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

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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 many other currencies.

The drive to form a 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. 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. The other Central and Southern EU member states, including the largest, Poland, are required to join ERM 2 for a defined period prior to joining the Eurozone.

Five 'convergence conditions' for aspiring members of the Eurozone were agreed by the EU governments: fiscal deficits less than 3% of GDP; national debt no more than 60% of GDP; inflation rate no more than 1.5% higher than the average of the best performing EU member states; long term interest rates no more than 2% higher than the average in the three member states with the lowest inflation; and membership of the exchange rate 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 derivatives 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 of this. Whilst Greece was being admitted to the Eurozone, Germany, which 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 also France flouted the fiscal rules. Hence, the two largest members undermined the pact, whilst the third largest, Italy, had been 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 its 'transition recession' (Murinde and Mullineux, 1999). The fiscal union that was required to underpin a GMU and monetary unions in countries like the United States of America (the 'US') and the Australian Commonwealth of States ('Australia'), was absent in the Eurozone. The US and Australia combine a currency union with fiscal transfers from surplus states to deficit states (Western Australian Treasury, 1999). For the Eurozone to become such a 'transfer union', a 'solidarity tax' would have to be levied on surplus countries, such as Germany, to assist adjustment in deficit states, such as Greece at the present time.

The European political elite seemingly hoped that participation in a common currency area would accelerate economic and political convergence, leading eventually to the fiscal and political union amongst participating countries necessary to underpin a full monetary union. The EU 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 participating countries declined and their government bond rates converged on the rate of the most credit worthy member country, Germany.

Germany's credit worthiness was boosted following the successful implementation of the structural reform of its labour market in response to the 'Hartz laws' and a series of restrained annual national wage bargains in the mid-2000s; 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.

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 seemed 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, or Great, 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 regulators failed to force them to write down. Some countries, notably Ireland and Spain, generated housing price bubbles, as did the UK outside the Eurozone, whilst others, including Germany and France, did not. In some countries, such as Greece and Portugal, fiscal balances deteriorated, 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 developing a growing deficit. Meanwhile, Germany's fiscal deficit had declined significantly. Greece meanwhile had a growing trade deficit with the rest of the EU and the world, whilst in Germany had surpluses were growing.

In May 2010, Greece was rescued by the European Commission and the ECB with assistance from the IMF. Then, in November 2010, Ireland also received financial assistance from the same 'Troika'. Subsequently, in May 2011, Portugal negotiated 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 design their own fiscal austerity and structural reform programmes without assistance, as did the UK outside the Eurozone. The 'conditionality' imposed on the borrowing countries reflected the 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 and countries that voluntarily adopted austerity,

particularly Spain, experienced economic slowdowns and sharp rises in unemployment.

After the 'bail-out' of Greece in May 2010, the 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, the cost of servicing government debt arguably becomes unsustainable (Reinhart and Rogoff, 2011).

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

Loop' in Spain it was clear by June 2012 that outside help was needed to resolve Spain's banking crisis and to ease austerity and reduce unemployment by re-stimulating growth; but would the rest of the Eurozone, and in particular, Germany, the largest and wealthiest country, help?

Additionally, monetary policy within the Eurozone was 'fragmenting', in the sense that the low interest rates set by the ECB were not preventing the charging of 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 leaving, or '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 fully-fledged monetary union and was distorting the allocation of capital and inhibiting the supply of funds to SMEs in particular, and consequently economic growth, in 'the periphery'. The banks based in the 'core' countries potentially faced higher capital requirements on their more risky lending in the periphery and there was some evidence of 'capital flight' (Dickinson and Mullineux, 2001a,b) 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.

There was thus a growing case for supplementing traditional monetary, or interest rate, policy intervention in order to contain the capital flight and to reverse the

fragmentation, which was making it harder to achieve growth in the periphery through ECB induced monetary stimulus. This might be done through ECB purchases, on the secondary, or perhaps even the primary, markets of bonds issued by periphery countries' governments, or 'Quantitative Easing'. Such a policy, and particularly the purchase of primary government bond issuance, was strongly opposed by Jens Weidmann, the President of the Deutsche Bundesbank

If the EU was a political union with a single Finance Ministry, as well as a central bank (the ECB) and as well as a 'banking union', then a Eurozone wide agreement to help any region, or state, in the union, would be all that was required. A Eurozone 'banking union' requires unified Eurozone deposit insurance and 'resolution' schemes involving banks subject to common regulation and supervision by a Eurozone bank regulator; in place of the national regulatory and supervisory regimes, deposit insurance schemes and patchy resolution regimes that were operating at the time.

A new 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.

