THEORY OF OPTIMUM CURRENCY AREA

The economic theory examining the necessary and desirable characteristics of countries' economies for membership in a monetary union is the theory of the Optimum Currency Area (OCA). *Optimum Currency Area* theory states that there are regions, not bounded by national borders, that should share a common currency.

In 1961, Canadian economist Robert Mundell published his theory of the OCA. He outlined the criteria necessary for a region to qualify as an OCA and benefit from a common currency. OCA theory by Canadian economist Robert Mundell was based on earlier work by Abba Lerner. OCA theory posits that implementing currencies by geographic and geopolitical region instead of by country leads to greater economic efficiency.

Optimum currency area theory (OCA) states that specific areas not bounded by national borders would benefit from a common currency. In other words, geographic regions may be better off using the same currency instead of each country within that geographic region using its own currency. The optimum currency area can be defined as the geographical area that would maximize economic benefits by keeping the exchange rate fixed within the area.

An optimum currency area (OCA) is the geographic area in which a single currency would create the greatest economic benefit. While traditionally each country has maintained its own separate national currency, work by Robert Mundell in the 1960s theorized that this might not be the most efficient economic arrangement.

An optimum currency area (OCA) is also defined as the optimal geographic domain of a single currency, or of several currencies, whose exchange rates are irrevocably pegged and might be unified. The single currency, or the pegged currencies, can fluctuate only in unison against the rest of the world.

An optimal currency area (OCA) can also be defined as the geopolitical area over which a single, unified currency will provide the best balance of economies of scale to a currency and effectiveness of macroeconomic policy to promote growth and stability. Economist Robert Mundell first outlined criteria for an OCA, which are based on the degree of integration and similarity between economies. The US and euro are an example of an application of an OCA.

The main features of OCA

- **High labor mobility throughout the area.** Easing labor mobility includes lowering administrative barriers such as visa-free travel, cultural barriers such as different languages, and institutional barriers such as restrictions on remittance of pensions or government benefits. For instance, the Schengen Area is an area comprising 27 European countries that have officially abolished all passport and all other types of border control at their mutual borders. A Schengen visa is a short-stay visa that allows a person to travel to any member of the Schengen Area, per stay up to 90 days for tourism or business purposes. The Schengen visa is the most common visa for Europe.
- **Capital mobility and price and wage flexibility.** This ensures that capital and labor will flow between countries in the OCA according to the market forces of supply and demand to distribute the impact of economic shocks.
- **A currency risk-sharing or fiscal mechanism to share risk across countries in the OCA.** This requires the transfer of money to regions experiencing economic difficulties from countries with surpluses, which may prove politically unpopular in higher-performing regions from which tax revenue will be transferred. The European sovereign debt crisis of 2009–2015 is considered evidence of the failure of the European Economic and Monetary Union (EMU) to satisfy these criteria as original EMU policy instituted a no-bailout clause, which soon became evident as unsustainable.
- **Similar business cycles/ similarities between economies.** Cyclical ups and downs that are synchronous, or at least highly correlated, across countries in the OCA are necessary since the OCA's central bank will by definition be implementing a uniform monetary policy across the OCA to offset economic recessions and contain inflation. Asynchronous cycles would unavoidably mean that a uniform monetary policy will end up being counter-cyclical for some countries and pro-cyclical in others.
- **Economic openness, diversification in production and consumption, similarity in inflation rates, fiscal integration and political integration**.
  The diversification in production and consumption. A high diversification in production and consumption, i.e., in the "portfolio of jobs", and correspondingly in imports and exports, dilutes the possible impact of shocks specific to any particular sector. Economic shock is an unexpected or unpredicted event that affects the fundamental factors of production. E.g. droughts, changes in oil supply, hurricanes, wars and technological changes.

The costs of OCA

Critics have pointed out certain costs of the optimum currency area.

