Abstract

Nel seguente elaborato cercheremo di valutare l'adeguatezza e il rilievo di alcune unioni monetarie esistenti, in corso di sviluppo o nascenti nell'integrare paesi confinanti e le loro società da una prospettiva politica, economica e sociale. In maniera specifica, esamineremo i fondamenti legali e le caratteristiche tecniche, sia di progetti di unioni valutarie teoriche che di esperimenti duraturi e consolidati, come l'euro, vagliando la loro capacità di favorire l'integrazione regionale e di rafforzare la coesione e la cooperazione tra gli stati membri. Determineremo, inoltre, quali conseguenze tali accordi monetari potrebbero implicare: più precisamente, ci concentreremo su molteplici benefici e opportunità che l'implementazione di un sistema a moneta unica è in grado di produrre, ma anche le potenziali sfide che potrebbe comportare. Infine, discuteremo le cruciali implicazioni istituzionali, geopolitiche ed economiche che rappresentanti politici e organizzazioni intergovernative dovrebbero tenere in considerazione nel dibattito sulle reali possibilità di stabilire un'unione monetaria in una specifica area del mondo.

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MONETARY UNIONS: EVALUATING THE ROLE OF EMERGING CURRENCY UNIONS IN THE PROCESS OF REGIONAL POLITICAL, ECONOMIC AND SOCIAL INTEGRATION

UNIONI MONETARIE: VALUTAZIONE DEL RUOLO DELLE UNIONI VALUTARIE EMERGENTI NEL PROCESSO DI INTEGRAZIONE POLITICA, ECONOMICA E SOCIALE REGIONALE

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Abstract

In this paper we will attempt to assess the suitability and relevance of existing, still developing and emerging currency unions in integrating neighbouring countries and their societies from a political, economic and social perspective. Specifically, we will examine the legal basis and the technical features of both theoretical monetary union projects and ongoing and consolidated experiments, such as the Euro, evaluating their capability of fostering regional integration and deepening cohesion and cooperation amongst member states. We will also determine which consequences such monetary agreements may entail. Precisely, we will focus on the multiple benefits and opportunities that the implementation of a single currency system my produce, but also on the potential challenges that might come along. Furthermore, we will discuss the crucial institutional, geopolitical and economic implications that representatives and intergovernmental organizations ought to consider when debating on the real possibilities of establishing a monetary union in a specific area of the world.

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Introduction

In a world and in a century that are children of globalization, dominated by increasingly interconnected and interdependent societies, where the relationships between economic, political and religious realities, geographically and culturally divergent, are in constant development, an approach oriented towards individualism and isolation no longer finds reason to exist.

On the level of international politics, the increasingly numerous supranational socio-economic institutions are the demonstration of how constant cooperation and mutual discussion on key issues of global geopolitics can benefit all member states. Also considering the current international context characterized by the presence of superpowers, the coordination of everyday life issues, such as economy, security, defence, health, environmental protection and sustainable development amongst multiple countries can make decision-making procedures more efficient and generally guarantee optimal allocation of resources intended for the implementation of ad hoc policies.

As part of the various regional integration processes currently underway on the global scene, *monetary unions* are assuming ever greater importance: not only do they facilitate commercial transactions or foster cross-border investments, but they also promote political cooperation, providing particularly stable economic environments. However, currency unions, such as the euro, do not constitute separate stand-alone entities. On the contrary, they only represent the final step of endless and complex projects of political, economic and social convergence, which very often have led to disagreements and clashes amongst the countries involved.

In this paper we will examine the role of monetary unions as active promoters of socioeconomic integration amongst neighbouring countries. In particular, we will focus on the structural preconditions and criteria necessary for the proper functioning of single currency systems, the need and the suitability of such systems in determined regions of the world, as well as the benefits and the possible risks and challenges strictly related to the implementation of monetary regimes in specific geopolitical contexts.

In the first chapter we will provide a precise definition of *currency union* with its multiple facets, briefly introducing R. Mundell's theory of optimum currency areas, along with its implications in the real world, and explaining how these unions might stimulate greater cooperation amongst neighbouring states. In the second chapter we will retrace the main steps in the history of the European Monetary Union, with a retrospective focus on both its main contributions and challenges, discussing the key lessons that such an experience has to offer.

Finally, in chapter three to six, we will introduce four different examples of monetary union projects, examining the current political and economic structure of the regions involved and their geopolitical relevance in the international scene, presenting the main features and properties of such monetary agreements and discussing the requisites needed, the actual feasibility and possible related challenges and constraints. Specifically, the areas of the world we will analyse will be, in order, the South American continent, the West African region, the states of the Persian Gulf and the lands of Southeast Asia.

1. Monetary unions and regional integration

1.1 Definition and features of monetary unions

Before dealing with explaining the existing and consolidated monetary unions and emerging single-currency systems, including outlining how political and socioeconomic events led to the creation of such agreements, and analysing and comparing both benefits and drawbacks of the multiple examples, we shall firstly provide a detailed definition of a monetary union, examine its fundamental characteristics, and then observe the main prerequisites which guarantee its permanence.

A *monetary union* (or *currency union*, or *single-currency system*) is a zone where a single monetary policy prevails, and where a single currency, or perfectly substitutable currencies circulate freely. American economist Polly Reynolds Allen (1976) distinguishes between those elements that define a monetary union, and those additional characteristics that are necessary for the continued and successful existence of such unions. A monetary union is defined by the following characteristics:

1. A single money, or several fully convertible currencies at immutably fixed exchange rates.
2. An arrangement whereby monetary policy is determined at the union level, allowing no national autonomy in monetary policy.
3. A single external exchange rate policy.

In this respect, P. R. Allen affirms that "*Toward this end, national authorities must relinquish individual control over their international reserves and invest such control in a union authority,*"[1] **(Allen, 1976, p.4)**.

[1] Allen, P.R. (1976), *Organization and Administration of a Monetary Union*, Princeton Studies in International Finance No. 38, Princeton University Press.

A monetary union represents an example of full, or nearly full, *monetary integration*, which is a crucial concept defined by Australian scholar Max Corden (1972) as the combination of two fundamental components, i.e. "*an exchange-rate union, that is, an area within which exchange rates bear a permanently fixed relationship to each other* […]" and "*convertibility - the permanent absence of exchange controls, whether for current or capital transactions, within the area*"[2] **(Corden, 1972, p.2)**. Corden also distinguishes true exchange rate unions from *pseudo-exchange rate unions*, where there is an agreement to maintain fixed exchange rates but "*there is no explicit integration of economic policy, no common pool of foreign-exchange reserves, and no single central bank*"[3] **(Corden, 1972, p. 3)**. Since the tools for maintaining exchange rates which are permanently fixed do not exist in pseudo-exchange rate unions, the possibility remains that one country would find it expedient to allow its exchange rate to depreciate or appreciate against the others. The expectation that this may occur will interfere with the regular operation of monetary unions and prevent complete monetary integration.

The aforementioned authors stress the need for institutional safeguards to ensure that there will be a single monetary policy, and, in the presence of more than a single currency, an irrevocable fixation of exchange rates. The need for such guarantees explains why the authors believe that the continued existence of national central banks and national currencies casts some doubt upon the permanence of the union, e.g. they make exit from the union too easy. Similarly, the pooling of reserves is viewed as essential to ensuring a common external policy for the currency union.

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[2] Corden, W. M. (1972), *Monetary Integration*, Essays in International Finance No. 93, Princeton University Press.
[3] Corden, W. M. (1972), *Monetary Integration*, Essays in International Finance No. 93, Princeton University Press.

More specifically, the permanence of a monetary union requires a strong bond of solidarity among member countries. Cohen (1998, p. 87) argues that in the absence of a dominant power with an interest in making the arrangement function effectively upon terms acceptable to all, there must be a genuine sense of community among the partners. This sense of community may be the result of a long period of close cooperation, and it may be manifested by other institutions that enable each member to benefit from assistance from the others, if suffering unfavourable circumstances[4].

In order to get the widest possible range of benefits from the implementation of a common currency as a means of payment, convertibility within the area is essential. Typically, enlarging a currency's area of circulation is a key objective of monetary union, but this is only useful when the currency can fully serve as a means of payment, in other words, if the currency is *internally convertible* within the region. External convertibility also enhances the usefulness of the currency for residents of the monetary union, since restrictions upon the ability to acquire foreign currency to make external transactions may provide incentives for domestic residents to hold foreign currencies, legally or illegally. Nonetheless, *external convertibility* is not a defining feature of a monetary union.

The function of a currency as a store of value and, ultimately as a medium of exchange, depends on the currency keeping its value in terms of goods and services against which it is exchanged. This, in turn, requires an institutional setting in which the responsibility for the single monetary policy of the currency area is clearly established. The mandate is given to the central bank to maintain the value of the currency, and the central bank is granted the independence, and the tools for achieving such an objective.

[4] Cohen, B. J. (1998), *The Geography of Money*, Cornell University Press, Ithaca

In particular, the common monetary policy must not allow for uncontrolled sources of monetary expansion, nor should the central bank be subject to pressures to provide direct financing of government deficits or indirect financing through the banking system. The central bank must be able to alter the quantity of high-powered money, and also the level of interest rates to control monetary expansion and achieve price stability.

1.1.1 Formal and informal currency unions

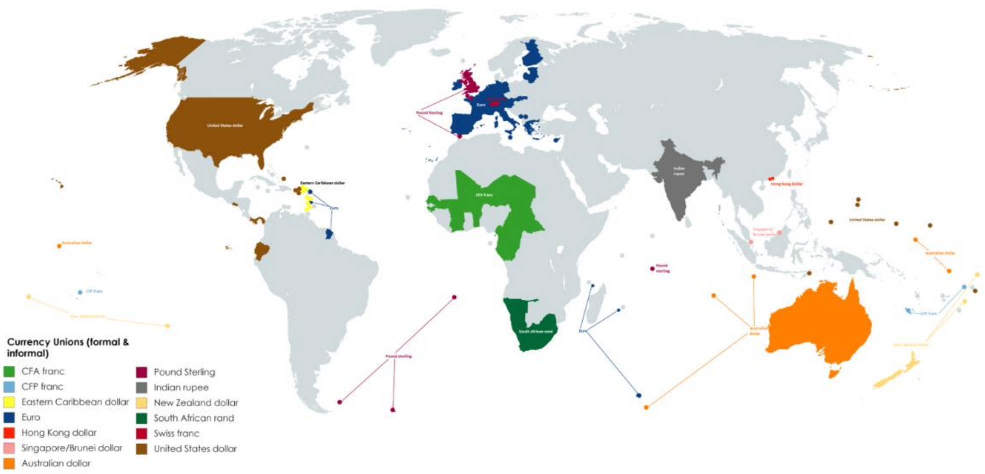
In order to fully understand the rising importance of monetary unions in the international economic panorama, a fundamental distinction must be made between formal and informal currency unions. A *formal* currency union implies the creation ex-novo of a common currency or the adoption by one or several economies of an existing foreign currency by virtue of bilateral or multilateral agreement with the monetary authority. In most formal currency unions, countries establish a common monetary policy and institute an independent monetary organism, namely a central bank for the issuing and the general management of the common currency.

Formal monetary unions include the *European Monetary Union* (Eurozone) which currently consists of 20 of the 27 member states of the European Union, the *West Africa Economic and Monetary Union* and the *Economic and Monetary Union of Central Africa*, whose economies share the *CFA franc*, pegged to the French franc once and to the Euro nowadays, and the *Eastern Caribbean Currency Union*, a further development of the Organization of Eastern Caribbean States, whose member states created the Eastern Caribbean dollar, firmly pegged to the US dollar.

To be precise, only the *European Monetary Union* theoretically falls within the exact definition of monetary union, since it represents the only regional economic agreement characterized by the presence of a fully independent monetary authority, whose policy is not strictly bound to that of foreign legal tenders. In the other aforementioned unions, the countries rely on common monetary authorities, which are technically autonomous from any external central bank; nevertheless, for reasons related to mere international credibility, the currency policy they implement is extremely connected to the decisions of foreign monetary institutions, and so is the accountability and the prestige of such currency.

Informal monetary unions, on the other hand, are generated by the unilateral adoption of an existing foreign currency, which is generally due to a country's intention to simplify transactions with strong trade partners, and, at the same time, enhance stability in its own economy. Amongst the currencies shared in informal unions we shall recall the *Australian Dollar*, official currency in Australia and several independent Pacific states, the *United States Dollar*, used in several countries outside the United States, such as Ecuador and Panama, the *Indian Rupee*, legal tender in India, the Maldives and Bhutan, and the *South African Rand*, official currency in South Africa, Namibia, and the kingdoms of Lesotho and Eswatini.

Figure 1.1 Formal and informal currency unions as of 2023



Source: VividMaps (https://vividmaps.com/currency-unions/)

1.2 Mundell's "Optimum Currency Area" theory

Despite the existence of currency unions, the international monetary system is mostly characterised by a multiplicity of different currencies, most of which are based on sovereign nation states, a situation which J. S. Mill (1874) famously described as *barbarism*. As the structure of modern government has developed, the economic segregation between currency areas has often become acute, notably through the imposition of exchange controls and inconvertibility. Even during the period of *monetary union* provided by the Gold Standard[5] before 1914, some countries maintained the gold link more successfully than others.

The initial formulation of what should determine the geographical coverage of a currency is widely attributed to the Canadian economist Robert Mundell[6] (1961). His analysis mainly focuses on the convenience generated by the adoption of a single common currency in a specific geographic area, in particular, it concentrates upon a comparison between the costs of adjustment through changes in wages, price levels and factor mobility and those of altering the exchange rate, as a response to macro-economic shocks, with special reference to the difference between symmetric and asymmetric shocks.

Mundell's crucial findings were shortly afterwards elaborated on by several scholars, such as McKinnon (1963), and Kenen (1969), since the *optimum currency area* (OCA) theory was developed by a growing number of studies, both theoretical and empirical.

[5] Monetary system in which legal tender banknotes are convertible at a set price into foreign currencies which are in turn convertible into gold.

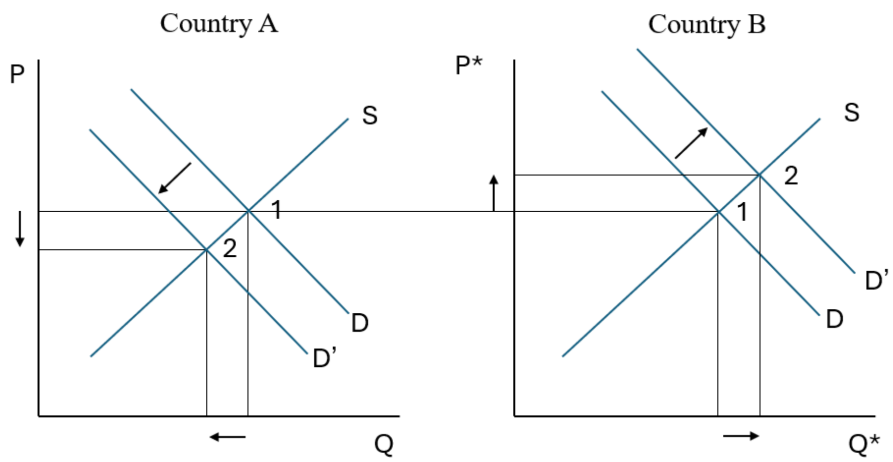
[6] Canadian economist (1932-2021), Professor of economics at Columbia University and the Chinese University of Hong Kong. He received the Nobel Memorial Prize in Economic Sciences in 1999 for his pioneering work in monetary dynamics and optimum currency areas.

1.2.1 Optimum Currency Area: hypothesis and findings

The 1961 paper by Mundell examined possible mechanisms of adjustment when countries or regions face exogenous country-specific shocks, with reference to the US and Canada. He concluded that exchange-rate changes between the two currencies did not provide either country with a satisfactory means of adjustment, since the main asymmetry was not between the countries themselves, but between the Eastern and Western parts of both. Mechanisms were therefore required to adjust relative prices between East and West rather than between North and South.

A simple version of the theory assumes two regions - A and B - each producing a good. A demand shift caused by a change in preferences from the goods produced by A to the goods produced by B (i.e. an asymmetric shock), will lower demand in A, raising unemployment and causing a trade imbalance, while inflation will increase in B (graph 1.2). In such a situation, a common monetary policy cannot solve the problems of both economies at the same time. A restrictive monetary policy (S↑) might reduce inflation in B, but worsen the unemployment problem in A. An expansionary monetary policy (S↓) would reduce unemployment in A, but worsen inflation in B.

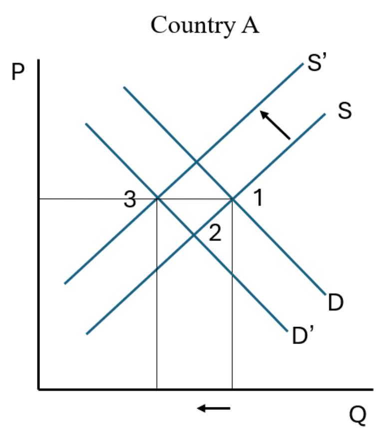
Graph 1.2 Effects of a demand shift caused by a change in preferences (A→B)



The disequilibrium caused by a shock will therefore require a change in relative prices to restore the previous equilibrium. If the two regions have separate currencies, this can be achieved by altering the exchange rates, i.e. by a devaluation of currency A vis à vis currency B. Country A would then recover its competitive position through lower real wages and prices, although nominal wages and prices would remain constant. Demand would rise (D↑) and unemployment will fall.

