

# Regional currency areas: a few lessons from the experiences of the Eurosystem and the CFA franc zone

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## 1. Introduction

Contemporaneously with the run-up to European economic and monetary union (EMU) and the successful introduction of the euro, the issue of whether or not to adopt common currency arrangements, from regional currency areas (RCAs) to currency boards and even the unilateral adoption of a foreign currency, has ranked high among the topics discussed by the policymakers of many countries.

As suggested recently by Alesina and Barro (2001, 2002), two main factors may have contributed to this renewed and sustained interest in exchange rate arrangements. One may be, rather obviously, the ongoing process of globalisation, which could be briefly characterised as the remarkable and steady increase in international trade in goods, capital and services over the recent period. The other, which is subtler, may be the increased emphasis that has been put by policymakers on price stability, as opposed to active macroeconomic stabilisation, as a primary goal for monetary policy. These changes have led to a general reassessment of the benefits and costs for smaller open economies of constituting an RCA. Although a number of criteria must be fulfilled (such as increased trade integration), the costs of relinquishing monetary policy autonomy at a national level may seem more and more likely to be outweighed by the benefits. The latter include reduction of transaction costs in external trade and increased price stability when anchoring to partner economies with a better inflation track record or a lower long-term inflation rate.

As a concise contribution to this important debate, this paper endeavours to underline some of the conditions underpinning the success of RCAs, in their different forms. It makes special reference to the experience of the Bank of France within the Eurosystem, the system composed of the ECB and the 12 national central banks of the euro area, as well as through its partnership with the central banks of the CFA franc zone.<sup>2</sup>

First of all, it is necessary to stress that the creation of any properly functioning monetary union is an achievement requiring primarily time. Apart from the CFA franc zone, which dates back to 1939, the example of EMU as the crowning phase of a very long process of nominal and structural European convergence would be enough by itself to underline the need for a strong political will to achieve union, sustained over several decades. See Annexes 1 and 2 for a short reminder of the EU and EMU construction process.

With this temporal aspect and the experience of both EMU and the CFA franc zone in mind, this paper seeks to consider present and future challenges. It focuses on macroeconomic policies and structural reforms, namely how to formulate monetary policy strategy in an RCA (Section 2); the degree of coordination required between decentralised fiscal policies in such an area (Section 3); and how to deal with financial stability issues (Section 4).

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<sup>1</sup> This paper has benefited from key contributions by Philippe Bonzom, Emmanuel Carrère and Jean-Stéphane Mesonnier, and from substantial comments, notably by François Mouriaux and Jean-Patrick Yanitch.

<sup>2</sup> The CFA central banks are the Central Bank of Western African States (BCEAO), the Bank of the States of Central Africa (BEAC) and the Central Bank of the Comoros.

## 2. How should monetary policy be formulated in a regional currency area?

This paper does not intend to tackle the theoretical issue of defining an “optimal” monetary policy in a regional currency area. Regarding the definition of monetary policy, it focuses on four practical issues - the prerequisites and consequences of the fixing of the exchange rate, the definition of price stability, the sources of price dispersion across participating countries and the assessment of the transmission mechanisms of monetary policy impulses - drawing, in particular, from the experience of the Eurosystem.

### The general requirements stemming from fixing the exchange rate

The fixing of an exchange rate, and the correlative forsaking of this instrument, can be successfully achieved only if decision-makers have settled a number of preliminary issues.

First, one has to be aware of the close interaction between the goal and the process. The goal is, most generally, to create a zone providing increased internal stability, based on price and fiscal discipline. The process for reaching this goal should include the establishment of appropriate institutions, frameworks and procedures, but also the achievement of a “culture” of peer pressure among decision-makers. In this sense, the process may be considered as important as the ultimate outcome. In the case of the European Union, for instance:

- Countries first accepted a constraint through participation in an exchange rate mechanism (the core group participated for over 20 years in this ERM and avoided any realignment for more than 12 years) before EMU.
- The countries set up preliminary institutions (eg the Council of Governors in 1964, the European Monetary Institute in 1994 and the Monetary Committee as early as 1958) in which a common culture for stability and an acceptance of peer pressure gradually emerged.

Second, a clear vision of the balance of costs and benefits is needed. However, the establishment of such a vision is not always easy. Indeed:

- Some costs may already be borne (eg in the case of small open economies with little monetary autonomy).
- Costs are often perceived quickly whereas benefits are usually enjoyed more progressively (although exceptions exist: some benefits can materialise even before the finalisation of a formal RCA, as was the case in 1998 with the “de facto EMU” leading to the quasi-elimination of bond spreads across countries one year before formal EMU).
- Unrealistic expectations often translate into higher costs. For instance, it would be wrong to believe that the establishment of an RCA will significantly reduce the external constraint and diminish the need for structural reforms. It is true that a single currency is a structural reform in itself, since it affects (ie reduces) the costs incurred by the economy. However, a practical consequence of a single currency is also the disappearance of some highly visible indicators of competitiveness or of market assessments of national policies (like the exchange rate of a country vis-à-vis its main trading partners if they participate in the same RCA). This means that, in an RCA, even more attention needs to be devoted to monitoring (and fostering) competitiveness through unit labour costs and productivity gains. As recent history has shown, this is also relevant for currency boards, in which undetected and unsolved currency mismatches, misalignments or fiscal slippages result in increased borrowing, which has to be repaid sooner or later, often at a high cost for the economy.

It is thus quite clear that problems may emerge if a critical threshold of requirements and conditions is not achieved and maintained by each country prior to and after the establishment of an RCA.

### The definition of price stability: the European experience

The Maastricht Treaty assigns to the Eurosystem the primary objective of maintaining price stability in the euro area as a whole. With a view to conducting a transparent monetary policy, this objective was quantitatively specified in 1998 by the Governing Council of the ECB as “a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%”. Furthermore, the

Governing Council stated that this objective has to be met over the medium term, reflecting the consensus that:

- Monetary policy is unlikely to affect the level of prices in the short run due to its transmission lags.
- Short-term volatility in inflation can thus not be offset by monetary policy.

