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RIS Policy Briefs

Road to a Single Currency for South Asia

The Indian Prime Minister's statement that over the long term we can even visualize a common currency for South Asia is inspirational and timely although the objective of common currency can be achieved only in a step by step manner. The first and immediate step that can be taken is to introduce a parallel currency and utilize that instrument effectively to promote regional cooperation in trade and investment, which can eventually prepare the ground for a common currency. The cynics about this vision should not be taken too seriously. It should be remembered that until only a couple of years ago, the mainstream opinion among economists (particularly in the US and the UK) was highly skeptical about the stability and viability of Euro.

Benefits of a Common Currency Regime in the Region

The common currency regime, when achieved, can confer substantial benefits to the region. With uncertainty about exchange rates removed, and transaction costs reduced, trade and investment in the region can get a big boost. Also with money creation under regional guidelines, there would be better prospects of synchronization of inflation, interest rates and GDP growth, all of which can contribute to accelerated growth and poverty reduction. In fact, a common currency regime can eventually play an important role in convergence towards a target of 7-8 per cent per annual GDP growth for all countries of the region which is essential for virtual elimination of absolute poverty in the region within a generation or so.

Timeliness of the Proposal

The spirit of enhanced monetary cooperation is very much in the air in Asia today. In 1997, in the wake of financial crisis in 1997, the Japanese authorities made a proposal for an Asian Monetary Fund (AMF). It was basically a sound proposal but was discarded immediately, partly because of the inadequate technical preparation and partly because of the conflict of interest with the major power in the global financial infrastructure. Since then, some of the basic ideas of AMF have resurfaced in other garbs. Chiang Mai Initiative has been able to put together a contingency fund of over $ 30 billion which can be activated, though under somewhat difficult rules and regulations, to help in balance of payments difficulties of member countries in East Asia. The Asian Bond Fund created under the leadership of Thailand also has a major potential for financing regional investments through public as well as private sector. South Asia should not lag behind in the area of monetary cooperation.

Importance of Parallel Currency as the Initial Step

For effective progress in regional currency reforms, it is important to make a distinction between parallel currency and common currency. Common currency means that individual countries do not have their own currency and whole task of currency creation and monetary

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This Policy Brief is based on a note on the subject prepared by Dr. Ramgopal Agarwala, Senior Advisor, RIS.

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policy is agreed at a regional level with agreements on national component of currency and money creation. Interest rate and exchange rate policies are also centralized. That system thus requires surrender of monetary sovereignty and of seigniorage associated with currency creation and monetary expansion.

Parallel currency on the other hand requires no such surrender of sovereignty. It requires little more than is what is being achieved even at the global level though creation of Special Drawing Rights (SDRs) under the International Monetary Fund. Individual countries will retain control of their currencies and monetary policies. But in addition there will be a currency created jointly according to certain rules and allocated among the member countries. There are important questions about the weightage of different currencies in the basket, about predictability of the value of the composite currency and about the extent of its usage by the general public. However, these are technical problems, which can be solved, even in the current context of South Asian cooperation efforts. In the context of European integration movement, the first stage was introduction of European Currency Unit (ECU), a composite monetary unit consisting of a basket of European Community currencies and the process of consolidation under European Monetary Union (EMU) before gradual evolution to the single currency, Euro. It is interesting to note that Robert Mundell, the Nobel Laureate and an authority on global monetary matters (sometimes called "Father of Euro"), in his recent lecture at Asian Development Bank argued that while Asia may not be ready for common currency it might be for a parallel currency. The same goes for South Asia. We can start immediately with a parallel currency which will be a currency composite of South Asian currencies and may perhaps be called SAR (South Asian Rupia).

