

# Issues in the Relation between Trade and Monetary Integration

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# Motivation

- Two Majors Avenues of Economic Integration
  - (1) Trade Integration
  - (2) Financial or Monetary Integration
- Interactively reinforcing each other
- What would be the optimal sequencing?
- Two Groups of experts pursuing each integration do not talk much to each other

# Monetary Integration First?

- The Opposite to Europe's Strategy
- What is Special about East Asia?
  - (1) Trade Integration is slow to materialize:  
Political resistance, No Grand Design for Multilateral FTA (only symbolic gesture, e.g. Japan-Singapore, Korea-Chile, China-ASEAN)
  - (2) The recent Currency Crisis: How to prevent future exchange crisis? (AMF, ASEAN+3)

# Europe's Experience

- No Serious Thought on Monetary Cooperation at the Beginning: The Bretton Woods System Provide Stability for the European Currencies.
- Divergences in inflation in late 1960s: The Werner Plan recommended a common currency.
- Two Heterogeneous Groups in 1970s: No viable exchange rate system and trade integration slowed down.
- EMS in 1980s brought further trade integration
- The Maastricht Treaty proposed a Monetary Union.

# Any Difference in Asia?

- Scollay and Gilbert (2001): trade agreements in East Asia is bewildering (bilateral approach rather than multilateral one).
- Bergsten (2000), Dieter (2001), Bird, G., and R.S. Rajan (2001) : East Asia will be successful in its attempt to jump into monetary cooperation ahead of building up the trade agreements (maybe, too optimistic)

# Slow Trade Integration

- Historically there has been much less active movement towards regionalism.
- More reliant on the U.S. and EU markets.
- AFTA in 1992: 6 ASEAN Countries
- China, Japan and Korea are not active on forming a regional free trade area.
- Agricultural sector is headache.
- No political support

# Recent Interests in a Monetary Union in East Asia

- East Asian countries are searching for an optimal exchange rate regime.
- A monetary union in East Asia may be necessary to avoid competitive devaluation of regional currencies.
- Stabilization of exchange rates will help East Asian countries achieve their full potential for growth and development.

# Does East Asia Satisfy OCA Criteria?

- Interdependence through Trade
- Symmetry of Shocks
- Mobility of Factors of Production
- Convergence of Macroeconomic Policies Objectives



# Empirical Support to a Currency Union in East Asia

- Bayoumi and Eichengreen (1994): a Breakdown of Shocks between Demand and Supply Shocks.
- Bayoumi and Eichengreen (1996), Baek and Song (2002), Lee, Park and Shin (2002)
- Wyplosz (2001) and Chow and Kim (2000)

# A Monetary Union ahead of FTA

- From a theoretical point of view, there is No clear reason for introducing trade integration ahead of monetary integration

# *Monetary Union and Trade*

- East Asian countries are more dependent on the U.S. and EU markets.
- East Asia would need to foster further trade integration until the benefits of a monetary union become high enough.
- Don't Worry!
- Rose (2000): membership in a currency union more than triples bilateral trade.

# Trends of Intra-region Trade in East Asia and Europe

East Asia (percentage of total trade)

	1980	1990	2000
China	42.4	58.9	48.7
Hong Kong	46.7	60.4	64.1
Indonesia	62.6	56.8	54.4
Japan	23.8	28.0	38.1
Korea	32.7	34.2	42.2
Malaysia	49.2	55.1	56.1
Philippines	37.4	40.0	46.5
Singapore	49.4	50.7	57.5
Taiwan	34.9	43.1	50.9
Thailand	40.1	47.5	54.2
Average	41.9	47.5	51.3

<u>Europe</u>	1980	1990	2000
Austria	69.8	75.6	71.0
Belgium	74.9	80.4	72.5
Denmark	74.4	75.5	74.8
Finland	57.4	66.6	61.7
France	57.8	67.1	66.7
Germany	63.9	67.4	59.1
Greece	48.2	70.1	56.1
Ireland	77.6	76.1	61.3
Italy	56.1	67.3	59.1
Netherlands	70.5	77.0	67.3
Norway	78.6	75.2	73.7
Portugal	58.7	78.5	78.6
Spain	43.2	68.2	67.8
Sweden	73.8	78.9	68.4
Switzerland	69.0	72.1	66.9
United Kingdom	55.8	62.8	57.0
<i>Average</i>	<i>64.4</i>	<i>72.4</i>	<i>66.4</i>

