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Regional Monetary Agreements and the Challenge of Optimum Currency Zones (OMZs): A Lesson Worth Examining!

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ABSTRACT

This paper analyses the issue of optimal currency areas, based on various studies, in particular that of Robert Mundell, which shows that the effectiveness of a monetary union is based on specific criteria: labour mobility, diversification of economies, degree of market openness, similarity of production structures and the ability to jointly manage transfers.

In the light of this theory, we argue that neither the euro zone nor the CFA zone fully meet Mundell's criteria for an optimal currency area. Both regions are characterised by structural challenges that undermine their effectiveness as monetary unions.

INTRODUCTION

The creation of a currency area represents an effort by a group of countries to establish a common currency, as described by Mundell (1961). This zone leads countries to adopt a fixed exchange rate between their national currency and a central currency that acts as a means of transaction (Gravet, 2014). An example of this concept is the European Economic and Monetary Union, which represents a model for other regional organisations which originated with the creation of the European Economic Community, later leading to the European Economic and Monetary Union, known as the "euro zone". This experience has also led to the emergence of regional economic communities (RECs), and eventually to a common currency, such as the CFA zone in Africa (Musungaie, A., 2010).

Mundell's (1961) theory of optimal currency areas (OCAs) examines the conditions under which it is economically possible to establish a common currency. The benefits of a common currency or an OMZ are weighed against the costs of abandoning national monetary and budgetary policies.

According to Mundell (1961), an optimal currency area refers to a geographical zone in which the benefits of adopting a common currency outweigh the costs. However, for such an area, certain conditions must be met, such as the mobility of factors of production, a high degree of economic openness, specialised production structures and strong financial integration (Mundell, 1961; McKinnon, 1963; Kenen, 1969; Ingram, 1969). These criteria form the basis for economic integration and the creation of a single MCA and a single currency.

However, the theoretical requirements of an optimal currency area are often difficult to meet in full. Mundell points out that the conditions for an optimal currency area cannot be fully met. However, they are met in only a few cases and to a limited extent. This means that economic homogeneity between member countries and the ability to cope together with shocks are not always present. In practice, "*it has been shown that many existing monetary unions, such as the eurozone, are repeatedly faced with crises that call into question the sustainability of their common currency*".

Frankel & Rose (1998) show that it is also possible to achieve optimal monetary union even if the initial conditions are not fully met. This is made possible by a gradual synchronisation of economic cycles and a deepening of inter-regional trade. The eurozone remains the most successful model of monetary union, even though it has repeatedly been confronted with various crises, notably the financial crisis and the Covid-19 pandemic, which led to large public deficits and inflationary tendencies. Similarly, the

RussoUkrainian war disrupted the European recovery in 2022, but a coordinated policy response prevented a severe recession (OECD, 2023).

There are currently several regional monetary unions in Africa, including the CFA zone in West and Central Africa and the West African Economic and Monetary Union (WAEMU). Despite efforts to create a common currency, many of these integration processes remain problematic.

The lack of economic complementarity and the difficulties in meeting the convergence criteria have considerably altered the potential of a common currency in the CFA zone (Diop, 2007). The economic disparities between Member States and the lack of overall political will to implement the necessary reforms are also challenges.

Given these challenges, the question arises as to whether optimal currency area theory continues to be relevant as a guide to policy-making in existing and planned currency areas such as the euro area and the CFA zone. This analysis explores the hypothesis that optimal currency area theory can only serve as a practical guide if specific policy reforms are introduced to improve the efficiency of these currency unions.

This dissertation is divided into two parts: (i) the first deals with the efficiency of Mundell's optimal conditions for the Euro and CFA zones of the WAEMU. The second looks at suggestions for possible reforms to improve the efficiency of the Euro and CFA zones.

1. Optimality of the Euro zone and the CFA zone: *analysis of t h e effectiveness of monetary integration "in the sense of Mundell"*.

Mundell's (1961) theory of optimal currency areas (OCAs) provides a basis for assessing the effectiveness and success of the euro zone and the CFA zone as unions. monetary integration. The focus is on criteria such as the mobility of production factors, trade integration, structural homogeneity and financial integration. These factors largely determine whether a monetary union can be considered 'optimal'.