In May 2003, following a thorough evaluation of the ECB's monetary policy strategy over the first four years of the euro, the Governing Council confirmed the definition adopted in 1998. At the same time, the Governing Council clarified that in the pursuit of its objective of price stability, the ECB aims at maintaining the inflation rate "below" but also "close to" 2% over the medium term. This clarification underlined the ECB's commitment to provide a sufficient safety margin to guard against the risk of deflation, while addressing the issues of the possible presence of a measurement bias in the HICP and the implications of inflation differentials within the euro area.

Price stability for the euro area is assessed in terms of a specific aggregate price index - the HICP. This index is the result of painstaking work in cross-country methodological harmonisation agreed on by all the participating states and including, for instance, common rules for the treatment of new goods and services, a harmonised classification of sub-indices - allowing for cross-country sectoral comparisons of price developments, as well as common revision procedures for the various commodity weights.

Moreover, since the price index is based exclusively on price developments occurring in member states, the single monetary policy would not take into account price developments (in fact, any developments) in other countries that choose to unilaterally adopt the euro as their domestic currency. In the view of the European authorities, the adoption of the euro is linked to EU membership and to the fulfilment of several macroeconomic criteria.

In the European case, the move to a single currency has rounded off a long process of convergence towards low inflation rates in all participating countries. And indeed, low inflation is among the criteria for EMU entry. All in all, this process has proved successful. For instance, national inflation levels ranged from 1.8% (for France) to 5.1% (for the Netherlands) in annual terms in 2001, while the rate of inflation for the euro area as a whole reached 2.5% in 2001. Inflation differentials across the area are now well below their 1996 levels of 8 to 12 percentage points. In addition, cross-country inflation differences within the euro area also remain moderate compared with inflation dispersion observed across US cities; see ECB (1999).

Nevertheless, some inflation differentials across euro area countries can still be observed. This has sometimes been pointed out as a possible issue of concern for the single monetary policy. Some clarification should be made in this regard. The existence of a monetary union per se does not imply that all participants either would or should continuously experience the same rates of inflation. Consequently, not all inflation differentials should be of concern for overall price stability and for the single monetary policy. In this regard, it is of crucial interest to determine the pattern of price dispersion effectively at play.

### **Price dispersion issues and convergence**

There are three sources of inflation divergence, with relatively little importance in terms of risks for overall price stability in the medium run.

First of all, a number of statistical factors, as well as unpredictable events, such as weather conditions or non-synchronised tax changes at national levels, may temporarily affect price developments in participating countries - unprocessed food prices, for example - without significantly affecting the risks for aggregate price stability in the medium term for the whole euro area.

More interestingly, the progress of market integration is very likely to speed up the convergence of price levels of traded goods if these were initially different among member states. Trends in car prices in the euro area over the last few years may provide a good example of this. To the extent that individual prices seldom fall, however, a reduction in price differentials translates, in the transition period, into increased inflation differentials between countries.

Finally, besides this nominal convergence process, a real convergence process may account for a part of inflation differentials among countries participating in an RCA, whose initial living standards may be

relatively heterogeneous. This is the so-called Balassa-Samuelson effect, which states that, under a set of standard assumptions, including the price of traded goods being set at the international level and cross-sectoral wage equalisation, intersectoral differentials in productivity growth between internationally traded and non-traded goods and services imply a rise in the relative price of non-traded goods. This sectoral rise in prices usually leads to higher total inflation in the less developed economy and to an appreciation in the real exchange rate under a nominal exchange peg. In the long run, as the real catching-up process advances, the magnitude of the Balassa-Samuelson effect is expected to diminish in absolute terms in the RCA. However, the disinflation process may increase the relative importance of this effect.

Undoubtedly, the Balassa-Samuelson effect was at play to some degree among the economies of the current euro area over the 1990s: for a review of empirical studies see De Grauwe and Skudelny (2000). Nevertheless, the available empirical studies suggest that most of the inflation differences between rapidly growing member states and the rest of the euro area cannot be attributed to this effect. In Greece, according to IMF estimates, the effect accounted for no more than 1.7 percentage points of annual inflation during the 1990-96 period, when the average inflation rate there reached 14%. In the case of Portugal, according to a recent study by their central bank, the annual inflation differential with Germany that may be justified by relative productivity gaps remained below 1.9 percentage points during the whole period from 1986 to 1995. In the case of Spain, available studies failed to provide evidence of any significant effect during the 1990s; see Estrada and Lopez-Salido (2002).

To sum up, many sources of inflation dispersion across the euro area are out of reach of the single monetary policy and should not be of concern for the Eurosystem. Nevertheless, as stated by the ECB (1999), “if sizeable and protracted inflation differentials not justified by the effects of either market integration and real convergence were to emerge, this could result in undue changes in competitiveness and in economic imbalances in individual euro area countries”. Such imbalances would require national policy responses in terms of fiscal and/or structural policies (see Section 3).

### **Monetary policy transmission mechanisms**

To a certain extent, the Eurosystem may have to cope with both increased complexity and increased uncertainty in the functioning of the mechanisms by which key interest rate changes are transmitted to relevant macroeconomic variables, namely long-term rates, inflation and activity:

- More complexity, as these transmission channels may remain somewhat country-specific well after entry into monetary union (due to the specific structural features of the banking and financial sectors, for example).
- More uncertainty, as the introduction of the new single currency may induce changes in consumption or production behaviours (eg with an impact on the stability of money demand) as well as changes in the monetary definition process itself, in order to account for the new environment (including the relatively reduced importance of the exchange rate channel).
- However, such difficulties should not be overstated. Firstly, there is no reason why the single monetary policy, which pursues an objective of price stability at the euro area level, should have identical effects in the different member states. Secondly, the convergence process between the core countries of the euro area was completed before the introduction of the euro. The new currency is therefore unlikely to have induced a regime shift in these countries or major changes to the monetary transmission process (Box 1 mentions a number of recent empirical studies based on a variety of econometric tools).

