



Global Advanced Research Journal of Economics, Accounting and Finance (ISSN: 2315-5124) Vol. 4(1) pp. 011-014, March, 2016
Available online <http://garj.org/garjeaf/index.htm>
Copyright © 2016 Global Advanced Research Journals

Full Length Research Paper

Can Eastern African Monetary Union Become a successful OCA? Comparisons with the Euro zone case

Dimitrios Dapontas

E-mail: dimisdapont@gmail.com

Accepted 31 July 2015

As long as the Eastern African Monetary Union (EAMU) is on its way debate on its fruition raises under the economic turbulence caused by Euro's non performance after only 16 years of existence. Using Monga's (1997) model on whether a monetary union is an OCA or not modified for the EAC we currently deploy eleven equal indicators checking the synchronization and symmetry of the future East African Shilling. The results show that under the existing conditions of both participants and the community in contrast to the European one a common currency can format an Optimum Currency Area effecting positively all current and future members.

Keywords: Optimum Currency Area, Symmetries, Developing economies, Economic freedom.

JEL Classification: E 42, E 52, F 41.

INTRODUCTION

The Euro has faced major difficulties since its formation. Currently the global credit crunch has brought the scheme near to its faux-pas. Countries having the obligation to adopt common European currency in the near future postpone their joining in as much as they can. These facts have made possible monetary union formation plans for other similar organizations to rethink and astringent their policies over a future common monetary policy, its taking part criteria and its framework. The case of EAC and its future common currency seems to be the more interesting case of a future OCA. Maintaining the symmetry and of a monetary union seems to be the biggest challenge. Following the literature question and conflicting results whether this scheme will work or not the present work focuses on whether this scheme is sustainable without possible asymmetries and specific sectors where improvements can strengthen the EAMU. The paper is structured as follows: In the current part a brief introduction has been made. Following part reviews past literature. On the third part methodology and results are presented. Fruitful

results and suggestions for further research are given to the final part.

Past Works

The idea of Optimum currency area was introduced by (Mundell 1961) it refers to an over national area where multiple countries share effectively the same currency or their monetary policy bonding their national currencies, where coordination among national central banks is crucial for the joint unit success. Literature has analyzed possible formation and disintegration of monetary unions wondering whether the formation was successful or not focusing on possible advantages and disadvantages. Early references (Snider 1967, Grubel 1970) seem to quote possible transformations that have to been made. The decolonization and political change turned research interest to monetary union consequences (Ishiyama 1975) and common European currency plans were also analyzed (Mundell 1975). While monetary union

in Europe comes closer technical and working issues are promoted (Melvin 1985, Canzoneri and Ann Rogers, 1989). Early 90's scholars questioned whether the European common currency will be successful as an OCA (Eichengreen 1991, Bofinger 1994). Following the "Black Wednesday" crisis narrators put criteria over a successful under crisis EMU and CAF zone (Bayoumi and Eichengreen 1997, Monga 1997). The first real effects of the Eurozone were present and possible Asian zone was debated (Mongelli F.P. 2002 and Kwack S.Y. 2004). Later scholars (De Grauwe and Moesen 2009) suggested that a common currency has similarities to a common language and its spread has positive effects for all its users. However the asymmetries and the disintegrations caused by Euro introduction (Dapontas 2011, Dapontas 2013) raised questions over the existence and prosperity of a unique or multiple OCAs consisting of European countries resulting that an OCA is impossible under the current European economy framework.

The recreation of the Eastern African Community and the desire for creating a monetary union (EAMU) and its eminence in the near future has motivated multiple recent works. The symmetry of this possible scheme was questioned (Buguit and Valey 2005) stated that the majority of the shocks within union were asymmetric. Therefore the support of a possible zone seem weak suggesting more integration efforts for the participants enmeshed by real output growth.

Business cycle synchronization as suggested on economic integration success sign has been also deployed (Kundan Kishor N. and Ssozi J. 2009). High synchronization level can be beneficial for symmetric shocks within monetary union. On the other hand asymmetric turbulences will have enmeshing contagion effect. As long as common demand shocks observed were low the development of the intra zone trade will promote the possible OCA formation.

United Nations sub-regional office for Eastern Africa has stated in 2012 that structural reforms were delayed. Under categorized criteria the future monetary union is applicable and plausible but major effort from all participating parties should be made. The partakers should not hurry and the political integration should be prepared and implemented as soon as possible in coordination to the economic one.

These difficulties compared to the problems raised on Eurozone caused concern (Rusuhuzwa and Masson 2012) considering major precautions for counterparts and a transition "common national currency basket" period should be considered. Greater openness and free trade promotion is need. Legal framework should promote macroeconomic stability, monitor and enforcement mechanisms should be designed along with national planning.

The EAMU technical niceties before implementation have been presented in detail (Rusuhuzwa and Masson

2013) focusing on problems such as budget deficits and inflation. They cannot tell whether the "Schilling scheme" will be an OCA or not but only positive synchronization signs have been indicated.

