stock of international reserves and collecting the revenue that arises from the increase in the demand for money. The magnitude of the loss for any individual country depends on the specific nature of the agreements within the arrangement, and in practice, the distribution of seigniorage among members has been a feature of most, but not all, of the regional currency unions.

In the Eastern Caribbean Currency Union, economic growth has been modest since the mid-1990s. This in part reflects national disasters, the dismantling of preferential trade agreements in bananas and sugar, the decline in activity in offshore financial centers, and reduced official development assistance. In response, the countries pursued expansionary fiscal policies in an effort to generate growth, create employment, and maintain living standards. The weak fiscal positions were not accommodated by domestic credit expansion, but through increased domestic and external debt. Greater progress towards fiscal consolidation will be needed to ensure consistency with the region's currency arrangement.

In the Central African Economic and Monetary Community and the West African Economic and Monetary Union, the strong economic gains achieved by all of the countries in the aftermath of the 1994 devaluation have given way to a more differentiated economic performance in recent years. Macroeconomic developments in the CEMAC have benefited from oil windfalls, and performance in meeting convergence indicators has improved. Economic growth has slowed in the WAEMU reflecting exchange rate appreciation, falling commodity exports, and political instability, and macroeconomic convergence has fallen short of targets. The peg of a common currency against the euro since 1999, and for many years earlier against the French franc, has provided a useful anchor for regional policy.

The Gulf Cooperation Council countries' objective of establishing a monetary union by 2010 is supported by the IMF. Higher international oil prices in the recent past have strengthened the financial position of these countries. Economic prospects would be further buttressed by the increased integration of the region with the global economy and the ongoing regional integration in the context of the planned monetary union.

IV. Issues in the Consideration of a Common Currency Area in the Pacific Region

In this section, possible advantages and limitations of a common currency arrangement with reference to the Pacific region economic circumstances are outlined, assuming they adopted a currency-board like arrangement or the currency of a regional anchor country, as in virtually all the other arrangements. The next part of this section expands the discussion to include the full range of common currency options available and includes a description of how the specific strengths and weaknesses would vary somewhat depending on the exact type of the arrangement. The fiscal and other transitional arrangements that would need to be addressed are then outlined.

A. Potential Advantages

The actual experiences of other countries participating in a currency union suggest that the average inflation level would likely be reduced by adopting a common currency arrangement. While inflation in the region has become less of a concern recently, especially because of favorable economic progress in Papua New Guinea and the Solomon Islands, this trend could be consolidated within a common currency arrangement, thereby helping to promote financial stability and to protect the balance of payments. There could also be a number of indirect benefits:

- *Boosting investment and growth rates:* Increasing domestic and foreign direct investment, employment generation, and the sustainable economic growth rate is primarily dependent on macroeconomic stability and wide-ranging structural reform to encourage an enabling environment for private sector activity. Reforms in this regard should include: streamlining existing regulations and controls over private sector investment and activity; clarifying the ownership status of land so that it can be more productively utilized, especially in the rural sector; increasing the quality of education and the flexibility of local labor markets, particularly with regard to the large public sectors; liberalizing the remaining controlled prices so they better serve as a signal for local consumption and production activity; and strengthening the local banking sectors, especially domestically owned banks and other financial institutions, including policies to guard against money laundering. If a common currency arrangement strengthens the commitment to addressing these issues, this could enhance policy credibility.

- *Achieving fiscal discipline:* To varying extents, the island countries need to increase public savings; improve the quality of public expenditure, especially by reducing the wage bill and raising development spending; strengthen revenue sources; and increase the efficiency of government and public enterprise services. To the extent that the limitations placed on central bank financing under a common currency arrangement enhance the prospects for fiscal reform, the currency arrangement could be beneficial.

- *Boosting trade flows:* The region has close trade ties with Australia, New Zealand, and Japan. Several empirical studies suggest that trade flows between members may increase under a currency union, although these results have been called into question by other studies. In any case, the additional trade benefits that would accrue to the countries in a currency union could be limited since inter-island trade will continue to be constrained by the similar production activities in the islands. In addition, the level of their exports to other countries is dependent on supply constraints in their own economies such as infrastructure deficiencies.

