

A Concept Paper on Common Currency in SAARC Countries: Problems and Prospects

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Abstract: *This paper explores SAARC countries' readiness to espouse a common currency in the region. Using the concept of standard economic procedures & practical experiences of adoption of Euro by the European Union (EU) and given the present status of economic integration, the paper finds that South Asian countries are not yet prepared to adopt either a common currency or a parallel currency in a foreseeable near future. The paper indicates that as per the 'Theory of Economic Integration' the SAARC countries are now under process of satisfying the prerequisites of second stage i.e. free trade area which is yet to be completed to reach successive phases of customs union, common market, economic and monetary union for achieving complete economic integration process in the South Asia. Finally, adoption of a common currency or even a parallel currency will depend not only on the political commitment but also on the capacity to resolve physical and non-physical barriers to trade and cooperation among the SAARC member countries.*

Key words: Common Currency, Economic Integration, International Trade, International Policy Coordination.

JEL Classification: E58, E63, F15, F42

The South Asian Association for Regional Cooperation (SAARC) was originated in 1985 with a view to promoting welfare and improving quality of life of the people of its member countries through enhancing active collaboration and mutual assistance for accelerating economic growth, social progress and cultural develop-

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ment. In the way of its last 28 years journey and from the experience of many powerful economic groupings of the world, the leaders of the SAARC nations meanwhile have realized that in order to develop SAARC as a stronger economic group, enhanced economic cooperation and harmonization of macroeconomic policies in the region are essential. Following this realization, the Heads of States or Governments of SAARC countries at their 10th SAARC Summit held in Colombo on 29 July 1998 agreed, in principle, to establish a "Network of SAARC Central Banks Governors' and Finance Secretaries' (SAARCFINANCE)" for opening dialogues on macroeconomic policies of the region and sharing mutual experiences and ideas. Later on, the Heads of States or Government of SAARC countries at their 13th SAARC Summit held in Dhaka during 12-13 November 2005 decided to engage their finance ministers to draw a roadmap for regional cooperation in South Asia for the next decade and to visualize the vision of South Asian Economic Union (SAEU) in a phased and planned manner. Accordingly, the First Meeting of SAARC Finance Secretaries which preceded the First Meeting of SAARC Finance Ministers held in Islamabad, Pakistan during 10-11 July 2006 recommended for forming an 'Inter-Governmental Expert Group (IGEG) on Financial Issues' to implement the directives of the 13th SAARC Summit. Subsequently, the Finance Ministers of the region and the officials associated with the SAARCFINANCE & SAARC-IGEG on Financial Issues have assembled a number of occasions to intensify regional economic cooperation. The process of this regional cooperation has been accelerated in the recent years with the region's integration into the system of globalization where the SAARC countries' overall performances in terms of achieving higher real GDP growth rates are also encouraged to go forward for further intensifying regional economic cooperation and materializing the ultimate aspiration of creating South Asian Economic Union (SAEU) and introducing a common currency in SAEU in a rapid way as per direction of the 13th SAARC Summit held in Dhaka.

2. Meanwhile, some member countries such as India has shown their curiosity to introduce parallel currency at least within three or more countries under the consideration of introducing common currency may take a large time to realize and the region as a whole may not even be ready to adopt parallel currency given the present state of economic integration and geopolitical reality. Under these circumstances, the basic purpose of this paper is to exploring SAARC countries' readiness to espouse a common currency in the region. Using the concept of standard economic procedures & practical experiences of adoption of euro by the European Union (EU) and given the present status of economic integration, SAARC countries' juncture to adopt common currency will be explored and possibility of espousing a common currency or parallel currency even with some limited number of SAARC member countries including Bangladesh will also be examined.

