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Single Currency for Africa; is it Possible? A Theoretical Review

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Abstract:
Despite being endowed with vast resources, Africa remains the poorest continent in the world. One effective way of eradicating poverty is through economic integration of continent economies as one economic zone with a single currency. Integration requires formulating convergence criteria acceptable by all participating countries. Implementing a convergence criterion calls for willingness and commitment amongst political leadership of republic states in Africa, merging of regional economic blocks that are spread across continent and countries accepting loss of sovereignty in some economic, financial and social policies. This paper reviews a likely process of convergence criteria, benefits and challenges of having a single currency in Africa.

Keywords: *convergence criteria, integration, regional economic blocks, single currency*

1. Introduction

The United States of America is a long-standing and effective monetary union operating a single monetary policy. Banking Act of 1933 centralized the implementation of countrywide monetary policy operations and reserve bank interest rate throughout the whole country. The Act has since been structured and subsequently operated extremely successfully to the current state (Owen and Cole, 1999). Fifteen European states came together to form European Union (EU) and in 1999, a major milestone was achieved with introduction of Euro currency. The benefits of single currency continue to spread as more countries continue to join despite the recent global financial crisis and exit of Britain. In 1999, heads of states of African countries through Organization of Africa Unity (OAU) issued a declaration calling for establishment of Africa union with a view of integrating the continent as a single economic superbloc with a powerful currency (Africa Union, 2008). Spurred by the success of the launch of the euro, the AU's idea is to create an economic superbloc with a powerful single currency for the continent by 2021. This idea muted another idea of having Africa monetary union with one of its objectives being to give the continent more economic and political clout (Steyn, 2004). So far, all indicators show this is not attainable within remaining time.

According to Siddiqi (2006), the strategy of creating a superbloc with a single currency entails two steps. First, building genuine monetary unions in Africa's five existing regional economic blocs. These regional trading communities, embracing Anglophone, Francophone and Lusophone Africa, represent the foundation stage towards 'full-blown' economic and monetary union (EMU), similar to the creation of the EU's single market in 1992. The second and more difficult stage entails mergers of regional blocs, leading to a new supranational institution modelled on the US Federal Reserve system or the European Central Bank. Such a far-reaching goal, if achieved, would radically transform Africa's politico economic landscape and place the continent on a solid footing to meet the formidable challenges of the 21st century.

This paper has four sections. Section 2 discusses convergence criteria required to have a single politico economic bloc with a single currency while section 3 discusses benefits of a single currency in Africa. Section 4 addresses challenges of having a single currency in Africa and concludes with way forward.

2. Convergence Criteria

All countries in Africa that are politically stable belong to a regional economic community (REC) (UNECA, 2004). Forty-eight countries in Africa belong to at least one REC, with an average of four per country and a maximum of nine (Page, 2006). The structure of each REC varies but they share a common objective: reducing trade barriers among member countries by creating a common, larger economic space (ECA, 2008). To realise maximum benefits, Africa states need to join hands and create a single Africa market with a single currency that will ease flow of trade between member countries rather than having memberships in multiple RECs. Convergence to a single currency bloc requires a market region that constitute an optimum currency area (OCA) (Karras, 2006). Two conditions crucial for optimality are large volumes of intra-regional trade and cross-country symmetry of shocks (De Grauwe, 2003). Robert Mundell pioneered this theory of OCA in 1991 and emphasised two key factors for its success; labour

mobility and capital mobility that includes price and wage flexibility (Mundell 1991). The theory resonated well with floating exchange systems that allows currency risk sharing across different countries.

