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Multilateral Currency Unions in Africa and the Caribbean:

Challenges of Monetary Subordination to an Outside Hegemon

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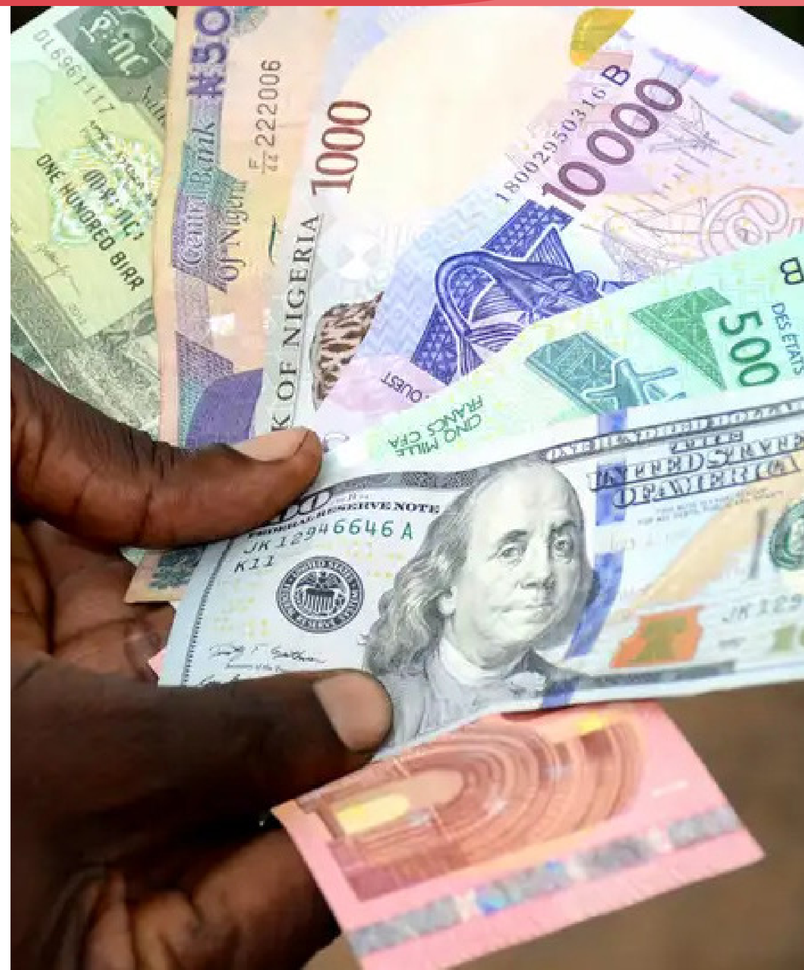

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Abstract

This paper discusses the challenges of multilateral currency unions of developing countries facing monetary subordination to an outside hegemon because they lack a credible internal anchor for monetary stability. The focus is on the economic consequences for a monetary union of a decision to import monetary credibility by anchoring its external exchange rate to a dominant foreign currency and the political commitment needed to make this type of monetary relationship work.

The paper looks at the experiences of the Central African Economic and Monetary Community, the West African Economic and Monetary Union (both linking their CFA franc to the euro), and the Eastern Caribbean Currency Union (linking its common currency to the US dollar). The main finding is that regional monetary integration combined with monetary subordination to an outside hegemon is generally more demanding because it must be embedded in an effective regional governance framework to sustain the cohesion and stability of the currency union, as well as a strong political commitment to underpin the fixed external parity to the foreign anchor currency. Some regions, therefore, look for ways to exchange this foreign-based monetary discipline for a new regime of monetary sovereignty. However, a multilateral currency union with an open economy wishing to adopt a free-floating external exchange rate must at least have a credible internal monetary anchor.

Therefore, the choice in favour of monetary autonomy depends on the region's ability to maintain strong economic fundamentals under a flexible exchange rate arrangement and on its political determination to maintain a stable common currency based on its internal strength.

Keywords

multilateral currency unions, monetary sovereignty, outside hegemon, Central Africa, West Africa, Eastern Caribbean

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The single most important aspect of an exchange rate regime is the degree of flexibility. (Frankel, 2012, 767).

1. Introduction

Many sovereign nation states use their own territorial currency as legal tender. Progress with regional economic integration and monetary cooperation in an open-market environment may lead a group of connected countries to enter into a multilateral currency union or monetary union (see also Cuyvers et al., 2005; Kenen and Meade, 2008). This type of currency union can be defined as a regional monetary arrangement in which the participating countries irrevocably fix their bilateral exchange rates and collectively introduce a single currency to replace their legacy currencies (Rose, 2008). They charge a newly-established regional central bank to conduct a single monetary policy for maintaining the internal and external value of the single currency in the common interest.

The room for the regional central bank to actively engage in macroeconomic stabilisation will, however, be determined by the external exchange rate regime operated by the currency union. Allowing the single currency to float freely in principle enables full monetary autonomy, whereas adopting a hard peg implies that it must follow the monetary policy choices of the foreign central bank that governs the anchor currency. This monetary dependence creates challenges for other policymakers each time the region's business cycle moves out of sync with the anchor economy.

The feasible external exchange rate regime will depend on the monetary stability embedded in the currency union.[1] When the multilateral currency union comprises countries with a credible stability-orientation, which is transferred to the regional central bank, and with the political will to act cooperatively, reflected in the regional governance framework, their collective economic and financial strength will anchor monetary stability. Alternatively, a powerful member state with strong monetary credentials (a regional hegemon) may be committed to serve as a stable anchor for a monetary alliance and to keep it functioning on terms and conditions agreeable to all partners willing to join. According to Cohen (2003), one or both forms of political commitment are necessary to sustain the cohesion and stability of a multilateral currency union among like-minded countries.

A multilateral currency union among developing countries typically lacks a stable internal anchor for monetary stability; the group has no monetary credibility and no regional hegemon that could credibly fulfil the anchor role. To achieve macroeconomic stability, it will need to surrender its monetary autonomy by pegging the single currency to a stable external anchor, i.e. the currency of an outside hegemon, in order to import monetary credibility. This 'client-anchor' relation (Alesina and Barro, 2002) places a currency union of newly independent nations under the foreign monetary influence of a former colonial ruler or a world economic power.