- *Promoting regional integration:* Putting in place other initiatives to encourage closer economic integration would help increase the potential economic gains under a common currency arrangement. Policies that could be considered in this regard include: freer movement of goods and services to maximize trade and efficiency, with new revenue measures introduced to the extent that the reduction in tariffs cause a significant loss of revenue; allowing freedom of movement of capital within the proposed union, which will require removing the present exchange controls at least between members of the union; and efforts to enhance labor mobility.

B. Potential Disadvantages

There are also several policy and practical limitations that the island countries would face should they adopt a common currency arrangement:

- *Loss of the exchange rate as a shock absorber:* As discussed previously, the countries have at times successfully undertaken unilateral nominal exchange rate devaluations to offset external and domestic shocks. However, while all have suffered from shocks, these have occurred at different times in each island, and the ability to undertake unilateral exchange rate actions to facilitate domestic policy adjustment would be lost. Furthermore, business cycles between the region and the likely anchor countries in the region are also not generally closely synchronized.

- *Loss of lender of last resort facility:* While the overall impact is uncertain, the domestic financial sector could come under pressure following the adoption of a common currency area if there was a greater degree of capital mobility within the region. At the same time, the ability to provide a lender of last resort facility may be hampered, although this would depend on the exact institutional arrangements established in the context of the regional currency.

- *Loss of direct seigniorage:* Seigniorage may not continue to directly accrue to the individual Pacific islands under a common currency arrangement, although annual seigniorage is in any case generally less than one percent of GDP.

- *Loss of potential aid flows:* The distinct characteristics of the island countries have helped to secure very high levels of per capita concessional assistance, compared with other regions. If the region was seen more as a unified group in the context of a common currency arrangement, it is possible that aid flows would decline.

- *Loss of national sovereignty and local policy advice:* There may be a perceived loss of national sovereignty following the adoption of a regional currency. Further, the reduction in the role of the national central bank may lead to a loss of country-specific policy advice within the region. There would be a heavy premium for skilled staff to operate any regional central bank, especially since local central banks would continue to have a major role in undertaking other central bank functions, such as banking supervision, and in providing local advice to a regional central bank.

C. Pros and Cons of Adopting Different Common Currency Arrangements

A currency union in the Pacific could in principle take one of several forms, including: creating a new regional currency that floated against other currencies; pegging the value of the regional currency to either a basket of currencies or a single currency; anchoring the regional currency in the context of a currency-board type arrangement; and adopting another country's currency ($A, $NZ, $US) as legal tender throughout the region. Each of these types of currency arrangement involves a gradual progression in the level of commitment by the authorities to maintain the external value of the local currency at the cost of an increased loss of national discretion over its own policies, and the magnitude of the potential advantages and limitations therefore differs somewhat depending on the type of currency union adopted.

- *Floating regional currency regime:* Adopting a floating regional currency would provide the opportunity for the countries collectively to continue to allow the exchange rate to adjust in response to shocks or temporary pressures that affect the region as a whole. However, securing the necessary institutional requirements in a new regional central bank could be challenging. The institutional requirements that would need to be determined and established include how to design an inflation anchor and how to ensure independence in a new regional central bank's monetary and exchange rate policy decisions, especially given fiscal considerations. With the exception of the euro zone, none of the existing regional currencies float.

- *Fixed regional currency regime:* A fixed regional currency regime would provide a degree of exchange rate flexibility while still allowing discretionary exchange rate adjustments to respond to large shocks or misalignments that affect the group. However, maintaining this degree of flexibility may undermine the perceived policy discipline of adopting a fixed regime, and thereby the confidence by the private sector in the permanence of the regime.

- *Currency board arrangement:* Under a currency board arrangement, a regional currency would be backed by the stock of international reserves, with the regional central bank obliged to redeem its liabilities at a fixed rate. Compared with adopting a fixed regime, a currency board is harder to reverse with consequent potential benefits in terms of greater certainty, lower risk premia, and financial stability. Adopting a currency-board regime would sidestep the requirement to design an inflation anchor, but there would still need to be a new regional central bank operating under clear institutional arrangements to support the currency board arrangement. As for the above options, the Pacific islands as a group would directly capture seigniorage. In practice, in all but the euro zone, the currency of a regional currency union has been fixed in a currency-board-type arrangement to that of a single anchor country.

