“Implications of the Eurozone Crisis for Monetary Unions in Sub-Saharan Africa”

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Abstract

This paper draws implications from the 2010-2012 'Eurozone Crisis' for currency and proposed monetary unions in Sub-Saharan Africa (SSA). A wide variety of currency and monetary unions exist, or are proposed, including 'currency boards'. Most involve a potential mix of 'core' and 'periphery' countries without the prospect of prompt major trade gains. Most also mix net commodity exporters with net importers subject to asymmetric commodity price shocks. The experience of the Eurozone, with its well defined post crisis core and periphery countries, suggests that greater convergence and political and institutional preparation is required before a successful and fully fledged monetary union can be established.

Keyword: African monetary unions, Eurozone crisis, bank bad debt problems, fiscal consolidation

JEL Classifications: F33, E58, E62, F15, O16, G18, G21, G23

1. Introduction

The ‘Eurozone’ is a ‘common currency area’ which has been formed by a group of countries (17 of the 27 European Union member countries). It is part of a wider Economic and Monetary Union (EMU) which has the European Central Bank (ECB) at the centre of a central banking system involving the national central banks of the Eurozone member country and the other EU member countries. Countries outside the Eurozone, such as the UK and Sweden, have their own currencies and central banks, the Bank of England in the UK, and the Rijksbank in Sweden, and which set their own interest rates; but the 17 countries using the euro, and also a number of other EU member countries that essentially ‘peg’ their currencies to the euro, effectively have their interest rates set by the ECB. As members of a common currency area, the Eurozone members cannot alter their exchange rate with other member countries. Meanwhile, the EU countries outside the Eurozone have the option to allow their currencies to depreciate relative to the euro in order to improve their competitiveness in international trade. The exchange rate of the euro can, however, fluctuate against the US dollar and other major currencies.

The drive to form a currency, or monetary, union started with the 1992 ‘Maastricht Treaty’. In January 1999 the founding members of the Eurozone (the nine signatories of the Maastricht Treaty excluding the UK and Denmark, which gained exemption adopted the euro for trading and accounting purposes. Then in January 2001 the euro was adopted as a means of payment; with euro notes and coins replacing domestic currencies (e.g. the French franc and the German Deutschmark) in the participating

countries. On 1st January 2001, Greece, which joined the EU in 198, also became a member of the Eurozone and other countries (e.g. Malta, Cyprus, Slovakia, Slovenia and Estonia) have also subsequently joined; whilst Latvia, Lithuania (with a fluctuation band of 15%) and Denmark (with a fluctuation band of 2.25%) are currently in the Exchange Rate Mechanism ('ERM 2'), and thus shadowing the euro's central rate and waiting in the wings to join the Eurozone; if it survives the current crisis! The other Central and Southern EU member states, including the largest, Poland, are required to join ERM 2 for a period (see below) prior to joining the Eurozone.

Five 'convergence conditions' for aspiring members of the Eurozone were agreed by the EU governments: <u>fiscal deficits</u> less than 3% of GDP; <u>national debt</u> no more than 60% of GDP; <u>inflation</u> rate no more than 1.5% higher than the average of the best performing EU member states; <u>long term interest rates</u> no more than 2% higher than the average in the three member states with the lowest inflation; and membership of the <u>exchange rate</u> mechanism ('ERM II') agreed under the European Monetary System (EMS) for at least two continuous years without devaluing their currencies.

Under the 'Stability and Growth Pact' (SGP) between Eurozone members, participating countries were expected to continue to meet the fiscal deficit and national debt conditions, but no fiscal harmonisation involving common tax levels was required and no European Finance Ministry was to be established.

It has become clear that Greece was admitted to the Eurozone having massaged its national economic statistics in order to meet the convergence conditions for

membership. Goldman Sachs, the Wall Street investment bank, had devised financial derivates to move deficits and debt into the future, so that prevailing current levels appeared to qualify. It is less clear whether the existing members were really unaware that Greece's books had been cooked! Whilst Greece was being admitted to the Eurozone, Germany was struggling to meet the fiscal deficit requirements of the SGP as it incurred the costs of re-unifying East and West Germany in the 1990s and France flouted the rules. Hence, the two largest members undermined the pact, whilst the third largest, Italy, was heavily indebted from the outset.

The formation of the 'German Monetary Union' (GMU) following the replacement of the East German mark (the Öestmark) with the Deutschmark used in West Germany was followed by substantial fiscal transfers from West Germany to East Germany, funded by a 'solidarity tax' in West Germany; in order to help re-structure the East German economy more rapidly and to alleviate the 'transition recession' (Murinde and Mullineux, 1999) it experienced. The fiscal union needed to underpin a GMU and monetary unions in countries like the United States of America (the 'US') and the Australian Commonwealth of States was missing in the Eurozone. The US and the Australian federation combine monetary union with fiscal transfers from surplus states to deficit states. This is particularly true in Australia (Western Australian Treasury, 1999). For the Eurozone to become a 'transfer union', a 'solidarity tax' would need to be imposed on surplus countries such as Germany to assist adjustment in deficit states, like Greece.

