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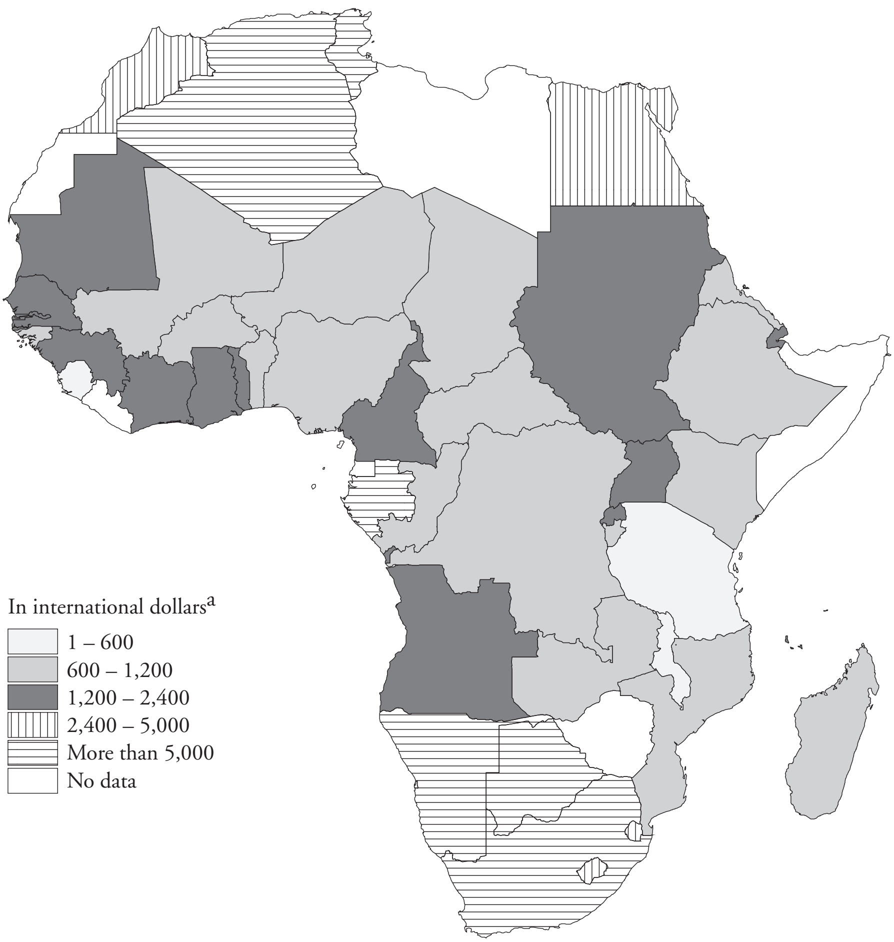
Monetary Union in Africa: Past, Present, and Future

Africa finds itself at an important juncture in its history as the twenty-first century gets under way. There is widespread consensus that Africans must take responsibility for their destiny. Nearly fifty years have passed since the beginning of decolonization and early hopes of rapid development have faded. In recent decades, the continent has suffered from abysmal economic performance. Africa has failed to benefit from the increase in prosperity experienced by the rest of the world, prosperity resulting from expansion of trade and other aspects of globalization. Instead, African countries have become increasingly marginalized, with their share of world exports falling from already low levels of 4 percent in 1980 to 1.6 percent in 2000. Per capita incomes almost everywhere on the continent have declined relative to world averages and have fallen in absolute terms in a number of countries. Figure 1-1 provides a conventional country map of the continent, and figure 1-2 classifies the countries into ranges of per capita GDP. Incomes are very low when compared to the typical developing country, except for southern and northern Africa, even when calculated using PPP exchange rates, as is the case in figure 1-2.[1]

1. PPP exchange rates correct for differences in the cost of living when calculating real incomes across countries. Using market exchange rates would give much lower U.S. dollar income levels, because prices (in particular of nontraded goods and services) are very low in these countries.