Mulhearn and Vane (2006) defined OCA as an area with internal factor mobility (including both interregional and inter-industrial mobility) and external factor immobility. According to these researchers, currency value adjusts to a demand shift. Mundell illustrated this by analysing two countries A and B, which initially are in their equilibrium defined as full employment and balanced trade, maintain their own currencies and thus each country can alter its monetary policy if necessary. The two countries were assumed to trade exclusively. If products of country B are in high demand relative to products of A in A, and monetary policy in the two countries are not altered, the result of demand shift will be decline in output and price levels in A and also likely, unemployment. If domestic spending does not decline at the level of output decline, a current account deficit will occur and possibly a budget deficit too. On the hand, if country B product prices rise at higher speed than prices in country A (due to increased demand and production cannot be increased in short run), then B takes partially the burden of adjustment from country A, because price increase will deteriorate its competitiveness. If country B tightens its monetary policy in order to fight inflation, then the whole burden is thrown onto country A. If both countries use flexible exchange rate regimes, the whole adjustment can be solved through the depreciation of the country A's currency (Molle, 2006). If A and B are different locations in same country under the same monetary policy and currency regime (proxy for countries in the same economic monetary union), exchange rate regime cannot bring the countries to equilibrium. Countries would be able to get rid of either inflation or unemployment but not both problems (Frankel, 2006). Frankel (2006) and Copaciu, (2005) explain how some non-exchange rate solutions may restore equilibrium but with disregard to transaction costs.

First, there is wage flexibility. Wage claims in the location (country) A are reduced and increased in B. This has the effect of lowering cost of production in A (making goods cheaper hence more attractive) and raising cost of production in B. Second, there is labour mobility. Workers can move from A to B. They do this in order to eliminate the excess labor demand occurring in the B due to high demand of products. Wages would remain constant and unemployment and inflation vanish. Third, there is a fiscal policy. Authorities can raise taxes in B in order to decrease B aggregate demand and transfer the surplus to the A. A still has a current account deficit, but transfers finance it. Empirically, EMU may have regional redistribution systems through a federal budget because of the centralization of the government budget as explained using A and B. As a result, when output in A declines, the tax revenue of federal government declines. At the same time, the social security system will increase transfers to this region. Transfers do not solve adjustment problems, but make it easier to live with. If the negative shock is permanent, then either it will be necessary to send the transfers forever or to adjust wages "painfully" (Eichengreen, 2008). Put differently, a monetary union between two or more countries is optimal if one of the following is satisfied: (a) there is sufficient wage flexibility; (b) there is sufficient mobility of labour (De Grauwe, 2005).

Most of Africa economies are closed than open. A closed economy focuses all economic transactions inward rather than outward. The idea behind the closed economy is to meet all consumer needs with internally produced goods and services. Essentially, an autarky goes to great lengths to avoid trade with other countries. Closed economies are the direct opposite of open economies. With an open economy, much of the goods and services produced within the country are exported to customers around the world. At the same time, the open economy actively encourages importing any goods or services that cannot be produced domestically at competitive prices. The open economy motivates the interaction in a global community, while a closed economy is definitely built on the concept of isolation from other countries (Brunner and Meltzer, 1976). The introduction of ***openness*** as a factor in convergence means that there are essentially two types of goods in the economy. These are traded goods, such as manufactured products, which are exchanged internationally, and non-traded good, such as most services, which cannot move from one country to another. The prices of traded goods are determined in world markets and thus taken as fixed by any one country, while the prices of non-traded goods are determined by domestic economic factors such as the level the domestic wages. In closed economies, prices of domestic factors of production are determined by the non-traded goods sector. By contrast, in the case of an open economy, domestic wage levels are dominated by the prices of traded goods. Currency depreciation causes inflation and thus an exchange rate change is not useful as a policy tool. Clearly, the loss of the exchange rate has less significance for open economies so they are better candidates for joining a monetary union (Owen and Cole, 1999).

A requirement for monetary union specified in the early economic literature on the subject was that participating economies should be well diversified. If each economy in the proposed union produces a wide variety of products, then a demand disturbance in any one industry would not unduly disrupt a particular member of the union ('asymmetric shock'). However, this criterion is seen as ambiguous. As trade between countries increases, the traditional economic theory of comparative advantage suggests that, greater specialization should occur. If each country concentrates its resources in producing the goods in which its factors of production are most efficient, then overall output is maximized. The paradox on this is greater specialization among members of a monetary union calls for exchange rate to counter industry shocks (ECA, 2008).

Owen and Cole (1999) state that only countries with roughly similar inflation rates can maintain fixed exchange rate vis-à-vis each other. The adoption of a common currency between two or more economic areas means that exchange rate can no longer be used as a policy tool and member countries cannot operate independent monetary policies, as interest rates will be set by a union-wide central bank. Convergence of inflation rates ahead of monetary union and the subsequent maintenance of zero differentials under permanently fixed exchange rates may only be achieved at a much higher unemployment cost in one area versus another. Monetary union is thus only desirable if it can be established that the political will exists, first, to maintain a given inflation rate target at whatever cost, and secondly, to surrender national autonomy of policy in achievement of this goal.