This paper discusses the challenges facing multilateral currency unions existing in Africa and the Caribbean, namely the Central African Economic and Monetary Community, the West African Economic and Monetary Union, and the Eastern Caribbean Currency Union. The focus is on the economic consequences for a monetary union of a decision to anchor its external exchange rate to the currency of an outside hegemon and the political commitment needed to make this type of monetary relationship work. The analysis should also be helpful for the many regions worldwide considering introducing a currency union involving groups of developing countries and emerging economies.

A political decision to participate in a multilateral currency union and to transfer direct control over monetary policy and the exchange rate to a regional central bank will reflect the expectation that the economic benefits of currency consolidation will well exceed the costs, even though the loss of monetary instruments will make it harder to address country-specific shocks. The academic literature on optimum currency areas, as it has evolved over time, specifies the criteria that the participating countries must meet to achieve optimal economic results (see Mundell, 1961; McKinnon, 1963; Kenen, 1969; Mundell, 1973; McKinnon, 2004; and the collection of articles in Honohan et al. (eds.) 2020).

1 See Frankel (2012) for the respective advantages of floating and fixed exchange rates, and Levy Yeyati et al. (2010) on the main theories explaining the choice of exchange rate regime.

For the single monetary policy to be effective in stabilising the region's economy, national business cycles must be sufficiently synchronised and reflect above all common demand shocks. In addition, an effective regional governance framework must support the member countries in maintaining a resilient and flexible economy and allow for public risk-sharing to absorb common supply shocks as well as country-specific shocks. The authors writing on optimum currency areas point out that only the regional central bank of a 'stability union' among partner countries with close economic ties, similar preferences and a sense of community will be able to pursue an autonomous monetary policy under a floating external exchange rate and an open capital account, as is the case for the European Economic and Monetary Union (see for example van Riet, 2016).

A separate body of literature discusses the optimality of a currency area of developing countries with few economic interactions and without a credible internal anchor for monetary stability (Guillaume and Stasavage, 2000; Acevedo and Walker, 2013; Monga, 2015; Koddenbrock and Sylla, 2019). Pegging the single currency to a stable external anchor in order to import monetary credibility, as a substitute for the missing regional stability reputation, in principle, supports a steady nominal path for the region's economy.

In this regard, a group of former colonies may opt to stay together in a common currency arrangement after their political independence, as in the cases of Central Africa, West Africa and the Eastern Caribbean. Absent a stable monetary anchor of their own, they may have little choice but to continue to peg their single currency to the currency of their former colonial master or that of another outside hegemon with whom they have a close economic and financial relationship.

The net economic benefits of a pegging currency union rest on the success in importing low inflation, fiscal discipline and financial stability, and in turn, on the ability to exploit this stable environment for enhancing external competitiveness, increasing productivity growth and improving living standards for all the participating developing countries. The criteria for achieving these positive economic results are generally more demanding than those for an optimum currency area (Boughton, 1991).

The countries concerned must not only have similar business cycles, but the region as a whole must also have a close cyclical alignment with the economy of the anchor country, i.e. a situation in which the common demand shocks originate mainly from the anchor economy. The member nations must further have the capacity to absorb not only common supply shocks and country-specific shocks but also any region-specific demand shock that the regional central bank cannot counter without endangering the external exchange rate peg. The political leaders of a pegging currency union must, therefore, commit to a tight regional governance framework that demonstrates their willingness both to make the currency union work and to underwrite the fixed external parity or else, explore a feasible route to economic and monetary sovereignty (Gadha et al. (eds.), 2021).

Following this introduction, Section 2 summarises the economic and political criteria of optimum currency areas, after considering three options for creating a stable monetary anchor. Section 3 describes the architecture of monetary subordination in the three existing multilateral currency unions in Africa and the Caribbean that operate with an exchange rate peg as an external monetary anchor. Section 4 examines the main achievements of these pegging currency unions, looking at the empirical evidence of their effectiveness. Section 5 concludes on the appropriate regional governance framework for a multilateral currency union with a pegged external exchange rate.

2. Optimal Currency Areas and Monetary Stability

A successful multilateral currency union offers a variety of economic advantages for the participating nation states which offset their loss of own monetary control (see Kenen and Meade, 2008; Mongelli, 2008; Santos Silva and Tenreyro, 2010). The conduct of a single monetary policy by a regional central bank with a credible mandate is more effective than national monetary interventions in an open internal market and is, therefore, more successful in maintaining the purchasing power of money while stabilising the regional economy. A single currency circulating over a wider geographical area offers more efficient liquidity services, increases the comparability of factor costs and tradable prices, removes foreign-exchange transaction and hedging costs and leads to an optimal allocation of scarce resources. A large common market with a single currency also offers more business opportunities, stimulates internal trade and enhances cross-border financial risk-sharing between savers and investors. For small, open economies without a large domestic market, these competitive advantages in cross-border trade and investment are the main engine of sustained output growth.

A well-functioning currency union is firmly grounded in a monetary stability framework which keeps inflation expectations at bay and is supported by internal policy discipline and public risk-sharing to sustain the single currency over time. A monetary alliance between neighbouring developing countries or emerging economies often lacks a credible nominal anchor. Linking the single currency to a stable foreign currency can function as an alternative disciplinary device. Challenges to the legitimacy of this monetary architecture occur mainly when political motivations are the driving force for the choice of anchor and the regional governance framework for safeguarding cohesion and stability is left underdeveloped.

2.1 The Monetary Anchor of a Multilateral Currency Union

Cohen (2003) describes a multilateral currency union as an exercise in collective action in the issue and management of a single currency, which will be driven by a common approach, a regional hegemon, or both. Whatever the route taken, the political connections between the participating nations are, in his view, most decisive for the sustainability of a currency union, more than the economic linkages between them. They are necessary to create the political commitment to a well-functioning currency union, as demonstrated by the common rules and regional institutions that govern it.

The common approach to regional monetary integration stands for a group of sovereign countries with the same history and culture and a similar set of norms and values taking concerted action to adopt a single currency as a symbol of their collective identity and common destiny. After gradually building common institutions, converging policy preferences and aligning rules and procedures, they establish a multilateral currency union grounded in a clear sense of community and solidarity. A stability union comprises, in this regard, a regional central bank with an independent mandate for preserving price stability and market liquidity, centralised prudential supervision to secure the integrity of the financial system, multilateral surveillance of national economic policies, a central fiscal authority that could issue common public debt and make fiscal transfers to member countries in a severe recession, and a common resolution fund for reviving systemic financial institutions in a crisis.

