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# Banking Union, Fiscal Union and Political Union as Pathways to Complete and Sustainable Monetary Integration of Africa

## by

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## Abstract

Following the monetary integration trends in Europe, there had been the desire for the African Monetary Union and the creation of a unified currency for the African continent. This proposed African common currency would be known as 'afro', a single currency for Africa by 2028. The continent of Africa, characterised by the largest number of countries and the largest number of currencies has consequently embarked on a special project for an African monetary integration. The 1991 Abuja treaty set out six stages in the process of achieving a monetary union and a single currency for Africa. This strategy for African monetary integration is based on progressive economic and monetary integration of African economic communities which are regarded as building blocks of Africa. These economic communities are the East African Community (EAC), the Southern African Development Community (SADC) and the Economic Community of the West African States (ECOWAS). Evidences generated from the analyses of the formation of the European Monetary Union (EMU) prompted many conclusions that there were major defects in its establishment as exposed by the Eurozone crisis. Some of these identified optimum currency area (OCA) related design flaws of the Eurozone are: (i) the absence of effective economic governance mechanism; (ii) the retention of banking supervision and resolution at national levels; (iii) the lack of financial back-stops and crisis resolution mechanisms at the union level; and (iv) defects in the design of the Eurozone's common central bank. Clearly, the Eurozone crisis has obviously revealed that banking union and integrated financial market, fiscal union and integrated fiscal framework and political union are all required in a monetary union, for completeness and sustainability. Unfortunately, these are issues not addressed by the OCA theory. From view-points in various debates on the sustainability and completeness of the EMU as well as various revealed faults in the design of Eurozone and the defects inherent in the original optimum currency area (OCA) theory and its application to monetary integration, this paper consequently discusses and highlights banking union, fiscal union and political union as pathways to complete and sustainable monetary integration in Africa.

## 1. Introduction

The continent of Africa characterised by the largest number of countries and the largest number of currencies currently has embarked on a special project for an African monetary integration.[1] Following the monetary integration trends in Europe, there had been the desire for the African Monetary Union which aims at the creation of a unified currency for the African continent. This proposed African common currency is to be known as '*afro*'. Economists and other analysts consider the step towards a stronger and great African regional integration which were to be in the interest of Africa because of the small size (in terms of economy and population) of many African countries.

Over decades ago, many regional economic groups were evolved in Africa for the purpose of free trade. Some of these regional economic groups still exist till date while some are modifications and rejuvenations of those that were in existence during the colonial regimes in Africa.[2] Nevertheless, there are plans in pipeline for several currency unions within the regions of Africa as at present. This plan, set out in the 1991 Abuja Treaty, makes an African single currency the African Union's long term goal. Article 44 of the 1991 Abuja Treaty states that "…....member states shall within a timetable to be determined by the Assembly (of the Organisation of African Unity), harmonise their monetary, financial and payments policies and boost intra-community trade in goods and services to further the objectives of the community and to enhance monetary cooperation among member states."[3] The 1991 Abuja treaty set out six stages in the process of achieving a monetary union and a single currency for Africa by 2028.[4] This strategy for African monetary integration is based on progressive economic and monetary integration of African economic communities which are regarded as building blocks of Africa. These economic communities are the East African Community (EAC), the Southern African Development Community (SADC) and the Economic Community of the West African States (ECOWAS).

There were major defects in the establishment of the European Monetary Union (EMU) as exposed by the Eurozone crisis. Some of these identified optimum currency area (OCA)

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[1] This is in respect of the currency unions sharing the two separate CFA francs in Central Africa and West Africa respectively

[2] Presently, South Africa's Monetary Area and the CFA franc Zones in Central and West Africa respectively are the monetary integration arrangements that still exist.

[3] Regional Integration- http://www.uneca.org/aria3/chap1.pdf

[4] The 1991 Abuja Treaty which was signed on 3 June 1991 and was effective in May 1994 established the African Economic Community.

related design flaws of the Eurozone are: (i) the absence of effective economic governance mechanism; (ii) the retention of banking supervision and resolution at national levels; (iii) the lack of financial back-stops and crisis resolution mechanisms at the union level; and (iv) defects in the design of the Eurozone's common central bank.
Clearly, the Eurozone crisis has obviously revealed that banking union and integrated financial market, fiscal union and integrated fiscal framework and political union are all pivotal in a monetary union, for completeness and sustainability. Unfortunately, these are issues not addressed by the OCA theory.
From view-points in various debates on the sustainability of the EMU and various revealed faults in the design of Eurozone and well as the defects inherent in the original optimum currency area (OCA) theory and its application to monetary integration, this paper consequently discusses and highlights banking union, fiscal union and political union as pathways to complete and sustainable monetary integration in Africa.