If, however, the two regions have a common currency, or maintain a fixed exchange rate, production and employment in A must be restored through other means, i.e., a fall in nominal wages and prices, an upward shift in the supply curve (S↑) of the home-produced good through, for example, labour migration out of the country (graph 1.3) or, eventually, an expansionary fiscal policy.

Graph 1.3 Effects of a supply shift caused by labour migration out of country A



Mundell´s analysis therefore suggested that:

- If the impact of shocks on particular areas is similar (i.e. symmetric), a fixed exchange rates regime, or a monetary union, is appropriate.
- If the impact of shocks is asymmetric, however, high labour mobility and/or wage flexibility, more particularly in a downward direction, are the main prerequisites.

Further refinements of theory by Kenen (1969) pointed towards a high degree of *product diversification*. The more a group of countries specialized in the production of particular goods, the more likely it would be that external shocks would have asymmetric effects. The different parts of a currency area should therefore produce a similar mix of goods. McKinnon´s (1963) main criterion was the degree of *openness* in an economy, linked to the relative importance of traded to non-traded goods. A high degree of openness reduced the effectiveness of an autonomous monetary policy, and limited the usefulness of exchange-rate changes as a means of restoring competitivity, since devaluation rapidly fed through into domestic prices.

1.2.2 Different types of macroeconomic shocks

- *Country-specific* vs *sector-specific shocks*: Changes in monetary policy or in exchange rates are the wrong instruments to meet a shock which affects only one sector or region of a precise economy. A purely sectoral shock can only be of any real relevance if a particular area is overwhelmingly dependent upon the industry in question. In these circumstances, it becomes identical to a regional shock and opens up the question of whether the region should create its own currency or whether it should reduce its degree of specialisation.

- *Real vs financial shocks*: Variations in nominal exchange rates are only an appropriate remedy if the effect is on real aggregate demand. If, on the other hand, the shock is purely financial, the correct answer is the adoption of fixed exchange rates, or a single currency system, which minimises the impediments to money flows across national borders. Studies upon the effect of shocks on employment have reached similar conclusions.

"*Financial shocks can occur as a result of currency-specific portfolio adjustments. In response to financial shocks the exchange rate should be kept constant and the shift in the portfolio composition should be satisfied by varying the supply of assets denominated in specific currencies. Asymmetrical financial shocks can be better dealt with in a monetary union than in a system with adjustable exchange rates and are thus not an additional source of unemployment*"[7] **(Ochel 1997)**.

- *Exogenous vs policy-induced shocks*: A final distinction shall be outlined between shocks caused by outside events over which the authorities in a particular economy have no direct control (exogenous) and shocks arising from internal policies. Whereas many shocks appear at first sight to be "exogenous phenomena with which policy authorities are suddenly faced", they can turn out, on more careful examination, to be the consequences of their own political activities (e.g. a rise in wages as a result of employers' and unions' expectations that the rise will be accommodated by monetary or fiscal expansion).

"*Even if countries experience large, asymmetric disturbances, it need not follow that policy autonomy is useful for facilitating adjustment. One interpretation of asymmetrically distributed aggregate demand shocks is that the countries concerned are poor candidates for monetary union, because policy makers can use demand-management instruments to offset demand shocks emanating from other sources. But, if domestic policy itself is the source of the disturbances, monetary unification with a group of countries less susceptible to such pressures may imply a welfare improvement*"[8] **(Bayoumi & Eichengreen, 1994)**.

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[7] Ochel W. (1997), *Europäische Wirtschafts- und Währungsunion und Beschäftigung*, ifo Schnelldienst, vol. 50, No. 15, 9-23, München

[8] Bayoumi T. & B. Eichengreen (1994), The political economy of fiscal restrictions: Implications for Europe from the United States, European Economic Review, 1994, vol. 38, issue 3-4, 783-791, Elsevier B.V., Amsterdam

1.2.3 Symmetric and asymmetric shocks

Investigating the nature of different macroeconomic shocks occurring in the Old Continent since the effective foundation of the EU, the European Commission (1990) identifies country-specific shocks as asymmetric, by definition. Major natural disasters are likely to fall into this category, as will the immediate effects of political events like German re-unification or Portuguese de-colonisation. Since they are by definition unpredictable, it would not be logical to establish separate currency areas in order to deal with them. More arguable is the case for a separate currency in an area particularly prone, for example, to earthquakes - though it is by no means obvious that adjustment via repeated devaluations would be less costly in such cases than other adjustments within a larger currency area.

On the other hand, common shocks, for instance a rise in world commodity prices or a technological innovation, might have either symmetric or asymmetric effects upon different economies, depending on their structure. As Caporale (1993) observes, the Commission's finding that "*sectors producing homogeneous goods with few trade barriers mainly experience symmetric shocks*" while "*in other sectors there appears to be an inverse correlation between the existence of trade barriers and the degree of symmetry of the shocks*"[9] **(Caporale, 1993)** has the obvious implication that completing the single market should decrease asymmetry.

[9] Caporale G. M. (1993), Is Europe an optimum currency area? Symmetric versus asymmetric shocks in the EC, National Institute Economic Review, Vol. 144, pp. 95-103, Cambridge University Press

A more useful distinction can perhaps be made between short-term and long-terms causes. A rise in short-term interest rates may, for example, have diverse effects in different areas because they are at unequal stages in an economic cycle. But they may also be due to long-term differences in financial structure and monetary transmission mechanisms.

When it is stated that a shock has an "asymmetric effect", it is useful to know exactly what is being measured. One approach is simply to measure exchange-rate changes. If some event is followed by the realignment of parities between any two currencies, the effect of the event may be said to have been asymmetric, and the realignment to have been the mechanism of adjustment to it.

There are at least two problems with this approach. First, exchange rates change for a variety of reasons making it difficult to isolate the effects of a particular event. Secondly, only asymmetric effects between currency areas can be measured, not those within them. Where a currency union is being created from separate areas, as in the case of the European Monetary Union, it cannot be presumed that the effect of shocks will be as before, for the reasons outlined above.

The effects of a particular economic shock can also be measured in terms of differential inflation rates, in the case of separate currency areas or differential movements of consumer prices, unit labour costs or asset prices can be taken into account i.e. both between and within currency areas. Changes in GDP can also be measured both in relation to separate currency areas and to some extent within them, where comparable regional statistics are available. A more precise statistical analysis is provided by rates of unemployment, and data are available even at the very local level of travel-to-work areas. It is probably for this reason that a number of recent studies have defined asymmetry upon the basis of differential employment effects.

1.2.4 Mundell's convergence criteria

Mundell's research on optimum currency areas helped economists further develop the concept of monetary unions and analyse the contrast between symmetric and asymmetric shocks. However, according to many scholars, its main contribution is represented by the individuation of four precise convergence *criteria*, that is, macroeconomic preconditions before the actual implementation of a regional single currency system.

Such criteria have been discussed and debated for decades and there still exist diverging opinions on what factors exactly constitute an optimal currency area, as intended by Mundell. Nonetheless, several key elements are generally agreed upon as being fundamental in determining whether a group of states can successfully share a currency and, in broad terms, a monetary policy:

1. *Labor Mobility*: it refers to the ability of workers to move freely amongst countries in search of employment. In a monetary union, labour mobility between member states is an essential element, so that workers can effectively balance out any economic imbalances. For instance, if one country experiences high unemployment while a second has a labour shortage, workers ought to be able to move from the former to the latter in order to even out the job market.

2. *Fiscal Transfers*: these refer to the movement of capital from one country to another, which can take the form of direct aid, loans or diverse tools of financial assistance. In a currency union, the mutual ability to transfer funds is a fundamental requisite to guarantee an equal redistribution of resources and to ensure economic stability and social well-being in all the member states, especially in those which are financially struggling.

3. *Price and Wage Flexibility*: in a monetary union, different member countries may experience different rates of inflation. These rates, moreover, may be subject to rapid and sudden changes, generated by exogenous factors. Mundell suggests that a minimum degree of flexibility in prices and wages is necessary so that economies might efficiently adapt to those changes, since an overly rigid approach in determining prices and wages may lead to economic imbalances and difficulties in the adjustment process amongst member states.

4. *Similar Business Cycles*: a crucial criterion in optimum currency areas is the level of homogeneity of business cycles amongst the member states. In this sense, national economies should experience economic growth and contraction at roughly the same time, since, analogously to inflation dynamics, notable differences in economic performance parameters may generate considerable discrepancies amongst countries and, once again, make the restoring procedures extremely complicated.

The aforementioned criteria have prime importance in determining whether a group of countries is suitable for the institution of a properly functioning currency union, as they represent the basic requirements to ensure economic prosperity and financial stability in the long term, yet in the absence of a universally faultless formula of optimal monetary union. Furthermore, they constitute an essential agenda, the basis for an efficient roadmap that national policymakers interested in creating sustainable and beneficial currency unions should always keep in consideration.

1.3 Monetary unions and economic integration

A currency union represents an instrument of economic integration or a feature of an already existing economic union. All current monetary unions around the globe have observed the basic general rules of a common market, and there is no plan for a future union which would not be accompanied by the establishing of a *common market*[10]. The degree of economic cooperation required to achieve a currency union makes it useless to consider plans for common currencies in vast areas where individual countries have not taken the first steps towards converging their economies.

With that being said, it is now fairly legitimate to ask ourselves what advantages a currency union is capable of conferring to its member states, what kind of risks those economies could eventually face and what type of precautions they would be supposed to consider. In other words, we will attempt to understand how monetary unions may contribute to the strengthening of political, economic and social relationships amongst their member states, and to creating greater regional integration, considering, as we have already anticipated, that a discrete level of integration itself is an essential element for the creation of a single-currency system.

The basic claim of the advocates of economic integration is easy to understand. The competition resulting from the abolition of protective restrictions leads to increased specialization, efficiency, and productivity. The factors of production - labour and, particularly, capital - are used more efficiently, and the enlarged markets make possible the application of modern technology, which usually depends on economies of scale, that is, upon plants whose optimum size is relatively large.

[10] Agreement between two or more countries removing all trade barriers between themselves, establishing common tariff and non-tariff barriers for importers, and also allowing for the free movement of labour, capital and services between themselves.

In theory, a common market establishes freedom of movement for products and factors of production across member countries' borders, therefore unleashing the forces of competition. In practice, however, it is possible for any common market to have many imperfections, for instance, complete freedom for products and factors may not be guaranteed. Under one currency, some of these imperfections could not survive, and others would be subject to new pressures. The very first consequence of having a single currency is, of course, that it allows complete freedom of payment by any one place, to any other place in the union: in other words, complete liberty to facilitate capital movements. Currency unions also provide a crucial benefit to investors, as they guarantee against a devaluation loss. Even under full interconvertibility of currencies of countries in the common market, a change in par values remains a real possibility, a threat which is finally removed only by the unification of the currencies.

However, the positive expectations of benefits which economic integration brings may not be equally shared. There has been considerable controversy about the extent to which the benefits are offset by switching from less expensive foreign markets to more expensive suppliers within a union. Furthermore, an economic union, or a common market, may over-protect its area and thereby tend to create unsound industries. Essentially, these are arguments against excessive protectiveness, but it is true that the very process of integration, through the elimination of internal barriers and the maintenance of external ones, involves some losses which must be subtracted from the benefits.

Some critics of integration plans, while not attacking the theory, argue that local circumstances often prevent the plans from working. They affirm, for instance, that migration of labour will not act as an equilibrating factor in payments between member countries because tradition, language, and religion will discourage it. Other critics, while not doubting that the integration process will work, are disturbed by some of the results that they expect from it. In this sense, mobility of capital may be harmful if it results in capital being attracted to more developed areas rather than to the neglected ones which need it most. Therefore, integration may increase the uneven geographic distribution of incomes and wealth.

Yet often, opponents of integration, especially if their opposition is political, take their stand upon other grounds, and stress the loss of freedom of action which integration would entail for national governments. This argument is politically sensitive and therefore deserves a deeper analysis.

1.3.1 Economic integration and monetary sovereignty

In economic integration, a sovereign government's prerogatives are outlined in terms of its balance of payments position. An independent country can take various measures to correct its balance of payments deficit, such as reducing its import outlays, boosting exports, or devaluing its currency. However, these external measures are not available to a country within an economic union. Even a common market reduces a member country's arsenal of defences. The government can maintain the right to devalue its currency and regulate capital outflows but cannot impose restrictions upon imports or current payments without explicit authority from fellow members. In short, member countries in a union have limited freedom of economic policy, with limited differences in credit policy and taxation. Budgetary policies become of legitimate interest to fellow members, and deficit financing in one country is closely monitored by all other members. Monetary expansion one country increases its share of the union's resources but is only tolerated up to a point where it is challenged by other members. This can lead to social discontent and nationalistic overtones in sovereign states.

1.3.2 The prerequisite of discipline

The need for policy coordination and transfer of sovereignty to central organisations within economic unions may be seen as a negative aspect of integration, especially for new countries. J. Keith Horsefield (1965) discusses the experiences of countries with central banks over a period of more than twenty years, and observed that, while central banks can restrain governments from unwise policies, their powerful credit instruments have quite often been misused, leading to doubts about their effectiveness in inexperienced or weak governments. Governments rarely resort to inflation intentionally, but they are unable to resist political pressures and may benefit from constitutional stop signs. Some countries have such constitutional signs in the form of central bank laws banning certain policies or limiting the government's borrowing powers. In other countries, however, where inflationary deficits have become something of a habit, the national monetary authorities no longer have such signs. Multinational central banks could possibly take anti-inflationary positions against multiple governments, basically limiting excessive monetary expansions. Nonetheless, governments could use public opinion in other countries to address critical views, therefore leading to strong disagreements with the central authority, and eventually pre-empting exits from the union.

2. The Euro: a bastion of regional integration

2.1 An ongoing experiment

The European Monetary Union (EMU) is unanimously considered to be most integrated single currency system globally, and, considering the set of features that characterize it, probably the only fully functioning monetary union in existence. The European Monetary System differs from other transnational organisations, not only in the use of a single currency, but also in the presence of a central institution responsible for common monetary policy, and in the undisputed rigidity of the various economic convergence criteria that countries are required to observe for the correct functioning of the union. Nonetheless, the path towards its introduction cannot be described as *flawless*. Considerable frictions have been observed in the years preceding its full implementation and, even though this constitutes a common policy for the political union overall, several countries have decided not to join it (Figure 2.1).

In the following chapter, we will briefly retrace the main events over the last seventy years of the European geopolitical system, which have led to the full and total implementation of the monetary union that still characterizes the socioeconomic system of the Old Continent today. Furthermore, we shall propose a simple analysis of the costs and benefits of the whole system, with the aim of assessing the level of effectiveness of the common currency, in particular its ability to maintain stability and balance a homogenous policy with differentiated responses to asymmetric shocks within countries. Finally, we will focus on the future political and socioeconomic implications of the European currency union and, more thoroughly, on the most significant lessons of this twisted twenty-year experience from which the international community can draw benefits in the context of projects for greater regional economic integration.

Figure 2.1 Member states of the EU which adopted the Euro as legal tender

Source: Wikipedia

2.2 A long and troubled history

Although the Euro has been used as the sole European legal tender for only twenty-two years, the history of this common currency begins much earlier. The 1957 *Treaty of Rome*[1] already outlined the measures to promote intense coordination in economic and monetary affairs amongst its member states. However, the question of monetary integration was not considered prominent until the end of the 1960s, since the stability of the global monetary system at the time was ensured by the *Bretton-Woods arrangement*[2]. According to this arrangement, fixed exchange rates were established between the Western currencies and the US dollar, the latter being tied to the national gold reserves. It is only when the Bretton-Woods system began to show its limits, that the European institutions realised the urgency for monetary co-operation among themselves.

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[1] Signed on March 25th 1957 by Belgium, France, Italy, Luxembourg, the Netherlands and West Germany establishes the creation of the European Economic Community (EEC).
[2] Established a system through which a fixed currency exchange rate could be created using gold as the universal standard. The agreement involved representatives from 44 nations and brought about the creation of the IMF and the World Bank.

At the *Hague Summit* of 1969[3], EU member states entrusted Luxembourg's Prime Minister and Minister of Finance Pierre Werner with the task of conceiving a plan for the creation of an economic and monetary union as a solution to the growing instability of the Bretton Woods system. Such plan, which foresaw the gradual replacement of national currencies with a common currency, included the strengthening of coordination of budgetary and fiscal policies amongst the Union's countries, the removal of all types of restrictions to free movement of capital, and the irrevocable fixing of exchange rates between national currencies.

