South Asian Economies and Feasibility of Financial Cooperation: A Meta-Analysis

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Abstract

The paper is meta-analysis and addresses a policy question of feasibility of common currency among SAARC countries. It deeply investigates all those economic and political factors that contribute toward the formation of currency union. Author draws literal evidence of common currency if member states adopt framework confirming economic and political cooperation in form of market openness, liberalization of economies, direction of financial shocks, exchange rate market pressures and most importantly labor market mobility. Additionally, growth momentum among applicant countries and degree of political cooperation under the SAARC charter and diplomatic fronts would prove to achieve common goal of single currency in the time of global high and cry.

Keywords: SAARC, Liberalization, Mobility

Introduction

Globe has started adopting novel trends since the establishment of social, economic and political unions on the surface of earth. Such unification at different levels has also made capital and labor more mobile. Furthermore the advent of financial engineering has made economies more integrated and markets more coordinated, especially on the floor of financial market. Any change at the one corner of the globe is equally felt and realized on the other corner of the world. Advent of new technologies has helped to change the global economies completely.

This has made world more dependent, borderless and swift. Such mode of globalization has changed the worldwide landscape not only in traditional goods and money markets but also in exchanges of currencies making their volume over 1.2 trillion per day flowing on New York currency market (Time, 2014).

Ongoing globalization has also affected volatility in the world currency market and made it more dynamic and complex. Such complexity among market players make them cautious about investments options and led to new financial development. This diversity in the form of new financial products even though successfully translated market risks but speculations in futures and farwards markets kept exchange rate risk too high. Specifically all those countries who have adopted flexible exchange rate regime are exposed directly to exchange rate risk. Other countries too face this exposure by cross country exchange rate, even they are following other regime like managed, pegged or crawling peg.

Though Information era has made international transactions more transparent and minimized arbitrage effect but policy experts are divided about benefits they draw over the real economic activities. They go one step further and argue that market actor's political cooperation is also fundamental a requirement to achieve sustainability in financial market in

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general and currency market in specific. It is further suggested that political developments should be at country, institution and consortium level also to achieve long run stability in the markets.

Such socioeconomic paradigm shift stresses the need for more regional and country level cooperation as international financial institute like World Bank and International Monetary Fund (IMF) cannot comply with countrys' requirements of macroeconomic stability in the form of current account management and capital account liberalization. Failure of early warning system and multiple crises on the face of world is strong witness of market crashes. Since 1990 world witnessed dramatic changes in the international political and financial landscape. Demise of Soviet Union and breakup of Yugoslaia caused to dissolution of existing currencies and consequently gave birth to new currencies. Quite parallel to these political motives, European states decided to replace national currencies with single regional currency, the euro. Some other countries like Ecudar and El salvodar relinquished their own currencies and adopted dollar as legal currency. This turned down the notion of one country one currency and developed the belief that political fronts don't necessarily coincide with the boundaries of money and gave birth to new monetary cooperation and financial integration.

This global political dynamics appeared in almost all parts of the world and globe started to segregate into political and social blocks. Appearance of euro on the face of world and some political and monitory cooperation in Gulf Cooperation council (GCC) and East Asian countries are some examples of this.

Though South Asian countries have certain political, cultural and regional similarities but they lack poor political cooperation, weak economic ties, and least developed intra country trade. These states include Pakistan, India, Srilanka, Nepal, Bangladash, Bhutan, Maldevs.

Some stylized facts confirm fragility in the major macro indicators in South Asian economies. This region consists of 7 diverse member states in term of economic growth, inflation, and land area but their economic and human development parameters are exhibiting similar characteristics. Among SAARC the significant presence of India who is located in the centre and 300 times populous than Maldevs (smallest country in this region), and has a GDP of 79% of total GDP of SARC members. India is also the second largest consumption economy of region states. In addition member countries have diversity in macroeconomic shocks as well. Furthermore, SAARC member countries are divided into two different income group; least developed countries and developing countries. Pakistan, India and Srilanka are included into developing economies and fall in middle income group while Bangladash, Bhutan, Nepal and Maldives are included into least developed countries (LDC).

Just as there is huge diversity in the member states there also appears diversity in the exchange rate system as well. India, Pakistan and Srilanka have adopted managed float exchange rate while other have pegged exchange rate. Bhutan and Nepal have adopted a peg with Indian rupee and has rigid one to one convertibility. Empirics confirm that member states have shown similar trends in appreciation except Maldives who has pegged with dollar. Though currency fluctuations are natural outcome of flexible exchange rate system but it is influenced by numerous key factors. Most important is demand and supply shocks, economic conditions, index of inflation, price of money and capital inflow. Due to continuous change in these factors currencies of countries remain fluctuating and cause financial instability. It does not remain limited to this but any movement that happens across the shore also adversely affects domestic currency market. This dynamic nature of global currency market makes difficult for a country to keep itself safe from worldly fluctuations. Such fluctuations become more severe when countries are registering poor debt to GDP ratio, high current account deficit, high interest rates and limited foreign reserves. Such parameters are quite common in SAARC countries.

