

SINGLE CURRENCY AND AFRICAN INTEGRATION

A DIVERSION OR TRUE PATH?

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Outline of Presentation

1. Introduction
2. Economic Integration and Common currencies
3. Africa's Experience with Common Currencies
4. Single currency and Economic Performance in Africa
5. Conclusion

1. Introduction

1.1 The issue of single currencies

- Currency unification is a special case of monetary integration.
- As such, the issue of common currencies is often discussed as a particular case of broader issues of monetary and financial integration, and exchange rate policy.
- Corden (1972) distinguishes, in this regard, between ***pseudo-exchange rate unions,*** and ***“complete exchange rate unions.”***
- Establishment of single currency usually results from achievement of full monetary union.
- Single currency regime is an extreme case of fixed exchange rate regime.

1. Introduction (Cont'd)

1.2 Single currencies and regional integration

- Just as other aspects of economic integration, monetary integration is generally considered as an important element of economic management policy.
- It has been advocated for long dates by scholars, among whom, Copernicus (1526); Bodin (1577); Mill (1894); Lerner (1951); Meade (1957); Scitovski (1958), Mundell (1961, 1973); Johnson and Swoboda (1973) and a large number of modern economists.
- In modern history, the Treaty of Rome in 1957 has been instrumental in shifting the debate from an essentially academic field to the realm of economic policymaking.
- In general, there is not much debate about the need for some form of monetary integration.
- However, the issue of common currencies does not find consensus among economists, in particular after the breakdown of the Bretton Woods system which has led to a generalized floating in the world.
- Essentially, the question that feeds most aspects of the debate is “why would countries choose to adopt an extreme case of fixed exchange rate regime in a world of generalized floating?” An answer to that question is economic integration.

2. Economic Integration and Common currencies

2.1 Overview

- Currency/monetary integration is part of broad economic integration.
- As regional integration has become stylish nowadays, the issue of monetary integration has become a hot topic.
- In particular, there have usually been questions about
 - (i) the role currency integration can play in the broader process of economic integration, and more importantly in overall economic performance and development;
 - (b) the stage at which single currency should be adopted.
- Although that debate is far from being settled, it looks fair to examine the role, benefits and costs of common currencies.
- Essentially, the role of single currency is the well-known role of money in general in economic activity (means of exchange; store of value; etc.)
- The benefits and cost, are more complex, however.

2. Economic Integration and Common currencies (Cont'd)

2.2 The benefits of common currencies

- Single currency enhances the usefulness of money as a medium of exchange and as a store of value; as a result, it makes transactions between countries easier and more efficient by eliminating conversion costs and uncertainty about exchange rates between national currencies.
- The liquidity of a currency increases with the volume of transactions it is used in, or the size of the area it covers. Then, the currency of a very small and open country may lose some of its value as money to foreign currencies, if this country fares alone with a floating exchange rate regime.
- Moreover, currency unification is believed to reduce the need for external reserves. As Mundell (1973a) argues, when two countries form a monetary union, they do not need foreign reserves to do transactions with each other. Then, the larger the currency area, the greater the reserve saving.
- Furthermore, monetary union enhances the shock absorbing role of foreign reserves: the pooling of reserves by member countries is an application of the well-known principle of risk pooling.

2. Economic Integration and Common currencies (Cont'd)

2.3 The costs of single currency include

- (a) the loss of independence by national authorities to a supranational authority.
- (b) often, developments would occur from time to time that could push the relative cost levels of the participating countries out of line, and even some that would tend to push them progressively further and further out of line and threaten the coherence or the very existence of the union. Such possibilities arise if the participating countries do not harmonize or coordinate effectively overall economic policy or do not converge to some well-defined levels of key economic variables;
- (c) the giving up of alternative uses of the exchange rate as a policy tool;
- (d) the inevitable exposure of member countries to disturbances arising from any part the union;
- (e) the resources devoted to resolving internal conflicts of the union;
- (f) the resolution of the sometimes hidden but disturbing issue of seigniorage.

2. Economic Integration and Common currencies (Cont'd)

3.4 Under what conditions should countries adopt a single currency?

- Given the costs and benefits mentioned above, the question is “what are the conditions for two or more countries to join in to form a monetary union or to have a single currency?”
- In many cases, the answer to this question does not rest on simple economic grounds, but instead is formulated taking into account political, social and historical considerations.
- But definitely, for the decision to be made in favor of currency unification, it is necessary that the benefits outweigh the costs, however they are defined.