The gradual approach and the emphasis on economic coordination reflected an ongoing debate amongst the Community's member states. Some of them, so called "*economists*", like Germany and the Netherlands, considered economic convergence to be a crucial requisite for monetary integration, whereas others, generally referred to as "*monetarists*", such as France and Belgium, believed that monetary integration would naturally spur the member states' economies towards greater uniformity.

In an attempt to restore some stability in the international monetary system, and in the light of the US administration's decision to terminate the Bretton-Woods arrangement in 1971, the member states of the European Union developed, in 1972, the so-called *currency snake* system, according to which the national currencies were allowed to fluctuate against each other within a margin limited to 2.25%. Nonetheless, the 1973 oil crisis[4], and the following succession of uncoordinated responses of the member states pushed some countries to depreciate their respective currencies, and, ultimately, led to the failure of the currency snake.

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[3] Summit of the Heads of State and Government of the Member States of the European Communities on December 1st and 2nd, 1969 in The Hague (the Netherlands)

[4] In October 1973, the Organization of Arab Petroleum Exporting Countries announced a total oil embargo against the countries who had supported Israel during the 1973 Yom Kippur War, begun after Egypt and Syria's large-scale surprise attack in an ultimately unsuccessful attempt to recover the territories that they had lost to Israel during the 1967 Six-Day War.

The economic and financial slump triggered by the oil crisis arising throughout Europe, along with the categorical refusal of the United States government to maintain the value of the dollar at a fixed stable level and the consequent high volatility of exchange rates, persuaded European states to relaunch co-operation projects in relation to monetary matters.

At this stage, however, discrepancies emerged amongst member states on the reforms necessary to carry forward that integration process. While France was in favour of deepening monetary cooperation, Germany feared that the rampant wave of inflation across Europe during the mid-1970s might have a heavy impact upon its economy. Such disagreements, anyway, were soon overcome thanks to a gradual convergence between the German Chancellor *Helmut Schmidt* and the French President *Valéry Giscard D'Estaing*, who in 1978, proposed the creation of a new *European Monetary System*, which actually entered into force in 1979.

This monetary system was settled upon two fundamental features. Firstly, the plan included the institution of a virtual currency unit, known as the *European Currency Unit*, which did not imply the issuing of coins and banknotes, but rather the creation of a single basket of national currencies, expected to replace the dollar as the pivotal currency for the whole system. Secondly, the countries agreed on a novel exchange rate mechanism, which would be based upon fixed but still *adjustable* rates. Specifically, governments were supposed to set a central exchange rate, which could be subject to periodic readjustments, with a fluctuation band around the central rate, within which single national currencies were allowed to fluctuate.

With the signature of the so-called *Single European Act* of 1986[5], EU member states confirmed their objective to establish a fully developed monetary union. On the basis of the preconditions identified by Werner's report two decades earlier, a special committee led by the then President of the European Commission Jacques Delors, the "*Delors Committee*"[6], proposed in June 1988 the implementation of the *Economic and Monetary Union* in three sequential stages:

1. *Stage one* included the development of closer coordination of the member states' economic policies, increased monetary cooperation and the introduction of free movement of capital.
2. *Stage two* foresaw a gradual transfer of sovereignty over monetary matters to the central institutions, the establishment of a European system of central banks, and the narrowing of the fluctuation bands.
3. *Stage three* implied the full handover of competence over monetary matters to the union's institutions, the fixing of exchange rates between national currencies and their eventual replacement with a single European currency.

The Federal Republic of Germany had remained quite reluctant to give up monetary autonomy and control over its strong currency for years. The situation, however, drastically changed with the fall of the Berlin Wall in November 1989. According to experts, West Germany's consent for the launch of the currency union in such a renovated geopolitical context had become a powerful leverage to win its European partners' support for the country's reunification process.

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[5] EU Treaty signed on February, 17th 1986 and entered into force on July, 1st 1987, to amend the 1957 Treaties of Rome, to facilitate the construction of a free internal market and laying the foundations for the political Union.

[6] *Ad Hoc* committee set up in June 1988 upon a mandate from the European Council to examine and propose concrete stages leading to European Economic and Monetary Union.

While stage one of the monetary integration process had officially started in 1990, an *intergovernmental conference* was convened one year later by the European institutions to discuss the revisions to the original Treaty of Rome, necessary for the member states' economies to move to stage two. The conference saw old diverging lines re-emerge: Germans and Dutch representatives expressed their belief that member states should fulfil strict criteria upon economic convergence before stage three could officially begin, whereas French and Belgian officials were convinced that economic convergence would have followed naturally past the completion of the monetary union.

These discussions led to the signature, on February 7th 1992, of the *Maastricht Treaty*[7], which established a new concept of the Union, with a shared monetary policy. A compromise was found between the opposing opinions. Member states set the introduction of the new common currency for 1999, but also agreed on the definition of specific convergence criteria (Table 2.2) that countries were supposed to fulfil in order to participate in stage three.

Table 2.2 Maastricht convergence criteria for joining the Monetary Union

Price stability	Sustainable price performance and average *harmonised consumer price inflation* (HCIP) lower than 1.5 % above the rate of the three best performing states.
Sound and sustainable public finances	Annual government deficit lower than 3% of GDP and government debt lower than 60% of GDP.
Durable convergence	Long-term exchange rates lower than 2% above the rate of the three best performing states in terms of price stability.
Exchange rate stability	Participation in EMS for 2 consecutive years without severe tensions, with no devaluation against the Euro.

Source: European Commission

[7] Signed on February 7th 1992 and entered into force on November 1st, 1993, it defines the so-called *three pillars* of the European Union and establishes the political rules and economic and social parameters necessary for the entry of the various member states into the aforementioned Union.

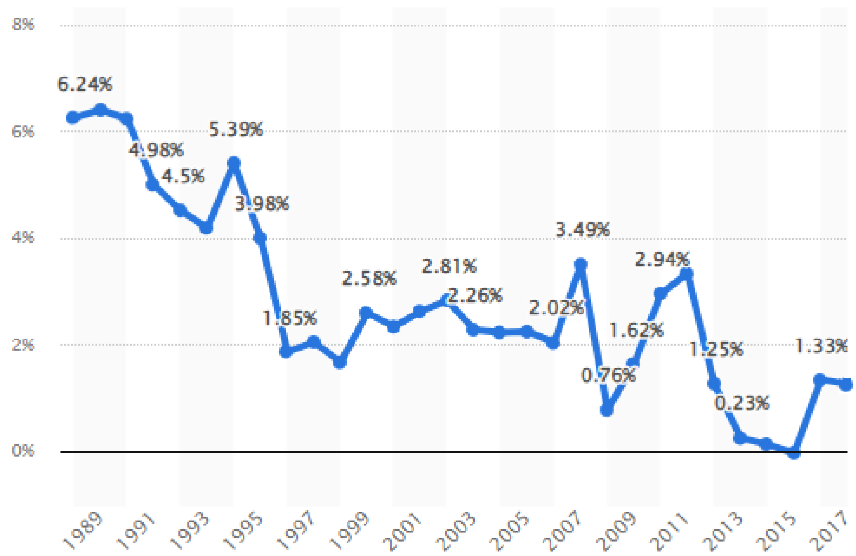
The whole process towards the monetary union was seriously put at risk, when, as a result of a popular referendum held in Denmark in June 1992, the Danish government rejected the provisions outlined by the EU with the signature of Maastricht Treaty. This was soon followed by a wave of speculations against the weaker currencies, such as the Italian lira and the British pound, forcing Italy and UK to leave the European Monetary System and the remaining states to widen the fluctuation band to 15% above and below the central rate, de facto making it a flexible rate system.

Despite this unfortunate series of events, the roadmap towards the creation of the currency union was comprehensively respected, with stage two officially beginning in 1994, when the *European Monetary Institute* was established as a precursor of today's European Central Bank. In 1998, eleven countries were deemed eligible to join the union upon the basis of the convergence criteria previously defined. UK and Denmark were granted opt-outs, while Greece and Sweden did not fulfil the preconditions to join. Stage three finally started in 1999, when the Euro was formally introduced as a virtual common currency, and the exchange rates between national currencies were fixed irrevocably, although it is just on January 1st 2002 that euro coins and banknotes began to circulate as recognized legal tender. New member states have joined since, and today the Euro is used in 20 of the 27 countries of the EU, and by more than 300 million Europeans.

2.3 Boosting stabilization and growth

The first major advantage associated with the adoption of the Euro is undoubtedly its capacity to maintain *price stability* all over the union (Figure 2.3). The yearly inflation rate target set by the *European Central Bank* (ECB), of 2%, helps states' economies anchor inflation expectations among consumers and businesses. In this sense, when stable prices are expected, individuals are less likely to engage in inflationary behaviours, such as demanding higher wages or increasing prices. The ECB employs various monetary policy tools to control the inflation rate. By adjusting interest rates and using unconventional measures like *quantitative easing*[8] when necessary, it is able to influence both money supply and demand within the continental economy. Currency sharing therefore facilitates economic coordination amongst EU member states by creating a unified monetary policy framework, which reduces disparities in inflation rates between countries that could arise from individual national policies.

Figure 2.3 Yearly inflation rate in Italy (1989-2017)



Source: Statista

[8] Procedure through which the European Central Bank purchases government bonds to lead to an increase in their prices, along with a decrease in their long-term interest rates

The second benefit represented by the introduction of the common currency in Europe is its significant role in minimizing *exchange rate risk* for businesses and families within the monetary zone. One of the primary ways the Euro keeps exchange rate risk particularly low is by eliminating currency fluctuations amongst member states: by using a single currency, individuals and enterprises engaged in cross-border trade can easily handle intra-bloc transactions without the need for conversion procedures, which might expose them to sudden unexpected changes in exchange rates. Moreover, the introduction of the Euro considerably reduced transaction costs associated with foreign exchange conversions, encouraging trade and investment operations amongst member states, and further stabilizing economic interactions and minimizing risks related to exchange rates.

Most economists praise the adoption of Euro for its significant contribution to enhancing *trade* amongst EU's economies (Figure 2.4). By eliminating exchange rate volatility, creating complete price transparency and, in general, providing the ideal economic environment for a stable and long-lasting growth, the single currency noticeably increased the forces that lead economic activity to be conducted across borders. Recent studies highlight the currency's ability to enable smaller and less productive firms to enter the market profitably by reducing export costs and expanding their product range by stimulating exports of lower value-added goods within the whole Eurozone. In other words, we might conclude that the monetary integration process in Europe has somehow democratized access to export markets.

Figure 2.4 Intra-EU exports of goods 2001-2023

Source: Eurostat

Monetary integration is inevitably associated with a specific level of *fiscal discipline*, a critical component in maintaining economic stability and growth amongst member states. It refers to the adherence of national governments to established budgetary rules and regulations that govern public spending, tax revenue collection and, overall, fiscal management. The *responsibility* for ensuring fiscal discipline falls upon politicians and policymakers at both national and regional levels, since they are tasked with creating and implementing fiscal policies that align with EU's broad economic objectives. This includes guaranteeing that government budgets do not exceed the stipulated limits set by various treaties and agreements, such as the *Growth and Stability Pact*[9], the *Fiscal Compact*[10] and *Article 123 of the Treaty on the Functioning of the European Union*[11]. Fiscal discipline empowers politicians with greater accountability, since they are expected to navigate such constraints while addressing popular needs, and discourages eventual tensions between fiscal rules and political pressures.

[9] Agreement among all the 27 member states of the European Union (EU),
to facilitate and maintain the stability of the Economic and Monetary Union (EMU).
[10] Intergovernmental treaty signed by all EU member states on March, 2nd 2012 and entered into force on January, 13th 2013, as a new stricter version of the Growth and Stability Pact
[11] Prohibits any type of direct central-bank credit to public bodies as well as the direct purchase of sovereign bonds by the ECB or national central banks of member states.

2.4 Between centralizations and sovereignty

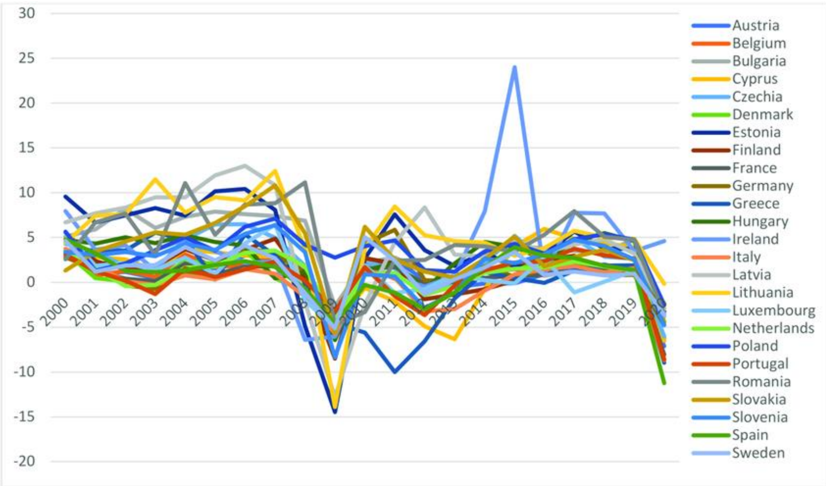
The largest drawback related to the adoption of the Euro is usually considered the inadequacy of a single currency policy to fit local economic conditions. Europe, in fact, is no stranger to divergent economic cycles, with countries recording extremely positive growth rates and low levels of unemployment, while others suffer from low levels of productivity, and get to cope with harsh recession phenomena. Sticking to *Keynes*'s classic theory, high growth countries ought to implement restrictive monetary policies to prevent inflation and eventual economic crashes, whereas low growth economies could enjoy lower interest rates to stimulate borrowing and promote credit expansion. This approach, however, cannot be applied in a monetary union, since, the monetary policy is by definition *centralized* and, therefore, unique for the entire community. In this sense, the monetary policy associated with the Euro is generally considered the opposite of a standard economic approach, as showed by the European *sovereign debt crisis*[12], when international investors, fearing for the solvency of troubled economies, such as Greece and Italy, heavily drove up interest rates. Such behaviour furtherly increased unemployment and started *deflationary* cycles in those states, putting them on the brink of financial default.

Each process of economic convergence is strongly linked to the concept of *monetary sovereignty*, which refers to the ability of a sovereign country to autonomously manage its own monetary policy. Most countries involved in regional integration projects are particularly reluctant to give up monetary sovereignty, since, not only are they unwilling to lose control over monetary policymaking and exchange rates flexibility, but they also fear waiving what is utterly considered as a crucial element of national identity and, as a consequence, a powerful tool for political propaganda.

[12] Financial crisis occurred in several European countries due to high government debt and institutional failures, begun in 2009 when Greece's sovereign debt reached 113% of GDP

Deeper economic integration in a regional context, such as the EU, is generally expected to enhance the degree of *interdependence* amongst member countries. Increases in intra-bloc flows of goods and services, capital and workers, eventually sustained by the establishment of a single currency, might lead different economies to equally enjoy the benefits of common trade, financial and labour policies, and therefore spur similar growth cycles in the entire economic union (Figure 2.5).

Figure 2.5 Evolution of GDP growth rate for 25 EU countries (2000-2020)



Source: Energies, MDPI

Such a correlation, however, may also affect an interdependent community in negative ways. For instance, severe economic turmoil in one of its member states may produce serious repercussions upon its tighter trade and investment partners, and the greater the political, economic and social weight of such country, the greater the intensity with which such a crisis could spread throughout the Union. This was true of Germany, whose recent recession, caused by the serious increase in energy prices following the start of the *Ukraine's War* in 2022, has significantly affected European nations by reducing trade demand from German consumers, limiting investment flows into neighbouring economies, and severely impacting labour market dynamics within the whole Continent.

2.5 What Euro's first 25 years has taught us

Despite catastrophic scenarios announced by sceptical scholars, the Euro has shown extraordinary resilience over its first twenty-five years of existence, navigating through critical challenges and disproving early predictions of its collapse. However, even though the single currency has delivered on some of its promises, it has failed to boost Europe's potential growth, or facilitate the continent's full economic and political integration. This is usually attributed to the incompleteness of EU's pathway to a full economic union, with fiscal frameworks being seriously underdeveloped compared to its monetary structure. To understand the consequences of the Eurozone's unfinished architecture, Buti and Corsetti (2024) analysed four distinct periods in the life of the Euro.

The first phase, from 1999 to 2008, known as the *2% decade*, with economic growth, inflation, and budget deficits hovering around this rate, saw the emergence of significant imbalances amongst the union countries, with nominal convergence masking structural disparities and conspicuous amounts of capital flowing from richer to poorer members.

The implications of *2008 global financial crisis* heavily eroded trust amongst member states and highlighted the necessity to discourage most prodigal countries from potential moral hazards, eventually covered by communitarian mechanisms for debt restructuring. The quantitative easing operation implemented by ECB President *Mario Draghi*, right after his pledge to do "*whatever it takes*"[13] to protect the Euro from speculative attacks, is considered a crucial turning point in the history of the common currency. However, with monetary policy still being the only instrument of economic integration at the continental level, the Eurozone's financial structures remained fragmented.