The European political elite had seemingly hoped that participation in a common currency area would accelerate economic and political convergence, leading

eventually to fiscal and political union amongst participating countries. The government bond markets seemed to ‘buy’ the idea that the adoption of the euro and participation in the Eurozone common currency area was irreversible, and consequently the risk premium on all member countries declined and converged on the rate of the most credit worthy member country, Germany.

Germany’s credit worthiness was boosted from the middle 2000s following a successful implementation of the structural reform of its labour market (the ‘Hartz laws’ and a series of restrained annual national wage bargains; which increased Germany’s productivity and competitiveness within the Eurozone, and internationally. As a result, that Germany began to re-build its trade surplus on the back of a strong manufacturing export performance, both within the EU and globally.

In effect, Germany had undertaken an ‘internal devaluation’, something which Estonia also subsequently achieved in the late 2000s, after joining the Eurozone in June 2004. An internal devaluation requires a country to reduce wages relative to other member states and/or to raise productivity (output per hour worked). This requires wage increases to be repressed for a period and perhaps even cut, as seems required in Greece, and is often associated with a recession with declining or negative wage inflation. A currency depreciation or devaluation is easier because it automatically reduces the ‘real’ wages of all workers relative to other countries, unless they devalue competitively. However, if wage inflation subsequently accelerates as workers attempt to restore their purchasing power in the face of higher import prices, the benefits are eroded (Sargan, 1964). The faster and further wages rise, the more quickly the competitive advantage achieved by devaluation is eroded. Worse, the

devaluing country may see price inflation rise and have to undertake a period of monetary, restraint and perhaps fiscal austerity, to bring it under control.

2 The Onset of the Crisis and the 'Doom Loop'

The 2007-9 Global Financial Crisis (GFC) sparked by the US subprime mortgage crisis left banks in many Eurozone countries (including Germany) with bad debts on their books (Beck, 2012) which their national bank regulators failed to force them to write down. Some countries, notably Ireland and Spain, had housing price bubbles, as did the UK outside the Eurozone, whilst others (e.g. Germany and France) did not. Some countries had deteriorating fiscal balances (e.g. Greece and Portugal), whilst others, including Ireland and Spain, had sound fiscal balances prior to their household and commercial property and consequently banking, crises. Italy was seemingly losing control of its fiscal deficit and France was also facing a growing deficit. Meanwhile, Germany's fiscal deficit had declined significantly after a period increased growth. Greece meanwhile had a growing trade deficit with the rest of the EU and the world, whilst Germany had growing surpluses.

In May 2010, Greece had to be rescued by the EU with assistance from the IMF. Then, in November 2010, Ireland also received financial assistance from the 'The Troika', the European Commission and the ECB with assistance from the IMF. Subsequently, in May 2011, Portugal came to a re-financing agreement with the 'Troika' to bring its fiscal deficit under control by adopting an economic reform programme. Italy and Spain chose to adopt their own fiscal austerity and structural reform programmes without assistance, as did the UK outside the Eurozone. The

‘conditionality’ imposed on the borrowing countries thus reflected traditional IMF practice of requiring fiscal ‘consolidation’ along with ‘structural’ economic reforms.

The fiscal austerity in Greece and elsewhere was arguably too much too soon, because countries that voluntarily adopted austerity, particularly Spain, experienced sharp economic slowdowns and sharp rises in unemployment. The UK economy, for example, went back into recession in the second quarter of 2012, but the Irish economy rebounded surprisingly well.

The ECB and the Bank of England have responded to the crisis by easing monetary policy, but this has not offset the negative effects of fiscal austerity on economic growth. France elected a new President (Mr Hollande) in May 2012, who pressed the Eurozone to ease fiscal austerity, increase the monetary stimuli and introduce more growth oriented policies. There is growing support from the IMF’s Managing Director, Christine Lagarde, for this, especially as regards more stimulatory monetary policy and slower fiscal consolidation, but efforts on structural reform are expected to be sustained. The US authorities are also pressing for resolution of the Eurozone crisis and faster growth in Europe, fearing that it is slowing the US and global economies and that a partial or full collapse by the Eurozone, with some or all participating countries reverting to domestic currencies, would have severe consequences.

After the May 2010, the post 2000 convergence of Eurozone member state bond interest rates gave way to divergence and the government bond interest rates moved above 7%, at which, with a national debt over 90%, as in Greece, and as a result of

bank 'bail outs' by the government, in Spain, then the cost of servicing government debt becomes unsustainable (Reinhart and Rogoff, 2011).

The ECB has been granting medium term loans to banks under the Longer Term Refinancing Operation (LTRO), enabling the banks to buy government bonds if they choose to. The biggest borrowers have been the Spanish and Italian banks and their purchases of domestic governance bonds helped reduce their interest rates, but has increased the exposure of the Eurozone's banks to domestic government defaults. Meanwhile, a significant proportion of the government debt in Spain, and indeed in many other countries, is the result of bailing out domestic banks. Further, to make them safer, the banks are required by the regulators to increase their holdings of short term government bonds and treasury bills issued by their home country governments, exposing them to greater risk of government default and thereby raising their costs of raising equity and bond finance. Thus, in the most troubled countries, there is essentially a 'negative feedback loop', or **'Doom Loop'**, linking the debts and credit worthiness of banks and their governments. As in Ireland before it, the cost of supporting the banks in Spain, for example, is too high for Spain's government to bear, because it will worsen the fiscal deficit, and this will further reduce the value of the government bonds held by the Spanish banks and the cost of Spain's government borrowing.