In addition world is also urging the need for coordinated international response so as repercussion in the financial markets could be mild and their corresponding cooperation be enhanced. It has been found that Asian financial crises has led East Asian countries over financial cooperation and developed consensus to set risk management standards so that future crises could be avoided (Jee-young , 2010).

ESAP (2012) argued that financial cooperation would decrease dependence over the international financial institutes and will promote regionalisms as well. Such regional blocks have helped to protects and strengthen cooperation in time when world has already experienced a havoc in the form of financial crises that not only crushed the global financial markets completely but also gone down the currency markets.

Even though dynamisms of Asian economies is a major driving force for post crises economic recovery but at the same time it is also being felt that these economies have similar characteristics in the form of fragile economic and financial stability. It is also an established fact that persistent fall in the economic growth in the advance economies, and growth in demand of goods and services may not recover to the pre-crisis level. Additionally the level of employment remained too low and debt market remained too tight in this time as well (ESCAP, 2010).

This poses a fundamental challenge for the South Asian economies to achieve sustainability in growth pattern and reduce fundamental macroeconomic equilibrium that generally arises due to poor market integration (ESCAP, 2012). The challenge becomes too important being the fact that South Asian economies are considered most divided and least coordinated due to the fact that all these member states have poor economic efficiency, stagnant movements of labor and capital flows across borders and poor market networks. Poor cooperation in interstate investment and mismatches of developmental approached are the contributing factors that are deteriorating to achieve economic integration.

Researchers Saman et al. (2012) are unanimous that economic inefficiencies persistent in South Asian are because of poor monetary cooperation that led to disintegrated economies of these countries. Furthermore they develop an argument that for economic integration and cooperation it is utmost important to settle down key developmental issues in this region (Economics and social commission for Asia and Pacific). Nagash (2012) recommends that regional dynamism could only be achieved if cross countries disparities be removed to achieve sustained economic development.

Jee made an affirmation that since the broke out of financial crises of 1990s, the debate is continuing on different international forum for financial cooperation for which many international forums have been staged. Even though Jee signal some challenges that are pre requirements to overcome for achieving meaningful financial cooperation along with well defined “direction” that need to follow for improving regional connectivity and cooperation.

SARC is another institutional development aim to achieve economic and social level to explore mutual agreement for attaining economic cooperation. (Nilay Chandra, 2005). Chandra confirms the need for economic cooperation but he did not mention any frame at monetary level to exist even he categorically mentioned to quicker settlement of barriers in the way for cooperation.

Tarlok (1979) argued that even though there appears large disparities among the SAARC countries but all those factors could be assessed that are responsible for dynamic process of change by setting the foundation of economic cooperation at sub regional level basing heavily across the whole field of development on selective factors that “cause change” with agreed time horizon.

Soranjan Dar makes an argument that within the institutional framework of SAARC not only constructive bilateralism exists between India and Pakistan but condition for regional stability do exist for South Asia.

Nephil et al. (2004) has termed that SAARC has acknowledged greater level of monitory cooperation that target a unification of currency but there is required high level political will to achieve long run economic integration. Author also made a cautionary note that process of monetary cooperation is long term goal that may even take half a century as confirmed by in case of European Union, so it must be rushed.

Sisira et al. (2005) developed an excellent piece of research work on the financial cooperation in SAARC countries and highlighted not only those factors that contribute to monitory cooperation but also identified major cost countries' economies will experience if successful currency union is achieved. They stated that an optimal currency criterion charges a negligible cost in the form of lacking control over functioning of monitory policy. They acknowledged the absence of synchronous shocks in these economies but developed a reasonable ground that even then provision of monitory cooperation exists. They also have the view that absence of real shocks could not be considered as reason to withdraw the move of unification of currency. They on the other hand noted the benefits that could be drawn in the form of achieving common currency.

They also highlighted the risk that will appear in the form of common currency because poor pace of trade, factor market movements and investment are countercyclical in nature. Authors made a unanimous view that if capital mobility, coordination among other financial markets, direction of trade and nature of exogenous shocks take up similar pattern then feasibility of long run monitory cooperation may possibly be ascertained.