## 2. Making the Case for Banking Union and Integrated Financial Market

The traditional OCA theory makes no provision for any theoretical basis for a banking union embedded in a monetary union. One of the probable reasons attributed to this was the prevalence of capital restrictions in the 1960s when the OCA theory was evolved.[5] Maes (2002) was of the view that the OCA theory was brought to the fore by those economists who were not well focused on theoretical bases of finance.[6] However, such banking union should be expected to encompass single financial rules and regulations, a single banking supervision, a well-funded single resolution mechanism for 'bad' banks and harmonised deposit insurance. These are essential whenever banks are involved in cross-border capital flows, given the destabilising effects of the inadequate supervision and regulation of a cross-border lending policies. In the event of insolvency of banks and the absence of orderly resolution mechanism, bail-out was seen as the only alternative. This promoted moral hazards, caused bank under-capitalisation problem, negatively affected the solvency of national governments that were responsible for bank capitalisation, and increased the spirits of robotic banks and companies. If not well

[5]Though, the 1973/74 oil shock and the 1978/81 upsurge in bank lending and the Eurodollar market all contributed to sudden increase in international flows of capital; and lessons could not be learnt about the reversals of these international capital flows leading to various debt crises.
[6]Ivo Maes in 'Economic thought and the making of EMU, Selected Essays, 2002.

addressed, this problems could lead to decline confidence in banking systems, spilling beyond the specific countries.

According to the OCA theory, the survival of a monetary union is the based only on the condition that benefits of the adoption of a single currency outstrip its cost for the loss of monetary independence and exchange rate instrument. If a monetary union's member state's economy encounters an asymmetric shock and this condition was not met, factor flexibility (labour mobility and price flexibility) would offer the desired solution. Otherwise, if cross border mobility is low, free cross border is weak, labour market is immobile and wages displays rigidity, the rationale for a banking union would be apparent. De Grauwe (2011) established that the reversal of capital flow could spark off asymmetric shocks in a monetary union (as exhibited by the EMU) simply because of the loss of control over national currency and monetary independence by the country that opted to be a member of such monetary union who, in comparison with countries outside the union, are vulnerable to reversals in capital flows as well as speculations against its sovereign debts.[7]

Further development made to the properties of the new OCA by Mundell (1973) reflects that pooling of reserve and diversification of portfolio could moderate adverse shock better in a currency area arguing further that if countries within a currency area can insure each through financial markets, they could still share a single currency in the absence of labour mobility, wage flexibility and solidarity mechanism. Courtesy of capital flows, asymmetric shocks are lessened by financial integration.[8] This would be made possible since member countries in deficit can borrow from member countries in surplus or rather, sell foreign assets if the need for current account for deficit financing arises. Financial integration and common currency are therefore the two sides of same coin in many ways (Draghi, 2014). Under the umbrella of a single currency, an 'adverse shock' country can easily share the loss with a trading partner in the monetary union due to the fact that the two countries can lay claims on each other's output while 'insuring' each other through private financial market as buttressed by Geeroms and Karbownik (2014).

[7] Owing to the retention of monetary policy control, it is very possible for the country outside the monetary union to, through its monetary authority, allow the erosion of its domestic debt by higher inflation or still, monetise its sovereign debt (Geeroms and Karbownil, 2014).

[8] It was at the point of conceiving the idea of euro that integrated financial market was seen as essential if a common currency would be effective – Delors Report, 1989

These are further justifications for an integrated financial market and a banking union in a monetary union.

The impossible trinity of Schoenmaker (2013) pressed home the justification and reasons for a banking union in a monetary union. The 'Impossibile Trinity' centres on how simultaneous banking union, national supervision and financial stability are. Two logical ways of overcoming the 'Impossible Trinity' are proffered as: embracing segmented national banking markets and forgoing benefits of financial integration; (ii) moving towards supra-national structure for financial supervision and crisis resolution.[9] Box A below shows the stabilising and destabilising effects of financial integration for a monetary union.

| ***Box A: Stabilising and Destabilising Effects of integrated Financial Markets in a Monetary Union***[10] |
|---|
| *Stabilising Effects:* Enhanced Portfolio Diversification: Greater cross-border diversification of banks and other investors within a currency area could reduce shocks at the domestic level as well as leads to higher income an d enhanced consumption risk sharing (with evidence of reduced consumption growth volatility<br>*Improved Allocative Efficiency:* This is about ensuring the channelling of productive capital towards most efficient firms, thus improving overall economic performance as evident in Europe, due to the presence of large cross-border banks.<br>Destabilising Effects<br>*Risk Taking:* This could be caused by the problems of asymmetric information which could emanate from cross-border lending, leading to misaligned incentives.<br>*Contagion in Interbank Market:* This is possible when and if there are negative shocks as there could be the compression of risks premia by imbalances in savings abroad, thus causing leverage increases in the domestic financial sector. These may also have effect on cross-border lending to the real sector<br>The welfare benefits of the stabilising effects (greater diversification and improved allocative efficiency) would offset the welfare costs of destabilising effects (risk taking and contagion). |