[13] July 26th, 2012, Global Investment Conference, London

The exogenous nature of the Covid-19 pandemic substantially changed this paradigm of fiscal rigidity and austerity measures, enabling EU leaders to present a unified front, unburdened by the pressure to avoid moral hazard. This is witnessed by the Union's decision to suspend the *Stability and Growth Pact* and implement the *Next Generation EU* recovery programs, financed through common borrowing.

Despite this demonstration of collective leadership and optimism, a global inflationary surge, induced by disruptions in pandemic-related supply-chains, was exasperated by the rise in energy prices that followed Russia's invasion of Ukraine (2022). Notwithstanding numerous efforts of European policymakers to reduce the EU's dependence on Russian gas, a collective response to the consequent economic turmoil was never agreed, and EU member states today must confront themselves with worryingly rising deficits and debt-GDP ratios.

The initial twenty-five years EU's experience can certainly be an inspiration for other monetary integration projects around the world. However, two fundamental lessons must be taken into account to avoid repeating the mistakes made by the Old Continent's institutions in their path to economic convergence. Firstly, the monetary union's *incomplete infrastructural framework* has proven to be costly and counterproductive. Finalizing the banking union, and creating a common resolution fund with the support of the ESM and deposit insurance, might be essential to ensure stability and enhance the international role of the euro. In other words, EU leader and policymakers need to "*strike a balance between risk sharing and risk reduction*"[14] **(Buti & Corsetti, 2024)**

[14] Buti M. & Corsetti G. (2024), *Lessons from the Euro's First 25 Years*, Project Sindicate, January 31st 2024

Secondly, the completion of the monetary convergence cannot detract from safeguarding and further development of EU's greatest achievement, namely the *single market*. European countries' attachment to national industrial realities, funded through state aid, undermines the core values of the single-market project. In this respect, the EU's institution ought to formulate a cohesive European industrial policy, which includes a plan for massive cross-border investments, aimed at fostering the development of human-capital and the green and digital transitions.

The Euro-system repeatedly demonstrated its ability to react and adapt to constantly changing circumstances and features of both regional and global economy. No one is definitely sure what type of political, economic and social challenges the European Union and the monetary community ought to expect and get prepared to face in future. What is crucial, however, is that EU's institutions develop the capability to comprehend, forecast and anticipate tomorrow's reality, to adapt to sudden and quick changes in society's habits, needs and expectations, and most importantly, to respond to adverse shocks in a coordinated and synergetic manner, as a fully integrated community is supposed to do.

3. South America: fertile ground for a monetary union?

3.1 Similarities and disparities among South American states

Latin America probably represents one of the most homogeneous regions of the planet: the majority of its countries share the same language – Spanish – and religion – Catholicism, they basically have a common history, since they all gained independence from the Spanish colonial empire and, although Brazil might constitute an exception, its pathway to the modern democracy it has become today is somehow very similar. From a purely institutional point of view, all the countries forming the South American continent share a culture of presidential governments ranging from the right to the left, but often with a common ingredient: populism.

All these similarities, however, exclusively apply to the socio-political structure of the nations, if we shift to the merely economic domain, the region in question appears to be poorly integrated: from Peru's unwavering prudence on controlling public accounts, to Cuba's historical communism and Argentina's endemic addiction to expansive monetary policies. Despite such a diversified economic and financial environment, numerous proposals involving a common currency in the whole area have emerged in the last decades, even though none of them has ever come to reality.

In the next pages we will examine the main monetary union projects in the last sixty years in Latin America, focusing on the intentions and hopes of their promoters and the key reasons that have caused their failure or stagnation. In particular, we will discuss the existence of a real need for a monetary union in the continent, its feasibility, dwelling on the prerequisites of such a proposal, and its ability to foster political, economic and social integration in the region.

3.2 Sixty years of long waited and failed integration

3.2.1 A pioneering project

On February 25th 1964, the governments of Costa Rica, Honduras, Nicaragua, El Salvador and Guatemala signed the *Agreement for the establishment of the Central American Monetary Union*: with this accord, the aforementioned countries urged their respective monetary authorities to integrate into a common central-banking system:

"*The cooperation mechanisms established by the Central Banks* […] *point out the need and the opportunity to adopt measures tending to achieve the monetary integration of Central America in stages*"[1].

Despite being a pioneering initiative in the region, numerous civil wars occurred in the area between the late 1960s and the early 1970s and plunged these countries into a period of tremendous political violence and drastically threatened the above cited project. Nonetheless, a new regional monetary agreement was reached in 1974, a step forward, modified again in the 1990s, aimed at relaunching a common monetary institution: its main objective was to advise the various governments on how to proceed with the reforms needed to eventually establish the common currency.

"[…] *The Council shall promote close coordination and harmonization of monetary policies with the fiscal, economic development and integration policies of Central American countries*"[2].

The expected reforms were never fully implemented, the single economies proceeded to act in distinct and discontinuous ways, making the perspective of creating a single-currency system in the region more and more unlikely, if not within the medium term.

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[1] 4th point of the agreement for the establishment of the Central American Monetary Union of 1964

[2] Art. 39 of the 1999 Central American Monetary Agreement

3.2.2 Latin socialism vs the dictatorship of the dollar

According to Federal Reserve estimates, between 1999 and 2019 the US dollar accounted for 96% of trade turnover in the Americas: in order to put an end to the so-called "*dictatorship of the dollar*", one of the most representative architects of the 21st Century socialism, president of Venezuela Hugo Chavez[3] proposed, in 2009, the implementation of a regional unitary compensation system, named "*Sucre*"[4]: such mechanism did not represent a currency in itself, but rather a payment clearing system, following which an exchange rate of 1.25 for each *Sucre* was established, which decoupled the use of US currency in imports and exports of the countries participating to this scheme. As many economists affirm, although this operation drastically reduced the circulation of the American currency within the region, the new currency was constantly backed by the real value of the dollar: in other words, the exchange rate system had a purely symbolic purpose.

Initially, the system was implemented by the *Bolivarian Alliance*[5], in which Venezuela, Ecuador, Bolivia, Cuba and Nicaragua participated: since 2010, the Chavista propaganda has been portraying Sucre as an ideal mechanism which could give rise to a new currency, with the objective of fully replacing the dollar in a relatively short period of time. However, the mechanism never managed to develop as a currency and remained stagnant as an alternative system to theoretically circumvent the use of the dollar.

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[3] Venezuelan politician and military officer (1954-2013), he served as the 52nd president of Venezuela from 1999 until his death in 2013, except for a brief period in 2002 (*coup*).

[4] *Sucre* stands for Sistema Unitario de Compensación Regional (eng. Unified System for Regional Compensation).

[5] Intergovernmental organization formed of Latin American and Caribbean countries, aimed at consolidating regional economic integration based on a vision of social welfare, bartering and mutual economic aid.

3.2.3 The Latin American Integrated Market

One of the best developed mechanisms of economic integration in the region is undoubtedly represented by the *Latin American Integrated Market*, formed in 2011 by the member countries of the *Pacific Alliance*[6], namely Peru, Colombia, Chile and Mexico (Figure 3.1). The governments of these nations opted for a gradual process to economic and financial integration: MILA agreement, in fact, does not constitute the establishing of a currency union, nor a payment mechanism, but rather originates from a sort of common capital market. This initiative currently brings together more than 700 companies from the economic bloc, which represents around 40% of the total GDP of Latin America and the Caribbean areas and 38% of the total foreign direct investment flows in the region.

Figure 3.1 Member states of the Pacific Alliance

Source: BizLatin Hub (https://www.bizlatinhub.com)

[6] Latin American trade bloc whose purpose is to improve regional integration and move toward complete freedom in the movement of goods, services, capital and people between the four member states.

For the time being, there is no concrete plan involving a currency union in the area, but the stability of the Alliance member states and their greater degree of openness and economic freedom, especially if compared to their counterparts forming the Mercosur organization (Figure 3.2), suggests that they might decide to move in this direction in the not too distant future, provided they will be able to achieve each step of the regional economic integration in a progressive and not disruptive manner.

Figure 3.2 Index of economic freedom 2022 (score out of 100)

Chile	Colombia	Mexico	Peru	**Pacific Alliance**
74,4	65,1	63,7	66,5	**67,42**
Argentina	Brazil	Paraguay	Uruguay	**MERCOSUR**
50,1	53,3	62,9	70	**59,07**

Source: Heritage.org (https://www.heritage.org/index/)

3.2.4 The most recent bets: Argentina and Brazil

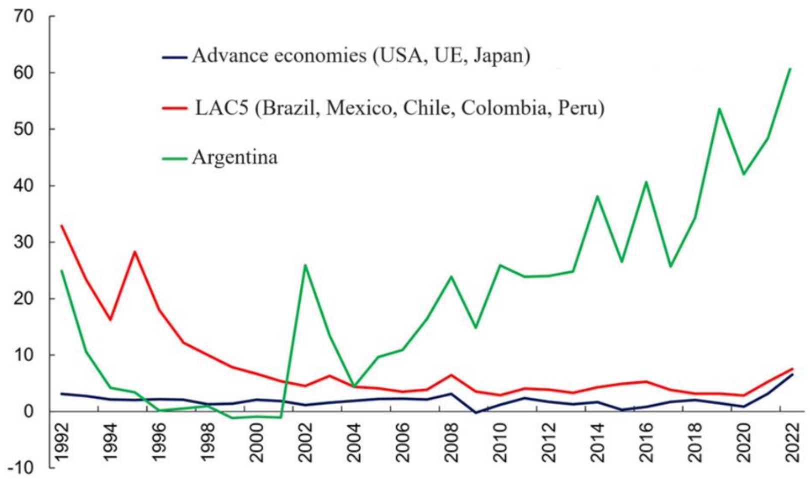
In April 2019, during an important meeting held in Washington amid an agenda of appointments with IMF and the World Bank, the then Argentinian minister of the economy Nicolas Dujovne and his Brazilian counterpart Paulo Guedes discussed the so-called "*Peso Real*", a potential common currency managed by the monetary authorities of Brasilia and Buenos Aires, into which other countries of *Mercosur*[7] could eventually join. Nevertheless, months after the meeting, the project was completely suspended with the election of Peronist Alberto Fernandez and the former military officer Jair Bolsonaro, respectively as presidents of Argentina and Brazil.

[7] Economic and political bloc formed by Argentina, Brazil, Paraguay, and Uruguay and Bolivia, founded in 1991 to create a common market, boost economic and human development, and bolster fundamental values like democracy and social equity

Former Brazilian Labour presidential candidate Fernando Haddad and banker Gabriel Gallipolo cohesively introduced in the national public opinion the idea of creating the *Sur*, a regional currency that would be issued by a supranational monetary institution, the *South American Central Bank*, eventually constituted through the contribution of foreign exchange by its member countries in proportion to their respective shares of regional trade.

The main obstacle to the actual implementation of such monetary agreement today does not have political grounds, but rather financial ones, and is related to a long-standing issue Argentina has been dealing with for decades: inflation. In 2022, the Argentinian peso was one the most devalued currencies in the world, with an annual inflation rate that surpassed 72% (Figure 3.3); the monetary reserves of the Argentine Central Bank were completely decimated, not to mention the enormous financial debt that has tied the country to the IMF for decades. Given these conditions, it is quite easy to understand why any alternative to the use of the US dollar may have been particularly appealing for the Argentinian government.

Figure 3.3 Yearly inflation rate per country (1992-2022)



Source: own elaboration based on the data provided by INDEC and IMF

Although current Brazilian president Luis Ignacio Lula da Silva has indicated he is willing to revive the project of a common currency, most economists have tried to persuade the government to freeze the monetary unification process for the time being. According to Steinberg and Otero-Iglesias (2023), creating a currency union in a poorly integrated regional context like the one in Latin America, where no common market exists, the existing free trade bloc struggles to properly develop, whilst the disparities in monetary and fiscal policies appear to be abysmal, may not only prove useless, but also dangerously harmful. Indeed as summarized by Busch (2023), anticipating a single-currency system "*on top of this fragile economic community is like putting the cart before the horse*"[8].

3.2.5 Milei and the dollarization of Argentina

The economic and eventually monetary integration process in South America underwent a sudden and drastic turning point in October 2023 with Javier Milei's unexpected win in the Argentinian presidential elections and, in particular, after his controversial proposal to adopt the US dollar as Argentina's official currency. Under his plan, the country's central bank would in effect be abolished and the economy fully "*dollarized*".

Most economists maintain a critical view of Milei's economic experiment, which according to them, may prove anything but beneficial, mainly for three reasons. First of all, Argentina and the US are very different economies: what might be the right monetary policy for the latter may be the wrong one for the former. Extreme attention is therefore needed when a country decides to give up its freedom to set its own interest rates and devalue its currency.

[8] Busch A. (2023), *The Sur: Argentina, Brazil put common currency plan on ice*, DW, January 24th 2023

The second problem is a practical one: the central bank of Argentina lacks the amount of US dollar reserves necessary to effectively implement the dollarization process and has limited access to global capital markets to obtain the stocks that would be required to keep the economy going. In purely theoretical terms, Milei could apply to the International Monetary Fund for a loan, but the chances of success would not be high, since the country is already the biggest borrower from the IMF and owes it $44bn.

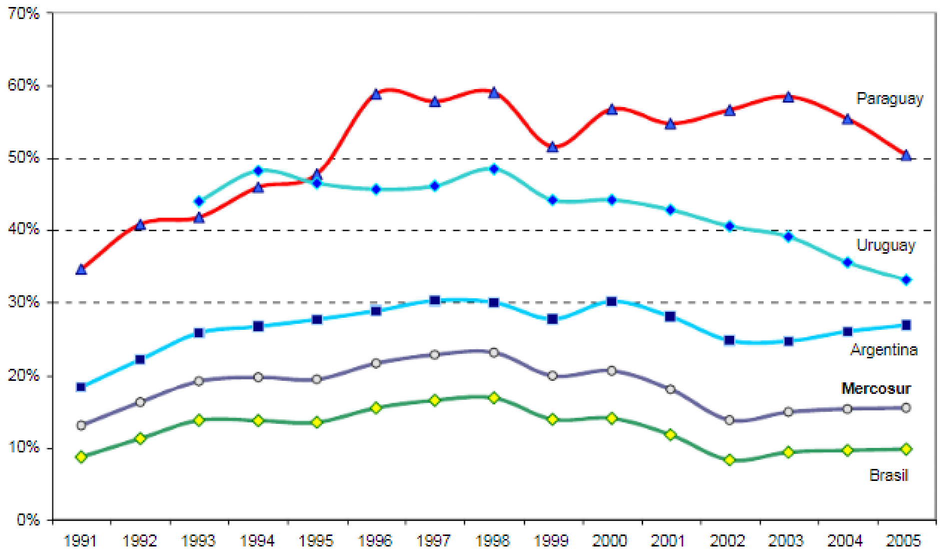
Third, even if a solution can be found to the technical problems associated with abandoning the peso, Milei's shock treatment could blow up in his face relatively quickly. Dollarisation is a one-way street – a policy gamble with no exit that could lock Argentina into an unsustainable course and crash-land the economy. Mark Weisbrot affirms that Argentina is still paying a heavy price for the mistakes of a previous administration led by Mauricio Macri in the year after 2015, "*but a crazed, economically suicidal approach would only make things worse – and as Argentina has experienced, things can get a lot worse*"[9] **(Elliot, 2023)**.

[9] Elliot L. (2023), *Does Javier Milei's dollarisation plan for Argentina make any economic sense?*, The Guardian, November 20th, 2023

3.3 South America and the need for a single currency

The formation of *Mercosur* amidst macroeconomic turbulence marked a significant step towards regional integration for the four countries involved; despite harsh diplomatic challenges such as the imposition of *antidumping duties*[10] and the escalation of trade tariffs, regional integration in the area continued to progress over the last two decades. The sensible increase in intra-Mercosur trade share over its first five years of existence (Figure 3.4) demonstrates how, aside from a favourable global economic environment which enables greater finance availability, the harmonization of macroeconomic policies represents a vital element for the success of free-trade agreements and other forms of supranational unions.

Figure 3.4 Trade interdependence: Mercosur-4 as a percentage of total bloc and member countries trade, 1991-2005



Source: CEI Statistics

[10] Economic measure implemented by an importing state to rectify the situation arising out of the dumping of goods and its trade distortive effect

Free-trade agreements only represent the first step upon the ladder to enhance regional economic interdependence and mutual cooperation. As observed, the issue of whether Mercosur and the South American continent as a whole needs closer macroeconomic policy harmonization, including an exchange-rate stabilization agreement or a single currency, to foster and expand its regional integration process has been discussed several times in the last decades, even though no real agreement has ever developed into a proper monetary union. When assessing the need for and feasibility of measures to stabilize exchange rates among the members of a regional arrangement, it is essential to properly and clearly understand the relationship between exchange-rates regimes and regional integration.

Exchange-rate variability disrupts trade and market integration, it complicates price comparisons, requires importers and exporters to incur the extra costs of hedging, and reduces the volume of intra-regional trade. This has long been the official position of the European Commission when advancing the argument that the Single European Market needed a single currency. Recent studies also suggest that the U.S. and Canadian markets are significantly less integrated with one another compared to the different U.S. states, despite the virtual absence of tariff and nontariff barriers to trade, suggesting that their separate currencies do in fact pose a non-negligible barrier to trade.

