

# The Role of Single currency for Countries Economic Development: a Case Study of the East African Community

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**Abstract** Ever since the re-introduction of the Eastern Africa Community (EAC), there has been a clamor for the introduction of a single currency. This is because the effect of multiple currencies in cross-border transaction has led to the increase of the value of goods and services. Just like some countries within the European Union have some. In as much as it may be the ideal, there is a need to make a critical feasibility study so as to determine the role of single currency to drive economic development of EAC. Single currency will serve as means of payment for cross border trade and payments, familiarize the public with the benefits of monetary integration, and would encourage coordination of EAC monetary policies. The study was centered around one research question; what is the role of single currency for economic development in EAC? The study was based in Arusha city the headquarter of EAC. The study revealed that majority of respondents have high knowledge of the factors that encourage the EAC member countries to seek for the adoption for single currency for economic development These factors include and not exhaustive: enhancing currency stability, reduction of financial risks, reduction of transaction cost, reduction of exchange rate fluctuation, enhancing price transparency and reduction of inflation that impact on trade within the region. The study shows that for the effective integration to take place: there is a need to explore several monetary union models, make a design of the integration process, and put into place a mechanism of implementing the monetary integration in a gradual manner.

**Key words** Single currency, enhancing currency stability, reduction of financial risks, reduction of transaction cost, reduction of exchange rate fluctuation, enhancing price transparency and reduction of inflation

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## 1. Introduction

The East African Community (EAC) comprises of five countries: Burundi, Kenya, Rwanda, Tanzania, and Uganda. It is time of progress that the EAC to achieve and contemplate its future challenges (Davoodi, 2012). Ever since the re-introduction of the EAC, there has been a clamor for the introduction of a single currency. This is because the effect of multiple currencies in cross-border transaction has led to the increase of the value of goods and services. Just like some countries within the European Union; the EAC countries are currently considering adoption of a single monetary unit. In as much as it may be the ideal, there is a need to make a critical feasibility study so as to determine its role for economic development.

Maritz (2011) provide evidence that one of Africa's biggest problems is the balkanization of the continent. The problem is that many of these countries are landlocked and face issues reaching international markets. Many of these countries are also very small. Regarding services there are still a number of services sectors that are closed or limited. Further he states that the EAC political discussions around the nature of the monetary authority as well as the institutions that are required for a monetary union are going to be quite challenging.

Based on the theory of an optimum currency area, East Africa could be quite suitable for a common currency if one looks at the nature of supply shocks that the region faces. The region is furthermore relatively homogenous, which implies that there are limited cultural barriers to free movement.

At the question on the role of adopting single currency there are factors that will be consider for economic development such as: enhancing currency stability, reduction of financial risks, reduction of transaction cost, reduction of exchange rate fluctuation, enhancing price transparency and reduction of inflation that impact on trade within the region.

### **Research Question**

The study is centered around one research question; what is the role of single currency for EAC member states economic development?

## **2. Literature Review**

### **2.1. Enhancing Currency Stability**

Countries that have more synchronized business cycles can benefit more from joining a currency union. It is more likely, though, that at least the currency union does not hinder further financial integration among member countries (Lee *et al.*, 2002). Historically common currencies have generally followed political unification (Rasheed *et. al.*, 2007). The role of a monetary union is the enhancement of foreign trade, which then leads to a faster economic development (Carmen, n.d.), and macroeconomic stability (Maritz, 2011).

While it might be most advantageous for countries to trade in their own currencies to reduce uncertainty over export (import) receipts (payments) for efficient outcome (International Monetary Fund, 2011), the euro was created because a single currency offers many advantages and benefits not only for fluctuation risks and exchange costs but also for closer co-operation for a stable currency and economy (European Commission, 2013).

The scale of single currency for the euro area brings new opportunities in the global economy. A single currency makes the euro area an attractive region to do business, promoting trade and investment (European Commission, 2013). According to Strickler (2012) the EAC should continue on its path of unification to bring stability to a region that has a huge growth potential. Working together to reduce the barriers that lie between them can make all members experience growth and prosperity.

The East Africa Economy (2013) report ascertains that monetary union will be a third pillar in the steadily deepening EAC union, following a customs union and a single market. The countries are more likely to satisfy the criteria for entry into a currency union after taking steps toward economic integration than before (Lee *et al.*, 2009). As stated by Ogawa *et al.* (2008) the feasibility of forming a regional monetary union and/or establishing a common currency unit in East Asia has gained a great deal of attention and has been lively debated in recent years. This was confirmed by Rusuhurwa, *et al.* (2012) that visible symbol of the region commitment to monetary union is a basket of existing national currencies that would contribute to generating public support for economic development and reduction of financial risks.