To break this 'Doom Loop' connecting government and bank debts, it was clear by June 2012 that Spain was in need of outside help to resolve its banking crisis and to ease austerity and reduce unemployment by re-stimulating growth; but would the rest of the Eurozone, and particularly Germany, the largest and wealthiest country, help?

The Eurozone with the help of Germany seemed likely to assist Spain, but seemed to have lost patience with Greece; where some citizens were failing to pay taxes due and the people had voted in early June 2012 against austerity following a second bailout by 'The Troika' in March 2012.

The German people signalled in local government elections in May 2012 that they did not want to bail out Greece and pay for its citizens to retire at a much younger age than German citizens can. Meanwhile, the German constitutional court was considering cases aimed at blocking bail outs of banks or governments using German taxpayers' money and purchases by the ECB of bonds issued by the heavily indebted Eurozone member countries (Portugal, Ireland, Greece and Spain), sometimes called 'the periphery', Italy, or indeed other member countries.

Monetary policy within the Eurozone was also 'fragmenting' in the sense that the rates set by the ECB led to higher lending rates by banks in the periphery countries than in the 'core' countries. This was because of the cost of funding to the banks based in the periphery was higher as a result of the devaluation or exchange rate 'convertibility' risk associated with the probability of countries 'exiting' the Eurozone, or indeed the Eurozone collapsing altogether and the euro being replaced by domestic currencies of uncertain value. The higher rates in the periphery thus reflected an exchange rate risk that should not be present in a monetary union and was distorting the allocation of capital. The banks based in the core countries potentially faced higher capital requirements on lending in the periphery and there was some evidence of 'capital flight' within the Eurozone with deposits being moved from banks in the periphery to banks in the core. Further, US money market mutual funds

ran down their wholesale funding exposures to the Eurozone in general and the periphery in particular. The risk of bank failures in Greece or Spain could lead to 'bank runs' with capital flight to the core was increasing and indeed of a capital flight out of the Eurozone as a whole. There was thus a growing case for supplementing traditional monetary policy intervention to contain the capital flight and reverse the fragmentation, which was making it harder to achieve growth in the periphery through ECB induced monetary stimulus. This could be done through ECB purchases, on the secondary, or perhaps even the primary, markets of bonds issued by periphery countries' governments. Such a policy, and particularly the purchase of primary issuance, was strongly opposed by Jens Weidmann, President of the Deutsche Bundesbank

If the EU were a political union with a single Finance Ministry, as well as a central bank, the ECB, and a 'banking union', then a Eurozone wide agreement to help the Greek region, or state, in the union, would be all that was required. A 'banking union' involves a unified deposit insurance scheme responsible, perhaps, for the 'resolution' of Eurozone banks subject to common regulation and supervision by a Eurozone bank regulator, in place of the national level regulation and supervision and deposit insurance currently prevailing. One possibility is that the ECB should take on the job of regulating the big international EU banks, leaving the future role of the European Banking Authority (EBA) uncertain, and that national central banks should regulate smaller local banks.

The Fiscal Compact, signed in March 2012 by all of the EU member governments except the Czech Republic and the UK, requires Eurozone member countries to

‘balance’ their government budgets (i.e. achieve a general budget deficit of less than 3% of GDP and a structural deficit of less than 1% of GDP, if government debt is less than 60% of GDP, or below 0.5% of GDP, if the debt exceeds that). If adhered to, the Compact might well prevent future fiscal crises. The parallel adoption of ‘macro prudential’ supervision (www.bis.org) would help prevent future asset price inflations, including house price bubbles. However, the political union and fiscal harmonisation required to underpin a full banking and monetary union remain a project for the future.

In mid June 2012, just ahead of the GdRE conference in Nantes, a second Greek election, which was necessary for the formation of a government, resulted in a coalition government favouring Greece’s continued membership of the Eurozone, but the stability of the government and Greece’s ability to service its debts without concessionary financial assistance remained in doubt.

Prior to that, in June 9th 2012, Spain requested a €100bn rescue fund for its banks following two external assessments of the banks’ need to write off bad and doubtful property loans. The Eurozone members initially offered the requested financial assistance to the government via Spain’s FROB (‘Fund for the Orderly Restructuring of Banks’), prospectively increasing the government’s liabilities above the danger level of 90%. The markets reacted unfavourably and the interest rate on Spanish bonds rose above the 7% danger level; making a Spanish government debt default more likely and aggravating fragmentation in the Eurozone’s internal monetary and capital markets.

This was the context in which the GdRE conference round table discussion, summarised in the next section, took place.