1.1. Mobility of factors of production: labour and capital

The mobility of production factors is a central criterion of the ZMO theory. It guarantees effective adjustment to asymmetric shocks within the monetary union. In the eurozone, there are legal bases for the free movement of workers, but language barriers, cultural differences and national interests hamper real mobility. This means that workers do not move flexibly enough between Member States to compensate for economic imbalances (Rousse H., 1997). For example, during the euro crisis, Greece could not count on sufficient labour mobility to mitigate the effects of asymmetric shocks. In contrast, capital mobility is higher within the eurozone, which facilitates economic adjustment but does not compensate for low labour mobility.

There are, however, a number of other factors that call into question Europe's MCA, notably the low mobility of the labour factor compared with that of the United States. The United States has almost the same political, cultural and social environment. On the other hand, European countries differ to some extent in terms of their political, economic, cultural, social and even linguistic environment.

Within the CFA zone, labour mobility is encouraged by the socio-cultural and historical links between member states. However, real mobility between these states remains limited due to inadequate infrastructure and a lack of economic integration.

United Nations statistics (2017) show that most population movements are to a country other than the one in which the region is located. The historical and cultural attachment of the peoples living there, their geographical proximity and the socio-economic relations maintained between states and populations since the colonial era facilitate these migratory movements within the CFA zone. According to Zouri (2020), the average proportion of migrants (% of the population) between 1990 and 2017 was 9.8% in Burkina Faso, 6.6% in Mali, 6.01% in Togo, 5.92% in Guinea-Bissau, 5.32% in Benin, 4.28% in Senegal, 3.46% in Côte d'Ivoire, 2.73% in Ghana and 1.79% and 0.56% respectively in Niger and Nigeria (Zouri. 2020).

This mobility is also faced with a number of challenges, notably the lack of agreement between states, which are reluctant to respect their sovereignty. There is also the language barrier (migration between English-speaking and French-speaking countries is rare), political instability, the lack of security in some regions, and the rise of terrorism, which requires tighter border controls.

So, according to Mundell's criterion (1965), this mobility of workers is poor and weak, and implies that conditions are not optimal for these zones (Euro and CFA).

1.2. Trade integration: degree of intra-regional trade openness

Trade integration is another important criterion. According to McKinnon (1963), open economies benefit from a common currency because exchange rate fluctuations have less impact on competitiveness.

The euro zone has seen a significant increase in intra-regional trade following the introduction of the euro. Monetary union has reduced transaction costs and encouraged trade. However, there are differences in specialisation and dependence on external markets that can lead to tensions. For example, Germany dominates industrial production, while the southern countries are more dependent on services and tourism.

In the CFA zone, intra-regional trade is less pronounced. Member states mainly export raw materials to markets outside the zone and import industrial products. This low trade intensity reflects structural differences between states, low economic diversification and a low level of industrial integration.

According to Zouri (2020), as far as integration is concerned, intra-Community trade in this intra-region was very limited between 2010 and 2017. Togo is the main exporter to other countries in the region, with a share of 18%, followed by Côte d'Ivoire (12%), Niger (6%), Senegal (5%), Burkina Faso (5%), Guinea-Bissau (5%), Mali (4%) and Benin (4%). Intra-zone transactions account for an average of 5%. So, although in the euro zone the criterion of trade openness seems to be met, the intensity of intra-zone CFA trade is not optimal according to McKinnon (1963).

Thus, in the absence of greater trade integration **and** a greater degree of intra-regional trade openness, economic integration remains limited and, by extension, the optimality of the monetary zone remains ineffective.

1.3. Structural homogeneity: specialisation in production and trade

According to Kenen (1969), a similar economic structure favours the symmetrical propagation of shocks within a monetary union. The eurozone has a high degree of structural heterogeneity, technological progress and innovation, as well as specialisation in sectoral production. Countries such as Germany and the Netherlands have highly developed industries, while southern Europe relies more on less productive sectors. These differences make economic adjustment difficult and lead to persistent economic imbalances. Similar challenges exist in the CFA zone. The characteristics of the Member States vary considerably in terms of economic structures, ranging from agricultural economies to countries with a greater reliance on services. These differences make it difficult to coordinate and converge structural and economic policies between these states.