OCA FORMATION METHODOLOGY AND RESULTS

Forming a monetary union can be an ultimate goal should be the implement of a common interest system allowing countries to participate in the financial markets equally within the zone as a presumption of the short term effective monetary policy along with specific and customized in each country's needs to eliminate regional disparities transforming zone to an OCA.

In a similar work (Monga, 1997) author listed 19 relevant criteria for a successful currency union in Francophone Africa. The level of freedom in certain sectors of the economy is crucial for creating or maintaining monetary unions. More freedom means larger flexibility for the referring country making it keen to accept needed transformations to be a part of an OCA. The OCA countries levels have to be equal. We have made transformations to the original variables in order to transform them to meet my current research criteria. We have deployed the latest (2012) dataset from Heritage foundation for economic freedom scores (Business, Trade, Fiscal, Government spending, investment, fiscal, property rights, Freedom from corruption and labor freedom), political risk from and credit rating from international agencies respectively consisting an 11 variables dataset. In (Monga, 1997) the measure is ordinal and based on estimates. Integer values range from -2 (heavy disadvantage or incentive) to +2 (strong advantage) using zero (0) if the effect is neutral. The variables have the same weight and added to make a final index.

In contrast to the referred one (Monga, 1997) we used quantitative data provided by referred sources using as population the specific scores for each series calculating its average and standard deviation omitting zero (0). The methodology choice has to do with the fact that asymmetries are present. We use these descriptive measures to give each country a score for each variable. The higher deviation means higher asymmetry. Thus, the effective grouping to two has to be made on the basis of higher asymmetries of the population average. The constructing of the indices is following the deviation ordination pattern. If the value is smaller than one standard deviation from the mean we note it as a heavy disadvantage (-2), from one standard deviation to mean (not included) is a minus one (-1), from mean to one standard deviation (not included) variable is a plus one (+1) and finally if the value is more than one standard deviation it takes a plus two (+2). Countries with positive final index can be counted as possible candidates for an OCA scheme and negative final index means that the

Table 1 OCA scores for EAMU

Country Name	Property Right	Freedom from Corruption	Fiscal Freedom	Gov't Spending	Business Freedom	Labor Freedom	Monetary Freedom	Trade Freedom	Investment Freedom	Financial Freedom	Political Risk	Credit Risk	Over all score
Burundi	4	0	1	4	1	1	0	1	1	4	4	0	1,0
Kenya	1	0	0	1	1	0	1	0	4	1	0	0	4,0
Rwanda	1	1	1	1	1	1	1	1	1	0	0	0	9,0
Tanzania	1	1	1	1	1	0	4	1	1	1	0	0	7,0
Uganda	1	1	1	1	4	1	0	1	1	0	1	0	7,0

country has to make possible transformations in order to improve its score or its candidate to format another OCA with other low final index countries. The results are shown on the following table.

As we can see all five countries have positive scores. We have to consider that in this framework the Eurozone countries were divided between positive and negative score countries forming the two groups of the "hard" and the "soft" Euro possible candidates for two new common currencies. In contrast for the EAC case under the known well worked criteria is assign that progress has been made in coordination terms and these countries can form an OCA. Negative scores in some indicators can guide action in specific sectors to enchase collocation. Rwanda seem to have the cumulative highest score among EAC countries. Country has adopted many reforms since its civil war end. The tally is positive for all categories. Tanzania and Uganda seem to share the same summation. The first should implement reforms in monetary freedom where is below average. The second should focus on business freedom effort. Kenya seem to rate lower in investment freedom where legal framework adjustments have to be made. Finally Burundi seem to score lower in five categories (Property rights, Fiscal freedom, Government spending, Financial freedom and country risk respectively) were more parallel action in cooperation with EAC and international organizations is needed. Although reforms especially with the external environment is urgent because of the raising importance of the EAMU project in the global economy. Furthermore more countries seem to desire to join a possible OCA where asymmetries if programming and strong filtering is not applied are unavoidable.

This scheme of international organization seem to work in contrast to the Eurozone where many problems are present. Even though suggestions were made before Eurozone formation (Tootel 1990) to break the future common currency to 3-4 optimum areas, the Europeans decided to make a unified one. Due its size and the differences among the nations and after a 15 year practice known problems seem to get worsen and more non-expected seem to rise (Dapontas 2011).

Furthermore this situation and the participation to the common European currency seems inevitable legally and economically and the zone cannot break to OCAs having still the problem of inequities (Dapontas 2013).

On the other hand EAC has major advantages compared to the Eurozone. The first foundation of the union goes back to 1917 following seventy years of successful coexistence as a union under the English Colonial States regime or as independent having a common language, economies of scale, integration and legal framework past. The community has collapsed already once (1977). In 2000 the union officially begun its operation and has given priority to the political rather than economic union process. It also put high standards on the participation and enlargement can eliminate possible weak links (as happened in the case of the European south).

CONCLUSIONS AND FURTHER RESEARCH PROPOSALS

The current work has indicated that EAC under the current economic and political conditions can become an OCA following coordinated action against turbulences that can occur in an over commotion world economy. The progress that has been made the later years was a result of the previous failure of the earlier similar political and economic union along with common elements of the participant's framework with the exception of minor number of sectors for each country. Guided vivacity is needed for maintaining and elevating the effects of this amalgampromoted by international organizations aid.