3. Escaping the 'Doom Loop'

In late June 2012, Angela Merkel, the German Chancellor, seemingly gave ground by allowing a concessionary loan from the Eurozone's forthcoming European Stability Mechanism (ESM) (or its predecessor, the European Financial Stability Fund (ESFS) which is currently in operation) directly to FROB, which does not consequently (directly) increase the Spanish government's debt. This initially calmed the bond markets in early July, but it has yet to be sanctioned by the German constitutional court. Broader proposals to form an EU-wide banking union and to advance fiscal and political union within the EU will take an appreciable amount of time to realise and many of the proposals will need to be ratified either by the legislatures of all EU members' countries, or just the Eurozone participants.

To further underpin stability, the scale of the ESM may have to be enhanced substantially by increasing member country contributions and allowing the ECB to lend to it, or by allowing the ESM to issue euro denominated bonds backed by member governments to fund its activities, and/or by giving it a banking licence and allowing it to borrow from ECB. Further, its scope will probably have to be expanded to allow the purchase of the bonds of governments facing 'high', (e.g. above 6%) interest rates. At the Eurozone Summit meeting in June 2012, Italy secured agreement that the ESFS or ESM could buy its bonds as long as it stuck to its austerity programme. The ECB responded positively to the Eurozone Summit initiatives by

cutting interest rates on July 5th, and further monetary easing was promised, if required.

Following the July 5 announcement by the ECB, Spanish government bonds rose above 7% again in mid-July, but a €30bn advance loan to FROB was promised provided junior bondholders (including savers at local and regional savings banks) took losses. This was politically contentious, but brought the rate back below 7%. The German constitutional court then deferred a decision on the proposed role of the ERM for three months and the Spanish regional governments began to request assistance from the central government of Spain, revealing its unfunded fiscal deficits to be yet higher.

Then in August 2012, another ECB announcement seemed to indicate an accommodation between the EC and the ECB, including Jörg Asmussen, the German nominee on the ECB Executive Board, and the German government The EC backed proposal to issue Eurozone bonds was dropped, along with the proposal to give the ESM a banking licence or a direct line of credit for the ECB, and there would be no direct purchase by the ECB of long-term government bond issuance; but the ECB could buy short term bonds on the secondary markets in order to reduce borrowing rates in periphery countries and to stabilise the euro as part of its 'open market operations' in pursuit of monetary policy. However, Jens Weidmann, President of the Bundesbank, publically expressed his disapproval. The overall aim of these 'Outright Monetary Transactions' (OMTs) is to re-establish common interest rates and free capital flows commensurate with a monetary union and to stem capital flight to the northern EU members, and from the EU altogether.

Increased economic growth was to be pursued through increased funding for the European Investment Bank (EIB) to conduct infrastructural investment. Its impact on growth was likely to be gradual and the source of funding was unclear given the difficulties expected in agreeing the next EU budget in November/December 2012.

The ECB was apparently aiming to do just enough to alleviate the crisis whilst keeping pressure on European politicians to make progress, with the proposed banking union and the fiscal and political unions necessary to facilitate the fiscal transfers and debt mutualisation necessary to underpin a currency union and establish a fully credibly monetary union.

Further progress was made towards establishing a banking union involving centralised supervision, to complement EU regulation set by the European Banking Authority (EBA), by the ECB (or 'Single Supervision Mechanism', SSM); but Germany required it to be effective and operational before the ESM could start using its €500bn fund to help with the re-capitalisation of troubled banks, and blocked the other components of a banking union; which would involve mutualisation of bank debts across countries by establishing common resolution and deposit insurance funds. To protect against moral hazard, the common supervisory system should precede mutualisation and, to protect taxpayers in Germany and elsewhere, progress needs to be made towards political union before explicit or implicit fiscal transfers, along with the necessary checks and balances, can be agreed.

Further, it was clear that it would take time to establish a proven operationally 'effective' supervisory system at the ECB level. The German authorities still hope

that, at least initially, this will mean that responsibility for the supervision of local savings and cooperatives can remain at the national level.

It is clear that the establishment of a banking union will take time and require considerable political will and compromise. The establishment of a political union with sufficiently large fiscal transfers and thus central budget will take even longer; especially whilst the UK remains within the EU.

It is hard not to conclude that shorter term solutions must involve debt forgiveness and payment rescheduling for Greece and other periphery country governments and their banks. The trick is to achieve this whilst imposing sufficient conditionality to curb moral hazard. At present it is proposed that conditions include: ceding sovereignty over the regulation and supervision of domestic banks; submitting to fiscal and structural economic reform with increasing emphasis on the latter and reduced emphasis on short term fiscal austerity.

4. The Eurozone after the crisis

If Greece were to 'exit' from the Eurozone, there could well be a widening and deepening of the banking crisis in Spain and other Eurozone and non Eurozone EU countries. Given the implicit underpinning of the big national banks by the taxpayers (who are also voters and, many of them, bank depositors) and thus governments, an exacerbation of the banking crisis would lead to increased government bond interest rate premiums. Ultimately, more and more countries might exit the Eurozone and it might revert to a monetary union for the core of northern European members, with the periphery (mainly southern) countries dropping out, or being ejected.