- ✓ **Firstly, each member nation cannot pursue independent stabilization, growth and other policies which it deems appropriate in its special conditions.** Have centralized fiscal and monetary policies that control them all as OCA members. Corden (1972) points out that forming a currency area with a group of partner countries entails a loss of direct control over the national monetary policy and the exchange rate. Asymmetrical shocks. At times economic conditions vary and may not affect all sectors/ regions uniformly. At times a single monetary policy may not fit local economic conditions. It is common for parts of the EU to be prospering, with high growth and low unemployment. In contrast, others suffer from prolonged economic downturns and high unemployment.
- ✓ **Membership in a currency area narrows the menu of policy instruments directly available to national governments.** As the responsibility for setting monetary policy and exchange rates is transferred to a supranational central bank, no country can pursue some real adjustment in the wake of asymmetric disturbances.
- ✓ **There are changeover costs from switching to a new currency. These** costs include administrative, legal and hardware costs such as re-denominating contracts and adapting vending machines
- ✓ **Costs from negative external effects.** If one, or more, member countries were to run sizeable and protracted budget deficits, accumulating an unsustainable public debt, eventually some pecuniary externalities might ripple through the currency area. For example, the fear could rise that such debt might have to be monetised. This might pose a strain on the interest rate of the currency union. International confidence in the single currency may even plummet. Every member country would suffer in this scenario, particularly those that previously had stable currencies.

The Benefits of OCA

- Firstly, the formation of a currency area eliminates the uncertainty that often results from continuously changing exchange rates
- Foreign Reserves. Member countries do not have to hold reserves of other member countries' currencies.
- If the monetary union is a large, successful, and stable economic entity, then its currency is likely to become an international medium of exchange—a dominant currency.
- This makes it easier and cheaper for the union to sell its debt in foreign markets.
- Foreign banks will hold its currency in reserve.

- The union may also contribute to price stability for its members, encouraging long-term commitment of resources by the public, and providing clearer economic signals to market participants.

- Secondly, the optimum currency area promotes flow of trade and investments among the member countries due to greater mobility of factors of production (labor and capital) across countries and lower investment risks.
- Reduced transaction costs –Labor costs, bank charges, exchange rate costs enhance resource allocation (see Appendix 1 for a more extensive discussion). Other benefits will result from more transparent and deeper financial markets, savings on transaction costs, and a wider international circulation of the single currency.
- Greater transparency and possibly greater competition because prices are easier to compare. (Krugman, 2012) .More competition results in lower prices and greater innovation, in turn leading to newer and better products and services for consumers.
- Currency risk sharing leading to more symmetric shocks across countries. If the shock is symmetrical, it will affect all regions/ sectors equally. Countries sharing a single currency can mitigate the effects of asymmetric shocks among them through the diversification of their income sources and by pooling their foreign exchange reserves.
- Greater flexibility in wages and prices among the countries of the union

THE THEORY OF CUSTOM UNION (CU)

Customs Union Theory

The customs union theory was established by Jacob Viner (1950) in his book, ''The Customs Union Issue'' which was published in 1950. The main objective of the customs union theory is to clearly distinguish between the terms trade creation which is welfare improving and trade diversion which is welfare deteriorating. Trade creation and Trade diversion are effects that occur in the customs union.

A Customs Union is defined by Strielkowsiki (2013) as a group of countries that trade together without trade barriers of tariffs and quotas. Customs Unions involves the elimination of tariffs on imports from member countries. Countries in a customs union adopt a common external tariff (CET). Oslington (2013) noted that customs unions is an arrangement between countries to reduce tariff barriers and maintaining barriers against imports from outside regions. Examples of customs unions are Andea Community formed in 1988, The East African Community Customs Union established in 2005, South African Customs Union established in 1910 and is the oldest customs union still existing.

As a way of assessing the effects of countries joining a customs union, Viner (1950) defined the terms trade creation and trade diversion. According to Akram and Rashid (2016), trade creation will increase welfare, whereas trade diversion will reduce welfare. Trade creation does improve economic efficiency because the partner country produces at a lower cost compared to the domestic producers whereas trade diversion is said to reduce welfare and is also detrimental because the importing country might not necessarily have the best choice of imports due to price discrimination against the third country product.

The customs union in the EAC has been in force since 2005 as stated in article 75 of the treaty establishing the East African Community. The countries agreed to establish a free trade or zero duty imposed on goods and services within themselves but agreed on a common external tariff meaning that imports from third countries, those are countries outside the EAC zone are subject to the same tariff when sold to an EAC partner state (EAC Members, 2013). The customs union was a great achievement for the EAC as the bloc was able to move to the Common Market where it now stands awaiting to join the Monetary Union in 2024.

Although the customs union theory received recognition as an economic integration theory, a few criticisms were raised. Lipsey (1957) stated that Viner's insight in the customs union theory was merely a special case of his general theorem of second best. Furthermore, the customs union theory was based on simplified assumptions of fixed proportions in consumption and constant costs in production. Besides, customs unions are based on a principle of geographical discrimination.