The African financial system that is heavily bank-based and in which banks play vital role in cross-border capital flow would require a banking union. If banking supervision and regulation in a monetary union's member country neglects the crucial implications of the lending policies of the domestic bank across the border, this can bring destabilising implications for other members of the union. Bail-outs would be seen as the only alternative in the event of insolvency of banks if there is a lack of orderly resolution mechanism. This, however (a) encourages moral hazard; (b) makes problem banks to be under-capitalised; (c) portends threats to the solvency of the sovereigns responsible for capitalisation; (d) increases the emergence of 'zombie' banks and firms (Eichengreen, 2014). All together, these erode and damage the confidence in banking; and this damage may go beyond the initiating country and spread over the entire currency area. The

[9]Explanations of Schoemaker's 'Impossible Trinity' offered by Geeroms and Karbownik

[10]Draghi (2014)

traditional OCA theory neglected and failed to recognise these due to the tight regulation of banks and strict limitation of cross-border finance (lending and borrowing) in the 1960s.

The 2007/2008 financial crisis in the Eurozone revealed the salient elements of banking union which are essential for the sustainability of a monetary union as: (i) a common supervisory mechanism; (ii) an adequately funded common resolution mechanism for bad banks; (iii) harmonised deposit insurance scheme.

*Common Supervisory Mechanism:* For an African monetary union, this would guarantee impartial and strict supervisory oversight which contributes to the 'destruction of the link between sovereigns and banks as well as reduce the probability of future systemic banking crisis within the monetary union. The common central bank would be armed with strong and adequate supervisory and control powers in this regard. Given the independence, incentives and its instruments, this mechanism would support supervisors better in the identification of risks and in acting counter cyclically. The features of a common supervisory mechanism in this respect should be: (a) legal independence; (b) independence of a single government or national financial system; (c) micro-prudential powers; (d) macro-prudential powers to resolve financial imbalances; (e) accountability for bank failures within the covered jurisdiction. Further, the mechanism comes with policy framework that is 'more conducive' for cross-border banking integration which would lead to the maximisation of the benefits of financial integration.

When the lines-of-divide between these jurisdictions (which bring up compliance costs) are destroyed, the distinction between cross-border 'home and host supervisors' would consequently be destroyed. This is in addition to the removal of 'hidden barriers' to cross border activity' linked to national presence. The highlights of the merits of common supervision in a banking union embedded in a monetary union are expressed in Box B below.

In spite of the listed benefits, a common supervision within an African monetary union (which would cause the union's banking systems to be strong and not prone to crisis) should not only focus on banking system failure or bank distress prevention, even if such supervision is at the high standard level.

| *Box B: Benefits of Banking Union through Common Supervision:* |
|---|
| As benefits for the African monetary integration, common supervision in a banking union will:<br>✓ ensure the identification of emerging excessive risk-taking and the associated cross-border externalities;<br>✓ increase transparency of national banking system. (More transparency, less uncertainty manifestation through the possibility of hidden risks);<br>✓ give accountability avenue for failure of banks;<br>✓ provide macro-prudential powers and instruments to counter financial imbalances and prevent financial instability;<br>✓ reduce the possibility of domestic banking system being swept in fiscal problems encountered by national governments. The reason is that, unlike the national supervisors, a supra-national supervisor would find it easier to intervene in situations where banks are made to join in providing cheap funds to household, firms and governments;<br>✓ result in convergence of rules standards and harmonised culture. This, for instance, would solve the problems caused by allocation of similar weight to risks in same category while recognising the influence of difference in markets and domestic economic situations; and furthermore, it would impose some principles, methods and parameters for the improvement of banks' internal models, harmonises the treatment of non-performing loans and provisions for bad/doubtful debts;<br>✓ reduce substantially, compliance costs, given the effect of consolidated nature of reports and savings in interactions with several, different authorities and the observance of different rules;<br>✓ minimise hidden barriers to cross-border activity linked to national preference;<br>✓ ensure uniform high standards and competitive conditions across the monetary union;<br>✓ facilitate measure necessary in dealing with cross-border systemic effects towards preventing the occurrence of financial crisis. |

If the common supervisor is to discharge its duty effectively, there should be an orderly resolution of banks in distress. This leads to second pertinent element of a banking union in a monetary union.

*Common Resolution Mechanism:* In a monetary union, if supervision is effectively shifted to a common supervisory mechanism, it is in effect, necessary for the responsibility for the resolution of banks to be shifted to the union level. A common resolution mechanism in an African monetary union would create a single authority that would be charged with the task of bank resolution within the monetary union.[11]More appropriately, this mechanism should come up with a single resolution fund that should be provided by all banks in the monetary union and made available to these banks in distress.