Sisira and his colleagues made an observation that in SAARC countries there exists not only large diversity in financial market linkages but also in the GDP growth and inflation. They adopted the Bayoumi and Ostry (1997) simple time series approach to regress output over its lags and made comparison of entire region. General comparisons, nature of exchange rate, real effective exchange, levels of domestic inflation were also analyzed for this purpose. While preparing a note of caution authors prepared analytical commentary that policy level barriers need to be abolished to achieve monitory cooperation so that move toward currency union could be actualized on more credible basis that will give smooth path toward for peace in South Asia.

But quite parallel to this, Rahul (2005) made an argument that financial and monetary cooperation should supplement others in the arena of trade, financial and industrial cooperation along with consolidate move in the form of common clearing house and temporary credit facility to member states and settlement in local currencies will set sound foundation of currency unification.

Muchkund (2007) terms that failure to achieve economic integration as misplaced in the presence of continuing security concerns between India and Pakistan and stresses the need of a more responsible role by politicians to achieve long run economic cooperation by achieving peace in the region. Chee (2010) made analysis of exchange rates prevalent in SAARC countries and traces a close associating between exchange rates and real exports but it cannot be confirmed for East Asian economies.

Saman (2010) made an analysis of South Asian economies in different direction keeping into focus political aspects of coordination. He made an opinion that SAARC chamber of commerce and industries need to play more responsible role to develop economic coordination. Furthermore he stresses the need not to over load the agenda of SAARC so that economic coordination may be given due weight.

Rafi (n.d) proposed that in recent years push toward common or unification of currency among the trading partners have received much attention of politicians and policy experts. He further terms that euro has set the standards of economic integration. It is also being expected that oil rich Arab countries would successfully drop all those barriers that are major hurdles for achieving common currency. He made a new addition and stresses the need that one must go to access the feasibility of currency union by Optimal Currency Area (OCA) index. He based his concept over the work of Bayoumi and Eichengreen (1997).

Bayoumi and his colleagues argue that there is need to check feasibility of optimum currency area on the basis of econometric model that encircles all economic variables. Generally structural vector autoregression models are used to test optimum currency union but such modular application is not adopted where exchange rate history is too troubled (Rafi 2009).

The proposed index is based upon changes in standard deviation of nominal exchange rate (YoY) between countries. In respect to exchange rate volatility it is viewed that volatile factors should go down over time as policy coordination increased. They traced the fact that exchange rate is major contributing factor in achieving coordination in both money and capital markets.

Other important variables incorporated in the indexation approach is the absolute difference in share of agriculture, mineral and manufacturing trade in total merchandize trade, share of total bilateral trade as percentage of total trade and size of the GDP between two countries.

Literal discussion guides that it is doubtless that economic integration could better if there exist improved financial and monitory cooperation. Experts and economists are of the opinion that European Union has set the foundation for successful currency but to actualize real financial cooperation it is mandatory to look into fundamental factors across countries that contribute to the formation of optimal currency area.

It is also being revealed that monetary cooperation not only demands coordinated movements of key macroeconomic variables but it also needs political will and economic structure of regional blocks. In very specific to South Asian economies optimality of common currency need to be looked in the light of famous work made by economists Mundell and McKinnon (1961) who give four key interrelationship among interacting states namely, trade volumes, nature and direction of shocks, degree of labour mobility and fiscal transfers.

Meta Analysis

In the context of optimal currency area among South Asian countries, economic literature makes known that it would be highly beneficial if countries could come to interact in a way that could lead them toward monitory cooperation. But such feasibility only exist if following fundamental requirements are met otherwise the dream of common currency could not be realized. These basic requirements are not only economic in nature but political in metaphor. Even though there exist large diversity in economic fundamentals of each countries but real problem that hinders peaceful cooperation at economic front is instability between two big counties at boarders, who had an experience of destructive collusion in past in the form of war.

Necessary condition for common currency in SAARC countries

Following key standard criteria (OCA) need to exist if future generation wishes to fulfill dream of common currency that will not only give economic benefits but also give peace in this region.

Criterion 01: Economic Structure

Economic integration level must be similar across member countries. Economic developments in the form of education and health improvement are necessary so that labor of equal profile should exist. This would give equal level of productivity and similar level of fiscal requirements in the economies. They should have equi-likely status of demographic profile otherwise system would nullify possible existence of currency union by disturbing the direction of financial flow.

The direction of economic development (GDP growth) and market openness along with Herfendahl index shows market level similarities with inflationary standing make a case for possible emergence of block in the form of common currency (Rose 1996). But trade would seize in case similar goods are produce if there would not appear inter industry transaction.