Figure 1-2. *GDP per Capita at PPP Exchange Rates, 2002*



Source: World Bank, World Development Indicators database (2004).

a. An international dollar would buy in the cited country a comparable amount of goods and services a U.S. dollar would buy in the United States.

The causes of this poor performance are many and diverse, and include inappropriate development strategies that are dependent on inward-looking policies meant to capture rents rather than foster growth; obstacles to trade, especially in agricultural products, imposed by OECD countries; undemocratic politics that have produced kleptocratic leaders; and the persistence of tribal and ethnic conflicts leading to civil strife and wars with neighboring countries.

Africa since independence has seen a series of regional integration initiatives aimed at defusing conflicts and promoting economies of scale in production and distribution. Starting in the mid-1980s, some countries liberalized payments and trade regimes in an attempt to stimulate growth. Despite a few success stories, however, there has not been a generalized takeoff toward rapid growth or expansion of trade. With the passage of time, there has been increasing recognition in Africa by the general population and their leaders of the need to carry out further structural changes and take responsibility for the success or failure of economic policies. This has led to a stronger consensus in favor of formulating outward-looking and efficiency-enhancing policies, making leaders accountable for their shortcomings, and favoring regional cooperation. The formation of the AU and its implementation plan, NEPAD,[2] are manifestations of this determination. The summit of African leaders in Lusaka, Zambia, in July 2001 heralded the replacement of the OAU and the creation of NEPAD, and the inaugural summit for the AU took place in Durban, South Africa, in July 2002.

Another manifestation has been the renewed impetus given to subregional integration initiatives, in particular, projects to create monetary unions. Monetary unions, groupings of countries sharing a common currency and central bank, are a particular type of monetary integration linking countries. The popularity of these unions has been dramatically increased by the creation of the euro zone in January 1999 and the January 2002 introduction of euro notes and coins to replace the German deutsche mark, French franc, Italian lira, and other currencies of the (at present) twelve member countries. Box 1-1 explains some of the forms that monetary integration can take.

There are a number of regional monetary integration initiatives presently being considered in Africa. In West Africa, ECOWAS since its formation has had the objective of constructing a free trade area and single currency union. The absence of any progress on the latter led a subset of ECOWAS countries to propose a second monetary zone—this in addition to the existing CFA franc zone in West Africa, known in English as WAEMU—as a fast track to the creation of the unified West African monetary zone. The timetable, which was set back by a few years, now calls for the creation of this second monetary zone, or WAMZ, by July 2005. This zone will include some or all of the following countries: the Gambia, Ghana, Guinea, Nigeria, and Sierra Leone. Such a monetary union would overlap closely with an earlier colonial grouping, the West African Currency Board. WAMZ would be subsequently merged with WAEMU to achieve the goal of a single West African currency.

2. See this book's Abbreviations and Acronyms section.

Box 1-1. *Types of Monetary Integration*

The European Commission's study to prepare for economic and monetary union and a subsequent article distinguish between three types of monetary integration.[1] Each type would involve current and capital account convertibility, but they are distinguished by whether there are separate currencies (and central banks) and, if so, whether their parities are perfectly fixed.

—An informal exchange rate union consists of separate currencies whose parities are fixed but only within margins (and central parities can be adjusted). The EMS's exchange rate mechanism after August 1993 is an example.

—A formal exchange rate union has separate currencies, but rates fluctuating within narrow or zero margins, and a strong degree of coordination among the central banks. In Africa, the CMA is an example, since the currencies of Lesotho, Namibia, and Swaziland are linked one for one with the South African rand.

—A full monetary union involves a single currency and central bank. The euro zone and both of the CFA franc zones would be examples of full monetary union.