Taking into account this difficulty in assessing the “true” transmission mechanisms of the single monetary policy, there is a clear rationale for the ECB to derive monetary policy decisions from a comprehensive, both “economic” and “monetary”, analysis in assessing the risks to price stability. The “economic” analysis serves to identify short- to medium-term risks to price stability. It includes an analysis of shocks affecting the euro area economy and projections of key macroeconomic variables. The “monetary” analysis then focuses on the identification of the medium- to long-term trends in inflation in view of the close relationship between money and prices over extended horizons. This analysis serves as a means of cross-checking, from a longer-term perspective, the indications coming from economic analysis.

#### Box 1

##### **Recent empirical studies on the transmission mechanism of the single monetary policy across member economies: a brief overview**

In 2001, an expert group from the national central banks of the Eurosystem performed a coordinated exercise of extrapolating from their individual macroeconomic models the impact on national economies of a temporary increase in ECB rates of 100 basis points. They concluded that the impact of monetary policy on prices and activity, while generally small, appeared to be somewhat higher in southern countries and Germany; see Locarno et al (2001).

Other authors preferred small structural models or structural VAR models, which suggested slight differences in impacts. See Jailliet and Pfister (2002) for a short selection of references.

Other Eurosystem studies focused more specifically on the pass-through of changes in ECB rates to retail banking rates and on the elasticity of flows of new bank loans to short-term rates, which may in both cases provide interesting insights into the credit channel due to the still important financing role of banks in the European economies. The results suggest the existence of some asymmetries among member states in terms of interest rate pass-through; see Mojon (2000). In any case, one should keep in mind that the relative role of the narrow credit channel, as opposed to both the interest-rate channel and the broad credit channel, is likely to decrease with the progress of financial market integration in the euro area and the development of these markets.

The exchange rate is, of course, one of the important variables belonging to this comprehensive information framework. In the process to EMU, the exchange rate was often a key anchor: in France, for instance, the stability of the exchange rate was a key element of the monetary policy strategy with a view, *inter alia*, to safeguarding the single market and completing EMU. Also, sustainable stability of the exchange rate in the context of a full liberalisation of capital flows was one of the criteria for entry into EMU. After monetary union, the exchange rate remains a relevant indicator, all the more so since the exchange rate channel of the monetary policy for the area as a whole remains active. Thus, although the exchange rate is not an objective as such for the single monetary policy, there is clearly no place for any benign neglect of the external value of the euro in the monetary policy strategy of the Eurosystem.

To conclude, the thorough cross-checking of the information derived from both “economic” and “monetary” analysis allows the conduct of a more robust monetary policy - ie a policy that is more likely to deal correctly with an uncertain environment.

### **3. How should fiscal policies be handled in an RCA?**

Besides the formulation of a single monetary policy for the whole area, the efficient coordination of fiscal (and structural) policies, which are still defined at the national level, is crucial to the success of an RCA. The academic literature on optimum currency areas (OCAs) emphasises the difficulty of coping with asymmetric shocks that may hit some of the participating countries, at a time when monetary policy autonomy has been relinquished at the national level. This section starts by looking at this question and then discusses the respective institutional answers of the euro area and the CFA franc zone to this major challenge.

#### **Coping with asymmetric shocks**

Since the seminal contributions by Robert Mundell (1961) and Ronald McKinnon (1963), the economic literature has become accustomed to assessing the sustainability of RCAs in terms of their distance from OCAs. These are defined as groups of countries which may optimally share the same currency (or irrevocable peg) because they fulfil a set of criteria or properties acting as prerequisites.

From the well known theoretical conditions singled out by Mundell and other pioneers of OCA theory, such as a high degree of bilateral economic openness, a significant mobility of factors, and price and wage flexibility as an alternative to exchange rate variability, the list of OCA criteria has of course evolved over time. It has been enriched to the point that it had become more and more difficult to rank the proposed criteria by priority and use them for the practical assessment of RCAs. Fortunately, the

similarity of shocks faced by economies applying to join RCAs has emerged over the years as a pertinent meta-property, a kind of a catch-all criterion summarising many others; see Mongelli (2002). Following this, Frankel (1999) proposed in particular to focus on two key indicators for deciding whether or not to adopt a single currency: the degree of trade integration among members of the area and the correlation of business cycles between them. Both are aimed at ensuring a low probability of asymmetric output shocks. Of course, these conditions should not be exclusive of others, notably labour mobility and the existence of some risk-sharing devices (such as a common budget or integrated financial markets) between members of the area.

In fact, the prevalence of asymmetric shocks affecting countries participating in an RCA should be a major concern for area-wide and national policymakers, since it could threaten the sustainability of the monetary union itself. In the face of an adverse asymmetric shock, the former policy tool of a devaluation is of course not available any more. Besides, as stressed by the consensus among economists, and in line with the Tinbergen rule of “one objective-one instrument”, the single monetary policy is committed to maintaining price stability. If it tried to fine-tune the level of economic activity, this would prove inefficient in the medium run since it would undermine the credibility of the monetary authorities and result in inflation premia for all participating countries. For an adversely and asymmetrically shocked country, the advantages of joining the union in terms of monetary efficiency (reduction of transaction costs, benefits of credibility, lower long-term inflation rate, etc) could be offset by the costs in terms of output stabilisation and unemployment.

In the same vein, smaller transition or emerging market economies that decide to unilaterally adopt the currency of an anchor economy, hereafter called “dollarisation” for the sake of simplicity, would be very likely to experience severe downturns in case of adverse asymmetric shocks. Countries usually expect to gain increased discipline or fiscal benefits from dollarisation - and indeed such a move should help to reduce debt servicing costs given that in such countries a high share of public debt is generally denominated in foreign currencies, and to tighten the government’s budget constraint. However, there is neither evidence nor strong theory to suggest that dollarisation will eliminate fiscal problems at a stroke; see Eichengreen (2002). Moreover, there is neither evidence nor undisputed theory that such a unilateral adoption of a strong foreign currency will lead to a smooth harmonisation of business cycles with the anchor economy or bypass the need for in-depth financial sector reform. All in all, there is a high risk of underestimating the necessary reforms to be undertaken before any move towards relinquishing the domestic currency. The consequences of a short-sighted approach in this regard would be all the more painful since, unlike in the case of a multilaterally agreed RCA, the small dollarised economy would in no way be able to influence the definition of the anchor area’s monetary policy.