A customs union is an agreement between two or more neighboring countries to remove trade barriers, reduce or abolish customs duty and eliminate quotas. Such unions were defined by the General Agreement on Tariffs and Trade (GATT) and are the third stage of economic integration.

The purpose of a customs union is to make it easier for member countries to trade freely with each other. The union reduces the administrative and financial burden of barrier trading and fosters economic cooperation among nations.

However, member countries are not given the freedom to form their own trade deals. The countries in the customs union usually restructure their domestic economy and economic policies in order to maximize their gain from membership in the union.

Essential features of a customs union:

- Elimination of tariffs on imports from member countries
- Adoption of a common external tariff on imports from the rest of the world
- Apportionment of customs revenue according to an agreed formula

Basic Assumptions:

- Perfect competition in commodity and factor markets
- Factor mobility within countries but not between them
- No transportation costs
- Tariffs are the only form of trade restrictions; they are assumed to be spesific
- Prices reflect the opportunity costs of production
- Trade is balanaced
- Resources are fully employed

Orthodox theory analyses the effects of CU on resource allocation in terms of trade creation and trade diversion.

- Trade Creation: Union-induced shift from the consumption of higher-cost domestic products in favour of lower-cost products of the partner country.
    - Production effect: The reduction or elimination of the domestic production of goods, instead being imported from the partner country.
    - Consumption effect: Increased consumption of partner-country substitutes for domestic goods that were formerly satisfied at a higher cost.

- Trade Diversion: Union-induced shift in the source of imports from lower-cost external sources to higher-cost partner sources.
    - An increase in the cost of the goods previously imported from abroad.
    - A loss of consumers' surplus resulting from the substitution of higher cost partner goods for lower cost foreign goods.

Advantages of Custom Unions

Customs unions offer the following benefits:

1. Increase in trade flows and economic integration

The main effect of a free-trade agreement is that it increases trade between member countries. It helps improve the allocation of scarce resources that satisfy the wants and needs of consumers and boosts Foreign Direct Investment (FDI). Customs unions lead to better economic integration and political cooperation between nations and the creation of a common market, monetary union, and fiscal union.

2. Trade creation and trade diversion

The effectiveness of a customs union is measured in terms of trade creation and trade diversion. Trade creation occurs when the more efficient members of the union sell to less efficient members, leading to a better allocation of resources.Trade diversion occurs when efficient non-member countries sell fewer goods to member countries because of external tariffs. It gives less efficient countries in the union the opportunity to capitalize on their position and sell more goods within the union.

3. Reduces trade deflection

One of the main reasons a customs union is favored over a free trade agreement is because the former solves the problem of trade deflection. This occurs when a non-member country sells its goods to a low-tariff FTA (free trade agreement) country, which then resells to a high-tariff FTA country, leading to trade distortions. The presence of a common extern

al tariff in customs unions helps avoid problems that arise from tariff differentials.

Disadvantages of Customs Unions

Along with the advantages, customs unions also come with a few drawbacks:

1. Loss of economic sovereignty

Members of a customs union are required to negotiate with non-member countries and organizations such as the WTO. This is necessary to maintain a customs union; however, it also means that individual member countries are not free to negotiate their own deals. If a country wants to protect an infant industry in its market, it is unable to do so by imposing tariffs or other protective barriers due to the liberal trading policies. Similarly, if a country wants to liberalize its trade outside the union, it is unable to do this due to the common external tariff.

2. Distribution of tariff revenues

Some countries in the union do not receive a fair share of tariff revenues. This is common among countries like the UK that trade relatively more with countries outside the union. Around 20%-25% of the tariff revenue is retained by the member who collects the revenue. It is estimated that the cost of collecting this revenue exceeds the actual revenue collected. Tax collected is diverted to a revenue pool and then distributed amongst members based on their GDP

3. Complexity of setting the tariff rate

A common problem faced by customs unions is the complexity of setting the applicable tariff rate. The process is very costly and time-consuming. Member countries often find it hard to forgo the trade of certain goods or services because another country in the union is producing it more efficiently.

In conclusion therefore, the establishment of customs unions is beneficial to economies in the long term. It helps small economies tap industries that may not have been accessible with domestic trade only. They can achieve large external economies of scale within the union from transport and infrastructure. Faced with competition from other economies, domestic markets will be more inclined to increase efficiency. Customs unions help foster growth and unite economies with liberal trade policies.