3. As the countries in any geographic region vary with respect to their economic,

political and social conditions; it is difficult to illustrate any single standard theory in introducing common currency within an economic region. So, there is no compatible economic theory on implementing common currency within a fixed geographical region. However, some economists, in their respective literatures, tried to explain the economic rationale behind the implementation of common currency depending on experiences of various nations. The 'Theory of the Optimum Currency Area (OCA)' appeared in the early 1960's as a result of the seminal work of Mundell (1961), along with the subsequent works of McKinnon (1963) and Kenen (1969). All the economists argued that the implementation of common currency depends on satisfying some common characteristics within the currency area which result in an improved welfare of the population of its residents. The common characteristics, mostly known as OCA properties, are: (i) mobility of labor and other factors of production; (ii) price and wage flexibility; (iii) financial market integration; (iv) economic openness; (v) diversification in production and consumption; (vi) similarity in inflation rates; (vii) fiscal integration; and (viii) political integration. The area/region that satisfies these criteria becomes an optimal currency area. Similarly, the 'Theory of Economic Integration' suggests that to introduce a common currency in any region, the following phases of economic integration are needed to be satisfied: (i) making preferential trading area (with reduced customs tariffs among certain countries); (ii) making free trade area (with no internal tariffs on some or all goods among the participating countries) (iii) making customs union (with the same external customs tariffs for third countries and a common trade policy); (iv) making common market (with common product regulations and free movement of goods, capital, labor and services); (v) making an economic and monetary union (a single market with a single currency and monetary policy); and (vi) completing economic integration (all the above plus harmonized fiscal and other economic policies). The European experience also reveals that the Euro did not spring forth full-blown on January 1, 2002 rather it took a very long, erratic and laborious process to gestate the common currency-Euro starting since the early 1950s by establishing the European Payment Union. In fact, the European experience does suggest that the adoption of a common currency is the last step of the process of regional economic integration, and hence takes a long time. Now, given this reality it has to be identified that how much progress the SAARC countries have achieved in terms of economic integration and what are the outcomes so far of this integration process.

4. It may be noted that with the adoption of SAARC Preferential Trading Arrangement (SAPTA) at the seventh SAARC Summit held in Dhaka during 10-14 April 1993² SAARC countries formally start its first phase to promote trade relations and remove trade barriers among member countries. The second phase of

² Although SAPTA was adopted at the 7th SAARC Summit in 1993 but it came into force on 7th December 1995 after finalizing all of its modalities by some technical meetings.

economic integration started with the agreement on South Asian Free Trade Area (SAFTA) being implemented from 2006. With this agreement SAARC has entered into a new horizon to create a free trade area of 1.8 billion people for 7 countries³; namely, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka. The seven foreign ministers of the region then signed an agreement on SAFTA to reduce customs duties of all traded goods to zero by the year 2016 in a phased manner. This means that SAARC countries have entered into the second phase of economic integration which is yet to be completed to reach third stage, i.e., customs union. But it is unfortunate that SAFTA is facing numerous challenges like non-tariff barriers and immobility of factors of production due mainly to lack of political commitment and shortage of appropriate technical expertise in the relevant fields for most of the SAARC countries to implement the agreement. As a result, the interregional and inter industrial trade among the SAARC countries are still remaining at a nascent stage. A recent study of Asian Development Bank indicates that although the share of trade over GDP⁴ of SAARC countries have increased over the last two decades but inter-regional trade among these countries is very low as compared to ASEAN and it is even lower than the other economic blocks of Central Asia (Table-1). Available data show that on an average only around 5% total international trade takes place among the SAARC countries which is over 26% in ASEAN and jointly over 12% in the countries of two Central Asian economic blocks⁵.

Table 1: Comparative Intra-regional Trade Shares of South Asia, ASEAN and Central Asia

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | Average (2001-2011) |
|----------------|------|------|------|------|------|------|------|------|------|------|------|---------------------|
| SAARC | 4.8 | 5.2 | 6.2 | 5.8 | 6.0 | 5.1 | 5.2 | 4.3 | 4.2 | 4.5 | 4.3 | 5.05 |
| Central Asia* | 6.0 | 6.0 | 6.0 | 6.0 | 6.0 | 6.0 | 6.0 | 6.0 | 6.0 | 6.0 | 6.0 | 6.00 |
| Central Asia** | 8.1 | 7.3 | 6.4 | 8.6 | 7.8 | 6.8 | 6.3 | 4.2 | 5.3 | 6.0 | 5.6 | 6.58 |
| ASEAN 10 | 24.0 | 24.4 | 26.6 | 26.7 | 27.2 | 27.1 | 26.9 | 26.7 | 25.9 | 26.3 | 25.9 | 26.15 |