The common resolution mechanism should ensure the orderly winding down of banking institutions that are not viable so as to protect taxpayers' funds. This primary aim only

[11]Bank resolution is the process in which a distressing bank is handled in order to avoid possible knock-on effects on other financial intermediaries, thus preventing systemic problems in the financial markets within the monetary union.

points at the giving assurance of financial stability and neither absorption of losses nor provision of capital to a banking institution under the resolution.

| ***Box C: Desirability of Banking Union through Common Bank Resolution*** |
|---|
| A single resolution mechanism in the banking union embedded in an African monetary union would be desirable because of:<br>✓ swift and impartial decision making that mitigates obstacles (national bias and frictions in cross-border cooperation to resolution and reduced cost of resolution (as economic values of banks to be resolved are maintained);<br>✓ reduction (as low as possible) in the resolution costs; and the breaking of the bank-sovereign nexus. If a resolution body backed by efficient resolution tool is strong and independent, it would possess the necessary independence and capabilities (administrative, financial and legal) to implement low-cost and effective resolution. Increased market discipline and minimised cost (residual) for taxpayers would be experienced in cases of bank distresses;<br>✓ as a complement to the common supervisory mechanism, it ascertains the restructuring and closing down of failing banks. As the common supervisory mechanism would make prompt and unbiased assessments of bank resolution needs, the common resolution scheme provides for the actual effective and timely resolution. |

Funds meant for this purpose would not be considered for the bail-out of failing banks. Resolution decisions under the mechanism are expected to address cross-border resolution issues in unbiased and effective manner. Logically, the common resolution mechanism would be complementary to the common supervisory mechanism. While assessing financial fragmentation within the union, the common resolution mechanism would break possible bank-sovereign link.

For the African monetary cooperation initiative, the desirability of a banking union derived from a single banking resolution mechanism is expressed in Box C above.

*Common Deposit Insurance Scheme*: The purpose of the common deposit insurance scheme for the African monetary integration schemes would be to serve as an essential assurance providing sufficient insurance of eligible deposits of all banking institutions in the integrated countries. This is necessary because even if the financial integration is of high quality, shocks that could not be contained within the private sector could still occur.[12]Therefore, this common insurance scheme would assist in the insulation of sovereign through the improvement of private risk-sharing within the monetary union. Though, at the Eurozone level, the idea of a harmonised deposit insurance had been contentious element of banking union, owing to its debt mutualisation implications, it was opined that such scheme is necessary for a banking union to succeed and consequently for a monetary union to be sustainable. A common deposit insurance

[12]The well integrated financial system of the US still has the Federal Deposit Insurance Scheme playing a vital role in crisis management.

scheme would mitigate risks inherent in capital flight because depositors would always perceive the common currency as safe in a strong member of the monetary union than in the distressed member state that encounters economic hardship. In consideration of these discussions on the essence of embedding banking union in a monetary union, it appropriate to support the view of Eichengreen (2014)that monetary union without banking union will not work.

### 3. Making the Case for Fiscal Union and Integrated Budgetary Framework

The main intention of fiscal union embedded in a monetary union is to ensure greater discipline in public finance and to provide a range of fiscal policy instrument at the union level. This would evolve a central union budget and common issuance of public debts. The main aim is the establishment of a central budget specifically meant for macroeconomic stabilisation of the entire monetary union. In a monetary union, the strength of national fiscal deficits are limited in helping to confront deep recession, hence the need for a union-wide support.

Generally, a central budget (fiscal union) has crucial roles to play in the absorption of country specific economic shocks within a financially integrated monetary union. It is believed that a union-wide, centralised budget should: (a) offer a significant transfer of resources (though may be temporary) whenever large regional shock would occur; (b) serve as severe recession counteracting instrument for the entire monetary union; and (c) promote financial stability within the monetary union (Wolff, 2012). In a monetary union, the fiscal policy, the mobility of labour of labour and capital, and the flexibility of price and costs all share the burden of adjustments to country specific economic shocks. If the mobility of labour and capital and the flexibility of price and cost are at the low ebb, it would therefore the necessary that fiscal risks are shared in such situation in which economic adjustment mechanisms to country specific shocks are less perfect (Van Rompuy, 2012). An integrated budgetary framework (fiscal union) would, for an African monetary union encompass: (i) mechanism for fiscal discipline and fiscal policy coordination; (ii) fiscal capacity as instruments that would, through centralised insurance system, help in dealing with country-specific shocks; (iii)establishment of forms of jointly and severally guaranteed debt mutualisation.