- *Using another country's currency:* Adopting a major regional currency as legal tender would eliminate the need to establish a regional central bank and its supporting institutional arrangements. The disadvantages would be the loss of flexibility to undertake any exchange rate adjustment, the loss of national sovereignty, and likely loss of seigniorage revenue. In practical terms, a decision to use the currency of another nation as legal tender would require receiving the agreement of that country in order to ensure adequate arrangements to ship currency, prevent counterfeiting, and access the payments system of the anchor country.

Whichever currency arrangement is selected, there may be too few countries participating to make it viable. Since the main advantage arises from the reduction in inflation to that of the anchor country, the advantages to any one are unlikely to be significantly affected by how many of the six islands under review choose to join the union. Indeed, for the same reason, the countries could, at least in principle, have one currency union anchored on the Australian dollar and another on the New Zealand dollar.

D. Implications for Fiscal Policy

Should the decision be made to adopt a common currency arrangement, the loss of exchange rate flexibility will leave each island economy with more limited room to adjust domestic policies in response to external and domestic shocks. As noted earlier, the major policy challenge facing most countries is the low level of economic growth and private sector employment generation, which can be traced to weak and inflexible fiscal policies as well as the lack of wide-ranging structural reform. While the authorities' attention should focus on addressing these issues regardless of the decision about whether to adopt a common currency, the loss of the exchange rate adjustment mechanism would put a greater premium on the flexibility of other policies. Unless the inflexibility in fiscal policy is adequately addressed in advance of the decision to adopt a common currency, subsequent shocks would have to be basically corrected through real sector adjustments, which could increase volatility in the countries and compromise the sustainability of a common currency arrangement. Furthermore, in the absence of fiscal discipline, rising public debt and current account imbalances over the medium term would increase the vulnerability to crises, which could also threaten the sustainability of the common currency arrangement. In contrast, fiscal consolidation would facilitate an expansion of private investment without undermining external stability and promote growth along with exchange rate stability.

A large deal of convergence to sustainable fiscal positions and systems would therefore be needed to support a common currency. Adopting fiscal criteria that should be met ahead of the introduction of a common currency arrangement in the Pacific would be helpful in this regard. In the currency arrangements in other regions, including the European Monetary Union, the Eastern Caribbean Currency Union, and those in Africa, fiscal rules and guidelines apply to the overall budget deficit and the current or structural fiscal balance, and there are limits on external debt and debt service payments. Nevertheless, there is no clear consensus among the countries that already participate in a currency union as to how to define these targets, including whether the deficit limits should be adjusted over the business cycle, how aid payments should be taken into account, whether to exclude certain categories of revenue and spending, and how the targets should be enforced. The convergence criteria most applicable for the Pacific would need to be determined, and procedures for meeting and enforcing the targets established.

E. Other Transitional Issues

In addition to the fiscal policy prerequisites, there are other transitional issues that need to be addressed in preparation for the introduction of a new currency regime. These issues are briefly discussed in this section, although each would require extensive further examination if it was decided to move forward with this proposal.

- How should the region transition from their current set of country-specific exchange rate regimes to the selected common currency arrangement? The European Union, for example, requires prospective member countries of the euro zone to keep their currency within a 15 percent band around a central rate in advance of adoption of the euro. The appropriate convergence process for the currently varying exchange rate regimes would need to be determined.

- If the Pacific chooses to introduce a new regional currency, should the external value of the currency be linked to a currency basket or to a single currency? Linking to a basket would have the advantage of providing a more stable nominal exchange rate with respect to all trade partners. Linking to a single anchor currency would have the advantage of greater transparency and potentially lower transaction costs for trade.

- If the island countries decide to link to a single anchor currency, which currency should it be? Ideally, in line with the optimal currency literature, the selection criteria should be based on the similarity of the economic shocks with the anchor country in order that the desirable monetary and exchange rate policies are the same between the island countries and the anchor country. The highest trade flows both for exports and imports are generally with Australia, and given the prominent role of commodity exports, the real exchange rates since the 1990s have tended to be closest to that in Australia rather than the United States or New Zealand. Nonetheless, the prominence of the U.S. dollar in international finance and trade, including the use of the dollar in setting commodity and oil prices, means it might serve as a suitable anchor currency.