### **The European case**

Turning back to the European experience, what can we say about the fulfilment of OCA criteria and Europe’s ability to contend with asymmetric shocks?

Until recent years, a common assertion by some economists was that Europe was too heterogeneous a geographical area to form a well functioning monetary area. Labour mobility within the euro area is indeed usually described as low and European labour markets as more rigid than, for example, that of the United States.

Yet the case for the sustainability of EMU in the long run is supported by the evidence of a high degree of trade integration among participating economies, the diversification in consumption and production of those economies and the achievement of a long nominal convergence process. Also, the correlation of business cycles in the euro area does not seem to be significantly inferior to the corresponding correlation between regions of the USA, as pointed out by Mihov (2001). This holds even though the observed long-run real convergence process between European economies, as measured by the series of intra-area standard deviations of annual output growth rates, has tended to slow since 1997; see Jaillet and Pfister (2002).

Furthermore, account must be taken of the fact that the main OCA criteria are partly endogenous. As Frankel and Rose (1998) put it, “more integration can be expected to lead to more trade and more international trade will result in more highly correlated business cycles”. Of course, such a case for monetary unions is not undisputed. In a famous paper, Krugman (1993) put forward an opposing view inspired by international economics, where decreasing transaction costs brought about by the peg lead to increased industrial specialisation and finally to a greater probability of destabilising

asymmetric shocks. This theoretical case against the sustainability of RCAs does not, however, seem appropriate for the European context, where intra-industry trade largely dominates intra-EMU trade, with a share, for example, of 70% in France, 67% in Germany and 54% in Italy, making Krugman's disintegrating specialisation process most unlikely. To conclude with the European case:

- The fact that the process might be partly “endogenous” does not mean that practical convergence criteria should not be considered as binding for joining the single currency area. As a matter of fact, the so-called Maastricht criteria are now part of the “acquis communautaire” for EMU. Those are “nominal”, rather than “real”, criteria but the “endogeneity” of the process means that the critical OCA conditions (eg labour mobility) may be progressively fulfilled, even if not totally ex ante.
- The probability of large asymmetric shocks endangering EMU is relatively low. The need for a single fiscal policy in the euro area, in order to prevent the occurrence of asymmetric shocks, should as a consequence not be overstated, although this does not mean that there is no need for close coordination, permanent vigilance and peer pressure in this area.
- Indeed, in the absence of a significant federal budget at the European Union level,<sup>3</sup> the very important tasks of stabilising output in face of area-wide output shocks and maintaining an adequate level of fiscal discipline lie with national economic policies, with strong coordination provided at the European level. This coordination is essential for several reasons, including the following:
  - A common budgetary response may be needed to dampen symmetric shocks that could affect the euro area as a whole.
  - The enforcement of multilateral surveillance and strict discipline of national economic policies - especially fiscal policies - also appears crucial to prevent “free rider” national behaviours, where excessive deficits in one country lead to increased risk premia on long-term interest rates for all countries. This is all the more important given that financial markets are slow to discriminate correctly between the different credit risks of sovereigns, including within EMU. Also, sound fiscal policies need to be conducted, over the medium term, in order to reload the “fiscal gun” during upward periods of the growth cycle and to build room for automatic stabilisers to play their role, if need be, during downward periods.
  - A consistent policy mix is in any case required at the euro area level as it is in any other economy. If the required surveillance and coordination fail to define the appropriate fiscal element of this mix, to accompany the monetary policy defined independently by the Eurosystem, then the union will face a host of threats. These could include the risk of “overburdening” monetary policy, or the risk that an opaque policy mix could be sanctioned by market operators and undermine the international credibility of the single currency.

How does this surveillance and coordination work in practice? The conduct of fiscal policies within EMU is fully decentralised, reflecting the still large differences among member states in national preferences with regard to both revenue and spending and reflecting also the fact that important public goods such as social security, health and education are provided at the national level. Against this background, the framework for the conduct of fiscal policies has nevertheless to be designed in order to minimise the risk of negative spillovers from inadequate fiscal policies in some of the participating countries. As an answer, appropriate forms of policy coordination, such as ex ante agreements on common rules and objectives that serve as guidelines for national policies, have to be created.

The present coordination framework of fiscal policies within EMU establishes, on the basis of the Maastricht Treaty provisions, a regime which could be best described as one of “constrained flexibility”; see ECB (2001b). The provisions for ex ante commitments are enshrined in the Maastricht Treaty. “Sound public finances” are put forward as a guiding principle (Article 4), which is consistent with the prohibition of monetary financing of public deficits and the existence of an explicit “no bail out”

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<sup>3</sup> The revenues raised at national levels for supranational activities of the European Union may not exceed 1.27% of member states' GDP.

clause (stipulating that neither the European Union nor the other member states shall be liable for the commitments of a member state). Most importantly, the Treaty contains an obligation to avoid “excessive deficits” (Article 104). This constraint has been complemented by the Stability and Growth Pact (SGP), which stipulates quantifiable debt and deficit rules and thus provides a clear policy orientation to the budgetary authorities in the member states.

Against the backdrop of such commitments, the member states have also developed a network of multilateral procedures and use a number of important policy instruments. Among these, the Broad Economic Policy Guidelines constitute the main instrument designed to facilitate the coordination of economic policies at EU level (apart from monetary policy, of course, thus respecting the independence of the ECB). By setting, annually, the common standard for various fields of possible public intervention, including public finances, taxation and labour market regulation, against which subsequent policy decisions at the national level have to be assessed, the Guidelines pave the way for a kind of “soft” coordination (see ECB (2001b)), which relies mainly on “peer pressure” to galvanise governments into appropriate policy actions. The procedure appears to be soft, but is effective. Even in the absence of strong enforcement procedures, the strength of the ex ante commitments serving as a cement for monetary union, combined with the fact that the Guidelines are endorsed by the heads of state or government of the member states, endows the proposed orientations with substantial political weight.