### **2.2. Reduction of Financial Risks**

International financial crisis should not be neglected, the turmoil on international markets increase uncertainty and difficulties in managing the monetary and economic policies (Carmen, n.d). Currency unions are also politically charged because they affect regional integration and disintegration. With reference to regions of European countries in the euro area, several commentators have noted that regional tensions within countries have been fueled by the monetary unification to reduce risks (Alesina *et al.*, n.d.)

Cullen (2012) commented that the EAC clearly has a long way to go before a monetary union can be completed. Although the numerous obstacles to deeper integration and monetary union can be overcome, entering into a monetary union before the people and the economies with free risks are ready could do more harm than good to the economic development of EAC.

### **2.3. Reducing Transaction costs**

It may be useful to have a 'group' issuance where a number of countries issue jointly, expanding the volume issued to reduce fixed cost to individual issuers (International Monetary Fund, 2011). According to European Commission (2013) the single currency brings new strengths and opportunities. The need to exchange currencies meant extra costs, risks and a lack of transparency in cross-border transactions. With the

single currency, doing business in the euro area is more cost-effective and less risky and less monetary fluctuation.

#### **2.4. Reducing Exchange Rate Fluctuation**

It is important to remember that in the past some of countries have found exchange rate targets a useful component of monetary stabilization programs when seeking to end a period of high inflation (Frankel, 1999). According to the European Commission (2013b) there is a system designed to avoid excessive exchange-rate fluctuations between the participating currencies and the euro that might disrupt economic stability within the single market. Kisambira (2013) finds that the EAC countries registered strong foreign exchange inflows, which coupled with the weakening US dollar to lead to strong appreciation of local currencies. According to Lee et al. (2009), in economic discussions, the loss of the exchange rate instrument was often put forward as the main argument against monetary union.

Frankel *et al.* (2002) and Talvas (2004) proved that currency unions seem to provide a significant stimulus to trade, and thereby to economic performance. Much of the literature on exchange rate regimes focuses on the requirements that currency union partner(s) have a stable currency and be subjected to shocks correlated with those of the domestic country.

The effect of common currency on trade is driven primarily from the reduction of exchange rate variability, which suggests that a credible arrangement of exchange rate fixing would have produced similar results on trade as those of a common currency (Costa-i-Fron (2012), Gupta. A. S. (2010)).

#### **2.5. Enhancing Price Transparency**

Before the euro, there was a need to exchange currencies meant extra costs, risks and lack of transparency in cross-border transactions (European Commission, 2013) and the introduction of single currency is usually seen as crown on achievement of price stability (European Central Bank, 2009).

European Central Bank (2010) shows that the development of unit labor costs and price indices is routinely considered in the assessment of price performance. It is envisaged that a stable monetary union will reduce the costs of doing business across borders within the EAC, thereby deepening trade links and promoting growth (Cullen, 2012). When a political unit adopts the currency of a neighbor, the creation of the monetary union over time promotes trade between the neighbors, which in turn has a positive effect on the correlation in incomes (Frankel, 1999).

European Commission (2013) provides evidence that individual consumers compare prices easily in cross borders trade and investment, with more efficiently throughout the euro area without the risks of fluctuating exchange rates. Within the euro area, there is now one large integrated market using the same currency.

#### **2.6. Reduction of Inflation**

European Central Bank (2010) considers the sustainability of the current exchange rate, based on the development of real bilateral and effective exchange rates. Milkiewicz, *et al.* (2003) study show that nations throughout Africa continue to be beset by civil wars, poor infrastructure, unsustainable fiscal policies, and low investment linked to corruption and the absence of rule of law, a monetary union will only accentuate the failure of Africans to tackle these more fundamental problems.

Bamiduro (2007) and Rusuhurwa *et al.* (2012) found that single currency programme will require greater analysis; given the changes it will bring to the political/ economic structure, and that the important challenges EAC region remains in building the solid foundation needed to support an EAC single currency. Compliance with the existing convergence criteria is still poor, especially the criteria for budget deficits and for inflation.

Starting a monetary union with over or undervalued exchange rates could create rapid price increases in some countries, and widespread public discontent for lowest inflation (Durevall, 2011). Adams (2005) study indicated that even as complete monetary unification may never be economically justified it represents a good opportunity to promote the harmonization of financial, banking and political systems that will increase the efficiency and development of African countries individually.

No simple measure that might be able to determine clearly whether a country should or should not join a common currency area. Often, political factors are those governing the decisions about joining/forming a

common currency area (Broz, 2005). A move towards coordinating the exchange rates of the various countries, with the objective of moving towards a single Asian currency in the future, will help to achieve both these objectives (Gupta, 2010). In the meantime, it could serve as means of payment for cross border trade and payments, would familiarize the public with the benefits of monetary integration, and would encourage coordination of EAC monetary policies.