3.5 The size of Intraregional transactions and convergence

- Very often, some of the most convincing arguments that are advanced on economic grounds in favor of currency unification are (a) the size of commercial and financial transactions between the countries involved, and (b) the extent to which member countries converge toward agreed levels of key macroeconomic indicators.

2. Economic Integration and Common currencies (Cont'd)

- 3.5 The size of Intraregional transactions and Convergence

- **(a) Convergence criteria**

- All RECs have defined convergence criteria that potential members of the monetary union being formed should follow.
 - See the Maastricht Treaty, the Revised ECOWAS Treaty, the UEMOA Treaty, the COMESA Treaty and the SADC Treaty.
 - Very often ,these criteria are not always respected even in the case of the Eurozone, because different member countries face different socioeconomic and political realities.
 - For more than fifteen years, member countries of ECOWAS and other African RECs have been struggling to meet these criteria. Most of these RECs have not even been able to achieve the stage of Free Trade Area.

2. Economic Integration and Common currencies (Cont'd)

3.5 The size of Intraregional transactions (Cont'd)

(b) The Size of Intraregional Economic Transactions

- The more countries are integrated, the larger tends to be the size of the economic transactions between them
- In this particular regard, currency unification would be more justified in an area such as the Eurozone, where intraregional trade is about 60% of total trade, than in most developing regions such as African RECs where it is usually low (Figure 2).
- Among African, RECs SADC countries are doing much better in this regard than COMESA countries where intra-community trade is usually less than one tenth of total trade.
- And despite all efforts or promises, the situation has not changed much over the last two decades. One of the reasons is that the structure of output is about the same in these countries so that they have little to trade in.
- Unfortunately, not much work is been done in that regard.
- However, the size of intraregional economic transactions and the degree of convergence alone should not determine countries to adopt single currencies. The costs should also be taken in to account.
- As is shown in Figure 3, Canada and the United States are arguably two of the most economically integrated countries in the world. But they continue to have national currencies.