Characteristics of a South Asian Parallel Currency

The parallel currency SAR will be fully convertible into any international currency and will be fully backed by reserve fund. It will be legal tender for cross country transactions within South Asia and will be increasingly used as unit of account for trade and investment transactions within the region. The issue of stability of SAR will of course be important. However, it should be noted that relative values of currencies in South Asia in the last ten years have been more stable than those between the three major world currencies, US$, Euro and Yen which dominate the SDR. And with increasing co-operation in macro-economic policies including exchange rate policies, South Asian can do even better. The policies followed in India and the relative stability of India's real effective exchange rate is a model to draw upon. At the initial stage, it is not necessary to enter into strict criteria on macro-economic policies. In the good old tradition of the British, the finance ministries in the region have been generally conservative and prudent and the record on inflation has been generally good. Shared understanding on macro-policies can improve upon this already good record.

Conditions for Regional Integration and Eventual Common Currency

South Asian countries can create a pool of foreign exchange reserves of say of 10 per cent of the current reserves of South Asian countries (which will amount to more than $11 billion equivalent) in an institution to be called, say, South Asian Reserve Fund (SARF). Backed with these reserves, SARs equivalent of a multiple of basic reserves can be created to be used for giving loans or buying bonds issued by South Asian governments or corporations as appropriate. The lending rates on these loans will be higher (say 5 per cent per year at present) than the interest paid on reserves (say 3 per cent per year at present) which will be higher than what most reserves banks in the region are getting today from their dollar reserves.

As the SAR gets accepted the SARF can earn profits which will be distributed among members as grants for development purposes. The principle of creation and utilization of SDRs for development purposes has been advocated by a long line of economists. Most recently, Amartya Sen, Joseph Stiglitz and George Soros made a joint call for further issuance of SDRs for facilitating world economic recovery and development. At a regional level, these proposals can be implemented by us for the benefits of the region and beyond, without waiting for approval by any non-regional entity.

Parallel currency can facilitate regional integration by funding provision of regional public goods in the area of transport and communication, energy, information technology and capacity building, biotechnology, food security, tourism and advanced science and technology. The improved provision of regional public goods can be a powerful supplement to programmes of regional free trade areas which are often frustrated by inadequate infrastructure for regional trade and investment.

The profits of the SARF (the seigniorage from the parallel currency) can be used to accelerate the process of convergence in the region as it happened in the European context. In allocation of profits of SARF, the less developed parts of the region can be given special and preferential treatment, which will help toward achieving a shared prosperity in the region.

Provision of regional public goods and concessional assistance for the lagging regions will help to build confidence in the region and facilitate bolder programmes such as open borders, labour mobility and common currency. The manner in which the bigger countries in Europe won the confidence of the smaller countries and helped to accelerate development of lagging will be a model for South Asia to learn from.

The Next Steps

The steps involved in the proposed process are: (a) creation of a parallel currency and associated agreements for its stability, (b) setting up of a reserve fund, (c) funding of regional public goods to promote trade and investment, (d) special and differential treatment of lagging parts of the region to help the convergence process in the region, and (e) building of mutual trust and confidence among the partners in the region. These steps will create conditions which are usually necessary for a common currency area.

SAARC Summit could take steps to set up a Working Group comprising of Central Bank Governors to evaluate the feasibility of the proposal and take it forward.

The parallel currency and the proposed institutional set up can thus make an important contribution towards realization of the Prime Minister's vision of an integrated South Asia region with open borders, labour mobility and common currency.

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- *Reforms, Labour Markets, and Social Security in India* by Ramgopal Agarwala, Nagesh Kumar and Michelle Riboud, (eds), Oxford UniversityPress, New Delhi for the World Bank Institue and RIS.
- *Indian Industrial Tariffs: Towards WTO Development Round Negotiations* by Rajesh Mehta. 2003.
- *Protecting Foreign Investment: Implications of a WTO Regime and Policy Options* by Carlos Correa and Nagesh Kumar, Zed Books Ltd., London and Academic Foundation, New Delhi in association with RIS, 2003.
- *Globalization and the Quality of Foreign Direct Investment* by Nagesh Kumar, Oxford University Press, New Delhi, 2002.
- *India-ASEAN Partnership in An Era of Globalization: Reflections by Eminent Persons,* RIS, New Delhi, 2002.

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- *Asian Biotechnology and Development Review,* Volume 6 No. 1, November 2003.
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