Chapter 1: INTRODUCTION
1.1 Background

1.1.1 The establishment of the European Economic and Monetary Union (EMU) has evoked widespread interest in other countries and regions to group themselves into similar regional monetary arrangements. The interest in regional cooperative arrangements, of course, precedes by several decades the formation of EMU as witnessed by the earlier creation of ASEAN and other regional cooperation arrangements in Asia, Latin America, and Africa. Indeed, the two current monetary unions in Africa, namely, WAEMU and CEMAC, have a long history of respective single central bank and single currency (two principal characteristics of a monetary union) dating to colonial days. However, the history of the CFA franc zone also shows that the primary reasons for its creation were political rather than economic, and the French convertibility guarantee was (and still is) a crucial element explaining its durability. In contrast, the EMU was endogenously promoted, is self-reliant, and more of an economic/monetary union than a political one. Furthermore, unlike the two African monetary unions, the EMU has evolved over a long period of preparation and institutional and intra-regional cooperation in economic and financial sectors, and has set up an elaborate framework of institutional and surveillance mechanism to ensure its stability and sustainability. It is these characteristics of the EMU that have renewed interest in monetary unions, and in the case of Africa that interest is heightened by the perceived advantages of “scale” economies that could help Africa accelerate its growth and reduce poverty. Indeed, both WAEMU and CEMAC, learning from the past experience that led to the devaluation of CFA Francs in 1994, have only recently begun to “strengthen” the organizational and institutional set up by replicating some of EMU’s practices and procedures, including the setting up of EMU-type convergence criteria, and other related measures.

1.1.2 Over the longer period, the goal of a common African currency has been advocated by the African Union (AU) and its predecessor, the Organization of African Unity (OAU). For that purpose, the AU envisions prior creation of regional monetary unions in the existing African RECs as an intermediate stage leading ultimately to their merger into an Africa-wide monetary union. COMESA, EAC, and SADC, as well as other regions in West and Central Africa, have agreed on the creation of monetary unions among their respective member states and have set up specific programs of monetary and economic cooperation, including convergence criteria, to achieve that goal.

1.2 Optimum Currency Area

1.2.1 The theoretical basis for the creation of a monetary union among a number of countries is based on considerations relating to Optimum Currency Area (OCA). The benefits of single currency arise from the elimination of transaction costs, both deadweight costs and efficiency costs (by eliminating relative price distortions caused by transaction costs, and eliminating exchange rate uncertainty). In addition, if the introduction of the single currency is preceded by an effective regional financial integration, there will be further gains from economies of scale. To counteract possible actions of speculators (Mundell, 1961) against the single currency’s exchange rate, the benefits will be more sustainable the larger is the size of the currency union. More generally, benefits would be higher the greater the degree of intra-regional trade (“openness” of the economies), the greater the labor and capital mobility, the greater the symmetry of shocks (including monetary shocks), and greater the degree of adjustment provided by fiscal tools. This increased flexibility compensates for the loss of flexibility in the ability to adjust exchange rates and conduct independent monetary policy upon surrendering currency issue and monetary policy to the common central bank.

1.2.2 Further specific benefits also accrue if the prospective monetary union contains a country with stable macroeconomic history that serves as an “anchor” for the rest of prospective members. In that case, other countries can derive immediate benefits from their (prospective) membership in terms of lower interest rates on their public borrowing, close to those applicable to the public borrowing of the anchor country. This was the case for EMU where Germany served as an anchor country. Since the adoption of the Euro, interest rates of member countries are closely linked to those on German public...
bonds, with interest rate differentials reflecting (small) risk premium (until the current Greek crisis).

1.2.3 These theoretical considerations relating to costs and benefits from joining a monetary union were given practical application in the policy announcement by the British Chancellor of Exchequer for joining the EMU. He specified five economic tests, including the following three that mirror the above theoretical preconditions for OCA that must be met to make a “clear and unambiguous” case for the UK to join the EMU:

1. Are business cycles and economic structures compatible so that the UK and others can live comfortably with Euro interest rates on a permanent basis? (convergence test),

2. If problems emerge is there sufficient flexibility to deal with them? (flexibility test),

3. Would joining EMU create better conditions for firms making long-term decisions to invest in Britain? (investment test),

These tests were meant to demonstrate whether joining the EMU would increase the UK’s net welfare, but they could also be used to demonstrate if a number of countries wishing to form a monetary union would increase their aggregate welfare, without reducing any single country’s net welfare. These tests underscore the importance of economic and financial convergence and homogeneity, and structural flexibility in individual countries as the determining criteria for the formation of a monetary union, or joining one.