3. Escaping the 'Doom Loop'

In late June 2012, Angela Merkel, the German Chancellor, 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 was still in operation) directly to FROB, which did not consequently (directly) increase the Spanish government's debt. Broader proposals to form an EU-wide banking union and to advance fiscal and political union within the EU would take an appreciable amount of time to realise and many of the proposals would 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 might 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. 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 on July 5th to the Eurozone Summit initiatives by cutting interest rates and further monetary easing was promised, if required.

Towards the end of July 2012, in a statement that effectively ended of the 2010-2012 Eurozone crisis, Mario Draghi, the President of the ECB, famously announced that the ECB was ready to do "whatever it takes to preserve the euro", adding: "and believe me, it will be enough". The markets indeed believed him and the crisis abated with

government bond rates in the Eurozone again converging on lower German rates and by mid-2014, rates on Spain's bonds were below rates on US bonds.

Further, 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, as President of the Bundesbank, publically expressed his disapproval. The overall aim of these 'Outright Monetary Transactions' (OMTs) was 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 that is required 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 under a 'Single Supervision Mechanism' (SSM) proposed by the EC in September 2012; but Germany wanted 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 SSM 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. It was clear that it would take time to establish a proven operationally 'effective' supervisory system at the ECB level. The German authorities hoped that, at least initially, this would mean that responsibility for the supervision of local savings and cooperatives could remain at the national level.

The SSM was subsequently enacted in October 2013 with the ECB assuming its supervisory role from 4th November 2014. In its final form the SSM reflects a compromise establishing a system of common bank supervision in the EU that involves national supervisors and the ECB, which has the final supervisory authority with national supervisors in a supporting role. A division of labour between the ECB

and national supervisors was established, with the ECB supervising ‘significant’ (large and cross- border) banks and national supervisors smaller domestic local banks.

In preparation for its role the ECB is undertaking a ‘Comprehensive assessment’, to be completed by end October 2014, of banks in the EU comprising of: an Asset Quality review (AQR) of banks, including the adequacy of their collateral and provisions against bad and doubtful debts; and a Stress Test, which is to be performed in close co-operation with the European Banking Authority (EBA), which is responsible for bank regulation in the EU, to test the resilience of banks’ balance sheets to stress scenarios and thus the capital adequacy of banks.

In April 2014, further progress towards the EC’s objective of creating a European Banking Union (EBU) consisting of an SSM, a Single Resolution Regime (SRM) and a Deposit Guarantee Scheme (DGS) with the adoption by the European parliament of a bank recovery and resolution Directive (BRRD) on 15th April 2014. This is a major step towards and SRM and is due to become effective, following ratification by national legislatures, from the end of 2015. The SRM and the DGF require building funds financed by banks and perhaps initially also out of revenue from financial taxes, such as the proposed EU Financial Transactions Tax. This raises issues around the size of the funds, moral hazard and cross country mutualisation and will require further consultation and political agreement. The EC consultation on contributions of banks (‘credit institutions’) to the resolution financing arrangements under the BRRD and the SRM were launched in June 2014. In the US the Federal Deposit Insurance Corporation’s deposit guarantee fund is also used for resolution of the smaller and local banks, it should be noted.

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

4. The Eurozone after the crisis

To curb fragmentation and restore the normal operation of the European money and capital markets, credible political steps towards banking, fiscal transfer and political unions needed 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. However, it should be noted, 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 have to be regulated separately, and would naturally be supervised by the ECB as their lender of last resort.

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.

The ultimate solution would therefore entail a full (or Eurozone wide) EBU 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.

5. Lessons

A GdR European Money, Banking and Finance (GdRE MBF) conference panel in Nantes in June 2012 came to the conclusion that the way forward was for the ECB to do whatever was necessary 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, non-fragmented, banking, monetary and capital markets within the Eurozone (Mullineux, 2013a). The panel recommended that 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. Good assets and the impaired bank assets should be apportioned to separate ‘good banks’ and ‘bad banks’. The management of the bad banks’ assets would naturally require creditors, including other banks, to take haircuts in order to reduce the exposure of Spanish taxpayers. The impaired assets might possibly be amalgamated into a single national asset management agency, such as the NAMA in Ireland. Further, the ECB might eventually need to take a ‘haircut’ on the periphery government debt it is holding in order to fully resolve the Greek debt crisis and it appeared to have opened the door to this possibility in connection with the bank creditor ‘bail-in’ arrangements that started to be devised in early 2013. These have subsequently evolved through the SNS Reaal bank crisis in the Netherlands, which was nationalised on 1st February 2013 with junior bondholders, along with shareholders, losing their investments completely, although senior bondholders were fully protected, and in the 2012-13 Cypriot banking crises which culminated in a bail-out by the Troika on terms agreed on 25th March 2013 which imposed losses on Laiki Bank shareholders and large uninsured depositors whilst protecting insured depositors up to the guarantee limit of 100.00 euro and imposed strict capital controls to avoid capital flight

Going forward, a banking union involving centrally coordinated banking supervision and ultimately a common deposit insurance fund and a common bank recovery and 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 use of ESM funds to re-capitalise Spanish banks conditional on Spain 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 agreed ESM commitments.