The OCA theory postulates that membership of a monetary union can be too costly because of: (i) the possibility and existence of incessant and strong asymmetric

macroeconomic shock hitting member countries differently; and (ii) lack of capable instrument for adjustment in efforts to absorb these shocks alternatively. This is where the lack of risk sharing elements between members of a monetary union is apparent.[13] In this regard, a common risk sharing tool and the provision of fiscal cushion would ease country-specific shocks and prevent of contagion across the monetary union, hence the essence of a fiscal integration in a monetary union. Box D below contains highlights of some reasons for the justification for the entrenching of fiscal union in monetary integrated African economies.

| ***Box D: Justification for Fiscal Union in an African Monetary Union*** |
| --- |
| A fiscal union embedded in an African monetary union will:<br>✓ smoothen shocks affecting only a constituent part of the African monetary union. It would provide a common fiscal cushion to meet idiosyncratic economic and financial shocks. This strengthens confidence in the entire monetary union, remove or prevent spill over of problem that may be erupted by crisis and thus reduces the cost of shock for all members of the monetary union;<br>✓ build effective risk-sharing arrangement for sovereign debts, while avoiding moral hazard problems and significant inter country fiscal transfer;<br>✓ finance large common investment projects with public debts that are jointly issued, as much as possible;<br>✓ enhance fiscal capacities through restriction of laxity in public spending by possible debt prone African countries. |

There were arguments brought to the fore against the acceptability or tenability of fiscal union in a monetary union. The distributional consequences of fiscal policy is the main adverse factor. The central view of seminal contributions to the OCA theory which postulate that transfer made through a centralised system of taxes and budgetary transfer as the alternative to labour mobility failed to consider the redistribution effects of such fiscal system because of the simple assumption that one-direction transfer in one period would be offset by transfer in the other direction in the next period (Eichengreen, 2014). There are the evidence of large on-going transfers associated with existing fiscal system demonstrating or reflecting important redistribution implications.[14] Buttressing further Eichengreen, (2014) posited that in practice, it is not possible to detach the redistributive effect of a federal budget in an integrated fiscal federalism from its

[13]A member of a monetary union, on (becoming a member), according to the OCA theory loses fast and simple adjustment instruments and there would be compounded problems if such country is hit by asymmetric country specific shocks or shocks exhibiting differences in national institutional details like flexibility of labour.
[14]Eichengreen (2014) demonstrated the evidence put forward by Bayoumi and Masson showing that "while Federal taxes and transfers have significant stabilisation effect on US region (they offset 31 cents of every US$1 decline in regional income), they also have permanent redistributional effects (of 22 cents on the dollar) from high to low income states and regions. In Canada, the stabilisation effect (17 cents) is smaller, but the redistributive effect (at 39 cents) is even larger."

assurance effect, thus (from his own opinion) making fiscal union untenable, given these distributional consequences.

## 4. Making the Case for Democratic Political Union

If properly implemented, a political union may give assurance towards the sustainability of a monetary union. The workability of a separate budget in a monetary union appears sceptical given expected difficulties and the political challenge in bringing members of a monetary union together in line to accept the very huge financial burden of the funding of the central budget. This makes a case for a monetary union embedded in a political union. Hence, a monetary union should be embedded in a political union as De Grauwe (2014) stressed that for a monetary union to be complete and sustainable, sovereignty should be transferred from national institutions to a supranational institution, adding that this denotes moving to a political union.

For instance, the European Monetary Union (EMU) failed to go the direction of all that were indicated by past history and experiences of successful monetary unifications (particularly, the US case) which all stressed the relevance of political union as essential prerequisite for monetary union to be effective. The 1970 Werner Report prompted the EMU to go the other way based on the conviction of Werner Report that the proposed monetary union and single currency "would act as a leaven for the development of political union, which in the long run, it cannot do without". The plan proposed by the Werner Report was the establishment of a currency union without a common budget and without a common central bank. This was based on the Report's conviction that a central budget and a common central bank could surface later on and that the proposed single currency and the monetary union would act as "a leaven for the development of political union, which in the long run it cannot do without". The 1971 'snake in tunnel' was the initial step taken towards centralised monetary policy. Two powerful reports after these strongly advised the essence of a centralised budget and stronger political union as pre-requisites for the workability and sustainability of a monetary union. Consequently, the Werner Plan thus believes a monetary union initiates movements towards a political union. The construction of a monetary union made by 1989 Delors Report was in terms of the continuation "of individual nations with differing economic, social, cultural and political characteristics" and the "existence and preservation of this plurality would require a degree of autonomy in economic decision-making to remain with the individual member countries." The EMU will have to become a political union to survive, given the

lesson from historical analyses of monetary union over the past centuries (Gerrard Lyons).[15]

Therefore, for the African monetary integration initiatives, if political union is to be sustainable, it is essential that it is established firmly so that it does not cause future political and economic problems in continent. In doing so, it is necessary to move fiscal and key regulatory powers to a central political institution. In the case of the EMU, it is unfortunately that there had been difficulties in complementing the monetary union with a political structure that is sufficient and adequate. In history, there had not been any historical precedents about building democracies at the supranational levels, even as there are democracies at national levels. These are important issues that should be given attention by African nations. Many of the African nations are weakly democratised, exhibiting low governance indicators. The complex decision to make is therefore about determining the form and dimension of political union to settle for. Nevertheless, various attempts to give an exact definition to 'political union' and explain its goals have failed.