Germany has however benefited from euro exchange rates being lower than the exchange rates that would have prevailed had if it had continued to use its own currency, and perhaps also from interest rates lower than it would have prevailed if it still had its own central bank; thus providing cheaper finance for its industrial companies and increasing their international competiveness.

Germany citizens thus face a difficult decision, but German industry is clear that it wants to the Eurozone to survive. Germany's politicians, the Bundesbank and the ECB are caught in the middle and it is evident that the third dimension to the Eurozone crisis is political. There is a limit to what the ECB can do to solve the problem, but it can buy time. It does not however want to give the politicians too much 'rope' to procrastinate, because political instability can severely aggravate financial crises by triggering capital flight, as in the Latin American and Asia financial crises (Dickinson and Mullineux, 2001a,b). Hitherto, the capital flight generated by riots and protests in Greece, Spain and to a certain extent Italy has largely been from those countries to northern EU countries; as German, French and other banks have reduced their exposure to the Greek, Spanish and Italian banks and governments. This in turn is causing the Eurozone monetary markets and capital markets to fragment and is pushing up interest rates in the affected countries.

As political uncertainty concerning the resolution of the crisis persists, capital flight from the periphery, and perhaps the Eurozone as a whole, to the UK, Switzerland, the US and elsewhere is likely to increase. To curb the capital flight and restore the normal operation of the European money and capital markets, credible political steps towards banking, fiscal transfer and political unions need to be taken to break out of

the 'Doom Loop'. The formation of pooled Eurozone Deposit Insurance Fund (EDIF) pre-funded using risk related premiums to contain moral hazard, would provide the basis for mutualisation and allow transfers between countries. It should, however, be noted, however, that Germany has never adopted a fully funded bank deposit insurance system; preferring instead to rely on its three (shareholder owned, savings and cooperative) banking associations to commit to bailing-out troubled members, as required. Further, the German constitutional court would have to approve to Germany's participation in EDIF. In return for access to the implicit transfers involved in drawing from for the fund, participating countries would have to give up sovereignty over domestic bank regulation. The EDIF fund could also manage the resolution of smaller banks and would naturally be involved in their regulation, as in the case of the FDIC in the US. Given their implicit insurance by taxpayers, too big to fail and systemically important banks would need to be regulated separately, and would naturally be supervised by their lender of last resort (the ECB), as in the US; with the EBA overseeing bank regulation across the EU.

The purchase of Eurozone member government bond issuance by the ESM would require 'conditionality' to be imposed on borrowing governments and the associated loss of sovereignty. The funding of the ESM through euro denominated bond issuance, implicitly guaranteed by member states, would thus be a further step towards fiscal and political union. The granting of a banking licence to the ESM, or ability to borrow from the ECB, would reduce the need for the Eurobond issuance, however, but may not be approved by the German constitutional court, and would be opposed by the Bundesbank. There are, however, calls from the German opposition Social

Democratic Party for a referendum to be called to consider amending the constitution to facilitate the issue of Eurobonds and the formation of a Eurozone fiscal union.

Germany must surely have a contingency plan to re-introduce the Deutschmark and may in the end choose to implement it. It would also prefer to re-capitalise its own banks, rather than the Spanish and other banks. However, recapitalising German banks, whilst also writing down their Spanish government and bank bond 'assets', would assist the Spanish banks and its government.

The way forward must therefore be a banking union followed by a full fiscal (and thus 'transfer') union and a political union for some or all of the current Eurozone member states to form a 'United States of Europe', and consequently a two or more speed Europe. These are, at best, medium term solutions, however, and in the meantime progress must rely on debt forgiveness for the government and banks of Greece and some other periphery countries, subject to imposing sufficient conditionality to curb moral hazard.

5. Lessons

The Nantes conference panel broadly agreed that the way forward was for the ECB to do 'whatever it takes' to break the Doom Loop by continuing to provide ample liquidity to EU banks and purchasing, perhaps eventually through the ESM, government bonds issued by the 'periphery' Eurozone countries; in order to bring down their costs of borrowing and re-establish, as far as possible, single monetary and capital markets within the Eurozone. Spanish banks should be re-capitalised through the ESM, subject to the Spanish government agreeing to a package of economic

reforms; ideally with less emphasis on fiscal consolidation and austerity in the short term and more emphasis on structural, particularly labour market, reforms. A 'bad bank' solution should apportion the good assets and the impaired assets into separate 'good banks' and 'bad banks'. The management of the bad banks' assets would naturally require creditor banks to take haircuts to reduce the exposure of Spanish taxpayers. The impaired assets might instead be amalgamated into a single national asset management agency, as with NAMA in Ireland and recently proposed in Spain. Further, the ECB may eventually need to take a 'haircut' on the periphery government debt it is holding in order to resolve the debt crisis and appeared to have opened the door to this possibility in connection with the bank creditor 'bail-in' arrangements being devised in early 2013.