This regional governance framework to collectively manage economic and financial risks bestows the currency union with a credible common anchor for stabilising both the internal value and the external value of the single currency as a precondition for sustainable output growth. A successful currency union that delivers higher living standards for all its members could culminate in a single sovereign state grounded in common citizenship, democratic principles, and the rule of law.

This common anchor model closely corresponds to the European Union's gradual approach towards an Economic and Monetary Union (EMU) comprising all Member States ready to join on the path of an ever-closer political union (Cuyvers et al., 2005). Since the euro was to be introduced by a fixed date, namely 1 January 1999, some Member States managed to enter the EMU even though they showed weaker compliance with the economic convergence criteria than others.

Alternatively, a regional hegemon could take the lead to form a sustainable monetary alliance among partner countries that are willing to agree to strict terms and conditions (possibly as an instrument for promoting stronger political cooperation under its leadership). A powerful state with a strong reputation for monetary stability will, in that case, itself function as the internal nominal anchor for the currency union. As the member country with the most credible monetary policy, it will have a keen interest in the effective functioning of the currency area because it stands to lose the most from giving up its own hard currency. As the member country with the deepest pockets, it must also be committed to ensuring the cohesion and stability of the currency union over time. Fearing the high costs of a break-up of the single currency in stressful times, it will face demands for financial assistance from the weaker members, which it will find difficult to resist (Tirole, 2015).

This type of currency union can only become a stability union if the regional hegemon succeeds in imposing strict policy discipline on all neighbouring countries willing to join. All participating nations must not only relinquish their monetary sovereignty but also sign up for effective multilateral surveillance of their economic and financial policies in a manner that de facto constrains their political autonomy; those that do not meet the economic convergence criteria on a sustainable basis should stay in the waiting room until they do.[2]

2 Note that a currency union organised around a regional hegemon without a history of monetary stability will lack cohesion and stability and is unsustainable.

The hegemonic anchor model corresponds with the view that all the European countries participating in EMU had to adopt the rules of the game of Germany as the powerful anchor country committed to European integration (Bulmer, 2014). During the EMU crisis of 2010-2012, foreign investors revived the sharp distinction they made in pre-EMU times between a core group of safe countries centred around Germany and a periphery group of risky countries, when considering where to place their capital in Europe (van Riet, 2021). All political stakeholders recognised the leading role of Germany as the country with the deepest pockets to safeguard the euro and the largest political weight to chart the path to institutional reforms. Although Germany hesitated to accept this leading role (as a reluctant hegemon), it still pushed through its views on how best to strengthen the EMU architecture.

A special case is that in which the member countries and regional central bank of a multilateral currency union have no history of monetary stability. Lacking an internal monetary anchor, they must look abroad to import monetary credibility. The role of external anchor is typically given to the currency of an outside hegemon with strong monetary credentials (such as the former colonial ruler or a world economic power). The choice of a stable foreign currency as an anchor should be expected to support a steady nominal path for the economy of the currency union, as long as the central bank of the selected anchor country is free from political instructions and more conservative and inflation-averse than the regional central bank itself (see also Alesina and Barro, 2002).

After their political independence, a group of former colonies may opt to stay together in a currency union and peg their single currency to that of their former colonial master as their most important partner in trade and investment (Boughton, 1991). The uncertainty about their economic future as newly independent nations lacking effective collective institutions to secure monetary stability may leave them no other choice but to adopt the currency of this outside hegemon as an anchor (when it has a credible monetary policy). The fixed parity, in fact, imposes external discipline on all policymakers as necessary to create and sustain confidence in the single currency (Guillaume and Stasavage, 2000).

Continued monetary dependence on the former colonial ruler supports low inflation. This positive result may, however, be accompanied by more output volatility. This negative result arises when the fixed external parity prevents the regional central bank from autonomously managing financial conditions to address real disturbances or when the currency peg prevents exchange rate adjustments to offset terms of trade shocks, i.e. in situations which do not also trigger a monetary reaction in the anchor country; or vice versa, when the regional central bank is confronted with large monetary spill-over effects related to real disturbances in the anchor country which are uncorrelated with the economy of the pegging currency union. To contain this output volatility, the currency union must have a combination of automatic economic stabilisers, sufficient financial buffers and fiscal policy levers as shock absorbers.

A regular occurrence of cyclical downturns that are not countered by adequate monetary measures could overburden the capacity of the pegging currency union to adjust and lead to a deteriorating output-inflation trade-off and an overvalued currency which, in turn, could trigger speculative capital outflows and undermine the credibility of the fixed external parity. To correct a fundamental exchange rate disequilibrium, political leaders should consider an alternative anchor currency or currency basket, or adopt a more flexible exchange rate regime for the currency union. The prevailing monetary architecture could, however, also provide local elites with specific financial privileges. With support from the former coloniser, they may have the political power to override the economic arguments for changing the external parity or the anchor currency, which could explain the continued existence of currency unions with an unsustainable exchange rate peg to an outside hegemon (Nubukpo, 2007).

This external anchor model applies to the history of all three multilateral currency unions of developing countries. The two in Central and West Africa, comprising former colonies of France, pegged their respective CFA franc initially to the French franc (later the euro) and signed a monetary cooperation agreement with France. The common currency agreement between a group of UK dependencies in the Eastern Caribbean (EC) initially involved a hard peg of the EC dollar to the British pound sterling (later a fixed parity with the US dollar, taken over by the subsequent currency union). All three currency areas thus maintained an architecture of monetary subordination to an outside hegemon also after their political independence (see Section 3 for details).

2.2 Economic Criteria for a Successful Multilateral Currency Union

The theory on optimum currency areas proposed by Mundell (1961) argues that sovereign nations favouring regional monetary integration must meet several economic criteria to make centralisation of their monetary sovereignty a success.

First, the member countries of a currency union must have achieved sustainable economic convergence and market integration. Fulfilment of this criterion may be evidenced by a high degree of synchronisation of the national business cycles and a limited variation around the area-wide average (Bayoumi and Eichengreen, 1994). As interdependent economies, they can expect to benefit from the operation of a single monetary policy as an effective macroeconomic stabilisation device against common demand shocks. A developed and integrated financial sector is essential to facilitate an even monetary transmission across the whole currency zone.

A high degree of financial integration also functions itself as an optimal shock absorber. Member countries gain from private risk-sharing in an integrated financial market. On the one hand, it enables private savers to diversify the country risks related to their direct and portfolio investments across the currency zone; on the other hand, it allows private borrowers with access to foreign credit to smoothen consumption and private firms to attract foreign capital to strengthen their balance sheet when national shocks occur.