However, Dullien and Torreblanca (2012), expressed that there are three dimensions of political union that should be well-balanced in order to avoid disaster within a monetary union. These political union dimensions which may be considered in the case of the proposed African monetary union are highlighted in Table 1 below. Central decision makers at a monetary union level face enormous tasks and difficulties in make choices from the extremes in the three dimensions of political union. The extremes in the first dimension are limited economic federalism (at one end) and full economic federalism (at the other end). In the second dimension, the extreme options are enforcement of rules (at one end) and giving rooms for discretion (at the other end) while indirect legitimacy (at one end) and direct legitimacy ((at the other end) are the extremes in the third dimension.

[15] Source: http://www.euro-know.org/europages/articles/rmu.html.
Gerard Lyons, a British economist is currently Economic Adviser to the Mayor of London and formerly Chief Economist and Group Head of Global Research at Standard Chartered. http://www.euro-know.org/europages/articles/rmu.html

**Table 1: Dimensions of Political Union**

| | ***Options*** | ***Features and Explanations*** |
|---|---|---|
| 1 | Limited Economic Federation or Full Economic Federation | *This is about making a choice between limited economic federation ('minimalist' vision) and full economic federation ('great leap' vision).<br>*Under the limited economic federation, the monetary union member states only transfer to the central levels, those powers that are strictly and specifically necessary to bring a particular crisis to an end and further prevent the break-up of the monetary union. There powers pertaining to fiscal policy supervision, regulation of the integrated financial market, the scope of banking union and common financial oversight of the common central bank. The aim of limited economic federation is just to stabilise the single currency.<br>* The full economic federation entails the creation of full fiscal, banking, and economic unions and also the setting up of new, solid and centralised structure of governance. The basis of this is the theory of fiscal federalism which postulates that policy decisions that significantly affect constituent parts negatively or positively should be moved to the central level in order to ensure that some degree s of specific competences are present at the centre through the desired endogenous mechanism. |
| 2 | Rules-based Federation or Discretion-based Federation | * This is about making a choice between rules-based federation and discretion-based federation.<br>*Rules-based federation gives little room for policy flexibility and innovation. With this, some binding rules are set at the centre so as to prevent member sovereigns from adopting some specific policies which are at the heart of central elements of sovereignty (for instance, powers to take decisions on budgetary matters).<br>*Discretion-based federation affords abundant discretionary powers to take economic decisions as a well as sufficient economic policy tools.<br>*For supporters of rules-based federation, rules are public goods that give benefits to all members as they guarantee sound finances as well as financial stability.<br>*The proponents of discretion-based federation believe that there are complexities in realities that could not be simply catered for by rules and consequently, powers at the centre should be discretionary, just as those discretionary powers enjoyed at the national levels. |
| 3 | Intergovernmentalism (Indirect Legitimacy Federation) or Federalism (Direct Legitimacy Federation) | *This is about making a choice between intergovernmentalism and federalism.<br>*Indirect legitimacy federation or intergovernmentalism is associated with the view that member countries possess the ultimate legitimacy and democracy and that if sovereignty is to be transferred through political union, this should require a parallel upgrading of member countries in the central decision making.<br>*Direct legitimacy federation or federalism confers abundant legitimate powers and authority on supra institutions (like European Union (EU) in Europe or Economic Community of West African States (ECOWAS) in West Africa) or a central parliamentary institution. |

Source: Author and Dullien and Torreblanca (2012).

These thus yield the two models of political union dimensions in Table 2 below.

**Table 2: Models of Political Union Dimensions**

| | ***Model 1*** | ***Model 2*** |
|---|---|---|
| ***Dimension 1*** | Limited Economic Federalism | Full Economic Federalism |
| ***Dimension 2*** | Rules-based Federalism | Discretion-based Federalism |
| ***Dimension 3*** | Indirect Legitimacy | Direct legitimacy |

Source: Author and Dullien and Torreblanca (2012).

Model 1 represents minimum departure from the existing position while Model 2 depicts a high degree of ambition. Conspicuously, Model 1 is rooted by limited economic federalism, rule-based federalism and indirect legitimacy just as Model 2 is about the establishment of full economic federation, sufficient powers for discretion to make policies and direct legitimate federalism. Analytical observation of the underlying notion of the extremes in Model 1 would lead to the conclusion that the application of the model would not yield a sustainable political union. Some of the reasons for the unsustainable posture of Model 1 is that rules involved may lack the adequate strength needed to attend to future economic needs and thus may compound and turn future economic predicaments into magnified economic crisis. Another reason is that at the various member countries' level, there may be political turmoil due to the absence of direct legitimacy; and this may further cause fresh crisis that may likely force the movements to Model 2 so as to benefit from the advantages of the components of this model.