Figure 1 Intraregional Trade in African RECs

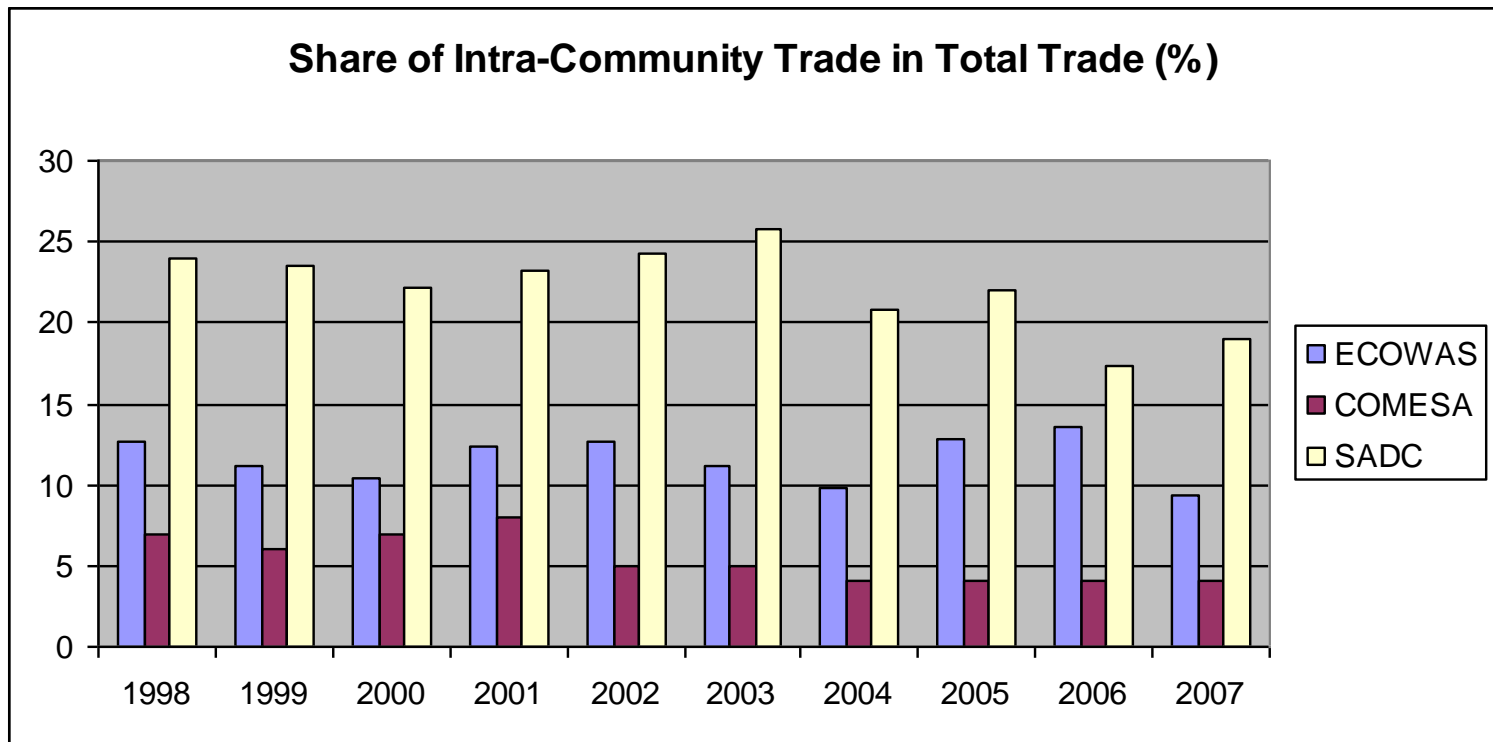
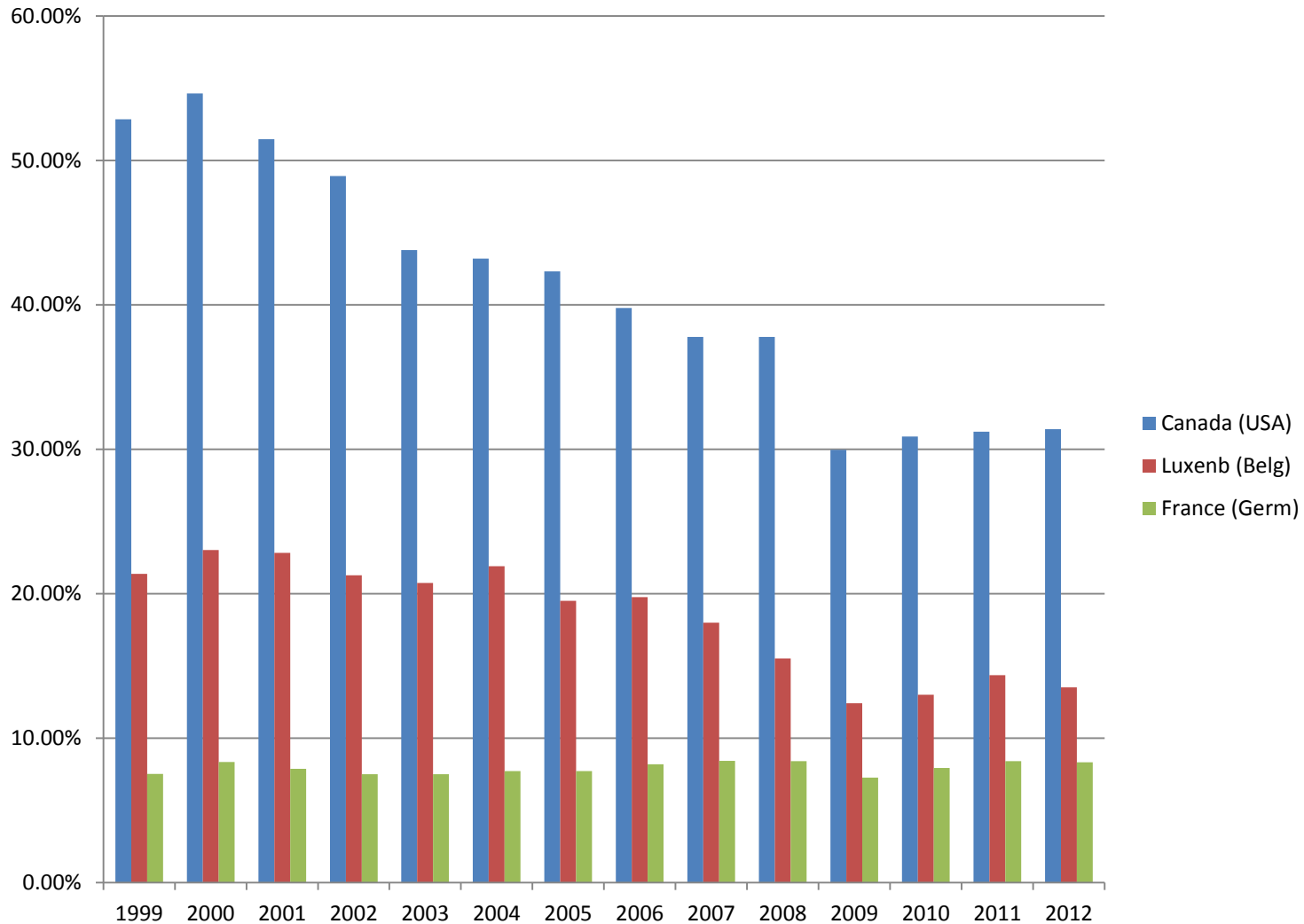