Exchange-rate swings may unleash import surges that jeopardize concentrated interests, forcing selected industrial groups to put pressure upon national governments so that countervailing duties and protectionist policies are implemented. In this sense, separate national currencies, which are unavoidably related to exchange-rate variability, might result in dangerously corrosive political support for regional free trade, which is fundamentally incompatible with market integration.

This is the other argument in relation to why Europe's Single Market created irresistible pressure for a single currency. Support for it can be found in the protectionist backlash in France and elsewhere in Europe following the depreciation of sterling in the latter part of 1992 and in the trade conflicts between Argentina and Brazil for the period from 1992 to 1995.

Some economists have pointed out that there is no incompatibility between regional integration and fluctuating exchange rates. The history of *North America Free Trade Agreement*[11] cements the case: the exchange rates between the three NAFTA member states has continued to fluctuate widely in the last three decades (Figure 3.5 and Figure 3.6). Nonetheless, except for limited disruptions, mainly attributable to political tensions or global macroeconomic dynamics, the intra-block trade has kept growing since the establishment of the free-trade area. In such florid commercial context, there has been no serious talk of a project for the single-currency system within North America.

Figure 3.5 CAN – USD Exchange Rate (1989-2019)

Source: Bloomberg Professional

Figure 3.6 MXN – USD Exchange Rate (1991-2017)

Source: Banco de Mexico

[11] Multilateral agreement establishing a free-trade zone in North America; signed in 1992 by Canada, Mexico, and the United States, effective from January 1st, 1994. NAFTA immediately lifted tariffs on the majority of goods produced by the signatory nations. Substituted in 2020 by USMCA (United Stets-Mexico-Canada Agreement).

The idea that Latin America needs a regional exchange-rate stabilization agreement, or a common currency mainly depends upon what kind of integrated regional market its architects are building. It might take the form of a customs union, like NAFTA, in which integration is limited to the removal of tariffs and other barriers at the border, or a full economic union, as the EU, which implies the harmonization of domestic regulations of all kinds, more open domestic markets and a more intense cross-border competition environment.

If South American policy makers' intention is to stop at the stage of customs union, exchange-rate fluctuations have limited importance. Moreover, if they intend to press ahead to deeper integration, like their European counterparts, they will also have to contemplate the chance of fostering a form of monetary union. Some critics object that the first solution is not feasible for Mercosur or any other supranational institution within the continent. By comparison, the US are by far the largest member of the NAFTA and a bastion of monetary stability: fluctuations in the exchange rate of the Canadian dollar and the Mexican peso are tolerable enough because both economies are relatively small compared to the U.S.

By contrast, no country among the member states of Mercosur and the Pacific Alliance is considered to be dominating and financially stable to the same extent, not even a colossus like Brazil. Brasilia's trade partners are large enough to have a first-order impact on its economy, in particular exchange rate fluctuations emanating from those other countries are likely to make exchange rates a touchier issue. If the largest country in Mercosur fails to follow stable monetary policies, the repercussions for the cohesion of the customs union could be quite serious, considering that all possible alternatives to variable exchange rates are not viable either.

3.4 How feasible is a Latin American regional currency?

After discussing the benefits and the risks associated with a potential project of monetary union within the intricate economic, political and social context of South America and evaluating the opportunity and the existence of a real necessity for such a complicated form of regional integration, we shall now consider its feasibility. In order to do so, we will refer once again to the European experience, in particular we will examine Latin America's current institutional and financial status using the Maastricht Treaty's preconditions for a smoothly operating currency union, the forerunners of today's so-called *convergence criteria*[12], as benchmarks, parameters for comparison.

The four criteria are:

1. An independent central bank
2. Wage and price flexibility
3. A strengthened financial sector
4. Existence of barriers to exit

Starting with the first topic, it is important to consider how the path to *central bank independence* within the region has been an uphill road. The influence of governments and sometimes the private sector strongly modelled monetary policy during most of central banks' lifetime. Fiscal dominance was entrenched by legislation for about six decades, authorizing central banks to provide direct credit to the government and to the rest of the public sector. It was only in the 1990s that most countries within the continent started to implement institutional reforms that could grant political and operational independence to central banks.

[12] Criteria, based on economic and financial indicators, that European Union (EU) member states must fulfil to enter the euro zone and that they must continue to respect once entered.

Further progress was made in the field of *financial institutions*: Argentina has taken significant steps to strengthen its banking system, raising capital standards and tightening regulation, while Brazil identified the need to impose hard budget constraints and modern management practices on its credit institutions. However, the road is still long: reducing the strains on the financial system also requires eliminating existing biases towards excessive deficits and reliance on short-term debts, in particular countries ought to carry out more far-reaching reforms to finally centralize the budgetary process, vesting more agenda-setting and expenditure-veto powers into the hands of the head of government or the finance minister as a way of diminishing common-pool problems.

Labor market flexibility is not a traditional South American strength. Countries have experienced significant shifts in their labour laws, mainly due to drastic changes in the political environment, especially during the periods of transition from authoritarian to democratic rules. During the late 20th century, most countries implemented neoliberal reforms aimed at increasing labour market flexibility as part of broader economic liberalization efforts, which usually included deregulation of employment contracts and reduced workers' protection. In Chile and Peru, for instance, labour laws were intensively reformed during the 1980s to favour employer interests, leading to a more flexible but also precarious employment situation for many labourers. Nonetheless, the labour market in the region remains relatively rigid due to strong union influence and legal protections that resist significant changes toward flexibility. Argentina and Brazil have seen moderate levels of reform that balance flexibility with worker rights: while there are provisions for flexible work arrangements like technically aided remote working and compressed workweeks, these are accompanied by strong union protections that limit individual discretion.

Finally, *barriers to exit* within the European Union are provided by the pillars of the integration process – a common economic policy, a common social policy, and a common security policy. Although these extensive initiatives do not prevent European governments dissatisfied with various aspects of the European project from discussing an exit as a hypothetical option, the fact that this entire network of interlocking bargains could be endangered by a country's decision to abandon one of them represents a formidable barrier to exit. Again, we may discuss the fact that a monetary union in Latin America makes sense only as part of a deeper integration project. If Mercosur ends with a customs union, then it will be hard to create the exit barriers necessary for that monetary union to operate smoothly. If, on the other hand, there develops a readiness to transform Mercosur and the Pacific Alliance into a more far-reaching integration initiative, involving the creation of a true single South American market, then exchange rate fluctuations will become more politically disruptive, and monetary unification becomes not only feasible but essential.

3.5 Building the house from the top down

As we have already discussed, Latin America represents a uniform and homogenous region from a social and cultural point of view, with very similar anthropological characteristics and common behavioural features. From a more political, jurisdictional and economic perspective, however, the continent lacks the right degree of conformity which is necessary for fostering greater integration throughout multilateral agreements.

Low levels of consensus and political participation, together with a serious and widespread tendency towards institutional and governmental instability heavily put at risk the idea of implementing a common currency, although such a project has universal support, from conservative and right-wing parties to more progressive and liberal factions.

Finally, we shall keep in consideration one fact: countries usually stabilize their economies in order to achieve monetary unification, not the exact opposite. Indeed, in most Latin American nations, those who argue for a common currency generally support it in the belief that it might help the country deal with structural financial problems i.e. constant inflation, just like *building the house starting from the top-down*. An economic system based upon a common currency could facilitate low inflation rates, reduce uncertainties and foster general growth and social prosperity, but it cannot guarantee it.

4. West Africa: the “Eco” project

4.1 Fostering monetary integration in West Africa

Of the various models existing today, the European one, amongst the rest, was a strong inspiration for the establishment of the *West African Monetary Zone* (WAMZ)[1] and the related common currency, the “*Eco”*, whose introduction, initially designated for 2003 and postponed several times, from 2009 up to 2020, will be completed by 2027, and will eventually apply to all countries constituting ECOWAS[2], i.e. provided no revisions of the project are introduced and no changes to the socio-economic environment will occur within the countries concerned.

The question we intend to ask ourselves is whether this important monetary policy operation is actually able to safeguard and stimulate the political, economic, and social integration of the West African nations, more than the current socioeconomic environment is doing nowadays. In the following pages we will take a brief look at the current economic and financial arrangement of West African countries, retracing the steps which led to the creation of the aforementioned monetary union. Afterwards, we will shift our focus to the general functioning of the currency in question, underlining the possible benefits deriving from the introduction of the currency and any eventual risk that the economies involved in the project could incur, especially in light of the data and the socioeconomic implications within Eurozone countries following the introduction of the common currency.

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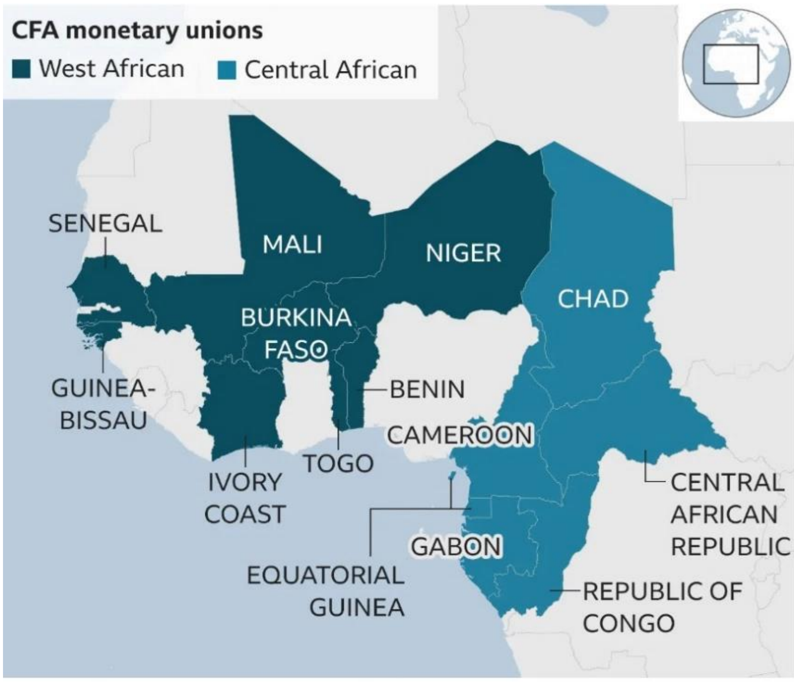
[1] WAMZ currently includes Gambia, Ghana, Guinea, Liberia, Nigeria and Sierra Leone

[2] Regional political and economic union of fifteen countries of West Africa, aimed at achieving "collective self-sufficiency" for its member states by creating a single large trade bloc by building a full economic and trading union

4.2 Rise and fall of the CFA franc

Unlike what happened within Europe, where the introduction of a single currency represented a novel intervention within the economic and financial environment of the continent, most nations that will constitute the future currency union have a reasonable familiarity with the topic, having been linked to the use of a common currency, namely the *CFA franc*[3], for more than half a century. This denomination actually indicates two distinct currencies issued by two separate central banks: the *West African Economic and Monetary Union* franc, in use in Benin, Burkina Faso, Ivory Coast, Guinea Bissau, Mali, Niger, Senegal and Togo, and that of the *Central African Economic and Monetary Community*, which is used in Cameroon, Chad, Gabon, Equatorial Guinea, the Central African Republic and the Republic of Congo (Figure 4.1).

Figure 4.1 African countries where the CFA franc is used



Source: BBC Research, 2023 (https://www.bbc.com/news/63708313)

[3] CFA stands for *Communauté Financière Africaine*, i.e. "African Financial Community"

The CFA franc was created in December 1945 following the ratification of the Bretton Woods Agreement by the French government and the resulting devaluation of the metropolitan franc against the US dollar. On that occasion, the Elysée decided to create two distinct currencies in the then African colonies, in order to protect them from the heavy financial consequences generated by this depreciation operation, and at the same time to encourage French imports from the colonies themselves. More specifically, France opted to peg the new currencies to the metropolitan franc through a fixed exchange rate regime, thereby guaranteeing full convertibility of the currencies in exchange for custody of half of the colonies' gold reserves.

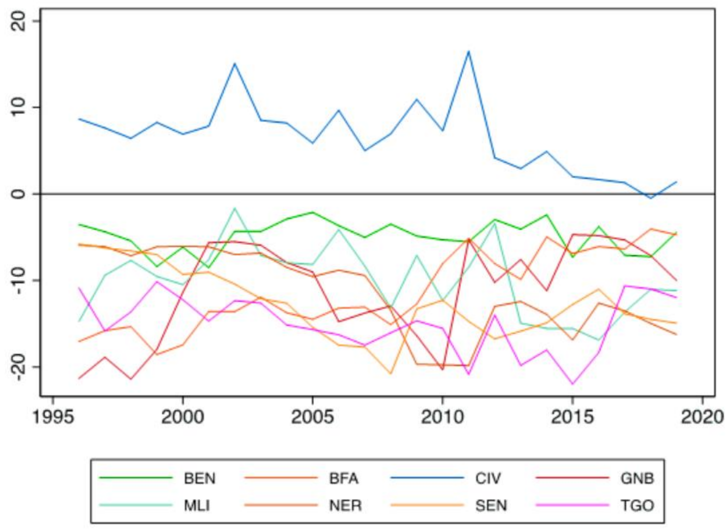
In January 1994 the two currencies were subjected to a drastic devaluation manoeuvre by the French treasury, in accordance with the *International Monetary Fund* (IMF), following the dramatic increase in the prices of export goods in the former French-speaking colonies. The fifty percent depreciation of the CFA franc against its metropolitan counterpart, aimed at restoring the trade balance of the aforementioned countries, and ended up causing a sudden increase in the prices of import goods within the union, and the vertical collapse of the purchasing power of the populations involved, which in turn contributed to generating political instability and violent civil conflicts.

4.2.1 Main criticisms on the CFA franc

The CFA franc has been harshly criticized throughout its history, mainly over the last decade, and global economic and financial institutions have repeatedly expressed themselves in conflicting ways on the issue. The International Monetary Fund has repeatedly spoken out against its application, while no French president has ever expressed the explicit intention of abandoning this currency, although multiple proposals to review the exchange rate system have been put forward over the years.

The CFA franc has the advantage of guaranteeing exchange rate stability, credibility, fiscal discipline, and protection from inflation. However, it’s been amply demonstrated how strong a currency it is, which of course does not promote exports and constrains the economies in such a way that it imports foreign products massively (Figure 4.2). In fact, the former colonies continue to depend upon the exporting of raw materials, and they lack processing industries, effectively therefore basing their survival upon trade relations with France. This is not different from what happened during the era of European colonialism.

Figure 4.2 Trade balance of WAEMU countries from 1996-2019



Source: J. Conrad, Growth Lab, Harvard University (2022)

Furthermore, the non-convertibility of the currency between the two distinct monetary unions represents an obstacle to the development of regional trade. In the countries participating in the monetary union there are solid agreements relating to the free circulation of capital. Nevertheless the expansion of credit is limited by the need to maintain the currency exchange rate fixed to the European currency.

4.3 A turbulent project

The economic consequences related to the drastic depreciation of the CFA franc in 1994, have strongly highlighted the undoubted intrinsic critical problems of this currency system, forcing the leaders of the nations involved in the *West African Economic and Monetary Union* to consider a radical project to overhaul the system. Amongst those who support the transition from a fixed exchange rate regime to a flexible one and those who instead push for the total abolition of the currency previously imposed by France, the hypothesis of adopting a completely new currency still prevails today i.e. a currency capable of guaranteeing and further stimulating the commercial and financial integration of the countries involved.

The creation of a common currency amongst the economies of the pre-existing monetary union first, and then of the entire ECOWAS community, was officially announced by the leaders of the countries involved in the year 2000, and initiated one year later with the establishment of WAMI, namely the *West African Monetary Institute*, based in Accra (Ghana) - an interim organization aimed at planning the work of the future central bank of West Africa. The launch of the currency, initially set for 2003, and then subsequently postponed to 2009, was later rescheduled for 2015 due to the dramatic international economic crisis that continued over the last decade, when none of the states which applied to participate within the project managed to meet the required criteria of economic performance and financial stability.

In June 2019, ECOWAS leaders formally adopted the name “*Eco*” for the common currency planned almost twenty years before, foreseeing its introduction by the end of the following year. This operation would have taken place at the same time with the expansion of the current *West African Monetary Zone* (WAMZ), and with the definitive closure of the

CFA franc experience. Although, as later affirmed by the Ivorian president *A. Ouattara*, “*the Central Bank of France would have maintained its role as guarantor of convertibility with the euro and the exchange rate parity would have remained substantially unchanged*”[4].

The outbreak of the Covid-19 pandemic in 2020 and its incalculable consequences have completely overturned the performance data of West African nations, effectively distancing them from achieving the minimum objectives envisaged for entry into the monetary union. According to the new roadmap designated by ECOWAS leaders in mid-2021, the adoption of the *Eco* should be definitive by 2027, although doubts persist amongst experts about the ability of governments to respect the financial parameters established at the time.