Although they share the single CFA currency, these states retain a form of independence, have distinct production and trade structures and are endowed with different levels of economic development and infrastructure. As a result of the diversity of resources and comparative advantages, there is a variety of sectoral specialities which are mutually focused in agriculture, manufacturing, financial services and tourism. Thus, in the sense of Kenen (1969), the heterogeneity of these factors constrains the optimality of these zones.

1.4. Financial inclusion

Effective financial integration is essential to mitigate the negative effects of asymmetric shocks. Ingram (1969) stresses the importance of a harmonised financial sector and capital mobility.

Measures have been taken in the eurozone, such as the creation of a banking union and the harmonisation of financial markets. However, there are differences between Member States in terms of the stability of banking systems and the depth of capital markets. According to the European Central Bank (ECB), risk sharing is insufficient compared to other regions, notably the United States.

According to the AfDB, the CFA zone is not very financially integrated overall. It notes wide variations in terms of financial inclusion between WAEMU countries. The degree of financial inclusion within the zone differs from one country to another. Some have made significant progress compared with others. The BCEAO report[1] (2023) indicates that Togo is the leading country with a financial inclusion rate of 87% and Niger is in last place with 16.7%. The low levels of use of banking services and financial *and capital* markets, combined with informal economic structures (almost 70% in 2021) according to the World Bank, and the conditions of access to credit limit the country's ability to absorb economic shocks. Poor access to financial services is reflected in a low banking service penetration (nearly 16.1% in 2016 according to the AfDB).

According to the BCEAO report (2023), the overall use of financial products and services (i.e. demand), the strict bancarisation rate rose from 23.4% in 2021 to 24.3% in 2022, remaining below 50% for the WAEMU. The extended bancarisation rate has risen to 46.3%, compared with 44.0% in 2021. In 2022, the cost of bank credit will be 6.48%, up from 6.27% the previous year. In addition, the return on deposits made by depositors with banks has fallen by 17 basis points to 5.18% in 2022[2].

This situation, coupled with a lack of structural funds, makes it difficult to develop essential macroeconomic and sectoral policies aimed at creating links between regional hubs and establishing an optimal monetary zone for the WAEMU Cfa zone.

2. Potential for reform and increased efficiency of the Eurozone and CFA

The factors and criteria for convergence towards optimality in a monetary zone remain complex and gradual, depending on the Member State. Looking at these factors, we see that

that it is appropriate to suggest possible reforms that could improve the structure and functioning of the euro zone and the cfa zone by putting in place harmonised economic policies likely to enhance their effectiveness. In particular: in relation to the mobility of production factors, cyclical adaptation and valorisation of the labour and capital factor, lower transport costs, and reductions in customs tariffs (customs duties) for certain products with a view to intensifying trade integration and the degree of intra-regional trade openness, diversifying production and trade, etc.

[1] BCEAO: Central Bank of West African States

[2] BCEAO (2023), "Rapport sur la situation de l'inclusion financière dans l'UEMOA, au cours de l'année 2022.

Transfer technologies, adopt digital strategies in the provision of financial services, lower the interest rate on intra-regional capital transfers in order to promote financial inclusion and access to financial services.

On this basis, the eurozone and the CFA zone should undertake comprehensive reforms to increase their effectiveness: (i) in the *eurozone*, introduce a common budgetary mechanism, a stronger banking union and European unemployment insurance. These measures could increase economic resilience to asymmetric shocks; (ii) "*CFA zone*", improving infrastructure, promoting intra-regional trade, the transition to a more diversified economy and promoting the agricultural sector, developing new technology and technological innovation with a view to digitising the intra-zone financial system.

CONCLUSION

The theoretical foundations of optimal currency areas (OCAs) have been continuously developed since the 1960s in order to better understand how they work. The eurozone has served as an "open laboratory" since its creation in 1999, helping to challenge existing economic theories and develop new solutions. At the same time, it has inspired African countries to create and strengthen regional currency areas.

Various theories and analyses show that neither the euro zone nor the CFA zone fully meet the criteria of an optimal monetary zone. Far-reaching reforms are therefore needed to achieve this objective and strengthen integration and resilience to asymmetric shocks. Neither the euro zone nor the CFA zone fully meets Mundell's criteria for an optimal monetary zone. Both regions are characterised by structural challenges that limit their effectiveness as a monetary union. Furthermore, long-term progress could be made through targeted reforms and greater economic integration to better exploit the potential of monetary unions.

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