3. Benefits and Opportunities of Single Currency

Substantial gains are anticipated from sounder economic policies, improved business competitiveness, a simplification of procedures and greater transparency in pricing at the sub-regional level. Greater currency stability also promotes intra-regional trade and simplifies business decision-making processes by relaxing this very real constraint. Exchange rate risks discourage cross-border trade and investments thus foreign long-term business projects requires more planning since projects value are significantly influenced by exchange rates both in short and long run (Siddiqi, 2006). Currency inhibitions felt by businessmen to enter foreign markets contribute to failure of fiercer competition and more efficient production and distribution across countries (Visser, 2006).

If a monetary union has earned itself a reputation for maintaining low rates of inflation, it may be advantageous for a single country to join the union in order to enhance the credibility of its monetary policy and so, among other things, contribute to a lowering of interest rates. Indeed, a country may decide to join a monetary union in order to give the Minister of Finance the necessary support against his/her colleagues from the spending ministries to prevent the government from following irresponsible fiscal policies. If there is a hegemonic country with a low inflation rate or a hard core of countries with low inflation to begin with, the forming of a monetary union may help to introduce credible non-inflationary monetary policies in other countries too (Visser, 2006). In the same line of thoughts, Siddiqi (2006) conquers that the other potential long-term gains are macroeconomic stability, as a common central bank is able to introduce anti-inflationary measures more efficiently. It seems indisputable that a single monetary zone leads to reliable fiscal control mechanisms. The consequence of fiscal prudence is that it enhances the credibility of the government's policies, while macroeconomic stability facilitates more efficient allocation of resources in member states, underpinning sustained growth and increased job creation as well as deterring capital flight from the region.

The most tangible benefits are likely to accrue through a reduction of transaction costs and exchange rate uncertainty. For businesses, a single currency eases transaction costs linked with conversion, resulting in savings in both time and money. Money is not only used as a means of payments, but also as a unit of account. In a currency union, there is only one unit of account, which makes for greater transparency of relative prices and thus for a reduction in the cost of digesting information (Bergin, 2008).

Some of the regional economic communities with small African countries are too small to achieve the large economies of scale needed to improve efficiency. Monetary union would overcome this disadvantage by pooling resources and combining markets (ECA, 2008). Barro (2000) notes the use of a single currency will raise the comovement of product prices. As an extension of this basic principle, free trade among member countries will improve welfare as long as the arrangement leads to a net trade creation in the Vinerian sense (Geda and Kebret, 2008). If a common currency substantially increases trade, there will be important repercussions. First, there will be an increase in trade disputes and frictions simply because the volume of international trade rises. Secondly, if greater international competition leads to layoffs and associated labour market pressures, there could be an increase in pleas for continuation or enlargement of the social safety net. Thirdly, higher levels of trade may lead to more synchronization of business cycles across countries. More generally, closer economic integration is likely to lead to greater political integration. Finally, and most importantly, a big increase in trade will lead to substantial extra gains from trade for consumers inside the currency union (Rose, 2000).

In the early 1960s, Africa accounted for as much as 10% of world exports; by 2000, its share had declined to about 2% (African Development Bank, 2003). The decline in Africa's share of world agricultural trade illustrates this marginalization much more clearly. According to the Food and Agricultural Organization, every region of Africa has experienced significant declines in share of world agricultural trade since 1961, with Southern Africa falling the most—from 9% in 1961 to 3% in 1998. Meanwhile, in 1998 Central Africa's share was 0.2%, West Africa's 1%, and East Africa's 1.1% (Stevens 2003). Thus, a wider regional integration could help Africa in negotiating preferable trading terms either bilaterally (with the US and the EU) or globally in a World Trade Organisation context (Siddiqi, 2006). While the objective of regional integration seems well founded, it is unclear whether forming a monetary union would contribute greatly to it. A currency that is ill managed and subject to continual depreciation is not likely to stimulate pride in the region or give the member countries any clout on the world stage (Masson and Pattillo, 2005).