Going forward, a banking union involving centrally coordinated banking supervision and ultimately a common deposit insurance fund and a bank resolution fund, as in the US with its Federal Deposit Insurance Corporation (FDIC), would be required to underpin a fully-fledged Eurozone monetary union. This would involve substantial loss of member state government control of bank supervision and the 'mutualisation' of taxpayer exposures across participating countries. Both developments are likely to prove unpopular in Germany and most of the other northern EU states.

In October 2012, the European Council made the use of ESM funds to re-capitalise Spanish, and other, banks conditional on Spain, and other participating countries, submitting to EU level supervision of their banks. Given the potential exposure of German taxpayers, the German government is pressing for fiscal and political union

ahead of agreeing to participate in pooled deposit insurance and bank resolution funds beyond current ESM commitments.

It is not clear how the formation of a complete banking union, beyond an agreement on how much of the banking system is to be supervised centrally, can proceed without making progress towards a political union amongst the participating states in order to agree on a system for fiscal transfers between them. Without it, the ECB risks progressively adopting a fiscal role through secondary purchases of government bonds, and perhaps eventually direct purchases of member state government bond and Eurobond issuance, and involvement in macro, as well as micro, prudential policies; and the northern European taxpayers would not be safeguarded.

The export oriented German industrial sector has clearly benefitted from membership of the Eurozone, but if the banking union evolves to encompass mutualisation of the costs of bank 'bail outs' without sufficient progress on fiscal and monetary union, and if the viability of Germany's popular local savings and cooperative banks is threatened, then the German government must surely weigh the costs and benefits of continued Eurozone participation. It might possibly conclude that a German exit from the Eurozone was in the interest of its taxpayers and the voting public. An alternative, northern European, monetary union (NEMU) might be formed.

Finally, political and social unrest as a result of continuing austerity in Greece might still lead to a Greek exit ('Grexit') from the Eurozone. It is unclear how damaging the shock waves from such an event would be, to what extent contagion could be contained, or whether it would precipitate further exits, or the complete breakdown of

the Eurozone and the demise of the euro! Current plans for escaping the Doom Loop may prove to be 'too little, too late' to save the Eurozone!

A big concern is that the unravelling of the 'Eurozone project' might lead to an to an unravelling of the whole 'European Union project', which was designed to prevent European wars ever happening again, and also to increase Europe's international influence beyond that achievable by individual, and globally relatively small, countries. If the EU cannot assure financial stability, can it assure peace?

6) Implications for Monetary Unions in Sub-Saharan Africa (SSA)

There is a large and growing literature on currency and monetary unions in SSA. Tavlas (2008) presents an in depth literature review whilst assessing the prospects for a proposed fourteen country common currency area (the South African Development Community, SADC). The review focuses on two categories of studies: those that assume that a country's characteristics are invariant to the adoption of a common currency; and those that allow a currency union to alter economic structures through trade creating reductions in transaction cost and exchange rate uncertainty and monetary policy credibility gains. The latter can result from a more credible commitment to monetary policy through greater central bank independence. Debrun, Massan and Pattillo (2010) ask whether SSA monetary unions should be expanded. They focus on two monetary unions sharing the CFA francs issued by the West Africa and the Central African Central banks (BCEAO and BFAC) and pegged to euro. A

survey of monetary regimes in SSA is provided by Masson and Pattillo (2005). They ignore potentials trade gains and see the commitment to a common monetary policy as potentially strengthening domestic fiscal frameworks and, in so doing, reducing fiscal, as well as monetary (interest and exchange rate) autonomy and ability to respond to 'shocks'! Gains for the 'core' countries may be offset by losses by the 'periphery', and the 'core' may anyway not need a currency or monetary union to condition fiscal policy. IMF Country Report No.12/59 (2012) covers discussions with the regional institutions of the West African Economic and Monetary Union (WAEMU). It is noted that: existing trade between the potential members of the monetary union is not substantial; the financial sectors lack depth and, in particular, interbank, domestic government and corporate bond markets are under developed. This leads to 'original sin' (Eichergreen, Hausmann and Panizza, 2003) in the form of heavy reliance for government funding on foreign currency denominated bond issuance; exposing the member country to foreign exchange funding risks. The lack of financial sector depth, however, makes development of domestic debt financing extremely difficult in countries that have underdeveloped capital markets and are thus heavily 'bank dependent' (Bernanke and Gertler, 1989) for external finance, but nevertheless have relatively low levels of financial intermediation. The IMF report contains an Appendix (Appendix II, pp 41-48 by Hervé Joly) that draws lessons from the Euro Area Crisis for the WAEMU, to which we return below.

The aforementioned and other reports tend to stress that financial intermediation, interbank and capital markets are underdeveloped and inter-country trade of potential members of the of the unions is relatively small, and hence trade enhancement effects

of a currency union might not be large, at least initially. Additionally, the proposed currency and monetary unions often include both large and relatively more advanced countries and small lesser developed countries, creating a strong potentiality of strong core groups and a weaker periphery groups within the currency, and proposed monetary, unions. This raises the issue of whether some potential members will require a period of convergence on the 'core' countries in terms of rates of growth, levels of inflation and unemployment, and interest rates and exchange rate levels and stability; and probably also, in light of the Eurozone Crisis, tax structures and welfare state (health, education and pension provision and unemployment insurance) provisions, for which no convergence criteria were set by the EU. Differences between countries also arise from the differing importance of commodity production and exports to their economies.