Criterion 02: Regional Trade

Inter regional trade level do have a significant role toward common currency. This will reduce cost of financial transaction and drop down financial risk as well. In case of SAARC countries direction of regional trade is positive but constrained which could be made more open if cross countries boarders are opened.

Regional connectivity, similar economic profile and trade direction provide a pliable ground for common currency which will translate low risk and less cost over the member states. Frankel and rose (2000) view that Markets (goods and financial) are open and due level of economic liberalization exist in these countries (SAARC) that support the idea of unification.

Criterion 03: Degree of specialization

Countries are required to achieve degree of specialization to be a candidate of common currency member, because it would absorb input shocks in production sector of the economies otherwise deterioration in export level will result among member states.

Analysis of Hefendhal index given by Engel (2002) confirms that average of Herfendahl Index for SAARC countries is approximately equal to the average of member of currency union. This measure of degree of specialization in the production market validates that there is room for common currency even though countries vary a lot in the level of output. Furthermore Bayoumi and Eichengreen (1994) traced that range of supply and demand shocks is -0.3 to 0.57 for SAARC countries which is near to Europe i/e -0.21 to 0.65. This measure strongly supports the possibility of common currency.

Criterion 04: Mobility in Inter Countery Labour Market

Literature on optimum currency area confirms that mobile labour has main role in supporting asymmetric shocks from area of high employment to low one. Degree of labour mobility is diverse across the SAARC countries. It has been seen that labour is very poorly mobile among India and Pakistan. Contrary to this it is too mobile between Nepal and India. The confirmation of Banerjee et al. (1999) terms the possible hurdles between Pakistan and India are legal in nature even though people share long history but their mobility is stopped by persistent immigration rules between two countries.

Nature of labour mobility lags far behind in SAARC countries as compare to the level of common currency area of Europe. This is severe legal hindrance that needs attention of policy experts and politicians are required to table this issue on diplomatic forum so as an air of more confidence building could be created for common currency.

Criterion 05: Fiscal Transfers

Fiscal transfers are emphasized in common currency area. The literature on fiscal transfer explores the demographic profile of countries over Optimum Currency Area (OCA), but many economists are of the view that fiscal federalism also hinders factor mobility because the burden of unemployment falls on entire union. Eichengreen (1997) however develops a space that SAARC countries may prepare federal budget at the pattern of European Union, to become a potential candidate for member of common currency.

Criterion 06: Geopolitical Factors

Economic factors contribute an important role in formulating sound case for stable currency union among SAARC countries, but international developments are equally important which appeared on the face of globe in the form of slow pace of economic development and increasing protectionism. Das (1996) give an argument that SAARC countries need to improve inter regional cooperation to take a successful graduation for confirming the feasibility of common currency area.

Das also argues that there is need to harness inter country potential because it would be difficult to get penetration into highly tight global market. Land connectivity of SAARC countries (except Srilanka), sharing common water, and surface of rich agriculture and fruits demands to tape down available potential by allowing goods' movements across their borders without involvement of third country as facilitator that contributes nothing but price hike, a tax over the countrymen.

Above debate confirms that untapped potential of economic integration among SAARC countries could play a significant role toward a common currency.

Conclusion

The paper is meta-analysis and addresses a policy question of feasibility of common currency among SAARC countries. It deeply investigates all those economic and political factors that contribute toward the formation of common currency. Paper also provides an educated audit to achieve a common currency without mentioning individual country's readiness toward such proposed unification.

It has been found that market openness, liberalization of economies, capital account liberalization, sharing of common boarders, fiscal transfers, direction of financial shocks, exchange rate market pressures and most importantly labor market mobility are those economic factors are pre requirements for developing a common currency union in the SAARC countries. Additionally growth momentum among applicant countries, degree of strong linear association between monetary policies and fiscal transfers are contributing interrelationship that develops a sound proposition for setting the stage of common currency block.

Even though direction of shocks is not much different from the European Union but there is required high level political will and diplomatic efforts to drop the legal and immigration restrictions so that SAARC block could achieve not only its dream of common currency by also access international markets which is resilient and highly protectionist now a days.

The currency unification will paves the way for transfer of risk, capacity to share financial shocks, decrease in financial cost and financial deepness in both money and capital markets which in turn not only provide economic integration but also give rise to peace in the South Asia.

Author deduces lesson that wave of globalization, advancement in information technology has actually made this world "borderless" which is driven by peaceful coexistence so that natural imbalances could be met in the best interest of humans. Furthermore countries' governments should stop individual policies that aimed to achieve particular objectives divorced from the side effects of various other policies that neither account interest of country nor humanity. This could only be a step to achieve desirable long run economic stability in the optimal currency area in the presence of long standing socially desirable development goals.

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