Currency unions can spur the development of a single market in trade, finance and investment. Transnational corporations targeting regional manufacturing and service sectors should find lucrative opportunities in a larger market that provides scope for economies of scale and production efficiency. This, in turn, will improve Africa's prospects of attracting higher foreign direct investment for sectors other than mining and hydrocarbons (Siddiqi, 2006). Large transaction will less likely cause a price shock in a large union market than in a relatively small national market. Put differently, the liquidity of financial assets is higher in a currency union (Visser, 2006). Further, a single currency would enhance monetary co-operation within sub-regional banking sectors, leading to improved payments and clearing systems (Siddiqi, 2006).

4. Challenges of Single Currency in Africa

The potential costs of Africa EMU are more complex and difficult to evaluate. However, the most significant cost derives from the loss of autonomy over macroeconomic policy. Under an EMU, member states must relinquish an important adjustment instrument for balance of payments, since the option of currency devaluation or revaluation is removed from individual countries (Rochtus, 2005). A new supranational central bank assumes responsibility for key aspects of policies, such as the future direction of interest rates and nominal exchange rate adjustments. By contrast, an independent monetary stance (i.e. a policy of flexible exchange rates) enables a country to determine its own rate of inflation and deal with unforeseen exogenous shocks. Moreover, unified monetary blocs will necessarily involve greater integration and co-ordination between individual countries' fiscal policies and impinge directly on matters of political sovereignty and control over taxation and public spending. This, in turn, could subject other participants to 'external dis-economies' through hikes in the average community interest rates and by the 'crowding out' of some private sector investment. Also, the system of fixed exchange rates could in times of market turmoil call for steep rises in interest rates to preserve a single currency's

stability (Siddiqi, 2006). Geda and Kebret (2008) point that regional experience in Africa indicates that countries are hesitant to create supra-national bodies and transfer power to them as sanctioning authority. The secretariats that are formed (such as that of ECOWAS and SADC, for instance) don't have the legal backing to force countries to fulfil their obligations in accordance to their commitments.

Simulations of a single currency for Africa suggest that only two of the five communities (ECOWAS and COMESA) would gain on average from a single currency. These are the regions with the largest financing needs in proportion to their GDP. In contrast, the regions with more disciplined fiscal policies (AMU, SADC, and ECCAS) would not gain, on average. Within SADC, South Africa, in particular (with its large share of the region's GDP), would face a significant welfare loss. Adding up the net gains (weighted by each region's share in total GDP) shows that monetary union among the AU members would lead to a small overall net welfare loss. For all the regions, trade with the rest of the AU is only a small fraction of GDP—typically less than 1 percent—suggesting that the gains from a common currency resulting from a reduction in the temptation for beggar-thy-neighbor depreciations would be very limited. Some economies would gain and others would lose from the proposed African regional and subregional monetary unions. Full monetary union among either West African Monetary Zone or Economic Community for West African States' members would be undesirable for most members (Masson and Patillo, 2005). In the same line, an outstanding issue relates to compensation issues. This relates to the issue of appropriate mechanism that ensures gainers will compensate losers in the short run and losses are minimized in the long run. Geda and Kebret (2008) argue that one of the reasons for the failure of integration so far is the fear of some countries, particularly the poor ones, that the few industries they have may migrate to relatively more advanced neighbours. This would turn such countries to largely consumers rather producers in the EMU.

For strategic and political reasons, many African countries belong to more than one regional economic community, especially in East and Southern Africa (UNECA, 2004). The multiplicity of regional economic communities has several drawbacks; Fragmented economic spaces and approaches to regional integration; Increased cost of membership in regional economic communities; unhealthy rivalry for donor funds; contradictory obligations and loyalties for member countries; inconsistent objectives and conflicting operational mandates; duplicated efforts; Reduced ability for regional economic communities to pursue coherent and effective integration programmes. Effective integration requires more than reducing tariffs and quotas. The process of seeking agreement among so many regional economic communities could delay creation of the African Economic Community, as laid out in the Abuja Treaty (Sako, 2006).

