Stable domestic and external monetary conditions are a necessary but not a sufficient condition for economic development. Monetary stability makes development possible. But no tricks of monetary policy—certainly not artificially low interest or exchange rates, despite the claims that are sometimes made for them—can truncate the long, slow grind of accumulating human and other capital and building economic, political and social institutions that leads to sustained increases in incomes. Monetary instability—high and unstable inflation, balance of payments problems and currency inconvertibility, a wildly fluctuating external value of domestic currency, high costs and difficulties of access to debt by credit-worthy borrowers—is hugely damaging to development, and can block its prospects while it persists.

The crucial question about the choice of exchange rate regime—for a small country, the choice between monetary integration with a larger country or region and monetary independence—is therefore whether it is likely to help or to hinder the maintenance of stable monetary conditions over long periods.

Here I will discuss mainly the choice of exchange rate regime in the larger island countries of the Southwest Pacific which currently have independent currencies managed by their own central banks, and whether the development prospects of these countries would be better if they opted for use of an external currency. I have the case of Papua New Guinea most strongly in my mind, but much the same issues arise in Solomon Islands, Fiji, Vanuatu and the smaller economies. The smaller the economy the weaker the case for monetary independence, so if it cannot be made for Papua New Guinea, it is unlikely to be compelling in any other of the island economies.

This paper addresses four issues. The first is the identification of the regimes amongst which a choice can sensibly be made. The second is whether the use of an external currency would create a ‘currency area’ that would be more helpful to economic development than monetary independence. The third is whether, if monetary independence were likely to be optimal in theory, it would be superior in practice to integration into an external currency area,
given the likely qualities of monetary policy at home and in the best alternative monetary area. The three issues are interrelated.

This paper supplements recent work by Duncan (2005). It supports Duncan’s conclusion, that the South Pacific economies would provide themselves with a firmer monetary base for economic development if they were anchored firmly to an external currency. It provides some additional information and analysis that strengthens the case beyond that made by Duncan, arguing for a single or series of South Pacific currency boards linked to the Australian dollar or, better still, for all of the countries concerned, but more difficult to achieve, to a new currency formed through monetary union between Australia and New Zealand.

**Currency and exchange rate regime choices**

Economic exchange is facilitated by use of a common unit of account. The use of separate currencies in different countries and regimes raises transactions costs in international trade and investment. So why doesn’t the whole world use a single currency?

There have been times when large parts of the world did use what was in effect the same currency. The purest form of global monetary union was the use of the ‘gold standard’ by many countries throughout much of the nineteenth century and into the early part of the twentieth century. Many countries applied a strict monetary regime, in which their monetary authorities (public or private) converted gold into domestic currency at a fixed exchange rate and undertook to convert whatever domestic currency was offered for sale or purchase at that exchange rate. The supply of domestic currency could only be increased if the country ran a balance of payments surplus, which would increase the domestic banking system’s holdings of gold. If a currency area ran a balance of payments deficit, its holdings of gold would decline, forcing the contraction of the domestic money supply. With many currencies pegged firmly to gold, they were in practice pegged to each other.

The currency boards that were used in many colonies until well after the breakdown of the gold standard in the 1930s and 1940s worked in much the same way. As an early example of a currency board-type mechanism, up until the Great Depression of the 1930s Australian banks would issue Australian currency that was backed by gold or by reserves of pounds sterling, the latter currency itself being based on the gold standard. Fiji had a currency board system backed by the pound sterling until about the time of independence. The monetary authority issued distinctive Fiji notes and coins, but these were all fully backed by pounds sterling. If there were a balance of payments surplus, the banking system’s holdings of foreign exchange would rise, and with it the domestic money supply. This would expand domestic demand and economic activity, in the process correcting the payments surplus. These mechanisms would work in reverse with a balance of payments deficit. There was free, two-way convertibility of the Fiji dollar into foreign exchange. The exchange rate of the Fiji dollar against the pound was firmly fixed.

Vanuatu was a special case, with the French authorities running a currency board backed by the French franc, and the British authorities accepting the Australian dollar as legal tender. The people of the old condominium of the New Hebrides could choose to exchange goods and services in Pacific francs or in Australian dollars. The two currencies were used side by side in the markets of Vila. If one was more inflationary and vulnerable to devaluation than the other, people would be inclined to hold the stronger currency as a store of value, so the relative
amounts of the two currencies on issue in the confederation varied over time.