Economic freedom levels determine whether a country participating a union can participate successfully adopting major adjustments. As the number of participating countries rises more and more compromises have to been proposed and applied thrivingly. Under very strict norms enlargement of the EAC and EAMU should be applied. The known case of the EU and especially he Eurozone rout should be expressly mediated. A possible asymmetric risk within the zone could have taint effect

within an extended area overwhelming the zone's limits. Furthermore an attainment of the union could demonstrate to European counterparts under which framework they could had built and distended their organization. Conformity in economic terms had to be their central idea rather than political compromise. Even more the Euro project under its irreversible character and its current turbulence could raise the possible time that a common currency should formatted and change the framework agenda focusing on possible crisis remedies such as a "lender of last resort" and a possible stability mechanism similar to the European ESM.

Further research should be mad for the new shilling at the level of technical and extension elements. For example how a new participant could become a member of the union at political and economic level and stress tests in country strata could determine whether and under what circumstances the zone will not lose its symmetry adding a new partaker. The introduction of the new currency economic effects in the further future should also inquested especially in terms of black market development in the states neighing the EAC. However the present work and its outcome should be included to a continuous debate for the area where possible tweaks on the initial plan are still present and desirable.

REFERENCES

- Bayoumi T and Eichengreen B (1997). "Ever closer to heaven? An optimum-currency-area index for European countries", *European Economic Review* Vol. 41(5):761-770.
- Bofinger P (1994). "Is Europe an Optimum Currency Area?" Center of economic policy, working paper no. 915.
- Buiguit S and Valev N (2005). "Is the proposed East African Monetary Union an Optimal Currency Area? A structural vector Autoregression analysis", Georgia state University working papers.
- Canzoneri MB and Ann RC (1989). "Is The European Community An Optimal Currency Area? Optimal Tax Smoothing Versus the Cost of Multiple Currencies" Tilburg university, center for economic research, 5000 le Tilburg the Netherlands. Working paper n.8923.
- Cohen B (2003). Are monetary unions inevitable? *International Studies perspectives*, vol. 4: 275-292
- Dapontas D (2011). "The Euro's next day scenarios. Break up or an OCA scheme?" 13th International Conference on Finance and Banking, ICFB 2011, 12-13 October 2011. Ostrava, Czech Republic.
- Dapontas D (2013). "Saving Euro by dividing Europe in multiple OCA's", *Acta Universitatis Danubius. Economica* Vol 9. issue no. (2/2013):107-119.
- De Grauwe P and Moesen W (2009). Gains for all: A proposal for a common Euro bond. *Intereconomics* University of Leuven, May /June.
- Eichengreen B (1991). "Is Europe an optimum currency area?" NBER working papers, working paper no. 3579.
- Fuchs W and Lippi F (2005). Monetary union with voluntary participation. Stanford Institute for economic research. Stanford University.
- Georgioni G and Holden K (2000). The crisis of the CFA Franc zone. Working paper, Economic modeling.
- Grubel H (1970). "The Theory of Optimum Currency Areas" *The Canadian Journal of Economics / Revue canadienne d'Economie* Vol. 3(2):318-324.
- Heritage F (2014). Index of economic freedom 2015. The Heritage Foundation, Washington DC.
- Ishiyama Y (1975). "The theory of the optimum currency areas: A survey", *Staff Papers (International Monetary Fund)* Vol. 22(2):344-383.
- Kundan KN and Ssozi J (2009). "is the East African Community an Optimum Currency Area?" Department of economics Bolton Hall University of Milwaukee discussion papers.
- Kwack SY (2004). "An optimum currency area in East Asia: feasibility, coordination, and leadership role" *journal of Asian economics* Vol. 15(1):153-169.
- Melvin M (1985). "Currency Substitution and Western European Monetary Unification" *Economica* New Series, Vol. 52(205):79-91.
- Monga C. (1997). "A currency reform index for Western and Central Africa. The world economy", Blackwell publishers' Ltd., 103-125.
- Mongelli FP (2002). "New' Views on the Optimum Currency Area Theory: What is EMU Telling Us?.
- Mundell R (1961). "A Theory of Optimum Currency Areas" *The American Economic Review* Vol. 51(4): 657-665.
- Mundell R (1975). "A plan for the European currency" Paper Prepared for Discussion at the American Management Association Conference on Future of the International Monetary System.
- Rusuhuzwa T and Masson P (2013). "Design and Implementation of a common currency area in the Eastern African Community" *African journal of Business Management* vol. 7(35):3575-3590.
- Sireh-Jallow A (2013). "The empirics of an Optimal Currency Area in West Africa", *International J. of Econ. and Finance* vol. 5(4):100-107.
- Snider D (1967). "Optimum adjustment processes and currency areas" *Essays in int. finance*.
- Tootel G (1990). Central bank flexibility and the drawbacks to currency unification. *New England Economic review*:3-18.
- United N (2012). "Towards a common currency in the East African Community (EAC), issues, challenges and prospects" Sub regional office for Eastern Africa.