We would add two other types of monetary integration, namely[2]:

—Adoption of another country's currency (often called dollarization or, by extension, euroization). In this case, there is only a single currency but not monetary union, since the country issuing the currency does not take into account the goals of the dollarizing country. Examples of dollarized countries are Ecuador, El Salvador, and Panama. There are several examples in Africa of countries using other countries' currencies temporarily before issuing their own (for instance, Botswana upon independence used the rand but in 1976 issued its own currency, the pula, and Eritrea used the Ethiopian birr for a period after independence).

In East Africa, Kenya, Tanzania, and Uganda have agreed to revitalize the EAC, which was effectively dissolved in the 1960s. The project envisions a single currency (at an unspecified future date), in effect reestablishing the currency union constituted around the East African shilling that was in place at the time of independence.

Southern Africa has been exploring regional integration in the context of SADC to build on the long-standing but more restricted SACU and the CMA. Though the focus of SADC is on trade and structural policies, some

—A currency board, in which a country pegs to another currency with zero margins, and the link between the two currencies is institutionalized through a mechanism that limits the money supply in the currency board country to the quantity of reserves held in the other currency. Countries operating currency boards include Bulgaria, Djibouti, and Estonia.

Within these five types of arrangements, it is interesting to distinguish those in which decisions on monetary policy (or coordination of exchange rate policies) are symmetric (that is, reflect the interests of all countries) from those that are asymmetric. By their very nature, dollarization and currency boards are asymmetric—countries adopt or peg to another currency unilaterally; there is no shared responsibility for monetary policy. But the first three arrangements can differ in their degree of asymmetry. The ERM was designed to be symmetric (with a parity grid defined around a basket currency, the European Currency Unit, or ECU), but in practice, given the superior credibility of the Bundesbank and strength of the German economy, it operated to an extent asymmetrically. Full monetary union is likely to be symmetric, since the creation of a single supranational central bank is likely to involve institutions that represent all countries, but this is not necessarily the case, nor is it true of formal exchange rate unions. In particular, in the CMA, South Africa, given the size of its economy, effectively sets monetary policy for the zone; the other countries peg their currencies to the rand. In discussing projects for monetary integration within SADC (chapter 7), we give some attention to the issue of whether an exchange rate or monetary union would be symmetric or asymmetric.

1. Emerson and others (1991), and Cobham and Robson (1994).
2. See Hawkins and Masson (2003).

consideration is also being given to expanding the CMA centered on the rand, which now includes Lesotho, Namibia, South Africa, and Swaziland, to include other SADC countries. An expanded monetary zone could involve shared monetary policy responsibility by South Africa's Reserve Bank with neighboring central banks.

A feature of regional cooperation in Africa is the existence of overlapping regional integration initiatives. For instance, COMESA includes most of the countries of SADC but also Egypt, Sudan, and East African countries and has a different timetable for trade liberalization. The CFA franc zones overlap partially with ECOWAS, as only one of the two CFA zones, WAEMU, is part of West Africa. Both WAEMU and ECOWAS have criteria for regional surveillance, but not identical ones, and dismantling of trade restrictions has proceeded differently in the two organizations. Overlapping initiatives with sometimes conflicting provisions may prove to be an obstacle to achieving the objectives of each; at the very least, they squander resources of expertise and money, which are in short supply in Africa.

In this book we focus on the effects of monetary arrangements, so we will not dwell on other aspects of regional integration, except to the extent that they are relevant to potential gains from introducing a common currency or other forms of monetary cooperation. This is not to deny that these other aspects may not be important. Indeed one of our themes is that it may well be a mistake to hope that monetary integration will be a substitute for directly addressing problems in other areas, such as regional conflicts, poor transportation links, or inadequate governance.