# *Endogeneity of OCAs*

- A monetary union can alter the costs of sacrificing independent monetary policy *ex post* (Frankel and Rose, 1998)
- Suitability of countries for a monetary union cannot be judged on the basis of historical data: Lucas Critique.
- A monetary union increases the benefits by promoting trade integration, but it may also increase the cost by diverging business cycles: Eichengreen (1992), Krugman (1993).
- Inter-industry trade: more asymmetrical shocks
- Intra-industry trade: more symmetrical shocks

- Fidrmuc (2001), Shin and Wang (2003): more intra-industry trade promote business cycle synchronization, leading to low cost of sacrificing independent monetary policy.
- Countries with more intra-industry trade due to similar industrial structure more easily pursue monetary integration.
- Although monetary integration promotes trade integration *a la* Rose, the type of trade integration is critical in determining the cost of monetary integration.
- So, endogeneity is not automatically guaranteed.

# Trends of Intra-Industry Trade

	1980		1990		1999	
	<i>IIT-2</i>	<i>IIT-4</i>	<i>IIT-2</i>	<i>IIT-4</i>	<i>IIT-2</i>	<i>IIT-4</i>
East Asia						
China	17.7	13.5	60.7	51.7	45.8	39.0
Hong Kong	45.1	41.1	58.4	55.8	56.8	56.5
Indonesia	33.6	5.8	34.1	13.6	44.9	26.0
Japan	29.8	16.4	37.5	28.2	56.4	41.0
Korea	35.8	28.2	44.4	37.9	43.4	32.8
Malaysia	39.6	23.1	48.6	40.1	68.9	56.5
Philippines	23.4	14.9	41.8	25.8	59.9	45.2
Singapore	34.2	22.3	57.9	42.4	74.1	61.9
Taiwan	23.1	12.2	32.0	26.0	60.4	48.1
Thailand	30.3	22.0	41.3	34.3	49.9	42.7
<i>Average</i>	31.3	20.0	45.7	35.6	56.1	45.0



Europe	1980		1990		1999	
	<i>IIT-2</i>	<i>IIT-4</i>	<i>IIT-2</i>	<i>IIT-4</i>	<i>IIT-2</i>	<i>IIT-4</i>
Austria	60.4	52.7	47.1	70.5	60.2	53.5
Denmark	58.7	50.8	44.4	66.9	56.5	49.5
Finland	49.7	43.4	40.5	59.0	54.0	48.9
France	78.2	65.9	60.0	79.3	71.2	64.3
GBR	74.9	66.8	61.1	79.1	72.3	65.5
Germany	67.1	62.7	59.4	71.6	68.0	64.5
Greece	42.6	22.0	16.5	39.1	30.5	23.2
Ireland	60.4	55.0	45.7	71.6	62.9	51.9
Italy	71.4	58.4	52.9	69.7	60.6	53.9
Netherlands	70.7	63.0	55.9	73.3	65.8	58.9
Norway	58.4	50.6	46.3	65.1	52.5	47.6
Portugal	32.4	26.4	21.2	45.8	40.3	32.7
Sweden	65.9	58.4	54.7	71.9	64.1	59.3
Average	60.8	46.6	66.4	51.8	67.9	52.3

# *Preventing Currency Crises*

- The East Asian crisis shows that an FTA is not helpful in preventing or mitigating a financial crisis.
- Indonesia, Malaysia, the Philippines and Thailand are all members of AFTA.
- Another example is MERCOSUR
- A monetary union implies a more durable political commitment on the macroeconomic policy front

# Political Aspects of a Monetary Union and Other Issues

- The debate over monetary integration in Western Europe has been closely related to discussions of political integration
- East Asia has much weaker precedents of movement towards political integration
- More heterogeneous economic structure
- Different stages of development

# Conclusion

- From a theoretical point of view, there is no clear reason for introducing trade integration ahead of monetary integration.
- Intra-industry trade promotes better conditions for monetary integration, while inter-industry trade increases the cost of monetary integration.
- Countries with more intra-industry trade due to similar industrial structure more easily pursue monetary integration.
- Monetary integration promotes trade by eliminating home bias. However, the costs of monetary integration will diminish only when intra-industry trade dominates afterwards.