In terms of the conditions necessary for successful participants in a currency union, it is initially advisable to test whether the countries share common definitions of money. This can be done using 'weak seperability' testing of monetary aggregates and their components within each of the potential member countries, Binner et al (2011) have done for the ASEAN countries plus Taiwan. Essentially, the test is for the compatibility of the monetary and, given the role of banks in creating money (Werner et al, 2011) thus the banking systems of the potential members.

Next, the extent to which the group of potential member countries deviates from the conditions for an Optimal Currency Area (OCA) (Mundell, 1961), should be assessed. These essentially require free movement of capital, and ideally also labour, between the members, as well as a free trade agreement. Beyond that, the countries should not

be expected to react significantly differently to internal and external 'shocks'. The conditions are rarely met within existing currency unions in countries such as the UK, the US, Germany and Australia (Fraser, MacDonald and Mullineux, 2011) and so countries seeking to participate in a currency union should weigh the costs (loss monetary and fiscal autonomy and ability to devalue or revalue the exchange rate) against the benefits (trade enhancement, lower and more stable inflation, and higher and potentially more stable growth). In a currency union consisting of a mix of net exporting producers of various commodities as well as net importers, in a world where commodity prices are subject to large fluctuations, big external commodity price 'shocks' can be expected.

The Eurozone is a currency union formed by a sub group of EU member states adopting a common currency (the euro) and a system of national central banks along with a European Central Bank (ECB) through which a policy committee sets short term interest rates in order to hit an inflation target (less than, but close to, 2%), Membership is based on achieving convergence criteria, as discussed in the first part of the paper, prior to joining, although in the case of Greece, the rules were not strictly applied and this had destabilising consequences. The criteria did not include convergence of tax and welfare systems and there was little provision for fiscal transfers from better performing countries, such as Germany and other 'core' member countries, to less well performing member countries. Further, the central EU budget is too small to effect significant regional transfers. More successful monetary unions, such as the Australian Commonwealth, provide for such transfers (Fraser, MacDonald and Mullineux, 2013).

To progress from a currency union to a monetary union, considerable fiscal harmonisation (of taxes and probably also welfare provision) is required and fiscal transfers need to be provided for, possibly via a larger central budget and an expanded development bank (in the EU's case, the European Investment Bank). In addition, to underpin the monetary union, a banking union is required to provide common bank supervision, and ideally also, common deposit insurance and bank resolution regimes (Beck, 2012; Schoenmaker and Gros, 2012: and Wihlborg, 2012) with procedures for resolving cross-border bank failures through risk sharing agreements. As discussed in Eurozone context, the need for fiscal and banking unions with transfers between states, modelled on the state based systems of the US, and Germany, Canada and Australia, *inter alia,* to transform a loose currency union into fully fledged credible monetary union (for life), has been revealed by the Eurozone Crisis. In short, a stable monetary union has to be underpinned by a political union that can contain and share the impacts of internal and external shocks.

In addition, those that believed that Eurozone membership would force convergence were proved to be mistaken because the periphery countries thrived on cheaper credit than they otherwise would have had access to and did not face binding fiscal budget constraints. With hindsight, more fiscal and political, as well as economic and financial sector, convergence was required prior to the formation of a trade enhancing currency union. And to assure its stability, a banking union was also required to convert the currency union into stable and lasting monetary union.

In the cases of the proposed currency unions in SSA, the micro 'conditions' of financial sector and monetary compatibility may well be absent and the countries

considering participation look unlikely to be optimal currency areas, whilst trade gains, at last initially, are judged unlikely to be large. Potential members must carefully weigh the short term and long term costs and benefits. Likely periphery countries should probably be persuaded to bide their time whilst they converge on core countries, and provisions need to be put in for the development of banking and political unions.

Options vary from currency unions based essentially on a ‘currency boards’, such as Hong Kong and the CFA zones, to arrangements for a central bank to be established to issue a common currency; in which case arrangements for sharing seigniorage need to negotiaited, as they have been in the Eurozone. The initial Eurozone group of countries essentially replaced the increasingly dominant Deutschmark with the euro, increasing the influence of member states other than Germany over monetary policy determination and allowing their governments a larger share of the seigniorage ‘revenue’. Given the post-war momentum the formation of the EU had built, this was agreed without too much difficulty by a sub group of the EU (excluding the UK *inter alia*).