If the rule-based federation and direct legitimacy federalism are combined with an economic federalism may result into revolt by citizens at the national levels whenever they find out that those elected at the central lack real powers to affect policies and rules or lack powers to enact new rules and policies (Dullien and Torreblanca, 2012). However, there could be some combinations of choices from the three dimensions.

Extra caution should be made to avoid 'free picks and choices' because some of these combinations could cause further economic, financial and political crisis. Apart from the three dimensions of political union explained above in Table 1 and Table 2, there are three different established benchmarks of political integration as shown in Table 3 below.

**Table 3: Dimensions of Political Union**

| | *Benchmarks* | *Features and Explanations* |
|---|---|---|
| 1 | Functional political integration | *This indicates the coming close together of various areas of government. It involves:<br>- the harmonisation of many aspects of member country's national laws;<br>- establishment of supra national laws and regulations;<br>- binding budgetary commitments;<br>- enhanced system of multilateral surveillance;<br>- common supranational constitutional framework;<br>- bringing absolute economic powers of the national governments to an end;<br>- transfer of income redistribution, allocation role and stabilisation, employment role and promotion of growth to the supranational level;<br>- harmonisation of legal and regulatory frameworks. |
| 2 | Transfer of sovereignty over elements of national economic policy | This entails:<br>-centralisation of monetary and exchange rate policies;<br>- relinquishing monetary policy to a common central body;<br>- joint decision on the overall framework for the conduct of exchange rate policy;<br>-sole responsibility for management and holding of foreign exchange reserves and the conduct of foreign exchange operations by a common central monetary authority;<br>- establishment of annual stability programme of national government, incorporating budgetary objectives. |
| 3 | Necessity for policy coordination | This involves:<br>- multilateral close-watch and regular exchange of ideas and opinions at supranational meetings, on policies and developments that are union-wide and country-specific;<br>- regular deliberations and joint participation in the operations of main supranational institutions within the monetary union;<br>- various ways of team-working on specific plans and programmes and collaborated rule-making. |

Source: Author

Generally, for a monetary union, the effects of political unification will manifest in two ways. Firstly, centralised budget that makes the alleviation of the plights derived from negative shock-countries possible and this consequently reduces the scope for potential liquidity crisis that may hit individual member countries within the currency area. Secondly, the degree of asymmetry would be reduced (De Grauwe, 2014). These two factors would cause political unification to increase the sustainability of monetary union, on the long run. If political union should increase the sustainability of a monetary union, it is critical that such political union is made sustainable.

**Table 4: Implications of Political Integration for the Optimality of a Monetary Union**

| | ***Through:*** | ***How it works*** |
|---|---|---|
| 1 | Possible centralisation of significant part of national budgets at the monetary union level | *Organising system of automatic fiscal transfer that provides some insurance against asymmetric shock.<br>*Therefore, whenever a union member is hit by a negative shock, the centralised budget automatically transfers fund from the 'boom' member country (experiencing good economic condition) to the 'doom'/'recession' member country (experiencing negative shock .<br>*Consequently, the 'doom'/'recession' country perceives her membership of the monetary union to be less costly than where there is no fiscal transfer mechanism.<br>*This reduces the scope for liquidity crisis hitting individual countries. |
| 2 | Consolidating part of national government debts into jointly issued debt at monetary union | *Political unification allows the entire monetary union to better withstand the movements of distrusts afflicting national government that by implications of the single currency, could not issue their own currency.<br>*Political union reduces financial fragility of the monetary union. |
| 3 | Removal of unilateral powers of the national government and parliaments to affect spending, taxes, social policies and wages within the monetary union | *The unilateral decision to lower (or increase) taxes (as well as decision on wages and social policies) create asymmetric shock<br>*Political unification thus reduces extent of possible the politically originated asymmetric shocks.<br>*It further increases long term sustainability of the monetary union. |

Source: De Grauwe (2014)

Apart from general applications, information in Table 4 above suggests (from the three channels) what African political integration implies for optimality of African monetary cooperation.