The gold standard was effective in reducing transactions costs in and facilitating international trade and investment. It kept interest rates reasonably close together in countries with similarly credit-worthy borrowers—with lower interest rate penalties for less well known and smaller economies than emerged in the later era of independent currencies. There was no scope for the government to expand economic activity by printing money, thus removing what was to become a persistent source of monetary instability. There was no room for protracted balance of payments crises of the kind that characterised many developing economies in the era of independent central banks.

The gold standard’s disadvantage was that a country would be forced into immediate monetary contraction whenever it had an external payments deficit and (less commonly seen as a problem) into potentially inflationary expansion when it had a payments surplus. This imposed costs of adjustment to phenomena that might turn out to be temporary, and sudden change on economies that might have experienced less stress from more gradual adjustment financed by some domestic monetary expansion.

Papua New Guinea and Solomon Islands simply used the Australian dollar until independent central banks were established around the time of independence. This carried most of the disadvantages and advantages of the currency board. In the absence of domestic currency issue, the profits from the note issue went to the Australian rather than the domestic authorities.

In the industrialised world, after the Second World War, an attempt was made to re-establish some of the advantages of fixed exchange rates on a global scale that had been provided by the gold standard, but with provision for more gradual adjustment when countries had external payments imbalances, and for occasional adjustments of exchange rates when their economic conditions had moved a long way out of line from their trading partners. Within the ‘Bretton Woods System’, which operated until the early 1970s, independent central banks in the major industrialised economies were able to exercise discretion on rates of monetary expansion. The exercise of this discretion in very different ways in different countries—some applying much more expansionary and inflationary policies than others—led to the breakdown of the Bretton Woods arrangements, and the movement of most large economies and eventually others as well to more-or-less freely floating exchange rates.

Once the major currencies were floating against each other, smaller currencies could no longer choose to have a fixed exchange rate against all of their economic partners’ currencies. They could fix their exchange rate against one external currency—rigidly through a currency board, as the Hong Kong monetary authorities chose to do against the United States dollar in 1984; or as a matter of policy that could be varied from time to time, as Papua New Guinea did against the Australian dollar for the first couple of years after independence. Or they could fix their currency’s exchange rate more or less firmly against a basket of currencies. Or they could float their currencies, allowing external value to vary with supply and demand, with the monetary authorities undertaking transactions to influence the exchange rate heavily, occasionally or not at all.

The breakdown of the global system of more-or-less fixed exchange rates increased transactions costs in international trade and investment. This was most damaging to relatively small economies which sought to maintain monetary independence. While
there were deep international markets for the currencies of the major industrialised countries, much knowledge of their value and how it was changing from time to time, and well-developed mechanisms for hedging exchange rate risk, there was little trade in or understanding of the value of currencies of small developing economies. Exchange risk was a significant deterrent to trade and investment with the small economies—the more so for economies with badly managed independent currencies.

These realities were not well understood at the times of independence in the South Pacific countries. Each of the larger South Pacific countries chose full monetary independence. In practice, the independent monetary systems were closely similar to those of Australia and New Zealand at the time: a central bank with the full range of powers usually available to industrialised countries’ monetary authorities, including powers to set the rate at which domestic currency was converted into foreign exchange, power to create money for lending to the government, and powers and mechanisms for controls on conversion of domestic currency into foreign exchange.

In Papua New Guinea at least, there was considerable discussion of the relative merits of alternative monetary systems around the time of independence. The ultimate choice of monetary independence, managed by a fully fledged central bank, was strongly influenced by sentiment, encouraged by advisers from the Reserve Bank of Australia, that this was a normal and therefore necessary aspect of political independence.

The global monetary system has changed a great deal since these decisions were made thirty years ago. Movements of capital across national borders have become much larger and more volatile. Amongst other things, this has made it harder and more costly for central banks to enforce exchange controls or preferred exchange rates for their domestic currencies. Economic crises in many countries have demonstrated the risks of domestic monetary expansion in response to domestic or external macro-economic problems. There is greater awareness of the damage to economic development that comes with high inflation, exchange rate instability and a high supply price of investment.

So now is a good time—better late than never—to review fundamentally the South Pacific economies’ choices of monetary systems and exchange rate regimes.

The most basic choice—now and thirty years ago—is whether to maintain a fully independent monetary system, managed by a central bank with the full range of powers; or to use an external currency directly (‘dollarisation’); or to establish a currency board, which issues domestic currency under rules that tightly constrain domestic monetary expansion and the exchange rate of the currency.