Source: Draft SAARC-ADB Study on "Regional Economic Integration in SAARC, its current extent and recommendations for further deepening", 2013

- SAARC- Afghanistan, Bangladesh, Bhutan, India, Maldives, Pakistan, Nepal and Sri Lanka
- ASEAN 10 - Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam.
- Central Asia* - Afghanistan, Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyz Republic, Pakistan, Tajikistan, Turkmenistan, and Uzbekistan

³ Afghanistan became the 8th country of SAARC in the 14th SAARC summit held on 3 April, 2007 at New Delhi, India after the introduction of SAFTA.

⁴ Total trade as percentage of GDP also represents the status of openness of an economy.

⁵ It is true that the share of SAARC countries inter-regional trade can be altered if informal trade is taken account but this should also be considered that informal trade gets momentum where openness of the economies are restricted by trade barriers.

- Central Asia** - Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan

There has thus far been little progress in South Asia on a sequenced adjustment path towards regional integration, as is evidenced by the still very low share of regional intra trade in total external trade of the regional countries. The small share of inter-regional trade in SAARC countries mainly originates from the lack of sufficient complementariness of exportable items. If we consider the major export items of all SAARC countries, it will be found that export items of all SAARC countries are almost similar to each other due to similar comparative advantage profiles. Moreover, the inter-regional trade potentials are restrained by numerous tariff and non-tariff barriers such as Sanitary and Phyto-Sanitary (SPS) measures, Technical Barriers to Trade (TBTs) and other related measures; tariff quota and anti-dumping measures; licensing requirement etc. Another significant barrier to expansion of inter-regional trade in the SAARC countries is of existence of a huge number of sensitive lists. It has been observed that although the working group on reduction of sensitive lists under SAFTA has completed its task of reducing the sensitive lists by 20% within January 1, 2012; a remarkable number of items under sensitive lists are still remaining in almost all SAARC countries (Table-2).

Table 2: Revised Sensitive Lists of the Member Countries

| Member State | No. of products in the earlier sensitive lists (before reduction) | Number of products in the revised sensitive lists (Phase-II) (after reduction) |
|--------------|---|--|
| Afghanistan | 1072 | 858 |
| Bangladesh | 1233 (LDCs); 1241 (NLDCs) | 987 (LDCs); 993 (NLDCs) |
| Bhutan | 150 | 156 |
| India | 480 (LDCs); 868 (NLDCs) | 25 (LDCs); 614 (NLDCs) |
| Maldives | 681 | 154 |
| Nepal | 1257 (LDCs); 1295 (NLDCs) | 998 (LDCs); 1036 (NLDCs) |
| Pakistan | 1169 | 936 |
| Sri Lanka | 1042 | 845 (LDCs); 906 (NLDCs) |

Source: SAARC Secretariat, 2013.

Moreover, poor trade facilitation, insufficient regional investment cooperation and underdeveloped capital markets in most of the SAARC countries are also considered as large hindrance to boosting up inter-regional trade in SAARC countries. It is, therefore, with the present-state of South Asian economic integration in trade liberalization, investment cooperation, capital markets development, trade facilitation (custom, standards, transit and logistic), cross-border connectivity, energy sector cooperation and the current institutional structure to facilitate realization of the South Asian Economic Union to introduce common currency within the region may not be possible in a foreseeable near future. In fact, introducing a common regional currency needs to be preceded by decades of resolute work towards deep-

ening regional economic integration, from tariff harmonization (customs union) onward to fiscal and monetary union, entailing substantial pressure of readjustments in existing production structures in the member economies in face of resistance from sectors under adjustment pressures.