### **The CFA franc zone**

The case of the CFA franc zone is worth describing briefly in this context, since both similarities and differences with EMU are instructive. One of the major similarities is the progressive deepening and widening of regional integration. A major difference lies in the reverse order of integration: from economic integration to monetary union in the European Union; vice versa in the CFA franc zone.

The CFA franc zone, as well as its two main sub-components, the two monetary unions of WAEMU for Western African States and CAEMC for Central African States, are clearly not OCAs in the full economic meaning of the term. In particular, in the absence of any regional budget, member economies of each union are exposed to potential external asymmetric shocks, due to the export specialisation of many of the countries in raw commodities (including oil), and also to the effects of climatic conditions on agriculture, in particular in the Sahelian countries.

Also, living standards across both regions are very heterogeneous, especially within the CAEMC. Across the whole CFA franc zone, GDP per capita, for instance, ranges from a factor of one to 24. Admittedly, labour mobility is relatively significant (the foreign population can be high - in Côte d’Ivoire it is 27%, mainly employed in cocoa fields) and has benefited from recent reforms such as the introduction of regional passports. However, regional labour mobility remains hindered, inter alia, by poor transport infrastructures. Commercial integration remains low by EMU standards, even though official figures are likely to be underestimated, given the significant role of unofficial trade in these areas (official intraregional trade accounts for only 6% of total official trade in the CAEMC and around 12% in the WAEMU). Last, financial integration remains weak, as suggested for instance by the low share of international transactions in interbank relations.

Nevertheless, the CFA franc zone monetary unions have functioned properly thanks to the effects of the CFA franc zone mechanisms, which provide a favourable framework for enhancing regional integration and economic development (see Box 2 on the following page for details about those mechanisms). There has also been a strong political will over recent years to foster regional integration. Indeed, African CFA franc zone countries have achieved further progress in recent years despite a testing political and economic environment, to the extent that the CFA franc zone stands at the forefront of regional integration efforts in Africa. New institutions have been set up and community regulations have been adopted in the form of directives, in particular to speed up the introduction of customs unions. Thus, the customs union in the WAEMU has been in effect since January 2000, together with the introduction of a common external tariff and the removal of customs duties on intraregional trade. A similar process is ongoing in the CAEMC. In order to maximise the benefits of customs unions, both regions have pursued their efforts at tax harmonisation, leading to the introduction of a harmonised value added tax in each sub-area. In the legal field, which is widely recognised as crucial for development, business law is now governed by a common treaty, and the WAEMU and CAEMC countries have set up (like the European Union) a Court of Justice in each sub-area. In addition, in accordance with the CFA franc zone agreements, both monetary unions have



set up regional exchange regulations that also support financial integration by lifting all restrictions on current transactions, in line with Article VIII of the IMF's statutes.

As regards the convergence of economic policies, both sub-areas have implemented a macroeconomic stability pact based on multilateral surveillance and convergence criteria rather similar to the euro area framework. The WAEMU introduced a Convergence, Stability, Growth and Solidarity Pact in December 1999 while the CAEMC adopted four new convergence criteria in 2001 which are identical to the top four criteria embedded in the WAEMU Convergence Pact, namely:

- a zero or positive budget balance by 2002;
- a public debt/GDP ratio of below 70%;
- overdue payments to be settled by 2002 for the WAEMU and by 2004 for the CAEMC;
- an inflation rate to be maintained below 3% per year.

Finally, as in the euro area, multilateral surveillance has been reinforced by a commitment to medium-term stability programmes. These efforts have enhanced budgetary policy coordination and added credibility to the CFA-euro peg. In the near future, one of the major challenges facing regional integration policies will be the formulation and implementation of sectoral policies and structural projects to foster more balanced development across the various economic sectors and across the various member states of the unions, with a view to increasing the benefits of monetary union.

#### Box 2

##### **Some stabilising features of the CFA franc zone mechanisms**

The smooth functioning of the supranational central banks (the BCEAO and BEAC) is a first indicator suggesting that both monetary unions have worked properly. These central banks have been able to deliver their objective of maintaining price stability. From 1996 to 2001, inflation averaged about 3% in both areas, compared with 15% in Africa as a whole. This performance can be attributed first and foremost to the nominal pegging of the CFA franc to the French franc, and since 1999 to the euro, as African CFA franc zone countries conduct around half of their foreign trade with the euro area. The vigilant monetary policies conducted by the CFA franc zone central banks lend credibility to this pegging and contribute to its sustainability, as the BCEAO and the BEAC pursue policies aimed at maintaining the internal and external value of their currency. The sound pegging of the CFA franc to the euro is also the fruit of multilateral surveillance of national policies (see Section 3 in the text). In addition, the convertibility of the CFA franc is backed by a foreign partner: the French Treasury (a key and noteworthy difference between the EMU and the CFA franc zone, of course).

CFA franc zone mechanisms have played an essential stabilising role in the area. First, solidarity between member states, via the pooling of all foreign exchange reserves in each issuing area, contributes to encouraging a more rigorous management of public finances. Second, the principle of free transferability within the area facilitates economic and monetary trade flows and tends to increasingly support investment. Thus, overseas direct investment in CFA countries averaged 5% of the total in sub-Saharan Africa over 1985-91, 8% over 1992-99 and 12% in 2000. Moreover, monetary policy, though based on single regional currencies and official interest rates, is implemented through effective decentralised procedures, in order to take into account specific national economic features and facilitate the absorption of potential asymmetric external shocks. Finally, it can be noted that even though all member states have defaulted on their external debt in the past, the sharing of sovereignty in monetary and exchange rate policies has prevented participating countries from experiencing exchange rate crises.

It should be added that the assertion that the CFA franc zone mechanisms have delayed the process of financial integration and rerouted financial links through Paris is unconvincing and not supported by any evidence. Rather, a look at countries neighbouring the CFA franc zone shows that their own degree of financial integration is lower, not higher. Furthermore, although not optimal, the degree of financial integration of CFA franc zone countries benefits from the favourable zone framework (for instance, regional exchange regulations, lifting of all restrictions to current transactions between members, common Treaty business law, common stock exchanges, etc). Finally, what is needed to further financial integration is a reduction in some divergences in market practices and, as elsewhere in Africa, solutions to the persistent lack of infrastructure.