Whatever the basic choice amongst these three alternatives, there are many subsidiary decisions to be made about the way in which the system is managed.

If the choice of a fully independent monetary system were confirmed, the subsequent policy decisions would include the choice of exchange rate regime (freely floating, pegged against a particular currency or a basket, or somewhere in between). They would include choice on the degree to which central bank decisions were to be independent of government, and the mechanisms through which the preferred extent of independence was to be secured. They would include choice of objectives of monetary policy—low inflation, or stable domestic economic activity, or exchange rate stability, or some combination of these and other goals.

If a decision were taken to use an external currency, a choice would need to be made among possible currencies.

If a currency board were chosen, much would hang on decisions on whether the
board were able to lend at all to the government. A crucial decision would need to be made on the currency against which the domestic unit was to be pegged.

The theory of optimal currency areas

Should the South Pacific economies continue to maintain full monetary independence, or would it be economically optimal to integrate some of them with each other or with other currencies into an ‘optimal currency area’?

The economic theory emphasises four factors which determine whether it is economically advantageous (‘optimal’) for two or more countries or regions to be joined by use of a single currency (Mundell 1961).

The first consideration is the effect of the sharing of currencies on transactions costs. The gains from monetary union will be greater the greater the proportion of international trade and investment transactions that the members conduct with each other. For most of the South Pacific, this makes Australia (or Australia and New Zealand if these economies were ever joined in a single monetary area) a prime target for monetary union. Transactions costs with the world as a whole are less if they are conducted in a currency that is widely known and understood. The Australian dollar does not fare badly on this criterion (being one of the half dozen or so most traded currencies), but if this were the only factor, a stronger case could be made for the United States dollar. Transactions costs argue strongly against full monetary independence for a small developing economy: most potential trade and investment partners will know little about the currency and will therefore apply a risk premium to any transaction in which it plays a part. Not even the best known of the independent South Pacific currencies, the Papua New Guinea kina, has its value quoted continuously in the standard sources of international financial information, or daily in the financial media of any industrialised country.

Second, countries are more likely to form part of an optimal currency area if they are subject to similar or at least positively correlated shocks. The most important external shocks felt by South Pacific countries are fluctuations in the terms of trade, most importantly with fluctuations in the prices of mineral and agricultural commodities on world markets. Duncan and Xu (2000) and Xu (1999) have shown that the correlations between the movements of Papua New Guinea and Australian terms of trade are close enough to make some case that the two economies are members of an optimal currency area. The correlation has become closer in the early twenty first century, with the relative importance of minerals and energy in exports rising in both countries.

Both economies also receive domestic shocks, which are not correlated. In Australia, the monetary expansions and asset booms of the late 1980s and early years of the twenty-first century had significant destabilising effects. The domestic shocks are larger in Papua New Guinea: the civil war in Bougainville; the periodic macroeconomic instability due to undisciplined government fiscal deficits from time to time through the 1990s. If Australia and Papua New Guinea were joined in a single currency area, Australian domestic shocks are unlikely to be significant sources of destabilisation in Papua New Guinea, especially under the steadier fiscal and monetary policies in Australia since the recession of 1991–92. Real domestic shocks from episodes of civil disorder or natural disaster are going to be damaging in Papua New Guinea whatever the monetary system, but being part of a larger currency area would prevent the compounding of the initial shock by domestic monetary instability. The damaging domestic
shocks of the 1990s, deriving from excessive money creation to fund government deficits, would be avoided by well-structured monetary integration.

Third, an economy can readily form an optimal currency area with another country or region if it has a high degree of price flexibility, or if labour and capital move freely between the two economies. Papua New Guinea now has a high degree of factor price flexibility: regulated urban wages (historically the most important price rigidity in the economy) have become much less significant since the abolition of the separate urban minimum wage in 1992. Wage rigidity is now less important in Papua New Guinea than in any but a few economies.

The transactions costs of monetary independence are high in an economy as small as Papua New Guinea, and much larger still elsewhere in the South Pacific. De Brouwer (2000) has commented that the presence of any one of the three components of an optimal currency area (the second, third and fourth factors above), or the presence of any one of them in some degree, would make the case for some form of monetary union. Monetary union of South Pacific countries (first of all Papua New Guinea) with Australia would be supported by all three elements of the case for an optimal currency area. The case would be weaker for monetary integration with other industrialised economies.