Where the currency union operates under the constraint of a fixed external exchange rate, the relevant benchmark for the necessary economic convergence and market integration will be the country of the anchor currency.[3] Since a monetary response by the foreign central bank also determines the financial conditions set by the regional central bank, the economy of the pegging currency area must be closely aligned with the business cycle of the anchor economy to achieve the same degree of macroeconomic stabilisation.

Second, in the absence of their own monetary and exchange rate policy as an adjustment tool, the member countries must maintain a high degree of resilience and flexibility to absorb or deal with national shocks to which the single monetary policy would hardly react, if at all, given its focus on the whole currency area.[4] Appropriate national institutions should secure this shock-absorption capacity.

The member countries of a pegging currency union, in addition, need to have sufficiently robust economies and prepare their national policies for any common shocks which do not trigger a monetary reaction in the anchor country and, thus, no counter-cyclical response from their own regional central bank. The same resilience and flexibility is needed to absorb monetary spill-over effects when the anchor country changes its monetary policy stance in response to purely domestic disturbances which hardly affect its foreign trade and finance.

These two optimality criteria reflect the trade-off between synchronisation and flexibility prospective members face when assessing the net economic benefits of joining a multilateral currency union with a free-floating single currency (De Grauwe, 2020). On balance, the price to pay for giving up national monetary autonomy and exchange rate flexibility in a globalised economy is small for countries which are unable on their own to shield their domestic financial conditions from the monetary policy spill-overs from the largest currency zones (notably the United States and the Euro Area). The costs are also limited for small open economies which participate in global value chains and trade a lot with their neighbours, for commodity exporters whose global export price is fixed in a foreign currency, or for unstable countries with a weak national currency that could benefit from a currency reform that imposes external discipline (Staehr, 2015).

The trade-off between synchronisation and flexibility is broader for countries assessing participation in a multilateral currency union operating under a fixed external exchange rate instead of a free float (Boughton, 1991). To successfully import monetary stability, their business cycles must, in addition, be closely correlated with cyclical movements in the anchor country. This

3 As Boughton (1991) explains, similarities in the direction of extra-regional trade have the same function as a high degree of intra-regional trade.

4 These country-specific shocks may arise from purely domestic idiosyncratic disturbances, from the asymmetric impact of common shocks hitting the currency union, or from the uneven transmission of a monetary policy shock that affects some participating countries more than others.

outcome is more likely when the country of the anchor currency is also the most important trade and investment partner of the currency union. At the same time, they need specific state capacity and sufficient structural flexibility to deal with situations when the business cycles of the currency area and the anchor country are out of sync. The external exchange rate constraint in a pegging currency union functions in this regard as a foreign-based disciplinary device that forces the member countries to adopt sound economic and financial policies and to organise a collective self-defence against significant disruptions.

The start of a currency union can trigger endogenous effects which can both be positive and negative (Frankel and Rose, 1998; Rose, 2000; De Grauwe and Mongelli, 2005). On the positive side, a single currency enhances price comparability and lowers transaction costs, which increases internal trade and investment and deepens factor and product market integration. These structural forces, in turn, promote economic convergence and business cycle synchronisation among the participating countries, bringing the currency union closer to an optimum currency area. For a currency union with an external exchange rate peg, these positive dynamics could also lead to more trade and finance activities with the anchor country, strengthening the alignment of their business cycles and enhancing the credibility of the fixed external parity.

On the negative side, more competition in trade and finance may breed tensions when member states protect their domestic industries through favourable industrial policies or attract foreign investors with distorting tax facilities, state subsidies and regulatory measures. Member countries could also specialise in goods and services in which they have a comparative advantage, making them more vulnerable to sector-specific shocks that affect the whole economy and cause deviating business cycles. The new monetary regime could also lead some member countries to free-ride on the stability of the single currency or on that of the foreign anchor currency. These endogenous forces could pull the member countries ever more apart and, where relevant, undermine the fixed external parity. The growing number of distributional conflicts could even lead some nations to leave the currency union or cause a total breakdown of the monetary alliance and/or the external exchange rate arrangement.

2.3 Political Criteria for a Successful Multilateral Currency Union

The more heterogeneous the member countries are and the more their preferences diverge, the more challenging it will be for their political leaders to turn the balance between the positive and negative dynamics operating within a multilateral currency union towards more cohesion and stability. To be successful, the single currency therefore needs to be embedded in a robust regional governance framework which ensures that the economic and financial policies of the currency zone are aligned with the single monetary policy and serve common interests. These political criteria are even more demanding for pegging currency unions since the member countries must also sustain confidence in the fixed external parity (Koddenbrock and Sylla, 2019).

First, common surveillance mechanisms should create the right incentives for the participating countries – both in the run-up to and after having entered the currency union – to observe strict economic and financial policy discipline so as to sustain their convergence to robust economies. Collective self-discipline, if credible and effective, could potentially replace the external discipline of an exchange rate peg (see also Amato and Nubukpo, 2020).

Second, the member nations need to coordinate their economic and financial policies and establish central public institutions to assist the regional central bank with its macroeconomic stabilisation task, supervise the integrity of the financial sector, and provide for fiscal solidarity in a crisis. These collective institutions should ensure that participation in an economic and monetary union is beneficial for all members – also when it operates with a currency peg – and make an exit too costly (see also Guillaume and Stasavage, 2000).

Together, these two governance conditions reflect the complementarity between effective public risk-reduction and comprehensive public risk-sharing in securing the cohesion and stability of the currency area. Political leaders must implement collective mechanisms for crisis prevention, crisis management, and crisis resolution to safeguard cohesion and stability. These common public institutions require a strong political commitment from all participating countries to control possible free-riding behaviour, address disruptive forces, and share the burden of resolving crises. An effective regional governance framework based on checks and balances in political institutions is even more vital when the monetary architecture comprises a strict peg to a foreign anchor currency.

3. The Architecture of Currency Unions with Monetary Subordination

This section describes the architecture of monetary subordination in the three multilateral currency unions of developing countries in Central Africa, West Africa and the Eastern Caribbean. As part of long-standing external exchange rate arrangements, the three regional central banks maintain a fixed parity between their single currency and a dominant foreign currency with a view to achieving their own monetary policy goal (see Table 1).