Figure 2 Bilateral Trade (as a percentage of total trade) between some developed nations



2. Economic Integration and Common currencies (Cont'd)

- Clearly, regional integration provides a strong argument for currency unification (Mundell, 1961, 1973; Johnson and Swoboda (1973)).
- However, there is no consensus among economists regarding the question as to whether currency integration is required for regional integration.
- Most of them do think that monetary integration is a possible part of economic. But an important number of them believe that currency unification could be a possible (but not a necessary) part of the general process of economic integration.
- Some believe that that currency unification may come only at advanced stages of the process.
- As Box 1 indicates, UNECA suggests that currency unification should come only when regional integration has reached the stage of full economic union

BoX 1 The Stages of Regional Integration

Regional integration arrangements take a variety of forms:

- **Preferential trade area (PTA)**—an arrangement in which members apply lower tariffs to imports produced by other members than to imports produced by nonmembers. Members can determine tariffs on imports from nonmembers.
- **Free trade area (FTA)**—a preferential trade area with no tariffs on imports from other members. As in preferential trade areas, members can determine tariffs on imports from nonmembers.
- **Customs union**—a free trade area in which members impose common (external) tariffs (CET) on nonmembers. Members may also cede sovereignty to a single customs administration.
- **Common market**—a customs union that allows free movement of the factors of production (such as capital and labor) across national borders within the integration area.
- ***Economic union—a common market with unified monetary and fiscal policies, including a common currency.***
- **Political union**—the ultimate stage of integration, in which members become one nation. National governments cede sovereignty over economic and social policies to a supranational authority establishing common institutions and judicial and legislative processes—including a common parliament.
- Countries can start with any of these arrangements, but most begin by removing impediments to trade among themselves. They then introduce deeper and wider integration mechanisms.

3. Africa's Experience with single currencies

- Africa's experience with common currencies dates back to at least colonial times during which both the British and the French colonial administrations instituted currency boards that issued and managed the currencies were used in the colonies.
- Thus these colonies all experimented with single currencies in their respective zones.
- After independence, the currency boards have been dismantled in the former British colonies but have survived and taken new forms in the former French colonies, which has progressively led to UEMOA and CEMAC, two of the best-known monetary unions in Africa today.
- The respective single currencies of these two monetary unions, the CFA franc (franc de la **Communauté Financière Africaine**, in West Africa, and franc de la **Coopération Financière en Afrique** in Central Africa) are just new names of the colonial CFA franc (franc des **Colonies Françaises d'Afrique**)
- The creation of these single currencies in the two monetary unions has nothing to do with economic integration; but rather it is a simple remnant of the French colonial past, and possibly a product of economic, cultural and geopolitical influence of the former colonial power. In fact, intra-community economic transactions are less intensive within UEMOA and CEMAC than within other RECs such as ECOWAS, SADC and SACU.
- Attempts by other African RECs to move toward single currencies are slow to materialize so far.

