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Towards a South Asian common currency: Evidence from macroeconomic shocks

Krishna Regmi[********]
University of New Hampshire

My paper empirically assesses suitability of the South Asian common currency by testing for symmetry of underlying shocks. Following Mundell's (1961) seminal work, a key precondition for the formation of a successful monetary union is that member countries face similar types of shocks for coordinated macroeconomic policy response, which paves the way for a currency union. I apply structural vector auto regression (SVAR) approach to determine the nature of shocks affecting the South Asian nations and to find out whether the South Asian Association for Regional Cooperation (SAARC) forms an optimal currency area (OCA). Through this econometric methodology, two series of exogenous shocks namely demand and supply shocks, for each country are obtained, and the pair-wise correlation matrix of the demand and supply shocks is computed. Apart from obtaining important information about the symmetry and asymmetry of shocks, the paper compares the response of the SAARC economies to the shocks in terms of magnitude and speed of adjustment. This is important because having huge symmetric shocks and slow adjustment process affect relative international competitiveness among countries as they cannot use exchange rate as a tool to correct disequilibrium in the balance of payments. The paper examines the size and speed of adjustment through the impulse response function (IRF).

The results obtained through SVAR models suggest that macroeconomic shocks are quite heterogeneous in the SAARC countries; therefore, this region is not an OCA. The correlation results show that the contemporaneous shocks are not perfectly and strongly symmetric among the countries. An immediate enforcement of a monetary union in the SAARC would cause a huge cost to the member countries as their economies have to undergo a costly adjustment process amid asymmetric shocks to bring their respective balance of payments (BOP) into equilibrium. In particular, an immediate adoption of single currency can be ruled out. The paper argues that the SAARC countries should enhance

[********] Graduate student, Department of Economics, University of New Hampshire, krish.regmi@unh.edu, krishregmi@gmail.com

economic integration first and then liberalize trade further so that patterns of shocks would turn to be symmetric overtime.