### 3. Materials and Methodology

#### 3.1. Research Settings and Participants

The study used the descriptive design with descriptive techniques. The secondary data set includes views and arguments from deferent scholars and other relevant studies. A structured questionnaire was administered to the participants as a tool designed to assess the role of single currency towards EAC region economic development. The study population included academicians/Scholars, business people, and individuals living in EAC region headquarter Arusha. The sample size was selected using the simple random techniques.

This analysis focused on the assessment of factors that justified the adoption of single currency in EAC such as enhancing currency stability, reduction of financial risks, reduction of transaction cost, reduction of exchange rate fluctuation, enhancing price transparency and reduction of inflation. These factors were assessed using a 5-point scale, ranging from (1) Very low knowledge (2) Low knowledge (3) Moderate (4) High knowledge and (5) Very high knowledge on the role of single currency for economic development.

#### 3.2. Procedure

Data set from this study was collected from respondents living in Arusha. The study used different respondents given the anonymous nature of participation. Respondents were explained of the purpose of the study and were encouraged to give truthful answers. Data were collected from 91 participants with structured questionnaires and responses of respondents were electronically coded and saved for analysis using Statistical Package for Social Sciences (SPSS) 16.

#### 3.3. Data Analysis

The data sets were analyzed using descriptive techniques. To assess the factors that would be adopted for single currency in EAC, frequencies, percentages for arguments and opinions were computed. For simplicity, percentages of corresponding responses for each variable were discussed. Since it was not the interest of the study to examine the relationship between variables for now any inferential statistics were not reported. The consistency of the descriptive techniques as stated above was analyzed at face value by observing the highest and lowest.

### 4. Results

The results of the study show that there are number of economic factors that tempt the East Africa Community to engage in the process of adopting single currency for monetary union.

Table 1.

		Frequency n=91	Percentage %
<b>Knowledge on enhancing Currency Stability</b>	Very High	28	30.8
	High	43	47.3
	Moderate	20	22
<b>Reduction of Financial Risks</b>	Very High	35	38.5
	High	28	30.8
	Moderate	26	28.6
	Low	2	2.2
<b>Transaction cost reduction</b>	Very High	49	53.6

		Frequency n=91	Percentage %
<b>Reducing Exchange Rate Fluctuation</b>	High	22	24.2
	Moderate	14	15.4
	Low	6	6.6
<b>Enhancing Price transparency</b>	Very High	42	46.2
	High	37	40.7
	Moderate	12	13.2
<b>Reduction of Inflation</b>	Very High	43	47.3
	High	21	23.1
	Moderate	14	15.4
	Low	7	7.7
	Very Low	6	6.6
	Very High	35	38.5
	High	42	46.2
	Moderate	14	15.4

#### 4.1. Enhancing Currency Stability

The findings in table above shows that 47.3% (43) of the respondents have high knowledge on the role of single currency to enhance currency stability, 30.8% (28) had very higher knowledge, and only 22.0 % had moderate knowledge on the role of single currency to enhance currency stability for economic development. In general, Majority 78.1% (73.8) of participants has high knowledge on the role of single currency to improve stability of currencies that are used by the member of the East Africa Community.

This was confirmed by the study done by Ogawa, *et al.* (2008) in East Asia certifying found that the feasibility of forming a regional monetary union and establishing a common currency unit has gained a great deal to its economic development. As agreed by Rusuhurwa *et al.* (2012) that visible symbols for commitment to monetary union of existing national currencies contribute to generating public support. And the East Africa Economy report (2013) indicates that monetary union will be a third pillar in the steadily deepening EAC union, following a customs union and a single market. The countries are more likely to satisfy the criteria for entry into a currency union after taking steps toward economic integration than before (Lee *et al.*, 2009).

#### 4.2. Reduction of Financial Risks

Findings show that 38.5% (35) of respondents have very high knowledge on the role of single currency to reduce financial risks for economic development, 30.8% (28) high knowledge, 28.6% (26) moderate and only 2.2% (2) have low knowledge on how single currency to reduce financial risks in the region of East Africa Community. This was supported by Carmen study (n.d) argued that international financial crisis should not be neglected, to avoid turmoil in the markets that increase uncertainty and difficulties in managing monetary and economic policies. However it was opposed by Cullen (2012) study stating that EAC has long way to go before implementing monetary union.

#### 4.3. Reducing Transaction costs

More than 53.8% (49) of respondents had very highly knowledge that single currency would reduce transaction costs, 24.2% (22) high knowledge, 15.4% (14) moderate and only 6.6% (6) had low knowledge for the single currency to reduce the transaction cost. International Monetary Fund (2011) and European Commission (2013) studies clarified that it may be useful to have a 'group' issuance where a number of countries issue jointly reducing fixed cost to individual issuers and the liquidity premium. Further it was indicated that the single currency brings new strengths and opportunities and the need to exchange currencies meant extra costs, risks and a lack of transparency in cross-border transactions. With the single currency, doing business in the euro area is more cost-effective and less risky.