How did exchange rate regimes evolve into their current constellation? Roughly speaking, African countries can be divided into three groups: countries colonized by France, countries colonized by other European powers, and countries of southern Africa (also at one time colonized by European powers but with a quite separate history). A review of the history of African monetary arrangements shows that in the early postcolonial period the non-French-speaking colonies largely abandoned their colonial monetary arrangements (which were typically currency boards linked to the British pound sterling, Belgian franc, Spanish peseta, or Portuguese escudo) in favor of the creation of a national central bank and looser exchange rate arrangement, such as an adjustable peg or managed floating. In contrast, the Francophone countries largely retained their institutional structures, which linked them to their neighbors in a multilateral framework as well as to France. There are essentially three reasons for the difference in postcolonial experience. First, the British, Belgian, Spanish, and Portuguese monetary arrangements were bilateral links with the home country and did not have sufficient institutional structure to survive independence. Second, the French made efforts to adapt the CFA franc zone in order to preserve it, while the other colonial powers did not as strongly resist the dissolution of the colonial currency boards. Third, Francophone African countries had stronger political and cultural ties with the metropolitan country before independence, which made the elites in these countries generally more willing to preserve colonial institutions.

The third set of countries mentioned above is found in southern Africa. Lesotho, Swaziland, and Namibia upon independence continued to be part of a zone centered on the rand, the currency of the continent's largest economy, South Africa. Another country in the region, Botswana, abandoned the monetary union and pegs the pula to a basket of currencies (in which the rand is given a large weight, however).

We consider the advantages and disadvantages of monetary integration from the perspective of the traditional criteria for a monetary union as well as from the point of view of providing discipline over fiscal policies and helping to achieve political objectives. The advantages of a common currency (for a region or for the continent as a whole) depend importantly on the savings of transaction costs, and these savings depend on the extent of trade among countries. Unfortunately, data for most African regions do not hold out much promise that savings of transaction costs will be large. In fact, trade within regional groupings (or even with all of Africa) typically is quite low. A new currency will be more attractive if it exhibits more stability (that is, maintains its purchasing power better) than the currencies it replaces. This might be the case if monetary union provides an institutional framework for achieving more discipline over fiscal policies and a sustainable regime that insulates the (regional) central bank from pressures to provide monetary financing. On the other side of the ledger, as stressed by the OCA literature pioneered by recent Nobel Prize winner Robert Mundell, having a common monetary policy is likely to be more constraining the more dissimilar the countries are, as their economies face shocks of a quite different nature (because they export different commodities, for example). Greater labor mobility or compensating flows of capital, achieved in a federation through a system of taxes and transfers, can mitigate the effects of asymmetric shocks. Labor mobility between some countries has been quite high, for instance, to South Africa from neighboring countries. In other countries there are periods of high mobility, but when the economic or political situation changes migrants are expelled, which has occurred in several countries in both West and East Africa. As for fiscal flows between countries, the shortage of financial resources means that they are likely to be severely limited.

We argue that an important source of asymmetry among countries relates to the degree of fiscal discipline. This is likely to be especially important in the African context, since in practice a central bank's independence cannot be guaranteed, even if it is a supranational institution associated with a regional monetary union. As a result, more disciplined countries will not want to form a monetary union with countries (especially if they are large) whose excessive spending puts upward pressure on the central bank's monetary expansion. We sketch out a simple model embodying this feature, as well as the traditional OCA criteria, and calibrate it to African data. It will serve in later chapters to evaluate the economic costs and benefits of various monetary union proposals.

The experience of the currency union countries in Africa (those that are members of the CFA and CMA zones) has been different from that of countries managing independent currencies. The CFA franc zone countries experienced significantly lower inflation than the rest of sub-Saharan Africa, though no better growth performance. And they suffered a period of exchange rate overvaluation and economic crisis in the late 1980s and early 1990s that culminated in a large devaluation in 1994 (cutting in half the value of the currency relative to the French franc). The crisis was due in part to the weakness of commodity prices, the strength of the French franc, overexpansionary fiscal policies in the zone, and excessive direct and indirect monetary financing of government deficits. In recognition of the deficit problem, member countries have attempted to put in place a process of regional surveillance over national fiscal policies in order to enforce greater discipline. Each of the two CFA franc zones has also made progress in creating an effective customs union with a common external tariff. It must be recognized, however, that even these two sets of countries differ considerably: regional surveillance, trade, and cooperation are more advanced in WAEMU than in CAEMC. The CMA countries have also generally benefited from low inflation, thanks to the monetary anchor provided by South Africa's Reserve Bank, and trade linkages are very strong between South Africa and the smaller CMA countries. However, this zone, unlike the CFA, has not been accompanied by regional surveillance over fiscal policies, probably due to the great asymmetry in size that has not favored the establishment of multilateral institutions.