4.3.1 WAEMU’s convergence criteria

Similarly to what is required within the European community, the introduction of a single currency within the WAEMU countries is strictly linked to achievement of six specific macroeconomic parameters outlined by the *West African Monetary Institute in the Convergence, Stability, Growth and Solidarity Pact*, quantitative targets commonly known as *convergence criteria*, distinguishable into primary and secondary criteria.

The four primary criteria include:

1. Budget deficit to GDP ratio lower than or equal to 3%.
2. Average annual inflation rate lower than 10% in short term ad 5% as from 31st December 2019.
3. Financing of public debt by the central bank not exceeding 10% of previous year’s tax revenue.
4. Gross external reserves covering imports for a minimum period of three months.

[4] A. Ouattara, December 21st, 2019, Abidjan (Ivory Coast)

Added to these are two secondary criteria:

5. Nominal exchange rate variation lower than or equal to +/- 10%.
6. Public debt to GDP ratio lower than or equal to 70%.

The turn of events, however, was not kind to the countries of the monetary union in question. Global events such as the 2008 financial crisis, the pandemic from Covid-19, and the ongoing conflicts in Ukraine and Palestine, together with continuous political disruptions and violent civil conflicts within the same countries, heavily influenced the economic performance of such nations. Macroeconomic results within these countries were disappointing over the reporting period, despite the enormous effort of their governments to achieve substantial convergence and to complete the monetary reform within the shortest time possible. More specifically, up to year 2023, none of the countries involved in the project effectively met all the convergence criteria outlined at the time by the WAMI, if not discontinuously (Figure 4.3).

Figure 4.3 Number of countries that met the convergence criteria in ECOWAS

CRITERIA	TARGET	2018	2019	2020	2021	2022	2023*
Primary Criteria							
Budget deficit (commit. basis, including grants)	≤3%	8	8	2	2	2	2
Average annual inflation rate	≤5%	12	9	9	9	2	4
Central bank financing of budget deficit	≤10%	11	13	12	12	11	14
Gross external reserves	≥3	12	14	13	15	14	15
Secondary Criteria							
Nominal exchange rate variation	±10%	14	14	15	14	11	13
Ratio of public debt to GDP	≤70%	13	13	10	10	10	10

Source: WAMI, ECOWAS (2023)

4.4 Benefits and opportunities of a common currency

The existence of different currency exchange regimes in the West African area represents one of the major obstacles to the development of regional trade. This limitation is mainly due to the high transaction costs involved in the international marketing of goods and services, with particular regard to conversion fees and costs of insurance against exchange risk. The adoption of a single currency, together with the free trade agreements currently in force in the ECOWAS countries, would have an enormous impact upon regional trade, specifically, the absence of extremely volatile exchange rates would greatly facilitate the movement of goods and services, as well as the circulation of capital and workforce.

The expansion of regional trade, as in Europe, also allows distinct national markets to access various resources that would otherwise be impossible to find within local networks, such as raw materials, intermediate goods and finished products, giving the companies the chance to abandon traditional business models based on generic markets and specializing in the production and the marketing of specific goods and services. Market specialization is strictly linked to the formation of industrial clusters in which important proximity economies arise and huge public and private investments in infrastructure works take place.

Finally, referring again to the twenty-year experience of the single currency within the Eurozone, it is worth highlighting how the implementation of the monetary union contributed to the slowing down the general increase in prices in European economies, after decades of continuously worrying inflation bubbles. The harmonization of different monetary policies within the countries of the union through the intervention of the *West African Central Bank* would bring greater stability to the economic and financial landscape of the region and would protect countries from potentially uncontrollable inflation phenomena. The ideal conditions would therefore be created for an economic environment free of uncertainties, capable of generating new investment opportunities and attracting foreign capital.

4.5 Risks and challenges that should be prevented

According to the theory of the *optimum currency area* proposed by R. Mundell in 1961, the effectiveness and regular functioning of a common currency within an interdependent regional system relies upon the presence of four fundamental elements, which inspire the above-mentioned ECOWAS convergence criteria e.g. a locally integrated labour market, capital mobility with prices and wages flexibility, centralization of fiscal transfers and similar industrial and business cycles.

The West Africa region, however, does not represent an optimal currency area if we consider the enormous differences within economic structures and levels of market development amongst the different countries: e.g., some economies are mainly based on the export of natural resources, while others strongly depend on the international marketing of agricultural goods. Also, certain nations possess particularly advanced manufacturing systems, whereas in others, industry is still notably backward.

Numerous economists with strong sceptical positions towards the possible monetary union underline how the introduction of a single currency as an instrument of regional integration cannot take place without the previous alignment of the economies involved in the project. Also in light of the heavy discrepancies currently recorded within Europe, especially between net contributors (e.g. Germany and France) and recipients (e.g. Poland and Hungary). Considering the specific case of Ecowas, Nigeria, the richest and most developed country of the union, could potentially be forced to provide huge financial support to more backlogged countries, such as Guinea or Sierra Leone. This makes the implementation of uniform monetary policies much more complicated.

Several scholars and academics, with a critical attitude towards the Eco project, especially from the English-speaking countries of the Ecowas area, finally argue that relinquishing of monetary sovereignty by the economies of the region could prove counterproductive in the event of localized financial crises. Individual governments could not actually exploit monetary policy tools, such as the depreciation of the currency, to adjust the accounts on the trade balance, as they would totally depend upon the action of the union central bank, being not necessarily willing to change the quantity of money in circulation.

4.5.1 Alternative solutions to the *Eco*

In addition to the introduction of the *Eco*, there are alternative solutions capable of providing the same benefits and circumventing the difficulties linked to the currency union simultaneously. The *African Continental Free Trade Area* Agreement (AfCFTA)[5] ratified by 44 of the 53 signatory countries (Figure 4.4), could help reduce trade barriers between African states and promote economic growth within the region. A second solution could be the implementation of financial agreements, aimed at creating regional mechanisms of liquidity risk sharing, such as foreign currency reserves sharing against the eventuality of financial bursts and external speculative attacks.

[5] Free trade area, established in 2018, encompassing most of African States

Figure 4.4 African Continental Free Trade Area (AfCFTA) as of 2024

Source: TRALAC, 2024 (https://www.tralac.org/resources/by-region/cfta.html)

In addition, a better application and general management of digital payment platforms, such as the *Pan African Payment and Settlement System*[6], can further improve relations between the countries. These platforms are capable of converting bank account movements into local currency, and firmly contribute to increasing the demand for the various regional currencies and to making cross-national payments faster, safer, and cheaper.

[6] Real-time gross settlement infrastructure for cross-border payments in distinct local currencies, publicly launched on January 13, 2022, by the African Union (AU) and the African Export-Import Bank to compliment trading under the African Continental Free Trade Area

4.6 A winning project?

Moving back to our research question, greater economic, political, and social integration within a geographical area through the introduction of a single currency is not only possible but represents a concrete and consolidated phenomenon within Europe. From an economic point of view, the elimination of exchange rate regimes enormously contributed to stimulating trade and intra-community investments, as well as strengthening transparency on prices and financial stability of the Union. Politically speaking, the necessity of coordinating economic and fiscal policies within the Eurozone helped create new collaboration and decision-making methodologies at a regional level. Finally, sharing of a common currency favoured the formation of a sense of belonging to an enlarged political entity that transcends national borders.

In purely theoretical terms, there is no reason why the same findings observed in Europe after the adoption of a single currency should not apply in the West African political and economic community. However, it is essential to note that the success of the *Eco* in promoting political integration among the countries of the region inextricably depends upon various factors, including the commitment of the member states, the presence of effective governance institutions and the resolution of structural problems, such as economic disparities between the countries that constitute the Union. As previously highlighted, the adoption of a common currency is a very complex process and requires careful planning and intense coordination among the participating nations. To sum up this concept, we can unwaveringly affirm that the unity of peoples cannot prescind from the unity of intent.

5. The Gulf States: integration plans beyond gas and oil

5.1 The status of regional integration in the Middle East

The key contribution of a common currency in a regional setting, either as promotor or as final stage of a project for greater political, social and economic integration, does not only concern the Western World. Six wealthy Middle Eastern countries, namely, Saudi Arabia, Qatar, Bahrain, Kuwait, Oman and the United Arab Emirates realized the importance of unity and invested big amounts of resources in the creation of the *Gulf Cooperation Council*[1] (Figure 5.1), to enhance cooperation towards economy, trade, finance, legislation, and other key policy areas. The idea of a common currency for the GCC member states to be pegged to the US Dollar or linked to a basket of selected currencies, initially named *Khaleeji* (Arabic word for *Gulf*), emerged in 2009 and its implementation was set for one year later. Nevertheless, various factors including serious global financial crises and lack of collaboration led to delays and, as of now, no significant developments on the project have been reported.

In the following chapter, we will try to comprehend the necessity and the significant role of a single-currency system in the GCC, mainly focusing on their characteristics, such as their current economic structures and the actual level of economic integration existing in the area, which implies the free movement of goods, services, capitals and people. Furthermore, we will examine the fundamental dimensions of monetary integration, paying particular attention to potential issues related to the creation of a currency union and the prerequisites that he GCC member states should achieve to ensure the correct functioning of such system.

[1] Regional intergovernmental political and economic union founded in 1981 to promote unity among its member states based on their shared cultural and political identities rooted in Arab and Islamic traditions

Figure 5.1 Member states of the Gulf Cooperation Council

Source: ResearchGate.net

5.2 The main features of the GCC countries' economies

The six GCC member states are overall largely similar in terms of economic structures and usually get to face common challenges, but they also have some considerable differences. The countries in question jointly account for 30% of global oil reserves (Figure 5.2) and 21% of worldly natural gas reserves (Figure 5.3): income from the export of fossil fuels makes them the region the wealthiest area in the Middle East and somehow comparable to many of the newly industrialised economies. Nonetheless, the income distribution is more uneven than in most other high-income countries and this is mainly due to the big presence of immigrant workers, who generally receive lower wages than their national counterparts.

The exports of fossil fuels largely compensate for the enormous internal demand for basic consumer and capital goods, due to the serious underdevelopment of the manufacturing and financial sectors. The union boasted a trade surplus equal to 16% of its total GDP at the end of 2022, although the intra-block trade is still backlogged, mainly because of the similarities in the composition of the countries' economies.

Figure 5.2 Countries by oil reserves

#	Country	Oil Reserves (barrels) in 2016	World Share
1	Venezuela	299,953,000,000	18.2%
2	Saudi Arabia	266,578,000,000	16.2%
3	Canada	170,863,000,000	10.4%
4	Iran	157,530,000,000	9.5%
5	Iraq	143,069,000,000	8.7%
6	Kuwait	101,500,000,000	6.1%
7	United Arab Emirates	97,800,000,000	5.9%
8	Russia	80,000,000,000	4.8%
9	Libya	48,363,000,000	2.9%
10	Nigeria	37,070,000,000	2.2%

Source: Worldometers

Figure 5.2 Countries by gas reserves

#	Country	Gas Reserves (MMcf)	World Share
1	Russia	1,688,228,000	24.3%
2	Iran	1,201,382,000	17.3%
3	Qatar	871,585,000	12.5%
4	United States	368,704,000	5.3%
5	Saudi Arabia	294,205,000	4.2%
6	Turkmenistan	265,000,000	3.8%
7	United Arab Emirates	215,098,000	3.1%
8	Venezuela	197,087,000	2.8%
9	Nigeria	180,490,000	2.6%
10	China	163,959,000	2.4%

Source: Worldometers

Heavy reliance upon oil and gas exports make the GCC countries vulnerable to fluctuations in global market prices and economically unstable in the short run. Moreover, the lack of alternative sources of revenue, such as a proper income tax or consumption tax, further exposes the region to the volatility of oil prices. It is commonly believed that the public sector and oil industry alone cannot create enough job opportunities for the growing population and developing the private non-oil sector is crucial to alleviate pressure on the labour market. To reduce reliance on fossil fuels, boost productivity, and improve economic stability, experts identified diversification and privatization as key economic priorities.

Countries like Saudi Arabia and the United Arab Emirates have launched comprehensive plans[2,3] aimed at expanding into new sectors such as manufacturing, technology, tourism, and renewable energy. National governments fostered the growth of the real private sector and created a more favourable and innovative business climate by investing huge amounts of capital in physical and technological infrastructures and

[2] **Saudi Vision 2030**: government program launched by the Kingdom of Saudi Arabia which aims at achieving increased diversification economically, socially and culturally
[3] **UAE Vision 2021**: strategic plan promoted by the government of UAE to ensure sustainable development while preserving the environment, and to achieve a perfect balance between economic and social development

implementing selected business policies, such as gradual reductions of regulatory burdens. GCC states are also reforming their education systems to better prepare graduates for careers in diverse industries beyond hydrocarbons and vocational training programs are being introduced to equip young people with skills relevant to the private sector. Finally, as part of their diversification strategies, many Middle Eastern nations are investing in renewable energy projects to accelerate the transition towards more sustainable economies.

A major problem for GCC economies is their large government sectors, in combination with the high degree of reliance of government budgets upon fossil fuels. Oil companies are nationalised, ensuring government control of this vital sector. Large privatisation projects in public utilities have raised the private sector contribution to GDP over the last decades. However, the distinction between the public and private sectors is not straightforward, as it is often difficult to attribute shareholder ownership clearly to the two sectors. Foreign investment regulations have changed considerably to permit foreigners to hold shares in GCC companies. However, restrictions upon access to the stock exchanges and on majority holdings in GCC companies in several member states continue to prevent the allocation of international capital to the GCC market.

5.3 Four dimensions of economic integration

The desire to develop coordination and interconnectivity among the Gulf States is explicitly affirmed in the *Charter of the GCC*[4]. In this document, the member states' governments express their commitment to strengthen relations, links and cooperation, and to formulate similar regulations in crucial fields, such as economic and financial affairs, trade, customs and communications, education, culture, scientific research, social policies, health affairs, information, tourism and legislative affairs.

The process of economic and monetary integration in the GCC is designed to follow an incremental approach, which should terminate with the establishment of a monetary union only after considerable groundwork in terms of economic integration occurs. The scope of the GCC's integration objectives is laid down in the new *Economic Agreement*[5], which comprises specific measures addressing crucial areas of policy coordination and harmonisation, and appear to be mutually consistent and complementary.

As in any monetary union, the economic viability of the GCC's project to introduce a single currency strongly depends upon the degree of economic integration amongst its member states. Potential benefits, such as reduced uncertainty, lower transaction costs and enhanced cross-border trade cannot transcend the elimination, at least partial, of non-monetary obstacles to regional integration. A high degree of cross-border factor mobility can also serve to mitigate the economic impact of asymmetric shocks and can contribute to the sustainability of the monetary union.

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[4] Foundational treaty of the GCC, signed on 25th May, 1981, establishing the framework for cooperation amongst the member states of the organization

[5] Multilateral agreement aimed at fostering economic cooperation and integration among the member countries of the Gulf Cooperation Council. It was adopted on 31st December 2001 and entered into force on 1st January 2003

5.3.1 Free movement of goods

A significant milestone in the GCC's effort to promote free trade of goods amongst the member states was marked by the establishment, in 2003, of a customs union, which implied the introduction of a common external tariff, a unified customs code and the *single-entry-point*[6] principle. Challenges remained in customs union implementation, with ongoing trade barriers and long transition periods for internal customs procedures. Nonetheless, crucial efforts to address intra-block trade impediments and harmonize standards have been made since the creation of the union and interregional commerce has constantly registered high annual growth rates in the following decade.

5.3.2 Free movement of services

The free movement of services within the GCC is not as advanced as the movement of goods. Trade in services is similar to trade in goods from a purely economic perspective, but legal barriers are more complex and deeply rooted in national laws. Implementation of the common market varies widely across countries and sectors, with some areas showing progress and others lagging behind. The underdevelopment of intra-block trade of services in the region is generally attributed to strict laws upon incorporation and real estate ownership, a low level of professional skills recognition and an unequal tax treatment. Monopolies and public entities in the sector also pose a barrier to reaping the benefits of free movement of services in the GCC, therefore reducing the effectiveness of the customs union itself.

[6] According to the single-entry-point principle, all customs procedures and duty payments for goods imported from outside the GCC must be finalised at the first point of entry, irrespective of the final destination

5.3.3 Free movement of capital

GCC countries have a long tradition of liberal capital accounts, but regulatory and structural elements heavily limit cross-border capital mobility: factors hindering intra-block capital flows include restrictions on foreign ownership, regulatory barriers on banking and backlogged capital markets. According to GCC governments, attracting private capital, such as foreign direct investment, is a priority in order to achieve economic diversification. In this regard, Article 5 of the Economic Agreement calls for the creation of an "*investment climate characterised by stability and transparency*"[7] as an ideal environment to complete capital market integration. To achieve this goal, member states committed themselves to harmonising their regulations upon investment, banking and financial markets, to eliminating all discriminatory regulations on trading and assets ownership, and thereby effectively to removing all barriers to cross-border banking services and investment.