5. We also need to remember that Eurozone's current problems with their common currency arose from their monetary union taking place before sufficient fiscal integration, which is making little or no headway even now. What has proven difficult for affluent European Union will obviously be more complex for the much poorer South Asia; and a better off ASEAN region with much higher level of intraregional trade than South Asia is making no attempt at a common currency. In this context, considering introduction of a common currency in South Asia will be far too premature at this stage, though desirable as a long term objective in the interest of better regional and global stability. Now, let us turn our focus on the consideration of introducing a parallel currency within the SAARC region or even with limited number of SAARC member countries including Bangladesh.

7. Robert Mundell suggested that the Asian currency would have to be a common parallel currency, used for international trade within Asia and with the rest of the world. Out of various currency options, he opted US dollar to anchor for a parallel currency in Asia. Mundell's observation can equally be applicable for South Asian countries. Because, although the major South Asian countries have common history but given the present stage of economic integration, mutual suspicion and in some cases mistrust towards each other, it will perhaps be very difficult, gauche and prolonged process of reaching a consensus for creating common currency among the existing eight SAARC countries. Realizing these difficulties and an uncertain lengthy way of reaching consensus of creating common currency in SAARC, some leading politicians and businessmen of this region are drifting the idea of introducing a parallel currency to promote regional cooperation in trade and investment, which can eventually prepare the ground for a common currency in their opinion. It may be noted that introducing common currency requires surrender of monetary sovereignty and seigniorage revenues associated with currency creation and monetary expansion by the member countries; because, an individual country can not print money and finance the deficit as per its own budgetary requirements. Parallel currency on the other hand, requires no such surrender of sovereignty. Individual country can retain control of its own currency and monetary policy. Normally, a smaller country which has very limited exposure to international markets adopts a bigger and internationally credible country's currency as parallel currency by pegging its own currency to that currency to expand its economic activities through attracting foreign investments and to maintain exchange rate stability. But sometimes a group of countries or a region as a whole may also adopt any one of their major currency or a new currency other than their any regional currency as a

parallel currency for avoiding currency conversion costs and risks of devaluation and to expand regional trade and investment. It may be noted that among the SAARC countries Bhutan has already started to use Indian Rupee as parallel currency. But Bhutan's case may not be equally suitable for Bangladesh for many reasons. Bhutanese are using Indian Rupee as a parallel currency in their country because of their huge trade dependency with India. It is notable that 75.7% of total Bhutanese exports destination was in India and 72.3% of their total imports came from India in 2011. At the same time, when we consider trade between Nepal and India it is found that 67.7% of total Nepalese exports destination was in India and 63.4% of their total import came from India in 2011⁶. On the other hand, although trade between India and Bangladesh is being increased in the recent years due to India's withdrawal of tariff on most of the Bangladeshi products but it has not yet reached to a significant level. Available figures show that only 2.3% of total Bangladesh's exports destination was in India while 13.6% of total Bangladesh's imports came from India in the same year as mentioned above (Table-3 and Table-4). Even in the recently past two fiscal years, the share of Bangladesh's total exports and imports with India remained almost at the same level. Moreover, trade between Bangladesh and the rest of the SAARC countries are also remained very insignificant with an unfavorable trade balance. It is most important to note that Indian Rupee is not world-wide fully convertible currency like US dollar and hence it cannot be conveniently used for investment of foreign exchange reserve or settlement of international payments outside SAARC. In addition to that, over the last two fiscal years Indian Rupee has depreciated not only against the US dollar but also against the Bangladesh Taka, which means Rupee is not much more stable currency than Taka. It may be noted that at the end of FY 2013 Indian Rupee depreciated by 21.1% from end of the FY 2011 against Bangladesh Taka and 33.5% against the US dollar while Bangladesh Taka depreciated by only 4.9% against the US dollar over the same period.