- How should the new central bank institutional arrangements be defined to protect its decisions from fiscal policy concerns across a common currency union? Experience indicates the critical importance of creating a single institution with a clear mandate and an explicit assignment of responsibilities for formulating and conducting monetary policy. This new institution should have the tools necessary to control all sources of monetary expansion, a governance structure that encourages coordination, and agreement among members on the central bank's policies and procedures. The unions of small countries, such as in the Caribbean, could be useful in crafting such an institution in the Pacific.

- How should transitional and operational issues be addressed? Operational procedures potentially include the production of a new regional currency and design of a new payments system, for which other country experiences could be a useful guide. Determining parity rates between the existing currencies and the new currency could be a challenging task, and any shortfall in the current stock of foreign exchange reserves in each country would need to be supplemented from other identified sources.

V. Concluding Remarks

This study reinforces the conclusions from many previous studies that, while a country's currency arrangement can have a major impact on whether the country is able to sustain external and internal economic stability, there is no perfect exchange rate strategy. Choosing an exchange system involves certain trade-offs, and there are a variety of economic forces affecting Pacific island countries that pull in opposite directions. Moreover, the strength of these forces varies considerably over time and between the different islands, reflecting political conditions, willingness to impose fiscal and monetary restraint when needed, and world economic conditions, especially commodity prices.

The major reform priority in the region at this time is to lift the sustainable growth of per capita income by implementing policies that would promote private investment and employment and maintain a stable macroeconomic environment. The question is how establishing a common currency arrangement could contribute to advancing this agenda, and whether it would be the best way to attain these goals. The experiences from countries already in common currency arrangements point to some of potential economic gains in this respect, particularly lower inflation levels, although there would be a loss of national discretion compared with existing exchange rate arrangements.

The decision and subsequent adoption of a currency union would require strong commitment to enhanced regional cooperation and agreement on important transitional issues. As experience has shown, a successful monetary union depends on the ability to build political consensus on critical policy issues and on the development of effective institutions. Achieving this goal would require a realistic timetable that allows for extensive collaboration on exchange rate issues and supporting policies.

Furthermore, adoption of a common currency arrangement should not be seen as a panacea. Raising economic growth will require major fiscal and structural reforms for which the contribution of a common currency may be marginal, at best. Indeed, rather than being seen as a means to reduce the necessary policy effort in these areas, the loss of currency flexibility will make substantial structural and fiscal reform even more pressing to ensure that private economic agents perceive the currency arrangement as a long-term commitment, anchored within a stable macroeconomic environment. In the absence of these reforms, it does not appear that growth rates will increase markedly, regardless of which exchange rate policy is adopted.

Box 1: History of Exchange Rate Regimes in Selected Pacific Island Countries

Fiji: During 1975-84, the Fiji dollar was pegged to the pound sterling, and thereafter to a currency basket. Following the 1987 coup, the dollar was devalued by over 30 percent and capital controls were introduced. Exchange rate pressures following the 2000 coup led to a tightening of exchange controls. These have since been eased following the upturn in real GDP growth, led by the pick-up in tourism and lifting of economic sanctions by other countries in the region.

Papua New Guinea: After gaining independence, the kina was pegged to the Australian dollar during 1975-78. The currency was pegged to a basket of currencies but was devalued in 1983 (by 10 percent), 1985 (5 percent), and 1990 (10 percent) to maintain competitiveness. Following the expansionary budgetary stance in 1992-93, the kina was floated in 1994. The float has helped secure an orderly adjustment to large terms of trade movements and has reduced the potential impact on competitiveness from bouts of expansionary policies. Accompanied by a tightening of fiscal and monetary policies, the kina has appreciated against the U.S. dollar since 2003.