**Table 5: Summary of Suggested Elements of Genuine and Sustainable European Monetary Union**

| | ***Main Elements*** | ***Features*** | ***Purposes*** |
|---|---|---|---|
| 1 | Integrated Financial Frame work – Banking Union | *Single or centralised supervision spearheaded by the common central bank (ECB).<br>*Single resolution mechanism.<br>*Single deposit insurance scheme. | *To brake the 'doom loop' between banks and sovereigns nations.<br>*To counter the threat that 'dealing with bank crisis would overwhelm the fiscal capacity of vulnerable member countries'. |
| 2 | Integrated Budget Framework – Fiscal Union | *Central budget for the monetary union.<br>*Debt mutualisation mechanism.<br>*Fiscal transfer mechanism. | *To ensure greater and better discipline in public finance within the monetary union.<br>*To establish a wide range of fiscal policy instrument within the monetary union.<br>To create capacity for the monetary union towards facilitating adjustments to economic shocks |

| 3 | Integrated Economic Policy Framework | *Coordination of economic policy.<br>*Member states regarding their economic policies as a matter of common concern. | *To promote sustainable growth, competitiveness and employment within the monetary union.<br>*To improve the resilience of the economy of the entire monetary union to shocks.<br>*To serve as a means of imposing economic decisions on member states under specific and well-defined circumstances. |
|---|---|---|---|
| 4 | Democratic Legitimacy and Accountability for Decision Making – Democratic Political Union | *Democratic control and accountability at the decision making level.<br>*European parliament involvement in accountability at the union level, while the pivotal roles of national parliaments are maintained. | *To enhance the domestic oversight of pooled economic policies.<br>*To ensure effectiveness of the integrated financial budgetary end economic frameworks. |

Source: Author

In summary, Table above 5 highlights the summary of the elements of genuine and sustainable EMU and the associated features and purposes as applicable to the future African monetary integration as exposed by the financial crisis within the Eurozone crisis:

## 5. Summary and Conclusions

Evidences generated from the analyses of the formation of the European Monetary Union (EMU) prompted many conclusions that there were major defects in its establishment as exposed by the Eurozone crisis. Some of these identified optimum currency area (OCA) related design flaws of the Eurozone are: (i) the absence of effective economic governance mechanism; (ii) the retention of banking supervision and resolution at national levels; (iii) the lack of financial back-stops and crisis resolution mechanisms at the union level; and (iv) defects in the design of the Eurozone's common central bank. From these, it is apparent that the Eurozone crisis has obviously revealed that banking union and integrated financial market, fiscal union and integrated fiscal framework and political union are all required in a monetary union, for completeness and sustainability. Unfortunately, these are issues not addressed by the OCA theory. From view-points in various debates on the sustainability and completeness of the EMU as well as various revealed faults in the design of Eurozone and the defects inherent in the original optimum currency area (OCA) theory and its application to monetary integration, this paper consequently discussed and highlighted banking union, fiscal union and political union as pathways to complete and sustainable monetary integration in Africa.

The paper established that for an African monetary union, a common banking supervision mechanism would guarantee impartial and strict supervisory oversight which contributes to the 'destruction of the link between sovereigns and banks as well as reduce the probability of future systemic banking crisis within the monetary union. Furthermore, it was highlighted that a common resolution mechanism in an African monetary union would create a single authority that would be charged with the task of bank resolution within the monetary union. More appropriately, this mechanism should come up with a single resolution fund that should be provided by all banks in the monetary union and made available to these banks in distress. A common deposit insurance scheme for the African monetary integration schemes was also considered as appropriate in serving as an essential assurance providing sufficient insurance of eligible deposits of all banking institutions in the integrated countries in Africa.

This paper also stressed the relevance of a fiscal union embedded in an African monetary union as one that will smoothen shocks affecting only a constituent part of the African monetary union and provide a common fiscal cushion to meet idiosyncratic economic and financial shocks, towards strengthening confidence in the entire monetary union, removing or preventing spill over of problem that may be erupted by crisis and thus, reducing the cost of shock for all members of the proposed African Monetary Union. Also, such fiscal union would build effective risk-sharing arrangement for sovereign debts, while avoiding moral hazard problems and significant inter-country fiscal transfer, financing large common investment projects with public debts that are jointly issued, as much as possible and enhancing fiscal capacities through restriction of laxity in public spending by possible debt prone African countries.

This paper further made a case for an African monetary union embedded in a political union because the workability of a separate budget in a monetary union appears sceptical given expected difficulties and the political challenge in bringing members of a monetary union together in line to accept the very huge financial burden of the funding of the central budget. This would involve transferring sovereignty from national institutions to a supranational institution, implying moving fiscal and key regulatory powers to a central political institution. It is considered necessary for the African monetary integration initiatives to always note that if political union is to be sustainable, it is essential that it is established firmly so that it does not cause future political and economic problems in continent. As established in literature, three dimensions of political union that should be

well-balanced in order to avoid disaster within a monetary union were consequently highlighted by this paper as: (i) Limited Economic Federation or Full Economic Federation, (ii) Rules-based Federation or Discretion-based Federation and (iii) Intergovernmentalism (Indirect Legitimacy Federation) or Federalism (Direct Legitimacy Federation). These three dimensions were transformed into two models of political union for the proposed African monetary integration.

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