#### **4. Financial stability issues: RCAs and systemic risks**

The creation of a new currency union requires that a series of technical issues have been properly addressed in order for the various sources of systemic risk to remain under control and for the central bank to maintain the financial stability of the whole area. Firstly, it is worth recalling that the goal of financial stability is closely linked to the achievement of price stability. If a systemic shock spreads within the financial system, the transmission mechanisms of monetary policy are unable to function effectively. Commonly expected consequences of a systemic shock are excessive interest rate volatility and a surge in risk aversion. Excessive interest rate volatility blurs monetary policy signals, while a surge in risk aversion goes along with shrinking liquidity, and affects the real economy through a wide array of channels.

It goes without saying that any central bank feels concerned with these issues. Yet, they have special importance for an RCA.

- The gradual creation and entry into existence of an RCA may accelerate the consolidation of the banking sector and financial markets.
- While a fully integrated money market is the cornerstone of a regional currency union, it does not necessitate a single financial centre or a unified set of legal or regulatory provisions governing the activity of the financial sector. Indeed, persisting differences in financial systems, as well as the coexistence of several financial centres, should be regarded as a benefit. They sustain competition, innovation, diversity of behaviour, and proximity - both geographical and cultural - thereby extending the benefits of monetary union beyond the achievements of price stability to the overall efficiency of the financing of the economy. However, systemic shocks arising from defaults in the financial sector may also occur in an RCA. On the one hand, such shocks are likely to be better absorbed in an RCA thanks to deeper and more liquid financial markets; on the other, the full integration of the money market and the increase in cross-border flows may magnify spillover effects from one financial centre to another.

Against this background, a framework has to be designed to monitor, and cope with, the risks to financial stability (see Pfister (2000) for a short overview from a central banker's point of view). In this respect, we can distinguish the framework for banking sector stability and supervisory issues from the framework for market integration issues.

#### **Banking sector stability and supervision**

##### ***The euro area***

From the point of view of financial stability, the expected effects of the euro on the financial stability of European banking activities may have been deemed ambiguous. On the one hand, the introduction of the euro, combined with the completion of the single market for financial services, raised reasonable hope that European credit institutions would rapidly benefit from new growth opportunities at a European level. On the other, increased competition and a greater homogenisation of activities may imply in the medium to long run significant downward pressure on margins and provide incentives for riskier behaviour, thus threatening overall stability.

However, it is likely that the ongoing consolidation process at the euro area level will be a fairly progressive one. Such a step by step approach - eg consolidation at the national level, followed by cross-border consolidation of specialised markets like merchant banking, fund management or leasing, and finally pan-European mergers - appears fully consistent with the smooth functioning of a currency area that allows, in a transitional period at least, for residual specificities in national financial markets.

The Eurosystem's ability to face and solve systemic crises in this changing financial environment has been questioned in the past. Two issues are at stake here: the institutional arrangement of prudential supervision and its capacity to prevent the euro area from experiencing any major banking crises, and, if a crisis occurs, the operational efficiency of lender of last resort procedures.

Two remarks may be made to tackle these two issues very briefly. Firstly, the perfect containment of the 11 September 2001 liquidity shock on European banks may supply enough ex post proof that the

fears expressed ex ante about the capacity of the Eurosystem to deal quickly and effectively with major liquidity shocks, in a decentralised but coordinated manner, were largely misplaced.<sup>4</sup> Secondly, as far as banking supervision is concerned, there is a good rationale in terms of efficient use of available information to support both:

- A decentralised system, which is able to “act locally”, ie implement banking supervision rules at the national level, while “thinking globally”, thanks to a constant flow of informational exchanges, mainly within the Banking Supervision Committee of the ECB and various other fora, including the Basel Committee on Banking Supervision and the European Union’s “Groupe de Contact” on banking regulation, and
- A system where banking supervisory responsibilities and the conduct of monetary policy are combined within the national central banks, or at least where close cooperation prevails, as recommended by the ECOFIN “Brouwer report” on financial stability of April 2000. Indeed, information stemming from banking supervision on the one hand, and monetary policy implementation on the other, offer obvious complementarities. Regarding the implementation of monetary policy, credit institutions participating in refinancing operations must comply with precisely defined regulatory and technical guidelines (timeliness and accuracy of reporting for the calculation of minimum reserves, compliance with the procedures regarding bidding and collateral delivery procedures). When a counterpart fails to meet these requirements, it points to possible internal malfunctioning, which acts as an early warning. Moreover, through the monitoring of aspects such as bidding behaviour, use of standing facilities, and user profiles in payment systems, the central bank is in a good position to detect liquidity stress situations. It appears natural that under such circumstances national central banks should play a pivotal role in instigating the relevant exchanges of information with banking supervisors at the national level, and within the “regional” system of central banks, as far as the assessment of the potential impact on money market functioning and the successful implementation of monetary policy is concerned. Thankfully, since the start of EMU, the Bank of France has gained no practical experience in such aspects. Nevertheless, preparatory works conducted to ensure a safe Year 2000 change included a review of potentially more vulnerable subsectors of the financial system. In this context, the relevant informational resources and analytical skills of the Bank of France and the Commission Bancaire were successfully pooled, paving the way for an easy monitoring of counterparties during the few days before and after 31 December 1999.

To sum up the European experience as regards supervision, the following has proven key: a set of sensible principles (proximity, exchange of information, cooperation), appropriate rules (eg the respective responsibilities of home and host countries), implementing texts (eg bilateral or multilateral memoranda of understanding<sup>5</sup>) and relevant bodies or committees where authorities can meet.