It is unclear how further progress towards a complete EBU, moving beyond the SSM to be implemented in November 2014 and the BRRD agreed in April 2014, can proceed without making further 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 primary, or direct, purchases of member state government bond (and perhaps also Eurobond) issuance if Quantitative Easing is adopted, and instigating macro-prudential policies aimed at curbing asset price inflations.

The export-oriented German industrial sector has clearly benefitted from membership of the Eurozone, but if the EBU evolves to encompass mutualisation of the costs of bank 'bail outs' without sufficient progress towards fiscal and monetary union, and if the viability of Germany's popular local savings and cooperative banks is ultimately threatened by more centralised supervision, then the German government might 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!

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.

Such 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 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 participation 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). 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, can anticipate big external commodity price 'shocks'.

The Eurozone started as 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%). In 2013/4 it began evolving into a monetary union by vesting supervisory responsibility for larger and cross border banks in the ECB with effect from 1st April 2014. Membership of the Eurozone 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 full 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 federal systems of the US, and Germany, Canada and Australia, *inter alia,* to transform a fragile currency union into fully fledged credible and resilient monetary union, 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 were able to avail themselves of cheaper credit than they would otherwise have had access to and thus did not face binding, or 'hard', government 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. To assure stability and resilience, a full banking union is also required to convert the fragile currency union into a robust monetary union.

In the cases of the proposed currency unions in SSA, the microeconomic pre-conditions of financial sector and monetary compatibility (Binner et al, 2011) may well be absent and the countries considering participation are unlikely to be optimal currency areas in the sense of Mundell (1961), whilst trade gains, at least initially, are judged unlikely to be large. Potential members must carefully weigh the short term and long term costs and as well as the benefits. Potentially peripheral countries

should probably be persuaded to bide their time whilst they converge on core countries, and provisions should 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 enhanced fixed exchange rate regimes, such as ERM 2, to arrangements for a central bank to be established to issue a common currency; in which case arrangements for sharing 'seigniorage' need to negotiated, 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 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 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 Financial Transactions Tax (FTT) and/or a Value Added Tax (VAT) on sales of financial products and services, as a means of funding deposit insurance and financial system oversight and capitalising a development bank for the union.. 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. Larger unions might however require regional reserve banks organised on a geographic, rather than a state or national basis, as in the US Federal Reserve System.

A key question is thus, what is the currency, or monetary, union supposed to achieve? For potential participating member 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.

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. However, such controls have proved hard to sustain in the medium to long term, as indeed have currency boards when the credibility of the pegged exchange rate is called into question, as in 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 thus find stability easier to achieve than a union of countries with much less advanced financial systems. Commitment to a monetary union with limited fiscal transfers requires a willingness to undertake painful 'internal devaluations'; as demonstrated by Germany after its '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 too. 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 threated in 2010-2012 to undermine the Eurozone currency union before a fully-fledged monetary union could be achieved. Without further substantial progress, the Eurozone 'core' countries, especially the Northern European ones, might ultimately choose to form a monetary union that excludes the current periphery countries!

7. Conclusions

Since Mario Draghi's promise in late July 2012 to do "whatever it takes" to preserve the euro, the Eurozone crisis has abated, banks have been recapitalising and the 'Doom Loop' has turned into a virtuous circle as falling government bond rates have generated own currency capital gains for banks holdings of domestic government bonds, which have continued to increase. Meanwhile the perceived improvement in banks' balance sheets had reduced the risk of imminent further government bail outs,

in turn reducing implicit government liabilities and re-enforcing their credit worthiness. Ireland, in December 2013, and then Portugal, in May 2014, both successfully 'exited' from their Troika rescue packages, both eschewing the option of continued 'safety net' support. Further, Spain managed to avoid a bail-out and returned to growth in 2013/4. Greece's debts remain burdensome and some further debt forgiveness and/or debt rescheduling may still be required and Cyprus was already was showing signs of resilience in mid-2014 following its Spring 2013 bail-out. Newly elected Prime ministers in Italy and France began pushing back in 2014 against the strict ('German') interpretation of the 2102 Fiscal Compact, promising accelerated structural reform to stimulate deficit reducing economic growth in return for being allowed more time to achieve fiscal consolidation.