In most of sub-Saharan Africa (with the exception of southern Africa), independent currency regimes have been associated with higher inflation and periodic devaluations—though devaluations have also served in some cases to cushion external shocks, for instance, to the terms of trade. Initially, the official pegs were maintained with exchange controls accompanied typically by inefficiencies and corruption, and parallel exchange markets developed. Under pressure from the Bretton Woods institutions, these countries moved toward liberalizing their payments regimes starting in the mid-1980s to enable current account convertibility and the elimination of parallel markets. In many of these countries, the current exchange rate regime is some form of managed floating.

We apply lessons from both experience and theory to the proposals for regional monetary unions. We consider ECOWAS, which as noted above has a project to create a second monetary zone of mainly Anglophone countries in West Africa (those countries that are not members of WAEMU) by mid-2005. This region, however, faces a major problem because Nigeria has both asymmetric terms of trade shocks (it is a large oil exporter while its potential partners are oil importers) and large fiscal imbalances that would not bode well for the effective independence or monetary discipline of a regional central bank. Any sustainable monetary union among these countries would have to be accompanied by reinforced fiscal discipline through effective regional surveillance and controls. We also consider another possible way toward greater monetary integration in West Africa, namely, through the expansion of the CFA franc zone. We find that indeed a few candidates would both gain and also produce gains for existing WAEMU members but that WAEMU would lose from admitting some of the other ECOWAS countries.

The concept of a full monetary union among the SADC countries of southern Africa seems infeasible at this stage, since a number of countries suffer from the effects of civil conflicts and drought and are far from having converged with the macroeconomic stability of South Africa and its CMA partners. More likely, any progress in achieving monetary integration would involve a limited expansion of the existing exchange rate union constituted by the CMA, and it would likely involve a monetary policy set by South Africa, as in the existing CMA, rather than involve the delegation by that country of monetary policy to a new and untried supranational institution.

Kenya, Tanzania, and Uganda's plan to revive the monetary union that formed part of the EAC, though unlikely to produce enormous economic gains, does seem to be generally compatible with other initiatives that could contribute to greater regional solidarity. However, economic gains would likely favor Kenya, which, unlike the other two countries, has substantial exports to its neighbors. The main issues would be whether the political will now exists to push regional integration ahead and whether it would continue to exist in the future. A wider project (which includes Kenya and Uganda but not Tanzania) is a monetary union among COMESA countries. This regional grouping also partly overlaps with SADC, exhibiting the overlapping regional commitments that prevail in Africa and often lead to inaction and contention. As is the case for SADC, differences in macroeconomic stability, fiscal discipline, and financial development among COMESA countries are great, making it unlikely that such a project is achievable as currently envisioned. Moreover, South Africa is not a member, so that COMESA would not benefit from the track record of monetary stability of South Africa's Reserve Bank.

Does that mean that the goal of a single African currency is beyond reach?[3] Probably, and in any case the idea that currencies should span a continent

3. Robert Mundell has argued that though a common currency would be a good thing, a more realistic goal in the medium term would be a common peg to the euro (Mundell, 2002).

does not make a lot of sense. At present, the euro is the only regional currency with a global role. Creating a single African currency would not likely give it prominence on a world scale, and the single African monetary policy (whatever it was) would impose considerable costs on very dissimilar economies. If exchange rate stability is the primary objective, then stability could be achieved at a much lower cost through a unilateral peg to the dollar, the euro, or a combination of the two, depending on a country's pattern of trade and financial relations. If the objective of a single currency is primarily to demonstrate continental solidarity, we think that since the economic costs would be substantial, a better way should be found to demonstrate that solidarity, for instance, through agreement to dismantle barriers to the movement of goods, people, and capital throughout the region. Of course, regional integration would be abetted by succeeding with the NEPAD initiative. By reducing conflicts, improving governance, eliminating corruption and fiscal excesses, and promoting the rule of law, African countries would become much more attractive partners in regional cooperation.