### ***The CFA franc zone***

As part of the financial integration process, in the early 1990s, each sub-area of the CFA franc zone set up a single regional supervisory authority, called a “Banking Commission”. There were no local supervisory structures prior to that. These Commissions are in charge of designing the prudential regulations applicable to banks and supervising banks through on-site and off-site inspections. The Banking Commissions, chaired by the governors of the regional central banks, played a key role in the restructuring process carried out in the last decade. By setting up common prudential and accounting standards, the Commissions contributed to achieving a level playing field throughout the RCA and to

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<sup>4</sup> In the Eurosystem, lender of last resort (LLR) responsibilities are well defined and lie mainly with national central banks (NCBs). First, commercial bank accounts are held at NCBs, and commercial banks have a centralised treasury generally at the head office, so liquidity problems arise in practice in the account held by the head office with the NCB concerned. Second, before providing LLR facilities, it is key to assess whether there is a liquidity or a solvency problem (only the former is treated by LLR) and, since supervision is also decentralised (either at the NCBs or close to them), NCBs can quickly assess the situation and potentially take action. Third, the associated costs are borne at the national level (a successful LLR operation has no cost; in the case of solvency problems, the cost of recapitalisation and restructuring operations is borne at the national level, by deposit insurance schemes and/or by the state). Of course, appropriate information is shared with the ECB.

<sup>5</sup> Such as that between Belgium and France on the supervision of Dexia.

consolidating the solvency of both local and regional credit institutions, thus enhancing deposit security and access to credit. However, the degree of banks' compliance with key prudential ratios varies across countries, pointing to a need for enhanced financial integration.

### ***Issues arising from dollarisation***

As far as financial and banking stability is concerned, the risks associated with the unilateral adoption of a foreign currency by a smaller open economy are twofold.

For the banking system of the smaller dollarised economy, the removal of the exchange rate can be viewed as a remedy to the widespread problem of currency mismatches, which is one of the major weaknesses of intermediation in emerging markets. However, dollarisation would drastically limit the freedom with which the central bank can fine-tune liquidity and thus smooth transitory shocks - including liquidity shortages arising from the failure of an individual credit institution - to safeguard financial stability. Thus, it is vital for a country contemplating dollarisation to reform its financial sector in depth, to foster, in particular, the upgrading of banks' internal risk management practices, and to overhaul the prudential supervision and regulation scheme. In any case, this is a long-run undertaking, and there is high risk that the country will dollarise too early in relation to the progress made in reforms.

For the anchor area - usually the United States or the euro area - the main concern would be that the country risk associated with the banking sector of the dollarised economy could spill over to international banking groups headquartered in the United States or the euro area. International banks of the anchor area would indeed have an incentive to increase their exposure to domestic banks or local branches in the dollarised economy, while country risk in that economy would probably not decrease rapidly after the adoption of the foreign currency. There would then be scope for very close cooperation between the prudential supervisors of the home and host countries to prevent a far-reaching weakening of the international credit institutions of the home country.

### **Financial market integration**

As mentioned above, financial market integration was identified very early in the academic literature on OCAs as an important factor that may contribute in the long run to the success of an RCA. Financial integration helps to reduce the need for exchange rate adjustments insofar as, for instance, it makes it possible to cushion temporary adverse disturbances through capital inflows. McKinnon (2001) reformulated this statement more recently, positing that countries sharing a single currency can dampen the effects of asymmetric shocks among them through adjustments in their wealth portfolio that result in a diversification of their income sources. Private financial markets, as well as common fiscal instruments, may thus provide a kind of insurance provision against asymmetric adverse shocks that would otherwise endanger the integrity of the RCA.

Conversely, the creation of an RCA and the consequent removal of exchange rate risk between the residents of different participating countries provide an obvious incentive for a rapid and deep integration of the various domestic financial markets. Integrated markets at the level of the RCA permit debtors to broaden their investor base and reduce their issuance costs, while investors may benefit from more liquid, deep and complete market segments.

However, two main factors might impede this self-reinforcing process of market integration and RCA consolidation. Firstly, the speed of the integration process is very likely to differ from one segment to another: the money market may integrate rapidly, while the integration of longer-term securities and equities might hinge on the speed of legal harmonisation, such as for instance the full harmonisation of repo markets. Secondly, the process of financial market integration may well enhance the efficiency of financial markets in the RCA, but it may at the same time translate into more risks of contagion of local shocks across the whole area. Such risks can nevertheless be addressed properly in the context of an RCA, thanks to the diversity of market participants and the enhanced resilience of market liquidity in the face of adverse shocks.

### ***The euro area***

As expected, since 1999 the introduction of the euro has triggered a remarkable process of integration of financial markets among member states. This process is almost complete in the market for short-term debt (monetary instruments) and is already well advanced in the bond markets, as shown by the

upsurge in issuance activity, notably in the corporate debt segment, and by the number of very large bond issues targeted at an enlarged basis of European institutional investors. Last but not least, this process has gathered pace in the equities markets thanks to the ongoing restructuring of the main European stock exchanges (eg Euronext, which groups together the exchanges of Paris, Amsterdam, Brussels and Lisbon plus the United Kingdom's LIFFE). The European financial markets are rapidly converging towards an integrated model, while the banking system still remains rather fragmented.

Furthermore, the recent Lamfalussy Report, which was prepared following a request by ECOFIN in July 2000, has paved the way for sound regulation aiming at simultaneously enhancing the development and the stability of the European securities markets. In this report of the Committee of Wise Men on the regulation of European securities markets, a four-level approach was proposed, with a view to making EU securities legislation more flexible and effective: for a detailed presentation, see ECB (2002). As a consequence of the recommendations formulated in this report, two committees have been established: the European Securities Committee, entrusted with the task of quickly adopting technical provisions to EU Regulations regarding securities markets, and the Committee of European Securities Regulators, entrusted with the task of ensuring effective cooperation between supervisory authorities, promoting best practices and carrying out peer reviews. A full review of this regulatory structure will be carried out in 2004.

### ***The CFA franc zone***

In the CFA franc zone, financial integration took place with the creation of the WAEMU regional stock exchange in Abidjan in 1998. A similar plan was devised for the CAEMC in 2001. CFA franc zone stock markets are to play an important role in financing regional economies, in particular in channelling domestic savings and foreign capital towards productive investment. Indeed, there is a substantial need for long-term resources for firms, in particular given the opportunities for privatisation and the expected development of the public debt market. These financing needs can only be met at a regional level.