5.3.4 Free movement of natural persons

The free movement of people within the GCC is well-established for citizens of member states, allowing visa-free travel and equal treatment in various areas. However, such forms of regional integration explicitly outcasts expatriates: whilst GCC countries' nationals may enjoy several benefits and rights across member states, like employment opportunities and property ownership, immigrants face restrictions in numerous areas, such as public sector employment and social insurance access. Moreover, the absence of a real common migration policy, with visas and residence permits being issued by the single member states autonomously, may lead to serious limitations in labour mobility and potentially hinder economic integration, particularly in the trade in services and cross-border transport.

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[7] *The Economic Agreement Between the GCC States*, GCC Supreme Council (22nd session, 31st December 2001), City of Muscat, Sultanate of Oman

5.4 Economic convergence of the GCC member states

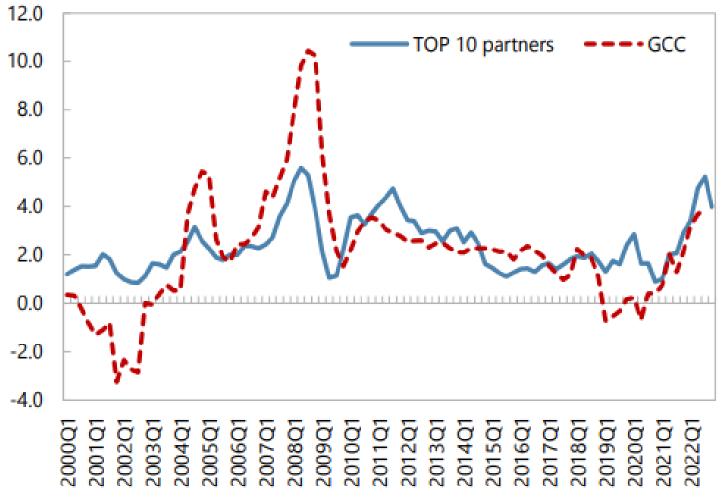
As discussed on several occasions in the present text, no real plan for a successful economic integration process at regional level can be fully implemented before the states involved have properly met a precise list of quantitative and qualitative parameters on the stability, reliability and general performance of their economy. Similarly to what happens in most other regional and supranational organizations, the convergence criteria established by the GCC apply to all member states and may be divided into three diverse categories: monetary, fiscal and structural.

5.4.1 Monetary convergence

In the last two decades, all the GCC countries have continuously maintained their inflation rates below reasonable percentages (Figure 5.4), extremely low rates compared to their Middle Eastern counterparts. This high degree of inflation convergence is largely due to the fact that nearly all the currencies of the countries involved have been pegged to the US dollar for years[8] (Kuwait dinar is currently pegged to an undisclosed group of currencies managed by the Kuwaiti Currency Board). The US currency represents an external anchor for monetary policy that helps with the stabilization of prices and limits central bank credit to governments in case of budget deficits. The degree of nominal exchange rate stability also reflects the long-standing common orientation of GCC countries' exchange rate policies towards the US dollar, which remarkably limited intra-GCC currency fluctuations. Finally, inflationary convergence and exchange rate stability resulted in national interest rates basically moving homogenously: this alignment is reflected in low spreads between GCC and US rates, indicating the credibility of the exchange rate peg.

[8] **GCC currency peg rates as of June 2024**
Bahrain: USD/BHD = 0.38, Oman: USD/OMR = 0.38, Qatar: USD/QAR = 3.64,
Saudi Arabia: USD/SAR = 3.75, United Arab Emirates: USD/AED = 3.67

Figure 5.4 Inflation in GCC and its Top 10 Import Partners (%)



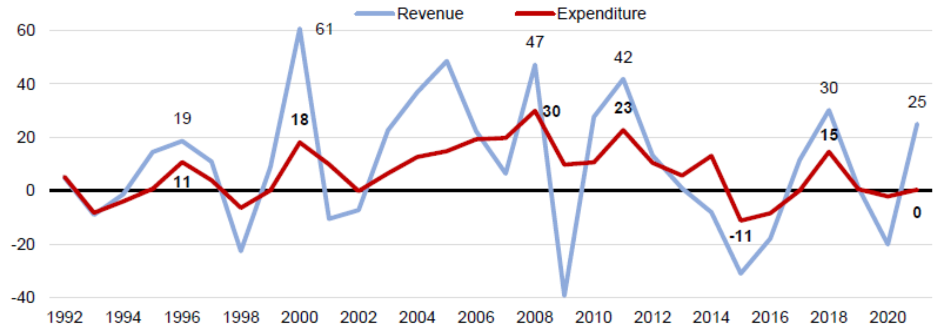
Source: countries' authorities; IMF calculations

5.4.2 Fiscal convergence

Budget balance-to-GDP yearly ratios in GCC countries showed significant alignment in the last two decades, but sensibly differ in deficit and surplus levels. Budget balances are heavily influenced by oil prices: in particular, international geopolitical events in the recent history, such as the oil crisis in 1973, the global recession of 2008 and the numerous conflicts occurred in various regions of the world have had a considerable impact on the countries' ability to register fiscal surpluses or deficits. The strong correlation of public revenues and expenditures to the average value of fossil fuels often leads to similar spending cycles within the GCC member states (Figure 5.5), with occasional deviations, like Kuwait's high deficit in the early 1990s[9]. However, this trend of homogeneity amongst the GCC economies does not hold when it comes to public debt in relation to national GDP, with Bahrain and Kuwait registering the highest and the lowest debt burdens in the region, respectively 121.2% and 3.4% (2022)[10].

[9] Gulf War Period (2nd August 1990 – 28th February 1991)
[10] *Source: TradingEconomics.com*

Figure 5.5 GCC Aggregate fiscal trends (1992-2020)



Source: Justin Alexander, GCC analyst for GlobalSource Partners

5.4.3 Structural convergence

The impact of relinquishing national monetary policy within a currency union varies based on the frequency and severity of asymmetric shocks: if shocks are infrequent or easily managed, a single monetary policy should be effective. Conversely, persistent shocks affecting only some states may complicate such policy implementation. Economic similarities and differences among member states can also influence the success of a unified monetary approach. As previously discussed, the economies of GCC countries are highly convergent due to their heavy reliance on oil and natural gas and this homogeneity in economic structure reduces vulnerability to asymmetric shocks, leading to considerable exchange rate stability. However, differences may arise as countries diversify their economies to reduce oil dependency, especially as some may need to face the depletion of reserves sooner than others. For this reason, in the future, price flexibility in markets could become crucial for adjustments once nominal exchange rate options are limited. Therefore, the development of effective adjustment mechanisms will determine the sustainability of the monetary union in the face of future challenges.

5.5 Issues related to a currency union in the GCC

The first issue regarding the creation of a single-currency system in a specific region, such as the GCC, as a means for greater integration is represented by the individuation of an effective decision-making process, in particular, the level of centralization of those institutions supposed to regulate monetary policy. We can easily affirm that the mere coordination of distinct national monetary policies by central banks is not adequate for a sustainable currency union. In this sense, GCC economies ought to unify their own monetary and exchange rate policies, keeping in consideration the economic, monetary, and financial conditions across the entire union, rather than individual member states. This requires *decision-making* based on union-wide objectives and data, resulting in a single set of interest rates influencing a unified money market.

The requirement of a single monetary policy has consequences for the institutional framework in which such monetary policy is formulated and implemented. Conceptually, it is important to distinguish between four crucial dimensions of policymaking: *analysis* of economic and financial developments, *decision-making* itself, *implementation* of monetary policy decisions, and their *communication* to the public. Whereas there may be some degree of decentralization in analysis, implementation, and communication, crucial decisions should always be made at a central level. For this reason, the institutional framework for monetary policy settling should centralize decision-making procedures at the supranational level, with a significant transfer of national sovereignty and representatives of the member states acting independently rather than carrying forward the objectives of their own countries.

A crucial prerequisite for a supranational monetary institution is the provision of a clear unambiguous *mandate*, which clarifies the primary objective of the union, and avoids the organization being overwhelmed with targets which it cannot sufficiently accomplish with the tools at its disposal or which may at times be conflicting. Furthermore, the mandates of the national monetary agencies and central banks of the single countries forming the union must be compatible with that of the supranational body so that any form of confusion or friction is avoided.

Another fundamental requirement for the regular functioning of both national and supranational central banks is *autonomy*. The decision about the degree of independence granted to the central bank is ultimately a political choice to be taken by the relevant authorities in the union, against the background of their historic experience and their political systems. A broad consensus upon the status of a potential GCC monetary institution and good relations with political authorities at the national level may reduce the risk of conflicts later on.

Moreover, central banks are considered truly independent only if there is no explicit obligation from national governments to extend them credit to finance public spending. The prohibition on *monetary financing*[11] has therefore a decisive role in preventing public institutions from funding themselves in a potentially inflationary, non-market-oriented manner. Given the fact that provisions with regard to monetary financing currently differ amongst GCC monetary agencies and central banks, a minimum level of harmonization amongst these rules should be achieved before the currency union effectively enters into force.

[11] Direct transfer of money from a central bank for a government to spending.
This might involve the direct purchasing of new government debt (bonds) by a central bank

Another crucial decision must be taken about how to distribute the *seigniorage*[12] revenues generated by the implementation of the monetary policy function. The two main options are the assignment of the revenues to the supranational body, assuming the existence of a single legal issuer of the currency, or its distribution to the single national monetary agencies and central banks, according to specific redistribution criteria, which ought to be agreed by the union's member states.

A single monetary policy also requires monetary policy operations to be executed on homogeneous terms and conditions in all member states. Therefore, GCC nations would need to agree on a common set of monetary policy instruments and procedures, which would ultimately constitute the *operational framework* of the GCC monetary institution. An accurate definition of these tools prior to the actual entry into force of the currency union is fundamental, so that the implementation of such instruments can work properly from its very beginning. An ideal approach in this direction is a thorough review and assessment of the different monetary tools used nowadays either by the individual central banks of the GCC member states or by other supranational monetary institutions in the world.

A final agreement must be made on the control and management of *foreign exchange reserves*, which could be fully or partially transferred to a supranational body or kept by national central banks. Such decision heavily depends on the desired level of centralization or decentralization, especially concerning policy implementation. An effective control over foreign exchange reserves is crucial for the monetary institution to execute interventions in the foreign exchange market; however, a minimum level of influence over large foreign exchange transactions by member states is necessary to maintain a coherent exchange rate policy.

[12] Profit for governments when they create currency that has a higher face value than the cost incurred in its production

5.6 Challenges and expectations on the GCC monetary union

The idea of a single currency in the GCC is supported by a long list of common features, such as history, language, and economic structure dominated by oil and gas production. Despite some differences among member states, the region of the Gulf States represents an ideal hummus for greater integration projects, especially for a full monetary convergence, reflected in stable exchange rates, low inflation, and similar interest rates. However, crucial challenges remain, such as limited intra-GCC trade and the need to eliminate legal and natural barriers to the free circulation of capitals and human resources.

As previously observed, the benefits of a monetary union include more liquid financial markets, increased non-oil trade, and diversification of economies. Nonetheless, the existence of a robust macroeconomic framework is essential to maintain stability and fiscal discipline in the long term. In order to achieve a credible and sustainable monetary union, GCC countries must focus upon deepening economic integration, establishing selected convergence criteria, and strengthening supranational institutions. In particular, enhancing price flexibility in the labour market constitutes a crucial requirement to absorb asymmetric shocks in the future, as well as setting up a supranational monetary institution to centralize monetary and exchange rate policy, which is vital for a successfully functioning union.

In conclusion, we can undoubtedly affirm that the GCC member states have designed a comprehensive and considered plan for a monetary union, but effective implementation and political support are fundamental to a favourable outcome. Addressing economic challenges, fostering integration, and instituting a strong macroeconomic framework will be key to achieving a credible and sustainable monetary union.

6. Southeast Asia: high time for a currency union?

6.1 ASEAN: a functional model of integration

Amongst the multiple supranational organizations for regional cooperation we have analysed, ASEAN (Figure 6.1) probably represents the most suitable context for the creation of a common currency system and the implementation of a single monetary policy. In fact, the region seems to comprehensively comply with the main macroeconomic criteria that make a geographical area an ideal currency zone, not that differently to Europe before the entry into force of the *Monetary Union*.

In particular, the Southeast Asian region is characterized by a high level of factor mobility, a marked flexibility in the setting of prices and wages, a relatively developed intra-bloc trade and an elevated degree of symmetry in economic and financial shocks. Nevertheless, differently from what we have already seen, a concrete plan for the fulfilment of a monetary union in the region has never been proposed. ASEAN's path to integration ran aground with the creation and subsequent stagnation of the so-called *Asian Currency Unit*, a basket of several national currencies, strongly inspired by the European experience, but it never actually entered into force.

In the next pages, we will briefly describe the functioning of the aforementioned system and its role in the process of economic integration. Furthermore, we will focus on the suitability of a hypothetical currency union in the ASEAN region, the convergence procedures and institutional reforms necessary for its implementation and potential constraints related to such a project, trying to explain how and to what extent a monetary union could enhance political, economic and social integration in the area.

Figure 6.1 Member states of the ASEAN

Source: freepik.com

6.2 The role of the Asian Currency Unit

The idea of a common currency system for the South East Asian community as a monetary instrument to enhance intraregional trade, financial stability and general economic cooperation amongst the nations, was initially presented as a joint project of the 21st century *Global Centers of Excellence* (COE) Program of Hitotsubashi University and Japanese government's *Research Institute of Economy, Trade and Industry*[1] (RIETI) in 2005. The original plan, supported by the *Asian Development Bank*[2] and considered an effective strategy to loosen the region's dependence on the US dollar, does not actually imply the adoption of an external currency (informal union), nor the creation of a brand new currency itself (formal union).

[1] Policy think tank established in Japan in 2001 to conduct theoretical and empirical research and make policy proposals based on evidence derived from such research activities

[2] Regional bank established in 1966 to promote the development of Asian and Pacific nations by providing financing and technical consultancy.

The scheme rather contemplates the introduction on the financial markets of a currency basket composed of thirteen East Asian currencies, including those of the ASEAN nations plus Japan, China and South Korea, later extended to three more countries, with which the aforementioned nations are to maintain solid trade relations, namely New Zealand, Australia and India (Figure 6.2).

Figure 6.2 ACU13+3 share and weights of Asian currencies (2023)

	Trade volume* %	GDP measured at PPP** %	Arithmetic average shares % (a)	Benchmark exchange rate*** (b)	AMU weights (a)/(b)
Australia	6.68	2.61	4.65	0.615285	0.0755
Brunei	0.22	0.05	0.14	0.587476	0.0023
Cambodia	0.45	0.14	0.30	0.000264	11.1742
China	32.21	47.53	39.87	0.121326	3.2862
India	4.47	18.22	11.35	0.022829	4.9696
Indonesia	4.40	6.46	5.43	0.000125	434.4000
Japan	13.12	10.18	11.65	0.009100	12.8022
Korea	10.52	4.43	7.48	0.000868	86.1175
Lao PDR	0.24	0.12	0.18	0.000125	14.4000
Malaysia	5.45	1.79	3.62	0.264305	0.1370
Myanmar	0.52	0.50	0.51	0.161891	0.0315
New Zealand	0.94	0.44	0.69	0.494035	0.0140
Philippines	1.33	1.86	1.60	0.024204	0.6590
Singapore	7.95	1.13	4.54	0.587478	0.0773
Thailand	5.18	2.50	3.84	0.025777	1.4897
Vietnam	6.33	2.04	4.19	0.000071	589.4366

Source: Research Institute of Economy, Trade and Industry (RIETI)

* The trade volume is calculated as the average of total export and import volumes in 2019, 2020 and 2021 taken from DOTS (IMF).
** GDP measured at PPP is the average of GDP measured at PPP in 2019, 2020 and 2021 taken from the World Development Report, World Bank.
*** The Benchmark exchange rate ($-euro/Currency) is the average of the daily exchange rate in terms of US$-euro in 2000 and 2001.

Each currency within the basket is assigned a weight that reflects its importance or share of regional trade and economic activity. The weighting can be determined based on factors such as GDP, trade volume, or other relevant economic indicators: this means that some currencies will have a greater influence on the value of the ACU than others. The formula to calculate the value of the ACU can be stated as follows:

$$ACU = \sum_{i=1}^{n} W_i \times ER_i$$

where n is the number of currencies in the basket, W_i is the weight assigned to each currency, and ER_i is its exchange rate against a conventional reference currency, i.e euro or US dollar.

In a completely analogous manner to the *European Currency Unit* scheme (ECU)[3], as precursor of the Euro, the idea behind the ACU is that if national central banks are able to align their monetary policies with this unit, internal exchange rate stability can be achieved in the region. In short, instead of each country independently managing its currency value against external currencies, the economies would stabilize their currencies relative to the ACU.

In this regard, an index may be constructed based on the basket by minimizing fluctuations in asset values expressed in national currencies. This index serves as a benchmark for assessing individual currencies' performance against the average value represented by the ACU, therefore allowing for surveillance of currency valuations across member states. In other words, it helps governments and monetary authorities identify over- or undervaluation trends relative to this regional average and individuates potential vulnerabilities in individual economies.