In Africa, however, the institutional challenges are much greater. Existing national central banks generally are not independent and countries with their own currencies have often suffered periods of high inflation because the central banks were forced to finance public deficits or other quasi-fiscal activities. A critical question for Africa is whether the creation of a regional central bank can be a vehicle for solving credibility problems that bedevil existing central banks.

Civil strife has presented threats to regional integration in Africa. First, conflicts in any member of a regional economic community undermine economic integration and growth throughout the entire community. Countries in conflict cannot focus on integration. Second, conflicts create distrust. Third, conflicts divert resources that could be used to strengthen national economies and promote regional integration. Fourth, conflicts result in contraction of markets and erection of non-tariff barriers to regional trade (Institute for Security Studies, 2006). Therefore, as Steyn (2004) suggests, as long as countries are racked by war and economic mismanagement, monetary union will remain a pipe dream. For example, the SADC can make no progress towards creating regional monetary union as long as Zimbabwe's economy is in a state of collapse.

The overall low level of effective demand in the region has also hindered regional integration. Although the number of conflicts has been significantly reduced and growth has resumed across much of the continent, poverty levels remain very high and purchasing power remains very low in all regions except North and Southern Africa. Unlike the Association of Southeast Asian Nations, there is also very little manufacturing industry in Africa, reducing the degree of complementarity among and across economies. And except in Egypt and South Africa, existing industries are largely unsophisticated, which may explain the limited degree of intrafirm trade in Africa. In addition, weak transport and communication infrastructure and lack of a skilled workforce further constrain integration (Mwanza, 2010). Masson and Pattillo (2005) reinforce this opinion by saying that because they are limited manufacturing, African countries suffer large terms of trade shocks, which often do not involve the same commodities and hence do not move together. Neither structural features of the economy nor available policy tools hold much promise for facilitating adjustment to these shocks.

Experience, especially in Europe, shows that regional integration is much more likely to be successful if one country serves as institutional leader and regional paymaster. European integration was successful largely because of France and Germany's willingness to serve this role. Germany was able to because of its strong economy, which by the mid-1990s was one of the largest in the world and exhibited higher productivity than the economies of other European countries. Its success was reflected in the strength of the Deutsch mark and the Bundesbank, which became the model for the European Central Bank. The country is by far the largest net contributor to the EU budget, easing distributional concerns. In 1996, for example, Germany's financial contribution to the European Union amounted to about two-thirds of EU net income, double the relative size of the German GDP in the European Union. Nevertheless, most regional economic communities in Africa lack leadership and very few countries are willing to serve as paymaster. Countries are also seldom willing to compromise on important treaties or to persuade others to agree (European University Institute, 2009).

Another major challenge is the creation of a multi-stakeholder constituency for regional integration in member countries. African governments often remain the principal advocates of regional integration—in stark contrast with the European Union where organized corporate groups emerged to support European integration. Corporate advocacy was also crucial in creating the North American Free Trade Agreement and expanding it to include Mexico. No mature business constituency for regional integration exists in Africa, and very few private citizens are aware of the anchor institutions of regional integration (ECA, 2008).

African civil society organizations have yet to show sufficient interest in regional integration as an arena for policy activism. There is very little domestic corporate pressure on African countries to provide an integrated regional or continental economic space—probably because African indigenous capital remains very weak and still cannot exploit regional economies of scale. Constituencies for regional integration in member countries' can be successfully created only through the advocacy and engagement of all stakeholders (Institute for Security Studies, 2006). To the extent that implementation of the treaties requires the understanding, conviction and confidence of the private sector, an active involvement of this sector is crucial. This aspect of the regional integration process in Africa has been singled out as one of the major weaknesses of regional integration. The participation of the private sector is hampered by lack of government resources to ensure full participation, and when some resources are secured, the participation is limited at the level of the chamber of commerce officials. In this regard, establishing specific government entities that would promote and administer economic integration at a country level (as some countries—Burkina Faso, Senegal, Ghana, Nigeria and few others—have done) may not only show commitment of countries but also enhance the effectiveness of implementing the treaties (Geda and Kebret, 2008).