Currency Union	Member Countries	Single currency	Central Bank	Monetary Goal
Central African Economic and Monetary Community (CAEMC)	Cameroon Central African Republic Chad Republic of Congo Equatorial Guinea Gabon (6 in total)	Central African CFA franc	Bank of the Central African States (BCAS)	Maintain monetary stability with a fixed exchange rate to the euro (pursuit of low inflation with a conventional peg)
West African Economic and Monetary Union (WAEMU)	Benin Burkina Faso Côte d'Ivoire Guinea-Bissau Mali Niger Senegal Togo (8 in total)	West African CFA franc, to be renamed the eco	Central Bank of the West African States (CBWAS)	Maintain price stability subject to a fixed exchange rate to the euro (pursuit of an inflation target with a conventional peg)
Eastern Caribbean Currency Union (ECCU)	Anguilla Antigua and Barbuda Commonwealth of Dominica Grenada Montserrat St. Kitts and Nevis St. Lucia St. Vincent and the Grenadines (8 in total)	Eastern Caribbean dollar	Eastern Caribbean Central Bank (ECCB)	Maintain monetary stability with a fixed exchange rate to the US dollar (pursuit of low inflation through a quasi-currency board)

Table 1: Three Multilateral Currency Unions in Monetary Dependence in 2022

Due to the monetary discipline implied by this external nominal anchor, they have little or no monetary autonomy. All three monetary zones are part of official plans to introduce a single currency for a wider geographical area, which, in case of their realisation, will open a debate on the usefulness of continuing with the existing currency peg.

3.1 The CFA Franc Zone

Africa has eight regional economic communities with official monetary integration plans, which might all be merged under the umbrella of a future African Monetary Union covering the whole continent (Masson and Pattillo, 2005; Asongu et al., 2017).[5] Among these eight, the predominantly francophone sub-regions of the Economic Community of Central African States (ECCAS) and the Economic Community of West African States (ECOWAS) already have a multilateral currency union.

The two existing multilateral currency unions respectively cover the six Central African and eight West African member countries of the CFA franc zone (CFA originally being the French abbreviation of Financial Community of Africa). This common currency area, which initially maintained a fixed parity with respect to the French franc, was formalised after World War II to solidify French economic and political influence over its African colonies. After their political independence from France in 1960, the original members of these two country blocs formed a customs union and opted to stay with the CFA franc. They both operated a currency union with a regional central bank effectively led by France. When the regional central banks came under African leadership in the early 1970s, they signed a monetary cooperation agreement with France (see Gulde and Tsangarides (eds.), 2008; Zafar, 2021).

Both the Central African Economic and Monetary Community (CAEMC, or CEMAC by the abbreviation of its name in French), created by agreement in 1994 with effect from 1999, and the West African Economic and Monetary Union (WAEMU, or UEMOA by the French acronym), established in 1994, have the CFA franc as their single currency. At the start of 1999, when the French franc was converted into the euro, both currency areas automatically switched to the euro as their foreign anchor currency. Although the Central African CFA franc (where CFA is the French acronym for Financial Cooperation in Central Africa) and the West African CFA franc (where CFA means African Financial Community) can be exchanged at par, they are officially different currencies and only circulate in their own currency area.

The monetary policy goal of the Central Bank of the Central African States (BCAS, or BEAC by its French acronym) is to guarantee monetary stability (in terms of low inflation) with a fixed parity to the euro (by keeping foreign currency reserves at a minimum level of 20% of its sight liabilities, assisted by foreign exchange regulations), and otherwise to support the general economic policies of the CAEMC member countries. The primary objective of the Central Bank of the West African States (CBWAS, or BCEAO by its French acronym) is to preserve price stability (by keeping inflation at 2% +/- 1 percentage point over a 24-month horizon), subject to maintaining the fixed parity to the euro (by observing a minimum level of foreign exchange reserves of 20% of its sight liabilities, helped by capital account restrictions). Furthermore, it must support sound and sustainable economic growth and further economic integration of the WAEMU member countries.

As part of the monetary cooperation agreements, the French government has always provided an unlimited guarantee for the convertibility between the two CFA francs and the French franc, and later the euro, at a fixed parity; in exchange, both regional central banks pooled at least 50% of their foreign exchange reserves in an interest-bearing operations account with the French treasury on which they could draw to cover reserve shortages. Moreover, French officials participated in the decision-making bodies of the two regional central banks and banking authorities.

This close monetary relationship between France and its former colonies in Africa secures the stability of the two CFA francs but has been criticised as a relic of the colonial past – or even as a case of neo-colonialism – as it suggests that France continues to exercise a dominant influence over the two currency unions. Even after the African monetary authorities received more autonomy, France could still influence monetary decision-making, prolong the extraction of natural resources at low cost, secure

5 The regional monetary integration efforts in Africa follow ambitious roadmaps which are often modelled on Europe but tend to underestimate the substantial practical preparatory work (Nierop and Nierop, 2020).

lucrative export markets, and exercise political influence (Taylor, 2019).[6]

A new chapter in the monetary relationship between France and the WAEMU started in December 2019 when their political leaders jointly announced three significant reforms.[7] First, the West African CFA franc would be renamed as the eco. At the request of the WAEMU nations, the peg to the euro would be retained at the same fixed parity and France would continue to be the guarantor of the convertibility between the eco and the euro. Second, the CBWAS would take over the management of all its foreign exchange reserves, and its operations account with the French treasury would be closed. Third, the French government would withdraw from the governing bodies of the CBWAS and the Banking Commission. Consistent with the intention of the CAEMC countries to modernise their monetary framework, similar reforms could be expected for the Central African CFA franc and the BCAS.[8]

The second and third of the three reforms of the WAEMU monetary cooperation agreement with France were implemented in 2020. However, the conversion of the West African CFA franc into the eco was postponed to align it with the latest ECOWAS roadmap for launching the eco as a single currency in 2027 for all 15 West African States, comprising the eight countries that belong to the WAEMU (listed in Table 1), the six mostly anglophone countries that form the West African Monetary Zone (WAMZ; the Gambia, Ghana, Guinea, Liberia, Nigeria, and Sierra Leone), and Cape Verde.

ECOWAS stated its objective of introducing a single currency in the year 2000. The preparatory work for establishing the future West African Central Bank was assigned to the West African Monetary Agency (WAMA). The five founding members of the WAMZ (later joined by Liberia) created the West African Monetary Institute (WAMI) and mandated it to develop the eco as a single currency alongside the WAEMU's CFA franc. They first committed to keep their national exchange rates within a 15% fluctuation range in relation to the US dollar but later adopted more differentiated monetary frameworks. The date of introduction of the eco and the corresponding transfer of national monetary sovereignty to the West African Central Bank was repeatedly moved into the future because many WAMZ countries failed to meet the economic convergence criteria – although political challenges (like the dominant weight of Nigeria) also played a role (Egbuna, 2018).