How will exchange rate regimes in Africa evolve in the short run to medium run in light of developments in the rest of the world? We believe that economic realities suggest that grand new projects for monetary unions are unlikely to be successful, though it is possible that expansion of existing monetary unions may take place, building on the considerable experience and credibility of the CFA franc zone and the CMA. However, enlargement of the CFA franc zone poses institutional problems. Turning to southern Africa, the CMA countries differ considerably in financial development and macroeconomic stability from their neighbors, so any expansion of the CMA is likely to be limited and delayed.

Recently, a great deal of attention has been paid to the hypothesis that countries need to choose between very hard pegs (in the limit, a monetary union) or flexible exchange rates. The intermediate regimes are not sustainable. The main argument relates to the trend toward capital account liberalization, which makes difficult the maintenance of anything but perfectly credible pegs. We consider that this factor is unlikely to dictate the choice of regime for most African countries, which continue not to be completely integrated with international capital markets, as there are capital controls, economic and political risks, and high transactions costs that inhibit capital movements. The absence of perfect capital mobility leaves open the full range of possible regimes, including adjustable pegs.

A major issue concerns the choice between a domestic nominal anchor and some form of exchange rate target. Exchange rate targets are fairly transparent (especially single currency pegs, less so for a basket peg) and do not require sophisticated financial systems, since the central bank essentially makes the foreign exchange market, buying and selling as necessary. If an exchange rate peg is preferred, the choice of the anchoring currency is also important. The euro, launched in January 2002, is already the world's second most important currency, and the euro area is set to expand further. Given the extent of Africa's trade with Europe, a peg to the euro may be an attractive option.

In this context, the question arises as to whether the EU could play some role in guaranteeing a peg to its currency, as is done by France for the CFA franc, now that the euro has replaced the French franc as the anchoring currency. An expansion and transformation of the CFA franc zone would allow countries joining it to achieve stability with the euro, while at the same time benefiting from the considerable credibility associated with the CFA franc. It would be natural to envision the EU assuming France's role of guaranteeing the currency peg. However, France's EU partners have shown no enthusiasm for doing so, especially since an enlarged CFA might have more serious budgetary and monetary consequences for Europe than is the case at present. The question for African countries would then arise of whether to continue to anchor the CFA to the euro and, if so, how. The three main alternatives would be a joint float, a currency board with a peg to the euro, or euroization (the outright adoption by African countries of the euro as their currency). If the former, the currency would then rely solely on the discipline and independence of the central bank operating a credible domestic monetary anchor. If the latter, countries would abandon any possibility of monetary independence vis-à-vis Europe, and doing so would likely revive perceptions of colonial dependence as well as produce a loss of the seigniorage that accrues to countries issuing their own currencies. The currency board option would allow little or no independence, except symbolic, but would at least raise some seigniorage for the central bank.

With increasing financial development, a domestic financial target becomes both more desirable and achievable. This is likely to be the route followed by the more advanced and larger economies or by regional monetary unions. It is already practiced in South Africa, which targets domestic inflation and lets the rand float freely in foreign exchange markets. At present, this is an option that is open to few of the countries or regions in Africa, but greater institutional and financial development could make it an attractive option for more—but by no means all—African countries. In the future, therefore, we see the monetary geography of Africa as including diverse arrangements—some regional currencies, some countries with independent currencies, and these currencies either pegged to international currencies or floating—as is currently the case.