## **5. Conclusion**

The EU experience is different from that of the CFA franc zone. Neither one nor the other is a blueprint for regional integration that can be applied directly and entirely to other regions. Nevertheless, as a conclusion, some tentative lessons can be drawn for others. In this respect, it should be emphasised that:

- A successful regional integration is the result of a long, gradual process, which includes monetary policy and also other economic policy aspects. The success of regional monetary integration, as in the European Union, depends on a number of key policy areas: improving efficiency in resource allocation through the development of competitive, market-based economies, macroeconomic policies geared towards stability and redistribution mechanisms to help less developed member states catch up.
- It has to be supported by a strong economic and political will, which implies the pooling or the partial transfer of national sovereignty to supranational entities. This pooling/transfer is itself dependent on a broader political will and project.
- Regional integration does not mean more freedom to define the role of monetary policy. Monetary policy in an RCA should still focus on the primary objective of price stability. Provided this condition is fulfilled, regional integration does not entail additional risks regarding price stability.
- Insofar as the creation of a currency area may foster financial market integration and increased competition in the banking sector, appropriate cooperation schemes among supervisors have to be developed and harmonised market regulations put in place in order for systemic risks to remain subdued.

In any case, time is what is required, if only to allow (i) for the proper development of an appropriate and credible institutional framework and strong "stability" culture for decision-making and (ii) for the achievement of a sufficient level of economic integration.

## Annex 1: A brief chronology of European economic and monetary union<sup>6</sup>

**1951:** Treaty of Paris: *integration of coal and steel markets*; establishment of federal institutions (parliament, high court and the precursor of the commission).

**1958:** Treaty of Rome: *integration of all goods markets, creation of customs union*; strengthening of institutions; **creation of the Monetary Committee; obligation to consider exchange rate policies as a matter of common concern.**

**1964:** **Creation of the Committee of Governors** of the central banks of the European Economic Community.

**1971:** Adoption of **Werner Plan** fixing the objective of EMU for 1980 (a deadline later abandoned due to the differing reaction of member states to the oil shocks and the collapse of the Bretton Woods system).

**1972:** “Snake” agreement limiting intra-EEC exchange rate fluctuations.

**1973:** Creation of the **European Monetary Co-operation Fund.**

**1979:** Creation of the **European Monetary System.**

**1987:** Single Act: *objective of single market* (goods, capital, services) by 1993, further strengthening of institutions.

**1989:** **Delors report on EMU approved.**

**1990:** Beginning of “**first stage of EMU**”: strengthened economic coordination, increased cooperation between central banks.

**1992:** Maastricht Treaty: widening of EU competencies, **objective of single currency by 1999**, further strengthening of institutions.

**1993:** Single market achieved.

**1994:** “**Second Stage of EMU**”: the **European Monetary Institute**, precursor of the ECB, replaces the Committee of Governors.

**1997:** Amsterdam Treaty: further strengthening of institutions.

**1997:** Adoption of the *Growth and Stability Pact* (implementation of Treaty obligations on fiscal coordination).

**1998:** Selection of the **first 11 countries** to join the euro area according to Maastricht criteria.

**1999:** “**Third stage (fully fledged) of EMU**”: creation of the euro, irrevocable fixing of parities, entry into function of the ECB/Eurosystem.

**2000:** *Common strategy for employment and structural reforms.*

**2000:** Treaty of Nice: further strengthening of institutions, adjustments in preparation for further enlargement.

**2001:** Greece becomes **12th member of EMU** after having met the criteria.

**2002:** **Introduction of euro banknotes and coins, withdrawal of national banknotes and coins.**

NB. Alongside these developments leading to the deepening of the integration process, the European Union was gradually enlarged from six countries (1951) to nine (1973), 12 (1986) and finally 15 (1995).

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<sup>6</sup> Economic developments are shown in *italics* and monetary developments in **bold**.

## **Annex 2: A brief chronology of the CFA franc zone**

### **The colonial period**

**1939:** Creation of the CFA franc zone.

**1945:** Creation of the CFA franc, pegged at 0.02 French franc.

**1951:** Creation of the Monetary Committee of the CFA franc zone: follow-up of monetary relations and coordination with local central banks.

### **Following independence**

#### ***West African Economic and Monetary Union***<sup>7</sup>

**1959:** Creation of the BCEAO, in charge of issuing the “Franc de la Communauté financière africaine” (or CFA franc), parity unchanged at 0.02 French franc.

**1962:** Treaty establishing West African Monetary Union.

**1962:** First monetary cooperation agreement between West African Monetary Union and France.

**1973:** Treaty consolidating West African Monetary Union.

**1973:** Cooperation agreement between the Republic of France and the members of West African Monetary Union (currently in force).

**1994:** 50% devaluation of the CFA franc to 0.01 French franc.

**1994:** Treaty establishing West African Economic and Monetary Union: deepening of economic integration.

#### ***Central African Economic and Monetary Community***<sup>8</sup>

**1959:** Creation of the BEAC, in charge of issuing the “Franc de la Coopération financière en Afrique centrale” (or CFA franc), parity unchanged at 0.02 French franc.

**1972:** Cooperation agreement between the Republic of France and the Member States of the BEAC (currently in force).

**1994:** 50% devaluation of the CFA franc to 0.01 French franc.

**1994:** Treaty establishing the Central African Economic and Monetary Community: deepening of economic integration.

### **The substitution of the euro for the French franc**

**1998:** The European Union Council decision of 23 November 1998 states that after the substitution of the euro for the French franc, France may continue its present agreements concerning exchange rate matters with the WAEMU and CAEMC.

**1999:** The CFA franc is pegged to the euro (1 euro = 655.957 CFA francs).

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<sup>7</sup> Benin, Burkina Faso, Guinea Bissau (since 1997), Côte d'Ivoire, Mali, Niger, Senegal and Togo.

<sup>8</sup> Cameroon, the Central African Republic, Chad, Congo, Equatorial Guinea (since 1985) and Gabon.

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