The Eurozone crisis has however revealed a problem with the arrangements under which the national central banks of the Eurozone member countries develop credits and liabilities to each other under the TARGET2 interbank payments system. The causes and implications of these real time exposures is a topic that is currently being hotly debated. Cecchetti, McCauley and McGuire (2012) and Buiter and Rahbari (2012) take strongly contrasting positions over whether the causes of the imbalances are predominantly due to trade or capital flows and the extent to which they reflect

‘capital flight’ from the periphery. To the extent that the imbalances involve *de facto* burden sharing by the core with the periphery, and potential large transfers in the case of the central banks of the periphery debtor countries imposing losses on the German central bank (the Bundesbank) and other Northern European creditor banks, they involve actual or potential fiscal transfers via the monetary system. These might be better and more transparently dealt with by actual fiscal transfers and through development bank (European Investment Bank and KfW etc) lending. This is a complex problem perhaps best resolved at the outset of a union whilst considering the fiscal implications of the sharing of seigniorage derived from the issuance of a common currency. Indeed seigniorage might be hypothecated, perhaps along with the revenues from a Value Added Tax on financial services, as a means of funding deposit insurance and financial system oversight, capitalising a development bank for the union, and perhaps also establishing a funded pension insurance system. In addition, the complexity caused by creating a system of central banks clustered around a common currency issuing central bank, could be avoided if political agreement allowed former national central banks to be closed down. A large union might however require regional reserve banks organised on a geographic, rather than state or national basis, as in the US Federal Reserve System, with its system of Federal Reserve Banks.

A key question is thus, what is the currency or monetary union for? What is it supposed to achieve? For potential participating membership countries, the question should be asked: will the benefits of membership outweigh the costs after a period of adjustment acceptable to the electorate.

Let us now consider what lessons Hervé Joly (IMF, 2012, Appendix II, pp 41-48) drew from the Eurozone crisis for the governance and stability of monetary unions in general, and for the WAEMU, which has developed a 'single market' for traded goods and services, in particular. A major difference, is that the Eurozone issues its own currency (the euro), whilst the WAEMU issues a currency pegged to the euro with guaranteed access to foreign exchange, and thus has characteristics of a currency board, such as Hong Kong. The WAEMU is, however, also much less integrated economically and financially than the Eurozone and less connected with the global financial markets. However, WAEMU has more highly developed regional regulation and supervision of the financial system, than the Eurozone to date. In light of these similarities and differences between the two unions, the lesson for WAEMU drawn by Hervé Joly is that market flexibilities and regional integration facilitate adjustment to asymmetric shocks; fiscal discipline is essential; structural reforms must be undertaken to assure competitiveness; regional economic and financial surveillance should be strengthened; and a crisis management system should be established. The review of what went wrong in the Eurozone suggests that monitoring to detect the emergence of systemic financial instability and the development of macro-prudential tools, operated by the central bank, to complement micro-prudential regulation and supervision, will be required; along with the implementation of structural reform aimed at raising productivity and developing the financial sector. Financial sector development, particularly of interbank markets, is a natural role for a central bank; whilst a development bank might be better placed to lead capital market development. The productivity enhancing structural reforms would need to be led by potential

finance and economy ministries, and so international coordination of policies will be required until common ministries are developed in a political union.

With regard to financial sector regulation and supervision, there may be a case for retaining local regulation and supervision of local commercial and savings banks, in contrast to cross border international commercial and investment banks. This is a matter being negotiated in the Eurozone at present.

Finally, even with fiscal transfers between member countries, external imbalances and competitiveness will need to be managed in currency or monetary unions operating as quasi-currency boards with pegged exchange rates, as in the case of WAEMU. This is much less of an issue for the Eurozone, given that the euro has been allowed to float freely against the US dollar and the Japanese Yen, *inter alia,* in the absence of the capital controls (except temporarily to combat aggressive 'shorting' and following the Cyprus 'bail-in' of creditors in March/April 2013). This has freed the ECB to set interest rates with the prime objective of hitting its inflation target. The central bank in a currency board has to target the exchange rate primarily, but may gain a degree of freedom by imposing capital controls, especially on capital inflows. Such countries have, however, proved hard to sustain in the medium to long term, as indeed have currency boards themselves when the credibility of the pegged exchange rate is called into question (e.g. Argentina in 2000). In contrast, the Hong Kong currency board has maintained a fixed rate since 1984. A small country with a sophisticated financial system may find stability easier to achieve than a union of countries with much less advanced financial systems, however. Commitment to a monetary union with limited fiscal transfers requires a willingness to undertake painful 'internal devaluations'; as

demonstrated by Germany after ‘re-unification’ and by the Baltic states, as they strived to meet the convergence criteria before joining the Eurozone. Greece, Portugal, Ireland and Spain are now learning this lesson. External devaluations, or depreciations, of the common currency can help reduce the bloc’s trade deficit, but only if real wages are cut as a result of import price increases and not offset by compensating inflationary nominal wage increases (Sargan, 1964). Internal devaluations that reduces unit labour costs tend to be politically more difficult to engineer, but are the only option in a currency or monetary union. In sum, entering into a currency, or a deeper monetary union, requires political commitment and the support of the electorates of the participating countries. The Eurozone member states have been criticised for not raising their electorates’ awareness of the implications of the ‘journey’ towards achieving currency, and eventually monetary, and thus banking, fiscal and political, unions. Instead, the political and intellectual elites forged ahead, leading to a ‘democratic deficit’, the political consequences of which may yet undo the Eurozone currency union before a fully-fledged monetary union can be achieved. Alternatively, the ‘core’, especially the Northern European, countries may eventually form a monetary union that excludes the periphery countries!

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