Table 3: Intra-regional export in South Asia (as % of total export) (in 2011)

| Country | Afghanistan | Bangladesh | Bhutan | India | Maldives | Nepal | Pakistan | Sri Lanka |
|-------------------|----------------|-------------|--------------|--------------|----------------|--------------|--------------|--------------|
| Afghanistan | na | - | - | 18.7% | - | - | 48.1% | - |
| Bangladesh | 0.0004% | na | 0.02% | 2.3% | 0.0005% | 0.07% | 0.36% | 0.08% |
| Bhutan | - | 5.8% | na | 75.7% | - | - | - | - |
| India | - | - | - | na | - | - | - | - |
| Maldives | - | - | - | - | na | - | - | 11.7% |
| Nepal | - | 2.9% | - | 67.7% | - | na | - | - |
| Pakistan | 10.5% | - | - | - | - | - | na | - |
| Sri Lanka | - | - | - | 5.2% | - | - | - | na |

(-)=insignificant; na= Not applicable.

Source: WTO database files, April 2013

⁶ If we consider unrecorded or illegal border trade these percentage shares of export and import may even be much higher than the recorded trade among Bhutan, Nepal and India.

Table 4: Intra-regional import in South Asia (as % of total import) (in 2011)

| Country | Afghanistan | Bangladesh | Bhutan | India | Maldives | Nepal | Pakistan | Sri Lanka |
|-------------------|--------------|------------|--------------|--------------|---------------|--------------|--------------|--------------|
| Afghanistan | na | - | - | - | - | - | 13.7% | - |
| Bangladesh | 0.04% | na | 0.06% | 13.6% | 0.004% | 0.14% | 1.99% | 0.08% |
| Bhutan | - | - | na | 72.3% | - | - | - | - |
| India | - | - | - | na | - | - | - | - |
| Maldives | - | - | - | 10.1% | na | - | - | 5.6% |
| Nepal | - | - | - | 63.4% | - | na | - | - |
| Pakistan | - | - | - | - | - | - | na | - |
| Sri Lanka | - | - | - | 22.1% | - | - | - | na |

(-)=insignificant; na= Not applicable.

Source: WTO database files, April 2013

Under the above stated circumstances, in terms of trade integration, although the existing OCA literature supports Bhutan's decision to establish and maintain a pegged exchange rate regime with India but it does not support introducing Indian Rupee as a parallel currency in Bangladesh or in other SAARC counties except Nepal. However, major South Asian economies like India may find it feasible to further liberalize their currency convertibility, permitting use of their currencies for international payment settlements by others, along lines now being tried out by China. SAARC countries may also think to introduce a third currency as their parallel currency for increasing inter-regional trade and also for increasing trade with rest of the world as per Mundell's observation on Asia⁷. But this will also certainly depend on satisfying some specific set of OCA properties of trade integration which SAARC countries have started by signing the SAFTA agreement.

7. A well coordinated and comprehensive efforts will be required to realize the ultimate vision of SAARC to transform it into a South Asian Economic Union (SAEU). For this, the existing SAFTA agreement will have to be implemented in a timely manner. SAARC Regional Standard Organization (SARSO) will have to be established to form a South Asian Custom Union and a priority will have to be given on free mobility of labor and other factors of production within the region by eliminating all existing trade barriers through tariff harmonization. Infrastructure and intra-regional connectivity will have to be improved and private sector initiatives will have to be encouraged particularly through the development of regional capital markets which are still remaining at a nascent stage in all the SAARC countries except India. An institutional development will also be required to visualize the vision of SAEU and as a first step of developing such institution; South Asian

⁷ It may be noted that in order to facilitate trade in South Asian countries including Iran and Myanmar have already created a system known as Asian Clearing Union (ACU) and a common artificial currency called ACU dollar already exists in ACU which can also be given physical shape after completing necessary steps of trade integration in the SAARC countries.

Development Bank (SADB) can be established with appropriate officials representing all SAARC countries.

8. Finally, considering the current status of economic cooperation and trade integration, it can be said that South Asian countries are not yet prepared to adopt either a common currency or a parallel currency in a foreseeable near future. And, the progress of the ongoing endeavor of creating a SAEU and finally adoption of a common currency or even a parallel currency will depend not only on the political commitment but also on the capacity to resolve physical and non-physical barriers to trade and all out cooperation in all spheres of activities by all the SAARC member countries.

9. What appears to be important at this stage is greater coordination of monetary & economic policies along with development objectives & strategies of the countries of the region. Some sort of formal mechanism for better coordination is the need of the future.

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