[3] Unit of account used by the European Economic Community from 1979 to 1998, composed of a basket of member country currencies.

6.3 Suitability of a currency union in South East Asia

Before asking ourselves how much a hypothetical monetary union within the ASEAN economies could enhance the degree of economic, political and social integration of the region, it is worth considering whether this geographical area is actually suitable for an upheaval of the economic and geopolitical structure of such magnitude.

In terms of renouncing independent monetary policy, considering the heterogeneous track record of most of ASEAN countries in conducting currency policy, surrendering monetary autonomy would most likely not represent a harmful decision to make. As a result of forming a currency union, indeed, it is quite probable that some of the nations that now have an inconsistent history of inflation control and exchange rate management might benefit substantially from a monetary policy conducted by a more credible regional central bank.

In relation to *factor mobility*, ASEAN finds itself in a very similar situation to the one experienced by the European Union right before the entry into force of the Maastricht Treaty. Despite the presence of both legal and cultural barriers, labour mobility within Southeast Asia has increased significantly over recent years due to economic disparities among member states, with millions of workers moving across borders in search of better economic opportunities every year. ASEAN has also made strides towards creating a single market for investment through various agreements aimed at facilitating cross-border capital flows.

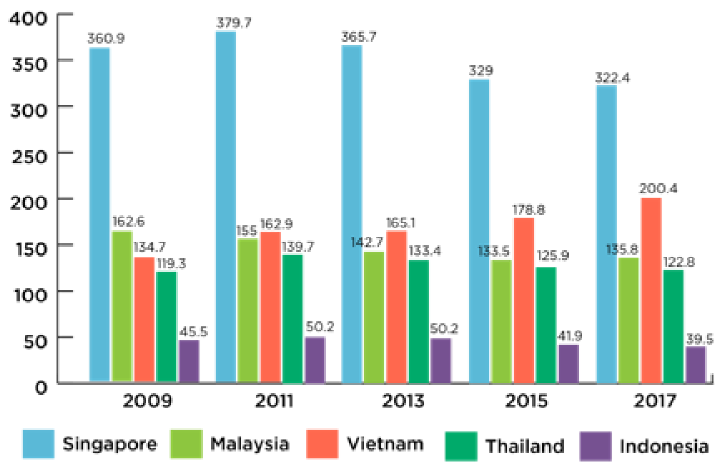
Compared to the EU, ASEAN also ranks quite high in terms of *wage* and *price flexibility*. South East Asia economies are traditionally known for their resilience to economic turmoil, especially for their ability to quickly adjust to external financial shocks. According to Bayoumi and Eichengreen (1994), almost all the change in output and prices in response to an economic shock in the region takes place in about two years.

With respect to *economic openness*, most ASEAN states annually register considerably high trade-to-GDP ratios[4] (Figure 6.3), generally higher than in the Western world, with Singapore ranking as the nation with the highest trade-to-GDP ratio in the world (311% in 2023). Albeit still less developed than EU, intra-bloc trade within the ASEAN region is far more advanced compared to other emerging currency unions, such as the Western Africa Economic and Monetary Union (WAEMU).

Finally, the level of *symmetry* in economic and financial shocks among the countries in the region is also comparable to the European case. This is evidently reflected in the high degree of openness, in relation to export orientation and capital flows, as well as in the similarities in the production structures among such economies.

In relation to all the macroeconomic and policy-oriented criteria we have just analysed, ASEAN might be considered to be an ideal region in which to implement a single-currency system, with special regard to Mundell's *Optimum Currency Area* theory, similarly as suitable as the European Union was prior to the ratification of the Maastricht Treaty.

Figure 6.3 Trade-to-GDP for selected ASEAN economies 2009-2017



Source: World Bank

[4] Indicator of the relative importance of international trade in the economy of a country. It is calculated by dividing the aggregate value of imports and exports over a certain period by the gross domestic product for the same period.

6.4 Macroeconomic convergence and structural reforms

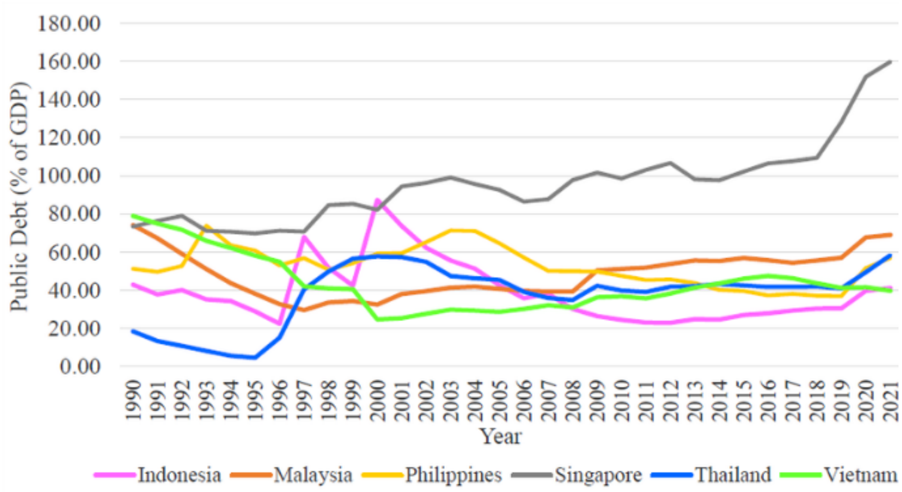
Sticking to Mundell's theory on *optimum currency areas*, we can affirm that macroeconomic convergence amongst the member states of an emerging or potential single-currency area is not strictly necessary. Indeed, *ex-ante* convergence is not considered as an essential prerequisite for the creation of a properly working monetary union, much less than the case of a unilateral asymmetric currency peg or a fixed exchange rates regime.

Nonetheless, a minimum degree of macro-economic convergence is critical to success when countries agree to the establishment of a single currency area as equal or symmetric trade partners, as in the case of the *Economic and Monetary Union* (EMU). In particular, in the absence of a sufficient level of macro-economic convergence, economies experiencing highly different inflation rates and fiscal deficits will struggle to gain from a common and non-inflationary monetary policy.

This fundamental principle represents the basis of the Maastricht convergence criteria. The standards for inflation rates, interest rates, fiscal deficits, public debt and exchange rate stability introduced in the early 1990s aimed at stimulating the EMS states to achieve fiscal and monetary homogeneity before becoming eligible for EMU membership.

Considering the latest macroeconomic data on ASEAN countries, and those applied to assess the *Maastricht convergence criteria*, it is clear that the region has not achieved sufficient macro-economic convergence in terms of inflation rates, policy rates, fiscal deficits and public debt (Figure 6.4), whereas, with the stagnation of the ACU plan, no exchange rate stabilization mechanism was implemented in the area.

Figure 6.4 Public debt to GDP (%) in selected ASEAN countries 1990-2021



Source: World Economic Outlook Database, IMF (2022)

Neither is structural convergence a discriminant requirement for optimum currency areas. Even if a country lacks solid macroeconomic policy institutions, such as a credible independent central bank and a disciplined fiscal authority before forming or joining a currency union, it could still unilaterally peg its exchange rate to the currency of a financially stable country that relies on strong economic infrastructures

Nevertheless, referring once again to the European experience, we should underline that the achievement of a certain structural uniformity amongst member states through intensive liberalisation measures and reforms of the institutional framework represented a precondition for entry into the European Monetary Community. In particular, to become full and symmetric members of the *Eurozone*, candidate countries must ensure the quality of their economic institutions to those of incumbent EU states and demonstrate a sufficient degree of macro-economic convergence before being considered eligible to join the currency system.

Considering the enormous differentials in per-capita incomes, industrial structures and institutional quality, we could simply affirm that ASEAN has not achieved a high degree of structural convergence. Hence, the first priority towards the formation of a currency area in the region would be the implementation by the interested national governments of structural reforms, both in the institutional framework and in the entire domestic industrial skeleton.

Of the crucial structural interventions ASEAN countries should implement to converge their economies, a conspicuous investment plan in physical and digital *infrastructures*, transportation networks and logistic systems has a primary role in enhancing people and business connectivity. Governments must also focus on *labour mobility* reforms, which include creating adequate job opportunities and developing specific policies that allow skilled workers to move freely across borders without excessive restrictions. Governments should ultimately concentrate on strengthening *governance frameworks*, enhancing transparency, combating corruption, and ensuring effective enforcement of laws and regulations to create a fruitful environment for business activities and attract foreign investment.

Fostering *innovation* with research and development initiatives is essential for sustaining homogeneous economic growth cycles within the region. ASEAN governments ought to invest in education systems that promote scientific fields and build partnerships between universities and industries to facilitate the transfer of knowledge and technology. Finally, drawing attention to the increasingly important themes of *environmental and human sustainability* has a crucial role in economic convergence plans; this is the reason why countries should implement structural reforms aimed at promoting sustainable practices in industries such as agriculture, manufacturing, and energy production, thereby encouraging investments towards green transition projects.

6.5 Constraints on the adoption of a common currency

Irrespective of the degree of sustainability by each individual state and the level of economic and institutional converge that lies amongst the nations of the union, we should not ignore the main constraints on locking in exchange rates and adopting a common currency over the long run. These generally include diversity in the extent of economic development across countries, weaknesses in the financial sectors, inadequacy of institutions required for forming and managing a currency union, and the lack of political preconditions for monetary cooperation.

Economic development levels vary significantly among ASEAN countries. For instance, Singapore's GDP per capita is nearly 70 times higher than that of Myanmar, respectively the wealthiest and the poorest members of the union, and this disparity does not diminish if we restrict the comparison only to the group's biggest economies, namely Indonesia, Malaysia, Philippines, Singapore, and Thailand. It is generally thought that such a high level of income differentials may hinder the development of a monetary union among these countries. However, we should keep in consideration that what is important for the adoption of a single currency is that relative prices and outputs across them have high co-movements following an economic shock, i.e. there must be strong correlation among countries on their reaction to sudden economic changes.

Income differentials across nations could represent a constraint to undertaking a common monetary policy only if such dissimilarities are reflected in the production structures, and consequently, in the movements in relative prices and outputs across them. This speculation, however, does not quite hold since some of the most populated countries in the world, such as China, India, Indonesia, or United States, also exhibit large intraregional income differentials within them. Yet, each of these countries uses a single currency.

Nations with diversely developed sub-regions can certainly share a common currency, but the same does not apply to diverse countries due to limited mobility of production factors (labour and capital), which may not move as freely across borders as they do within a country. Therefore, in order to manage a currency union with varying levels of development, allowing freer capital and labour flow across borders is crucial.

As for fiscal policy, it may be extremely challenging to provide a large, centralized budget at the union level to make resource transfers across countries. Greater mobility of factors ought to reduce the need for large transfers over the medium to the long term. Country-specific fiscal policies might still be used to respond to sudden asymmetric shocks across countries within a currency union. However, the scope for country-specific discretionary fiscal policies would be limited by a number of constraints on fiscal imbalances set at regional level, as is the case in the EU under the *Stability and Growth Pact.*

Recent financial crises demonstrated that when countries with weak banking and financial sectors and heavy dependence on foreign capital peg their exchange rates, banking issues may pre-empt an exchange rate crisis, and the same may occur with a common currency arrangement. The 1997 financial crisis in Asia[5] highlighted the fragility of the banking systems and the financial sectors of most countries in the area. Significant reforms and restructuring of the financial sector and the banking system are required among the ASEAN countries before they could eventually adopt a common currency, in particular an intense degree of harmonization of practices and standards may be crucial for such an integrated system to work properly.

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[5] Financial crisis started in Thailand in July 1997 after the serious devaluation of the Thai currency and quickly spread over East and Southeast Asia, which led to the collapse of countless currency and stock values in the domain of South East Asia.

Inadequate mechanisms for regional reserve pooling along with the absence of regional institutions could limit monetary cooperation and endanger the functioning and the real effectiveness of a common currency amongst the East Asian countries. The reserve sharing arrangements under the *Chiang Mai Initiative*[6] constitute a modest and insufficient experiment in addressing this constraint. Moreover, developing an adequate regional central bank to manage a common currency in the almost total absence of an institute responsible for monetary cooperation in the region, might be a major challenge, especially considering how long it took to Europe to establish a functioning institutional framework. Nonetheless, ASEAN countries could benefit from decades of European experience and leapfrog the development of regional reserve sharing mechanisms and institutions, provided that enough political support for such project is guaranteed.

Finally, it is argued that while ASEAN may satisfy the economic requirements for an *optimum currency area* as much as the EU does, it has not yet developed the political requisites necessary for a single-currency system. Monetary integration in Europe developed alongside big efforts to enhance political convergence. National governments gradually delegated a growing range of powers to new supranational entities. This process of political integration among the ASEAN countries might last a considerable amount of time before the monetary union enters into force. Yet, economic self-interest may persuade states to set aside political differences and forge strategically beneficial alliances. Political support may not be exogenous to economic outcomes, just as economic outcomes cannot be independent of political factors. Economic and political integration in the region may, therefore, be a joint although gradual process spanning perhaps decades.

[6] Multilateral currency swap arrangement among the members of the ASEAN, China, Japan, and South Korea, begun as a series of bilateral arrangements, member countries started this initiative to manage regional short-term liquidity problems and to avoid relying on the IMF.

6.6 A slow and incremental process of integration

The perspective on the costs and benefits of a common currency for ASEAN involves several factors, such as the continuous reorganization of geopolitical balances, the impact of globalization, and the diminishing role of independent national monetary policies.

Greater political and economic integration, possibly enhanced by the implementation of a monetary union in the Southeast Asian region, can represent an interesting tool for the equitable redistribution of geopolitical prestige in the Asian continent, especially for the smallest and most underdeveloped countries. In particular, a regional currency system can place ASEAN economies in direct competition with newly industrialized giants such as China and India, as was the case for the European Union in the context of the Cold War between the USA and the Soviet Union.

The actual development of such a form of integration, along with its preparatory groundwork and the inevitable transition phases might imply considerable efforts. Referring to the international experience, the time required to complete the process is unlikely to be short either. It is important, however, not to underestimate the Southeast Asian countries' capacity to achieve promising economic performances at a notable speed whilst reacting to adverse shocks with extreme adaptability.

The necessary creation of a new regional independent institution supposed to manage and implement the union's monetary policy might pose an obstacle to the full integration project. Nonetheless, the history of regional integration processes demonstrates how such a phenomenon may take a considerable amount of time and involve a number of small incremental steps, including a slow and gradual construction of political and popular support.

Final remarks

As we may deduce from the numerous case studies examined, multilateral monetary agreements have the ability to produce enormous benefits for the nations that opt for their implementation: the use of a single currency in a particularly integrated region may act as a powerful leverage for economic stability and for an efficient, sometimes optimal, allocation of financial resources amongst countries, which is able to generate positive whirls of sustained growth in terms of labor productivity and employment. In certain areas of the world, the institution of a monetary union may not only represent an effective strategy to boost consumption and investments, but also a necessary tool for an intense activity of *responsibilization* of the ruling political elite, as well as an indispensable mechanism of defence in a global context where competition amongst national superpowers has become increasingly ruthless.

Nevertheless, we have also witnessed the numerous difficulties in turning merely theoretical currency unions plans into effective geopolitical realities. The establishment of a monetary union hardly takes the form of one single drastic event, carried out in a relatively short period of time. On the contrary, it generally implies an inevitably prolonged and gradual process of policymaking and political confrontation on the most disparate and delicate economic issues, such as the definition of precise convergence criteria that countries should meet and the infrastructural framework that such monetary union eventually ought to assume. Furthermore, it requires national governments unmeasurable efforts on the progressive removal of legal and technical barriers to trade and free movement of factors, as well as on those activities necessary for the shift of competences and monetary sovereignty from the single states to the central institution.

Two fundamental lessons emerge from the analysis of developing currency union projects around the world today. Firstly, no single example of monetary convergence process has ever constituted a stand-alone entity, independent from wider schemes of regional cooperation. On the contrary, all monetary unions currently in force only represent the ultimate stage of long-lasting comprehensive pathways towards socio-economic integration on a regional basis, usually started with the establishment of blander forms of cooperation, such as preferential trade agreements or customs unions. In this sense, the identification of a detailed roadmap towards economic and political cohesion through an incremental plan of institutional reforms, may prevent individual member states from anticipating crucial steps in the overall convergence project and determine the eventual effectiveness of a single currency system.

Secondly, we have repeatedly highlighted how reduced uniformity of macroeconomic structures and dynamics between countries, as well as the lack of strong political proximity and consensus among the member states of a hypothetical monetary agreement, may seriously question the success of the currency union. The establishment of such a revolutionary geopolitical framework in a poorly integrated area, may not only prove counterproductive, but also endanger the stability of diplomatic relations and reduce the actual possibilities of reaching a form of unity in the region. Homogeneity in economic structures and tight coordination of policies are, therefore, indispensable elements in a properly working monetary union, in which the general interest outlined by supranational institutions often clashes with people's individual needs, wishes and expectations.

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