Fragmentation in the 'single' financial market remained a problem; especially for SMEs seeking affordable bank loans in peripheral countries. The 2013 GdRE MBF conference panel in Poitiers considered the topic: "Restoring the Bank Lending Channel". It concluded that much more needed to be done to stimulate affordable bank lending to SMEs in the EU (Mullineux, 2013b). Just as Mario Draghi, the ECB President, seemingly responded to the recommendations of the June 2012 GdRE conference panel by promptly promising in July 2012 to do "whatever it takes" to save the euro, so he responded with a package of measures in June 2014, howbeit much more belatedly, to the recommendations of the 2013 GdRE conference panel; this time just ahead of the next GdRE MBF conference panel held in June 2014 in Lyons!

The ECB's June 2014 package borrowed from the UK's 'Funding for Lending Scheme' (FLS) operated by HM Treasury and the Bank of England which began in

August 2012 to offer cheap loans of up to four years to banks and building societies that expanded their mortgage and SME lending. With the housing market stimulus focussing instead on an alternative 'Help to Buy' scheme introduced in 2013 to help first time buyers and subsequently extended to incorporate mortgage loan guarantees, the FLS was re-focussed entirely on lending to SMEs at the end of its initial 18 month window in early 2014. The FLS has not succeeded in stimulating a substantial increase in lending to SMEs in the UK, but nevertheless the ECB is to implement a 'Targeted LTRO' (TLTRO) scheme that provides increased access to cheap financing for lending to SMEs. To back this up, the ECB is exploring the possibility of purchasing SME-loan backed securities in the future to further stimulate the SME lending market. It is hoped that TLTRO will prove particularly beneficial to SME borrowers in periphery countries, thereby both ameliorating fragmentation and stimulating economic growth.

Below target inflation, and potential deflation, particularly in periphery countries, became an increasing cause for concern in the Eurozone in 2013/4, and with this in mind, the ECB also introduced negative interest rates on bank deposits with it in order to discourage banks from simply depositing their LTRO borrowings with it. A large portion of LTRO borrowing has hitherto been invested instead in domestic government bonds, although many banks have been repaying their LTRO borrowings ahead of the ECB's Comprehensive Assessment in the second half of 2014. The TLTRO scheme aims to encourage lending by banks to SMEs, rather than any further domestic government bond purchases, whose weight in bank portfolios has been further increased as a result of banks deleveraging through sales of their more risky

assets to improve their capital ratios ahead of the Comprehensive Assessment. Throughout the crisis the euro exchange rate against the US Dollar and the yen remained surprisingly strong, although some weakening against the US Dollar helped stimulate recovery in the periphery, and particularly Spain, and as the crisis has abated, it has strengthened further, adding to disinflationary pressures. As the Bank of England and the US Fed increasingly contemplate raising interest rates towards more normal levels, the euro might be expected to depreciate. If not, the ECB may yet have to adopt Quantitative Easing involving direct purchases of government bond issuance, despite the German Bundesbank's increasingly muted objections, in order to nudge the euro lower and raise inflation to nearer to the 2% target levels; which it was well below (closer to 1%) in mid-2014.

But, just when investors in bank shares thought it was safe to go back into the water amid a widespread and longstanding stock market 'bull-run', Banco Espírito Santo, Portugal's largest bank, ran into trouble in mid July 2014, causing widespread falls in European stock markets, particularly in periphery countries. Would the Portuguese government have to use the reserves it had so painfully built up before exiting the Troika agreement, or would the bank's creditors be bailed-in, or some combination of the two? The EU's BRRD does not come into effect until the end of 2015, so the EU's nascent banking union is nowhere near fully operative. The Eurozone clearly remains susceptible to shocks and, with Italy and France pushing back on the 2012 Fiscal Compact, a full fiscal and political union is far from secure. With its given powers, the ECB may try to do "whatever it takes", but that may ultimately not be enough unless

the Eurozone's evolution from a potentially fragile currency union to a fully-fledged resilient monetary union can be credibly progressed soon enough.

Countries in SSA should draw the lesson that forming a monetary union is not just an economic trade enhancing venture, but a major political agenda that is not to be entered into lightly. Currency unions may potentially enhance free trade agreements, but will be fragile unless backed by banking, fiscal and political unions to transform them to resilient monetary unions. This is especially true when, as seems most likely, the participating countries do not naturally meet the conditions for an optimal currency area. Potentially peripheral, often smaller, countries would be wise to pursue banking and financial sector, monetary, fiscal, economic and political convergence whilst using some mechanism to peg their currencies to the currency, or a basket of currencies, of the likely core country, or countries.

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