After missing the 2020 deadline, ECOWAS stated that it plans to merge the new WAMZ single currency with the West African CFA franc and to establish the eco as the single currency for the whole region based on a gradual approach, starting with the member countries that respect the economic convergence criteria. Those not yet able to adopt the eco could affiliate themselves through exchange rate agreements. The outbreak of COVID-19 in 2020 threw this plan off course, forcing ECOWAS to delay the launch of the eco to 2027.

To meet the new deadline, ECOWAS members must take action to overcome the political, technical and operational obstacles standing in the way of their monetary integration. In addition, they will have to settle two issues of cohesion and stability (Amato and Nubukpo, 2020; Prasad and Songwe, 2021).

First, the internal question to be addressed is whether a single currency is a suitable monetary arrangement for a very diverse group of a few large and many small countries with different production structures and varying levels of economic development. Some ECOWAS countries are net oil exporters while others are net oil importers, their mutual relations in trade and finance are weak, and their economic convergence is lagging.

Second, the external question to be answered relates to the appropriate exchange rate regime for this eco currency union. While some member countries favour inflation targeting with a free-floating exchange rate (as Ghana), others prefer a managed float, a conventional peg of the eco to the US dollar (as Nigeria), or a link to the euro or a currency basket. ECOWAS expressed

6 Hansen and Jonsson (2014) analyse for the whole of 'Eurafrica' how the political elites of the new sovereign states in Africa entered into cooperation arrangements with their former colonial masters in Europe from which both partners would profit at the cost of the majority of Africans.

7 See Press conference by Emmanuel Macron, president of France, and Alassane Ouattara, president of Côte d'Ivoire, in Abidjan, 21 December 2019 (in French). https://www.elysee.fr/emmanuel-macron/2019/12/21/a-abidjan-conference-de-presse-du-president-emmanuel-macron-avec-alassane-ouattara-president-de-la-republique-de-cote-divoire (Accessed: 13 September 2021).

8 One motivation for France to go along with these changes was to stem the tide of growing anti-French sentiment in Central and West Africa (Zadar, 2021, 37).

a preference for a monetary policy framework based on inflation targeting as a nominal anchor in combination with a floating external exchange rate to weather external shocks.[9] However, the authorities of the future eco monetary area so far miss the collective self-discipline needed to attain 'true monetary sovereignty' (Nubukpo, 2021); without a credible internal monetary anchor, the choice for a flexible exchange rate regime could be inflationary and can only be envisioned as part of a transitional process that may involve a longer period of foreign exchange interventions and capital flow restrictions (see also Duttagupta et al., 2005).

3.2 The Eastern Caribbean Currency Union

Superseding the British West Indies Federation and the Caribbean Free Trade Association, the Caribbean Community (CARICOM) was founded in 1973 by four independent anglophone states and later expanded to 15 full member countries and five British overseas territories as associate members. They set themselves the goal to advance their economic integration and political cooperation. The members signed an agreement in 2001 to move towards a CARICOM Single Market and Economy (CSME). The CSME started operating with a common market for the free movement of services, capital, technology and skilled professionals. However, observance of the economic convergence criteria was weak, and the envisaged harmonisation of economic policies, as necessary for a single economic space, met with substantial delays. Concrete plans for CARICOM moving towards a monetary union, dating back to 1992, were put on hold (Baladi, 2007).

The Organization of Eastern Caribbean States (OECS) was founded in 1981 as a sub-group of CARICOM to promote regional integration among a group of countries which had recently received political independence from the United Kingdom (Montserrat participated as an overseas territory of the UK). The seven founding members of the OECS started the Eastern Caribbean Currency Union (ECCU) in 1983 (later joined by the UK overseas territory Anguilla as an associate member) and mandated the new Eastern Caribbean Central Bank (ECCB) to maintain a strong and stable Eastern Caribbean (EC) dollar, which they had used since 1965 under a common currency agreement (see for example Rose and Samuel, 2013). The OECS members extended the currency union with an economic union as of 2011, which was subsequently integrated with the CARICOM Single Market and Economy.

The EC dollar was linked to the British pound sterling until 1976, when the UK faced high inflation and a balance of payments crisis. After a significant fall in the value of the pound, the Eastern Caribbean countries using the EC dollar changed the hard currency peg at par to the US dollar to recognise that the United States had become the region's leading trading partner. The ECCB strictly maintains the fixed parity to the US dollar through a quasi-currency board arrangement in order to sustain confidence in the single currency under a relatively open capital account. For this purpose, it keeps more foreign exchange reserve than the required minimum of 60% of its demand liabilities (while it targets 80%, in practice the backing ratio has been at least 95%). While economic factors determined the choice for a fixed exchange rate regime, the option of a quasi-currency board was likely influenced by the pre-existence of a currency board under British colonial rule (Pereira, 2018).

The ECCB's objective is to preserve monetary stability, whereby the hard currency peg to the US dollar serves to achieve price stability. In addition, it must support output growth and economic development in the ECCU member countries, ensure the integrity of the banking system and contribute to creating a single financial space. Access by member governments to ECCB credit is restricted by credit allowances, which may only be exceeded if the other countries accept a reduction in their own credit allocations. Hence, the ECCB's balance sheet functions as an important channel for public risk-sharing among the ECCU members.

4. Achievements of Currency Unions with Monetary Subordination

Participation in a multilateral currency union is based on the expectation that the positive economic effects will well exceed the costs of sacrificing monetary sovereignty and fulfil the promise of higher living standards. The performance of a multilateral

9 This option is also supported by Prasad and Songwe (2021), who suggest to supplement it with foreign-exchange interventions to 'lean against the wind' of short-term exchange rate volatility, while not fundamentally resisting market pressures.

currency union may be assessed by examining the degree of synchronisation and flexibility of its members and the ability of its governance framework to maintain cohesion and stability over time.

Assessing the achievements of the three multilateral currency unions in Central Africa, West Africa and the Eastern Caribbean is complicated by the fact that they peg the single currency to a foreign anchor currency. Hence, the economic costs and benefits of regional monetary integration in these three cases must be related to the irrevocably fixed internal exchange rates, as well as to the fixed external exchange rate (Boughton, 1991; Fielding and Shields, 2005).