1.3 Are African Monetary Unions Realistic for Africa?

1.3.1 Many economists and officials of international financial institutions have expressed considerable skepticism about African countries’ ambition to form monetary unions. Their argument is based on: (i) the theoretical reasoning that these regions (or indeed all of Africa as a single region) do not satisfy the conditions making for an OCA, and (ii) Africa should concentrate its attention on more pragmatic matters of implementing domestic policy and institutional reforms and harmonizing their regulatory and institutional structure to gain benefits, without incurring the costs, that are attributable to a monetary union. They cite the extremely limited degree of intra-regional trade, lack of surplus national savings in member countries that could stimulate intra-regional capital mobility, narrow and shallow financial systems, as well as limited capacity to manage monetary unions effectively, as, inter alia, the reasons for their skepticism. How far is this skepticism justified and does it undercut the very justification of regional convergence criteria and producing this report on proposing an effective Multilateral Fiscal Surveillance Framework? As the following paragraphs will show, this skepticism is not justified; in fact, moving towards a monetary union may correct the very conditions the skeptics cite against the formation of monetary unions in Africa.

1.3.2 Modern theoretical approaches to the OCA question the degree of effectiveness of both exchange rate adjustments and monetary policy in systematically maintaining internal and external balance of an economy. This assertion of diminished effectiveness of monetary and exchange rate policies relies on rational expectations that give rise to a vertical Phillips curve and questions the time consistency and credibility of monetary policies, as well as the role of flexible exchange rates, in equilibrating demand for and supply of domestic and foreign assets. On this score, in fact, differences in economic structure, lack of diversification, and high volatility of the terms of trade increase the net appeal of a monetary union because they increase the benefits of pooled foreign reserves and integrated capital markets, while reducing the costs from loss of monetary and exchange rate sovereignty.

1.3.3 Apart from considerations related to OCA, there is also some evidence that benefits from common currency are not region specific, and that (i) countries belonging to currency unions trade about twice more than do other comparable countries, and (ii) currency unions are (positively) correlated with trade creation, trade stability, and increased co-movement of prices. Further, the absence of exchange rate volatility within a currency union has positive effect on trade, and trade benefits could also accrue from financial integration that may be induced by common currency4.

1.3.4 There is also some evidence (Mongelli et al, 2005) that there is a causal link between institutional arrange-
ments (i.e. Free Trade Area, Customs Union, monetary cooperation and monetary integration) and trade deepening, with the causal link being more dominant from institutional arrangements to trade deepening. Andrew Rose (2004) analyzed several other studies on the effects of currency union on trade and concluded that bilateral currency unions increased trade significantly, implying that a common currency area could turn into an OCA after the establishment of a monetary union even if it is not so before.

1.4 The African Setting

1.4.1 This possibility that a common currency area could itself generate an OCA among its member countries could also be the case for African RECs. Moreover, COMESA and other RECs are implementing their projects in stages moving from Preferential Trade Arrangements to Free Trade Area to Customs Union and Economic Community prior to establishing a monetary union. This report emphasizes the need to complement these steps with moves towards greater regional fiscal convergence and financial integration. This process, if properly implemented, would establish most of the preconditions for a monetary union and the only question will be the timeframe within which such an objective could be realized.

1.4.2 Recent developments in the EAC also point to the seriousness with which countries are moving towards fostering monetary unions. The Parliaments of the five member countries have ratified the EAC Common Market Protocol that took effect on 1 July 2010. A High Level Task Force has been setup to continue negotiations on such issues as macroeconomic convergence criteria, social security benefits in the Community, and cross-border liberalization of labor and services. The final report on the establishment of the EAC Monetary Union was adopted by various Ministerial Meetings and by the joint meetings of the Monetary Affairs and Fiscal Affairs committees, and will be among the working documents for the monetary union negotiations.

1.4.3 COMESA and other RECs have agreed on specific timelines for the establishment of monetary unions among their respective member countries. To that objective, they have instituted monetary convergence programs and prescribed convergence criteria to be observed by member countries during various stages on the road towards monetary union. A major emphasis in these programs is on fiscal criteria relating to budget balance, public debt, public expenditure, etc. However, experience with the observance of these criteria, in particular the fiscal criteria, has been mixed. The next chapter highlights the importance of fiscal policies and fiscal convergence, as well as trade integration, for the formation and sustainability of monetary unions. In view of this role of fiscal convergence, and given the time table for setting up monetary unions, this underperformance on fiscal areas is of special concern to RECs who are anxious to understand its causes, and to set up a multilateral fiscal surveillance mechanism to guide, monitor, and sustain an eventual monetary union arrangement. The Bank shares this view, and in conformity with its mandate and strategy to promote regional integration, it has acceded to the request from COMESA to propose such a framework. The Bank is also aware of the interest of some other RECs in this work and has, accordingly, decided to follow and extend the scope of this report to cover developments in other two sub-regions (EAC and SADC) with whom COMESA shares some common country members. Assuming that the recommendations of this report will encourage regional member countries of the Bank to undertake fiscal reforms resulting in better fiscal outcomes at the country levels, the report would have served a valuable role in the short and medium term, even if monetary unions may be considered to be achievable in an undefined future.