4. Single Currency and Economic performance in Africa

- It has often been argued that (presumably because currency unification) that CFA franc countries have experienced some aspects of macroeconomic stability, notably low inflation rates and fair degrees of openness than other African countries. (Devarjan and de Melo (1990), Fischer (1993))
- However, these same researchers, and others as well, also find that CFA area countries have lower growth rates and have more difficulties to adjust to external shocks than other African countries.
- In addition, Evlo 1997 and 2008 shows that, these glorified low inflation rates hid other instability factors such as deflationary pressures and wild variability of inflation rates that are detrimental to economic performance (Figures 3-5).
- These findings seem to contradict the so-called Washington Consensus that prevailed at the time.
- Then, if after all, single currencies do not enhance macroeconomic performance, why adopt them? This is a question for which researchers and policymakers do not easy answers.
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Figure 3 Inflation Rate Variability

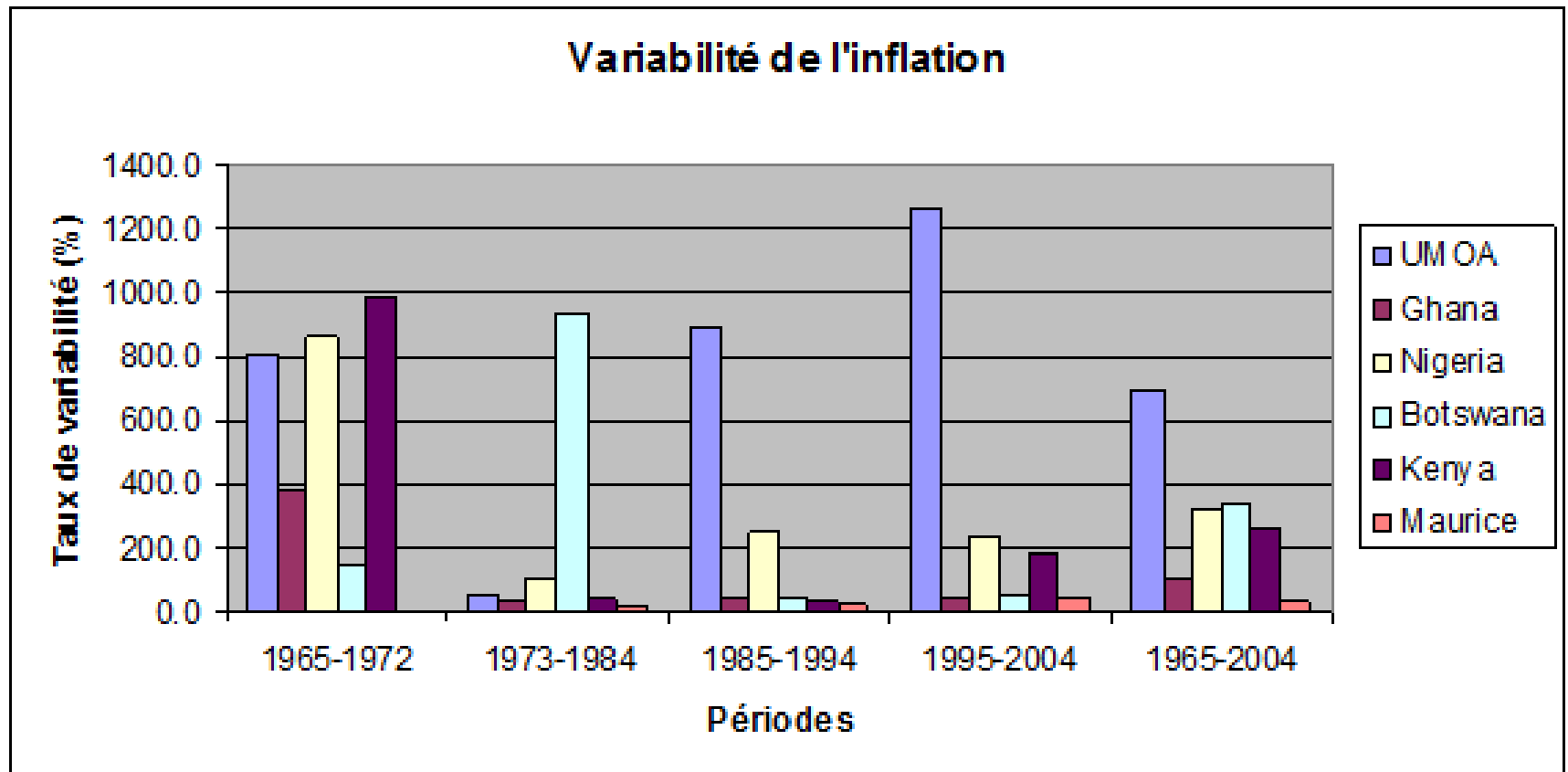


Figure 4 Inflation Rates

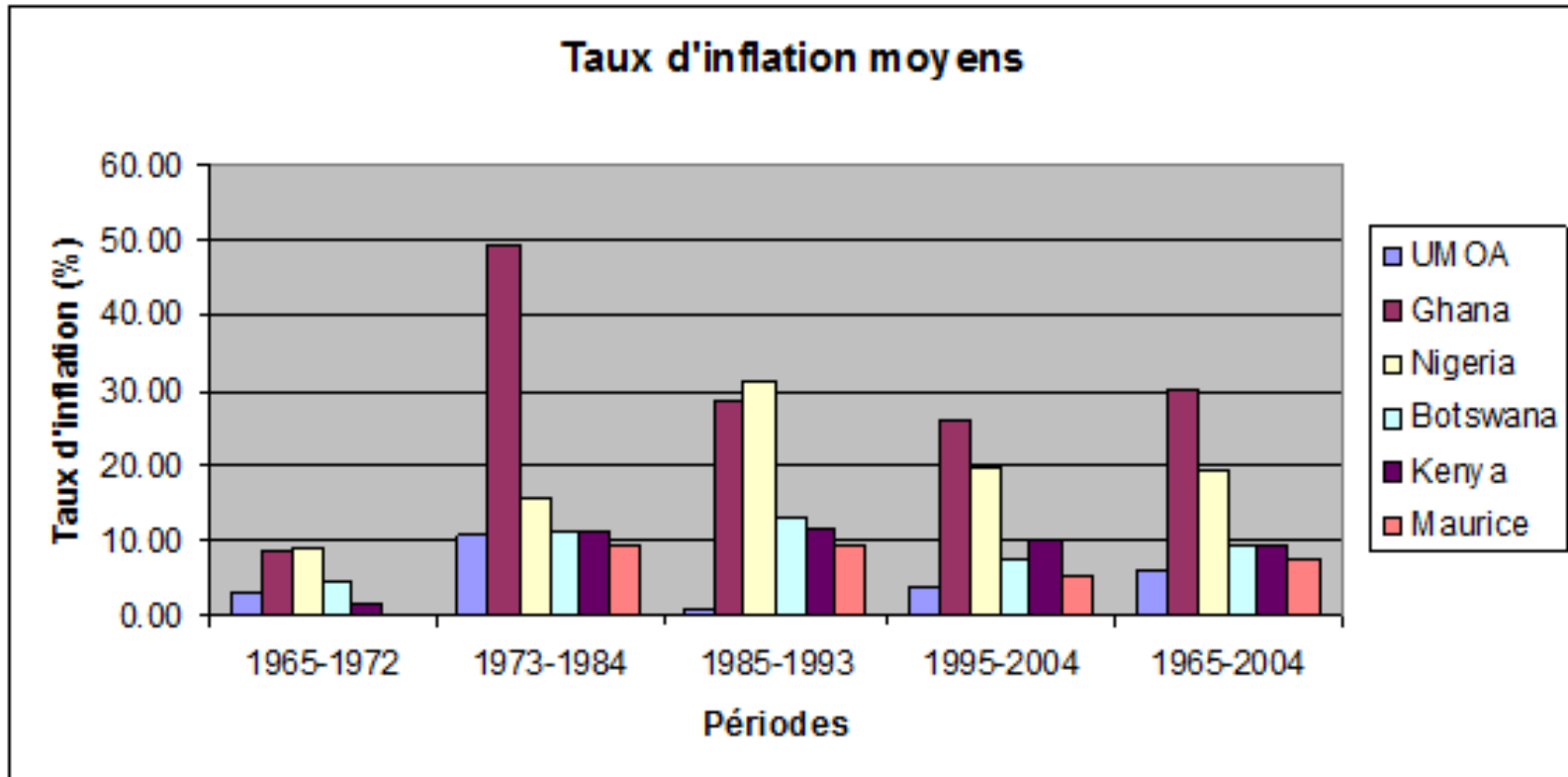
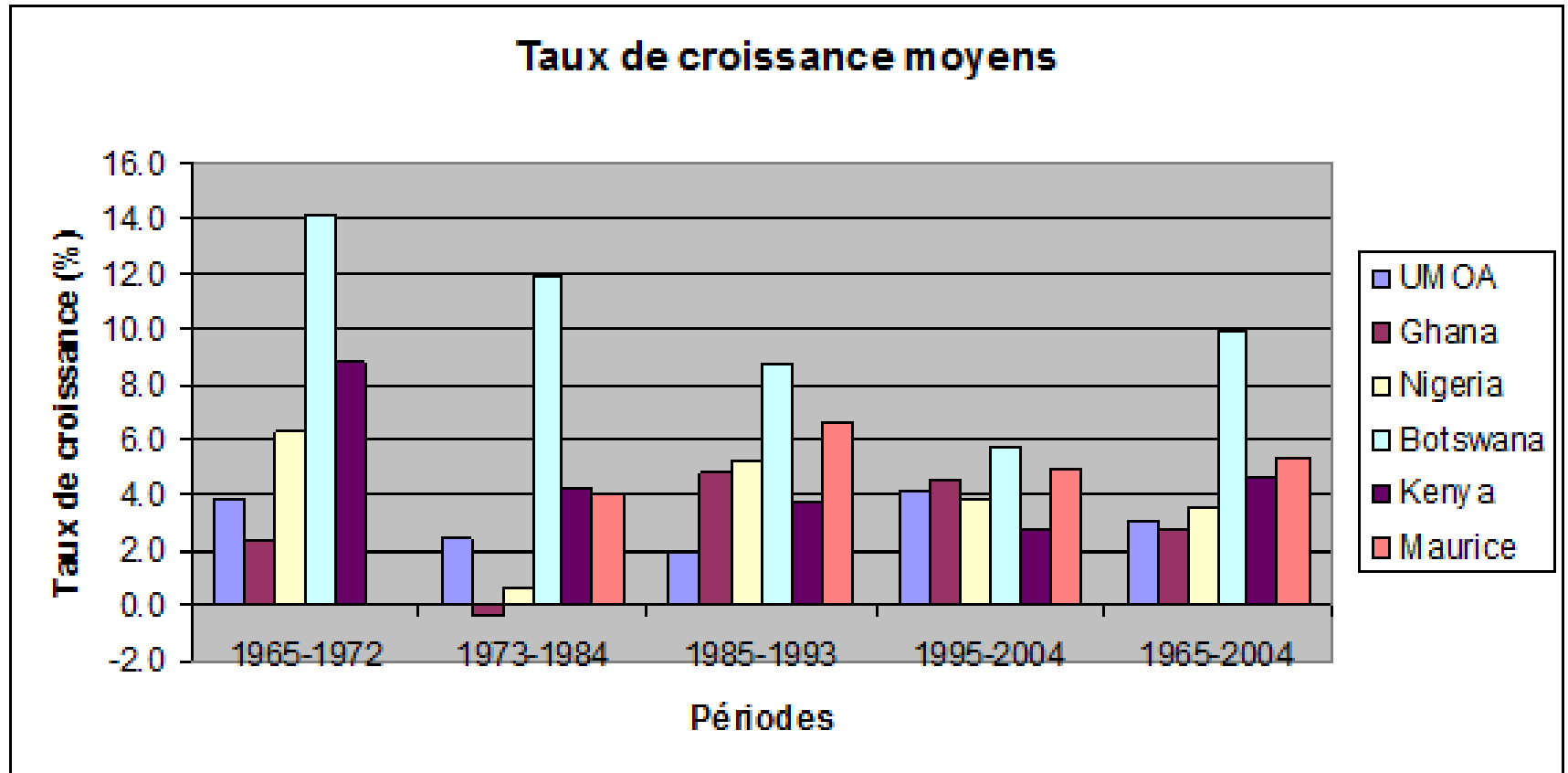


Figure 5 Growth Rates



5. Conclusion: Lessons for Africa's Development Policy

- Africa has a lot to learn from the experience of CFA area countries and the Euro Zone in the area of currency unification.
- Currency unification is a **possible** part of economic integration.
- High degree of economic integration can be achieved without single currency; however, well-designed and well-implemented monetary integration can be highly helpful.
- Currency unification is not required for rapid economic integration or strong macroeconomic performance.
- Currency unification may be desirable only after reasonable progress is made in overall economic integration.
- When adopted, single currency policy should be implemented with caution so that it does not hamper macroeconomic performance and economic development.
- Single currency is not a compelling path; it can become a real diversion if it is not well designed or implemented.

- THANK YOU

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- FOR YOUR KIND ATTENTION