4.1 The CFA Franc Zone

The fixed parity between the CFA franc and the French franc that the two currency unions in Central Africa (CAEMC) and West Africa (WAEMU) had inherited from colonial times was only realigned in 1948 (a revaluation) and 1994 (a sharp devaluation); it has been kept unchanged ever since, also when the two CFA francs were pegged to the euro in 1999. Due to the external exchange rate constraint, the two regional central banks have always directly imported the monetary policy stance governing the foreign anchor currency. The credibility of the exchange rate regime has resulted in low and stable inflation rates, both for the CAEMC and the WAEMU, which, in a context of weak monetary transmission, is a notable achievement when compared with other sub-Saharan African countries.

The inflation advantage has, however, not translated into a permanently higher real GDP growth rate. After their political independence in 1960, when the monetary arrangements under French guidance were still broadly observed, the member countries achieved relatively good economic performance. From the early 1970s, when African authorities took control, the monetary rules were relaxed, compliance was less strictly enforced, and output growth began to falter (Guillaume and Stasavage, 2000). The sharp devaluation of the two CFA francs that became necessary in 1994 gave a one-off boost to output growth. Afterwards, the output-inflation trade-off further deteriorated (Giorgioni, 2019).[10] Although there are significant cross-country variations, this negative trade-off can be related to long-standing internal weaknesses (such as a poor business climate, a fragile banking system, ineffective public institutions, and government borrowing crowding out private credit) and the corrosive impact of an overvalued currency on external competitiveness (Kangami and Aninkugbe, 2019). Economic development in the CAEMC and WAEMU countries is further compounded by pervasive corruption, social unrest, terrorist activity and political instability.

Although both currency unions are paired with a customs union, their intra-regional trade is still constrained by structural factors such as non-tariff barriers, missing cross-border production networks, poor infrastructure connections, and limited labour mobility, which hold back economic integration and synchronisation (African Union Commission et al., 2020). Moreover, the capital market is fragmented and the financial sector is underdeveloped. Since the two CFA francs only circulate in their own monetary area, the CAEMC and the WAEMU countries also miss out on the economies of scale that the free flow of goods, services and production factors across the whole CFA franc zone could offer.

Considering extra-regional trade, the automatic shift of the fixed parity from the French franc to the euro reduced transaction costs for exporters to other European countries than France and removed an important source of uncertainty for European firms outside France interested in trading with the CFA franc zone. Trade with the other eurozone countries clearly expanded as a result (Frankel, 2010). Although the peg to the euro assumes that both currency unions mainly trade with the eurozone, more recently, their trade focus has shifted from Europe to Asia, particularly towards China and India. This trend has led some observers to suggest that the CFA franc zone would be better off economically when the two currency unions would each adopt their own anchor currency or currency basket consistent with the currency or geographical composition of their external trade and finance (see for example Agbor, 2013; Zafar, 2021).

Fixing the exchange rate relative to a strong currency or, alternatively, a currency basket, obliges the two regional central banks to prioritise external over internal stability and challenges national and regional policymakers to absorb the terms of trade and output shocks that are uncorrelated with the anchor economy or economies (Monga, 2015). Exports are concentrated in oil

10 Even before the realignment of 1994, Devarajan and Rodrik (1991) concluded that for most of the CFA members the inflation benefits were not large enough to offset the output costs.

(CAEMC) or agricultural products (WAEMU), while most consumer and producer goods need to be imported. Significant price declines for oil, cotton and raw materials (quoted in US dollars) immediately hit public revenues and led to a withdrawal of foreign capital. Without a more diversified output structure, the big swings seen in the world export price of commodities and the terms of trade cause sharp movements in the current account of the balance of payments. Successfully managing these pro-cyclical shocks to the economy requires adequate common buffers in terms of foreign exchange reserves and commodity price stabilisation funds (UNECA, 2017).

Funding the recurring trade deficits through private capital inflows is hampered during episodes of macroeconomic uncertainty and political instability. The French convertibility guarantee for the two CFA francs and a more open capital account promotes direct and portfolio investments from Europe, but also makes it easier for local companies to place their profits in euro abroad and for political elites to move their money to off-shore centres. Capital flight from the CFA franc zone has been massive over the years and has acted as a barrier to domestic investment and economic growth (Ndiaye, 2017).

Governments regularly borrow abroad and receive assistance from France and other donors to finance the rise in net external liabilities. The national and regional authorities significantly relaxed macroeconomic policies and took supervisory measures in response to the COVID-19 pandemic, as was done in the eurozone. However, the low-income countries of the CAEMC and the WAEMU also had to call again upon France, the IMF and other donors for financial support and debt relief to address the socio-economic fallout from the health crisis. The global rise in food and energy prices following the Russian invasion of Ukraine in 2022 forced both regional central banks to tighten monetary policy. While higher oil prices helped the CAEMC countries to restore their fiscal and external buffers, the national fiscal authorities of both currency unions had to implement substantial budgetary support measures to shield their most vulnerable populations from the high cost of food and fuel.

The governance framework of the CAEMC and the WAEMU includes regional economic surveillance, providing for stricter rules than apply at the national level in preparation for an economic union. However, compliance with the economic convergence criteria is generally weak, and deadlines for correcting fiscal slippages from the common targets were frequently unmet. Lacking a central fiscal body for macroeconomic stabilisation and mutual financial support in a crisis, governments tend to rely on the capacity of the regional central bank to cover funding gaps. Alternatively, a more developed and integrated financial sector could help to smoothen shocks (Basdevant et al., 2015). However, banks favour lending to their own government, while lending to the private sector is highly concentrated and many loans are non-performing. More effective centralised banking supervision and coordinated macro-prudential surveillance could address these financial issues.

The members of the CAEMC and the WAEMU are altogether characterised by structural heterogeneity and vulnerable to country- and region-specific shocks that a single monetary policy constrained by an exchange rate objective cannot address. Considering business cycle convergence, factor mobility, financial strength and fiscal space to adjust, the CFA franc zone does not appear to constitute an optimum currency area (Zhao and Kim, 2009). Although the two multilateral currency unions may be viable in an economic sense, their continuation over decades appears to be based, above all, on political motivations (Masson et al., 2015; Giorgioni, 2019). The main political challenge for the future is to develop effective shock-smoothing mechanisms both at the national level and at the regional level (Basdevant et al., 2015); or else to explore a feasible route to economic and monetary sovereignty (Gadha et al. (eds.), 2021).

