

Customs unions, currency crises, and monetary policy coordination: The case of the Eurasian Economic Union

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Abstract

After achieving substantial progress in establishing a common customs territory and regulations, customs unions face potential disruptions due to a lack of monetary policy coordination. These disruptions might appear in the form of currency shocks and the ensuing trade conflicts. We approach this issue by looking at the case of the Eurasian Economic Union (EAEU). The volatility of national currencies in 2014–2015 resulted in sizable shifts in competitiveness, culminating in a currency crisis in some member states. This raises the questions of how to gradually achieve a more coordinated monetary policy, what monetary policy options are available, and what would be their relative impact on macroeconomic stability. Using a set of modeling tools and econometric models, we review three monetary regimes, which represent moves from fully independent exchange rate policy through increased policy coordination to joint exchange rate setting.

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1. Introduction

Despite widespread skepticism towards Eurasian economic integration, the five countries of the Eurasian Economic Union (EAEU) have thus far achieved a certain degree of success. Notably, a common market for goods and services has

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been established, with several important exemptions to be phased out according to the schedule specified in the 2015 EAEU Treaty. A common external tariff has been in effect since 2011. A common set of WTO-compliant technical standards is being elaborated. A common labor market has been in place since the beginning of 2015. The first EAEU free trade area (with Vietnam) was signed in November 2015; several further negotiation tracks are ongoing (Vinokurov, 2017).

An advanced form of monetary policy coordination remains a possibility at a later stage. The volatility of national currencies in 2014–2015 resulted in real exchange rate misalignments that could have diverted trade and culminated in a currency crisis in some cases, e.g., Kazakhstan. This turbulence engendered interest in stronger monetary coordination by gradually increasing it, exploring monetary policy options available to EAEU member states, and considering their relative impact on macroeconomic stability.

Theoretically, coordinating monetary policies in an economic integration bloc is desirable. This is particularly true when member states are simultaneously moving towards a single financial market. A single market with no common monetary policy could lead to imbalances and misalignments related to financial instability (e.g., multiplication of contagion and spillover effects, beggar-thy-neighbor exchange rate policies, and non-desirable arbitrage capital flows because of differences in inflation levels and interest rates).

More generally, these are the problems of a customs union facing potential disruptions due to a lack of monetary policy coordination. Viewed in this way, such issues could be relevant not only for the EAEU but also for the Gulf Cooperation Council (GCC), MERCOSUR, the South African Customs Union (SACU), and possibly ASEAN in the long term.

This paper assesses the benefits of monetary cooperation by using new Keynesian modeling tools for the five EAEU countries and a set of econometric models to assess the equilibrium exchange rate. We review three monetary regimes, which represent moves from fully independent exchange rate policies through gradually increased cooperation to jointly fixed exchange rates. The last option is similar to a full-fledged monetary union.

To analyze various scenarios, we present three sets of model simulations based on a dynamic stochastic general equilibrium (DSGE) system of models run jointly by the Eurasian Development Bank and the Eurasian Economic Commission (Demidenko et al., 2016). It covers the five EAEU countries and can be used to analyze economic processes, make projections, and develop proposals and guidance on streamlining economic policies within the EAEU. An important advantage of the Integrated System of Models is that it allows analytical and forecasting tools to be applied separately (to individual EAEU member states) and collectively (to the entire customs union), taking into consideration the links between the bloc's economies and the external world.

The paper proceeds as follows. First, we present a literature review on the choice of an exchange rate regime and discuss why monetary unions (and more generally various forms of monetary policy coordination) are introduced (or not) in a customs union. Second, we discuss some stylized facts on the recent exchange rate turbulence in the EAEU. Then, we discuss the “reality on the ground” in the Eurasian Economic Union regarding coordination of macroeconomic policies. In the next section, we present the results on model simulations. The final section concludes the paper.

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