The quality of monetary policy

The quality of independent monetary policy depends on the strength of institutions, the nature of government and the professional capacity of the people who make the system work. The quality of monetary policy within a larger currency area depends on these factors in the country which is managing policy—in the case of use of the Australian dollar or of an Australian dollar-based currency board, on the quality of monetary policy in Australia.

The Australian dollar now more than at any time since monetary independence in the South Pacific provides a non-inflationary and relatively stable peg for South Pacific economies. In the 1970s, a case could be made that monetary integration with Australia meant acceptance of damagingly high inflation and interest rates, and that the excellent conduct of independent monetary policy in a South Pacific economy might do better. Indeed, a case could be made that sound macroeconomic policy in Papua New Guinea in the decade and a half after independence gave that country better monetary outcomes than if it had used Australian currency or a currency board based on the Australian dollar.

But if Papua New Guinea secured some benefits from relatively stable monetary conditions and low inflation for some time after Independence, these were small compared with the large losses it suffered from excessive fiscal deficits, monetary instability and expansion, recurrent balance of payments crises and currency inconvertibility in the 1990s. Monetary instability was one and possibly the main economic policy cause of the 1990s being Papua New Guinea development’s lost decade. The outcomes over this period were similarly poor in other major South Pacific economies, and catastrophic in Solomon Islands.

Substantial monetary reforms, including the legislation of a high degree of independence for the Bank of Papua New Guinea secured a much firmer base for monetary stability after 1999. Supported by firmer fiscal policy since then, the monetary outcomes have been much better in the early years of the twenty-first century. Inflation has fallen to the low levels of contemporary industrialised economies. Interest rates have fallen to economically reasonable levels. External payments crises and currency
inconvertibility have been avoided. The exchange controls inherited from the Reserve Bank of Australia (and abolished in Australia in December 1983) have largely been removed.

This time of restored quality in Papua New Guinea monetary policy may seem to be one in which the advantages of use of an external currency or of a currency board are reduced, and therefore less necessary than in the preceding decade. But while the quality of policymaking recently has been high, as it was in the early independence period, the risks of monetary instability remain. The costs of instability to development are extremely high, and insurance against its recurrence is valuable.

A way forward

Papua New Guinea and other South Pacific countries with independent monetary systems would receive large benefits from monetary integration with Australia, through reduction of international transactions costs, and through removal of the risk of recurrence of the extreme monetary instability of the 1990s. The currency areas so formed would have the qualities of ‘optimal currency areas’ in unusually high degree.

Currency boards would seem to be the practical form of monetary integration. National entities would retain the symbolic value of distinctive notes and coins. They would secure the profits on the issue of notes and coin without complex negotiation. The benefits would be substantially the same as those from ‘dollarisation’, so long as the rules of the currency board made it impossible to lend to governments, to change the exchange rate under any circumstances, or to change the rules of the currency board. The irreversibility of the arrangements would be more secure and more credible if the rules were embedded in an international monetary agreement.

The currency board could be based on the Australian dollar. It would be better still if it were based on a currency created by monetary union between Australia and New Zealand. Amongst other things, this would be easier to embed in credibly binding international agreements. I myself am of the view that monetary union between Australia and New Zealand would have advantages for those two countries, including through the entrenchment of central bank independence (see also Grimes et al. 2000 for a New Zealand view). Considerable convergence between objectives of and approach to monetary policy in Australia and New Zealand in the early years of the twenty-first century has created a favourable environment for consideration of these matters. However, the issue of currency union across the Tasman will be discussed independently of the South Pacific monetary issues, and can be put aside until it has emerged as a real possibility.

Would it be better to have a multi-country South Pacific currency board, or separate national boards? The costs, especially in terms of scarce professional personnel, are not small, and there would be economies of scale in having a single board. This would not be inconsistent with issue of national notes and coins in individual countries. But the prospects of advantages of a single entity are not so large that they should be allowed to hold up progress on national boards, if they become politically acceptable ahead of a South Pacific arrangement.

It has to be acknowledged that the central banks in the region, first of all in Papua New Guinea, are at present amongst the most effective public policy institutions in the country. While good use could be made of the human talent that they now utilise in countries in which such talent and experience is scarce and valuable, it would be a pity if the institutional strength were dissipated.
It need not be. The central banks would retain their roles in management of the currency issue and in investment of the foreign exchange reserves of the system. They would retain important current roles in supervision of financial institutions. And alongside these supervisory responsibilities, they could usefully continue to play a valuable role in independent commentary on the economy and economic policy.

References


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