4.2 The Eastern Caribbean Currency Union

The eight members of the ECCU have a similar structure in that they are all small, open island economies. Their standard of living is highly dependent on trade settled in US dollars (agricultural exports, tourism revenues, essential imports) and foreign investments from the US. The parity of the EC dollar vis-à-vis the US dollar has been kept constant ever since it was adopted. The quasi-currency board arrangement ensures a high level of foreign exchange reserves, which protects the ECCU against balance of payments crises and secures exchange rate stability with respect to the US dollar during adverse shocks. The high credibility of this monetary arrangement has delivered relatively low and stable inflation.

While intra-regional trade and factor mobility between the islands is minimal, economic policy coordination seeks to promote output growth along a similar trajectory (outside the recurring natural disasters). Concerning extra-regional trade, local firms

offering tourist facilities and off-shore finance enjoy lower transaction costs from the constant parity to the US dollar, as the US is among the primary sources of demand for these services. The position of the US dollar as the world's reserve currency further helps companies to exploit economies of scale beyond the domestic market and to withstand foreign competition both at home and abroad. The business climate of the ECCU members is generally better than the Caribbean average (Boerdijk et al., 2021). The open capital market gives companies access to low-cost foreign capital, especially from the US, although governments also offer financial incentives to attract sufficient foreign direct investment.

As might be expected, both the trend and cycle of the ECCU members are highly sensitive to economic movements in the US (Sun and Samuel, 2009). Still, the degree of co-movement in output between the island economies and the US is low and has deteriorated somewhat over time (Acevedo and Walker, 2013). Although the strength of this relationship varies significantly between them, the highly concentrated production structure and the strong dependence on the US are a source of risk for their output growth.

The ECCU members' reliance on visiting tourists and off-shore finance turned into a vulnerability when tourists stayed away after terrorist attacks hit the US in September 2001, the great financial crisis of 2008 triggered a capital flight into the US dollar, the Covid-19 pandemic interrupted world travel, the energy price shock of 2022 increased transport costs, and when natural disasters hit the region and caused significant damages (Parlak et al., 2021). Given the hard peg to the US dollar, the ECCB (automatically) countered only those external shocks to which US monetary policy responded; the capacity to absorb other common shocks entirely depended on the ECCU members' own economic flexibility, financial strength and fiscal space (see also Pereira, 2018).

Governments regularly stepped in to protect economic activity, spend on social security, rescue fragile domestic banks, and rebuild infrastructure. As their revenues dropped and fiscal discipline was relatively weak, their budget deficits increased beyond a prudent level (Lorde et al., 2009). Public debt reached high levels relative to GDP, which could not be sustained by the small tax base of the island economies and the modest recovery of output growth. Large current account deficits on the balance of payments were covered by governments borrowing abroad and calling in foreign official sector support. Although several islands defaulted on their sovereign liabilities and restructured their outstanding obligations, public debt ratios remained elevated. The COVID-19 pandemic and the global hike in energy and food prices in 2022 further worsened the fiscal situation of the ECCU countries and shifted their compliance with the region's public debt target (of 60% of GDP) further into the future. To increase public revenues, they started selling residency permits to wealthy foreign investors under citizenship-by-investment programs. Some governments also began building up their own contingency reserve to cover for future natural disasters.

Overall, the ECCU countries share a number of structural characteristics and are exposed to symmetric shocks, in particular those coming from the US. Taken on its own, a single monetary policy for these small, open economies appears well-suited to address synchronised challenges, as in an optimum currency area (Acevedo and Walker, 2013; Zhao and Kim, 2014). However, the hard peg to the US dollar leaves the ECCB with little, if any, monetary autonomy to respond to the recurring output variations that differ from those affecting the US. Moreover, the economic resilience of the island states is generally modest, their exposure to changes in global financial conditions is high, and their fiscal capacity to address national adversity relies on contingency reserves, access to ECCB credit and foreign official sector assistance rather than effective fiscal coordination and a regional stabilisation mechanism (see also Birchwood and Goto, 2011). The ECCU experience shows that a central fiscal capacity to assist national budgetary policies and manage common public risks could be an efficient political complement to regional monetary integration.

5. Conclusions

The credibility of the single monetary policy and the effectiveness of the regional governance framework of a multilateral currency union are instrumental for stabilising the internal and external purchasing power of a single currency. As the experiences of Central Africa, West Africa, and the Eastern Caribbean show, a group of developing countries establishing a multilateral currency union tends to lack a credible internal anchor for monetary stability; it is accordingly obliged to peg the single currency to the currency of an outside hegemon with a strong reputation as an external monetary anchor, which could be

the currency of their former colonial master or their largest trade and investment partner.

The economic objective of importing monetary credibility from abroad is to stabilise inflation expectations and to realise sustained output growth. The price for this macroeconomic stability is a (continued) monetary subordination to a powerful anchor country or currency area that follows its own monetary policy course. This type of monetary relationship assumes a close correlation with the anchor economy, and it will lead to output volatility each time the economy of the multilateral currency union is hit by uncorrelated shocks which the regional central bank cannot counter without endangering the fixed external parity. Hence, this architecture of monetary subordination imposes strict external discipline on all policymakers, even more so than in a multilateral currency union where the member countries have transferred their monetary sovereignty to a regional central bank with full monetary autonomy and where market confidence determines the stability of the external exchange rate.

As part of the deal, each member country must enhance its resilience in good times so as to be able to bounce back in bad times, not only in the face of country-specific shocks but also when the counter-cyclical response of the single monetary policy to region-specific shocks is constrained by the need to preserve the currency peg. They will all need to secure flexible labour and product markets to maintain external competitiveness, ample fiscal buffers to stabilise the business cycle, a healthy banking sector to sustain the flow of credit and a sound financial system to preserve financial stability. They will further have to organise a tight regional governance framework comprising effective multilateral surveillance and collective stabilisation mechanisms. Therefore, a solid common political commitment is needed to sustain the cohesion and stability of the multilateral currency union and to underpin the credibility of the fixed external parity.

When the structure of the member economies changes, the currency or geographical orientation of their external trade and finance moves away from the anchor economy, and/or the output-inflation trade-off deteriorates over time, a political decision on changing the exchange rate peg towards an alternative and more flexible arrangement will become unavoidable. The more market confidence in the economic and financial strength of a multilateral currency union and the growth of the self-discipline of its member countries over time, the more the group will be able to express its monetary sovereignty, relying on its own fundamentals to anchor both the internal and external value of the single currency.

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