Samoa: The tala was pegged to the New Zealand dollar at independence in 1970. Persistent excess demand pressures led to depreciations in 1975 (by 20 percent) and 1979 (by 19 percent) in an effort to restore competitiveness. Wide-ranging reforms in the mid-1980s were preceded by a 30 percent depreciation in 1983-84, and Samoa switched to a currency basket peg in 1985. During the second half of the 1980s, small discretionary adjustments were frequently made to the pegged value of the tala to maintain competitiveness during the adjustment process. Since the mid-1990s, the value of the tala has been kept relatively steady in real effective terms, to serve as a nominal anchor.

Solomon Islands: After independence, the Solomon Islands dollar was pegged to the Australian dollar and devalued in 1981-82 (by 18 percent) to offset adverse external conditions. A currency basket was introduced in 1983, and the dollar was devalued by a cumulative 30 percent during 1985-87 in response to persistent adverse external conditions and loose economic conditions; further discrete adjustments were undertaken in 1990s. The Asian crisis prompted a 20 percent devaluation and tightening of exchange controls in 1997. Economic conditions deteriorated markedly after civic conflict broke out in 1999, and the authorities allowed the rate to decline by 30 percent during 2002. The economy started to recover following the restoration of law and order by a regional intervention force in mid-2003, and the exchange rate has since been held steady against the U.S. dollar.

Tonga: Between 1976 and 1991, the pa'anga was fixed to the Australian dollar, and steadily lost competitiveness. The currency was fixed to a currency basket between 1991 and 1997. In the context of the Asian crisis, the central bank was given the right to move the peg by up to 2 percent per month (widened to 5 percent in 2000) but the pa'anga has remained relatively stable against the basket.

Vanuatu: Between 1981 and 1998, the vatu was pegged to the SDR within a narrow trading margin. Several devaluations were undertaken in 1985-86 (amounting to 29 percent) in response to adverse external conditions. Pressures on the vatu in 1998-99 were addressed by a rebalancing of the undisclosed weights of the currency basket and some tightening of exchange controls. Since then, the real effective exchange rate has been broadly stable.

Box 2: Common Currency Arrangements in Other Regions

European Monetary Union: Twelve countries (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain) use the euro as their common currency. The remaining four countries in the EU and the accession countries may join in due course. Fiscal transfers across countries exist, and migration opportunities are open. Seigniorage is distributed to national central banks on the basis of their population and GDP. Criteria for membership include a fiscal deficit of less than 3 percent of GDP.

Eastern Caribbean Currency Union: Founded in 1983, eight islands (Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines, as well as Anguilla and Montserrat which are U.K. dependencies) use the Eastern Caribbean dollar as legal tender, which is pegged to the U.S. dollar. The central bank runs a quasi-currency board, enabling the central bank to provide temporary credit to members and a lender of last resort facility as members have surrendered their foreign reserves to the central bank. Seigniorage is distributed equally across the eight territories. Labor migration to the United States, Canada, and the United Kingdom is high.

The Central African Economic and Monetary Community and the West African Economic and Monetary Union: Six countries (Cameroon, Central African Republic, Chad, Republic of Congo, Equatorial Guinea, and Gabon) have a common central bank and currency under CEMAC. Eight other countries (Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, and Togo) have their own central bank and currency under WAEMU. Both currencies are pegged to the euro, and the French Treasury guarantees full convertibility. This is supported by limits on reserve holdings of both central banks: each is required to keep at least 65 percent of its foreign assets in the operations account with the French Treasury and to maintain a foreign exchange cover of at least 20 percent of its sight liabilities. Capital movements between each zone and France are free, although in practice a number of administrative restrictions severely limit de facto capital mobility. Also, capital flows between both zones are restricted insofar as both currencies are not convertible against each other.

Common Monetary Area in Southern Africa: Lesotho, Namibia, and Swaziland issue their own currencies, which are pegged to the South African rand. While all four countries have their own central banks and consult with the South African Reserve Bank, the latter does not forgo any monetary and exchange rate policy discretion. It allocates seigniorage to Lesotho and Namibia to the extent that the rand is used as legal tender. There are no restrictions on current and capital flows within the area. Labor migration to South Africa is high, as are workers' remittances.

Gulf Cooperation Council states: The GCC countries (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates) have already made progress towards regional integration through elimination of barriers to free movement of goods, services, capital, and national labor, and through a common external tariff. Their exchange rates are pegged against the U.S. dollar. By 2010, they intend to establish a monetary union.

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