The major problem with establishing free trade areas and custom unions is that most African countries depend on foreign trade taxes as revenue to finance public expenditure. They have been reluctant to remove barriers to intracommunity trade because they fear a significant revenue loss. But tariff and non-tariff barriers must be removed for intra-regional trade to increase. The endurance of tariffs and quotas, the lack of physical connectivity and the heterogeneity of policies and trade, limit trade and market integration and must be addressed (Sudan Vision, 2008). However, the persistence of high tariffs and other policy constraints is not the only impediment to trade and market integration. Structural deficiencies, limited product diversification, similarity of products and production structures, lack of market information on member countries, and production and supply-side constraints are also impediments to trade and market integration (ECA, 2008).

Transport costs in Africa are among the highest in the world. Gains from integration will be limited or eroded by fragmented transport networks (ECA, 2008). EU countries have much better communication and transportation links than African countries, so Africa may not expect the same gains from economies of scale and reduction of transaction costs, even in proportion to its economic size (Masson and Pattillo, 2005). The *Trans-African Highway* network comprises nine highway sections: Cairo-Dakar, Algiers-Lagos, Tripoli-Windhoek, Cairo-Gaborone, Dakar-N'djamena, N'djamena-Djibouti, Lagos-Dakar, Lagos-Mombasa, and Beira-Lobito. An analysis of 103 cross-border links (*Trans-African Highway* sections leading to border posts) showed that 33% were unpaved roads, 16% were paved roads in poor condition, and 38% were paved roads in good or fair condition. Using the share of missing links (sections that are not paved all-weather roads) in a region as a measure of physical integration shows how each region is at a different stage of physical integration. For instance, in 2000 the East African Community had the most integrated road system, with only 14% of its sections being missing links, followed by the Common Market for Eastern and Southern Africa, with 17%. The Economic Community of Central African States was the least integrated region, with 47% (Sudan Vision, 2008).

There has been little convergence of transport programmes and efforts across regional economic communities despite the fact that they share common objectives: improving infrastructure links between countries; harmonizing policies and practices; simplifying standards, regulations, and procedures to facilitate cross-border transport; and mobilizing investment for infrastructure construction, rehabilitation, and improvement (Mwanza, 2010). The problems that remain in transport across regional economic communities and across Africa raise the cost of doing business and impede factor mobility, investment, and competitiveness. For landlocked countries, transport costs can be as much as 77% of the value of exports. It costs about $1,500 (including insurance) to move a car from Japan to Abidjan—and more than three times that to ship the same car from Addis Ababa to Abidjan. In addition to upgrading transport infrastructure and increasing connectivity within and between regional economic communities, transit facilitation and documentation and procedures along major transport corridors must be improved. Moreover, both of these objectives must be supported by efficient communication. Regional integration efforts in communication focus on policy convergence, physical facilities, connectivity, and exchange programmes, particularly in broadcasting. The goals are to spur growth of trade and finance and to reduce production and service costs by enhancing the accessibility and affordability of information and by linking Africa regionally and with the rest of the world (ECA, 2008).

The limited mobility of factors of production, especially labour, across national boundaries is a major constraint to regional integration in Africa. Labor mobility in some African regions is higher than in Europe but is still limited and politically sensitive. And currently, little scope exists for intra-African fiscal transfers (Masson and Pattillo, 2005). The need to harmonize investment laws and procedures has already been discussed, but rules on the movement of people also need to be harmonized to encourage labour mobility across countries. While labour mobility is included in the protocol and objectives of several African regional economic communities, many practical obstacles still hamper its effective realization. To improve labour mobility, members of regional economic communities must first relax visa requirements for nationals of other member countries. Member countries should also adopt common travel documents and labour standards. Many regional economic communities have agreements on free movement of people, but several have yet to implement them. Thus, labour markets remain fragmented, serving as a barrier to the free movement of labour among countries (ECA, 2008).

5. The Way Forward

Masson (2004) suggests two alternatives that show promise and are worth evaluating pursuing. First, limited expansion of existing monetary unions could be feasible; such expansion would give strong incentives for existing members to scrutinize the policies of potential members. Given the widespread lack of both fiscal discipline and stable macroeconomic policies, it is vital to use the goal of monetary union to encourage greater discipline and better governance. Moreover, success breeds success. As the monetary union

grows by adding countries with stable macroeconomic policies, it becomes more attractive for others to join and eventually creation of EMU with a single currency.

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