#### 4.4. Reducing Exchange Rate Fluctuation

The study findings reveal that 46.2% (42) of respondents very highly agreed that single currency will contribute to the reduction of exchange rate, 40.7% (37) of respondents had high knowledge on the role of single currency adoption to reduce exchange rate fluctuation in EAC, and only 13.2% (12) of respondents moderate. As confirmed by Frankel study (1999) and European Commission (2013b) suggest that it is important to remember that in the past some of them have found exchange rate targets a useful component of monetary stabilization programs when seeking to end a period of high inflation. And there was a system implemented for non-euro countries to avoid excessive exchange rate fluctuations between participating currencies and the euro for stability within single market. In opposition to this, Kisambira (2013) study reveals that the EAC countries registered strong foreign exchange inflows, which coupled with the weakening US dollar to lead to strong appreciation of local currencies thereby complicating monetary policy and export sector competitiveness. Lee *et al.* (2009) and Frankel *et al.* (2002) studies found that the loss of the exchange rate instrument was often put forward as the main argument against monetary union, and that the currency unions seem to provide a significant stimulus to trade, and thereby to economic performance.

The effect of common currency on trade is driven primarily from the reduction of exchange rate variability, which suggest that a credible arrangement of exchange rate fixing would have produced similar results on trade as those of a common currency (Costa-i-Fron, 2012), and that the key deterrent to a move to a single currency is the associated relinquishment of monetary and exchange rate policy (Gupta, 2010).

#### **4.5. Enhancing Price Transparency**

When asked about the role of single currency enhancing price transparency, 47.3% (43) of respondents had very high knowledge on the role of single currency enhancing price transparency, 23.1% (21) high knowledge, 15.4% (14) moderate, 7.7% (7) low and only 6.6% (6) of respondents with very low knowledge on the role of single currency to enhancing price transparency. This result is in line with European Central Bank study (2009) found that the introduction of single currency is usually seen as crown on achievement price stability. Together with European Central Bank study (2010) also states that the development of unit labor costs and price indices is routinely considered in the assessment of price performance. Last the studies done by Cullen (2012) and European Commission (2013) find that it is envisaged that a stable monetary union will reduce the costs of doing business across borders within the EAC, thereby deepening trade links and promoting economic growth and individual consumers compare prices easily in cross borders trade and investment, with more efficiently throughout without the risks of fluctuating of exchange rates.

#### **4.6. Reduction of Inflation**

The findings show that 46.2% (42) of respondents had high knowledge on the role of single currency to reduce inflation in EAC region, 38.5% (35) had very high, and only 15.4% (14) moderate. European Central Bank (2010) positively commented this result that the sustainability of the current exchange rate is based on the development of real bilateral and effective exchange rates. In contrast with Milkiewicz, *et al.* study (2003) stating that nations throughout Africa continue to be beset by civil wars, poor infrastructure, unsustainable fiscal policies, and low investment linked to corruption and the absence of rule of law, a monetary union will only accentuate the failure of Africans to tackle these more fundamental problems. But for Bamiduro (2007) single currency program will require greater analysis; given the changes it will bring to the political/economic structure.

Rusuhurwa *et al.* study (2012) opposed stating that there is an important challenges that remain in building the solid foundation needed to support an EAC single currency that include compliance with the existing convergence, criteria for budget deficits and for inflation. This negative opinion was supported by Durevall (2011) and Swoboda (1999) commented that starting a monetary union with over or undervalued exchange rates could create rapid price increases in some countries, and widespread public discontent stated that monetary union itself is a factor of integration which will at the same time increase the mobility of the factors of production and reduce the probability of unbalanced shocks of currencies.

However, the sequence of approaching currency union has been pointed out that political cooperation and institutionalization was the prerequisites for a successful currency union Lee, *et al.* (2002) and acknowledgement of single currency is impossible in the short term. Broz (2005) and Gupta (2010) observed

that there is no simple measure that might be able to determine clearly whether a country should or should not join a common currency area.

## 5. Conclusion

Creating a monetary union for the East Africa Community requires extensive institutional preparation as well as convergence among the region's economies. The experience of the euro zone shows the need for putting in place adequate safeguards against excessive fiscal deficits and debt (Masson, 2012). Single currency will serve as means of payment for cross border trade and payments, familiarize the public with the benefits of monetary integration, and would encourage coordination of EAC monetary policies.

The study concluded that the critical factors that encourage the EAC member countries to seek for the adoption for single currency shows that majority of the participants are highly knowledgeable on the role of integrating single currency in EAC for economic development that include, enhancing currency stability, reduction of financial risks, reduction of transaction cost, reduction of exchange rate fluctuation, enhancing price transparency and reduction of inflation that impact on trade within the region.

## 6. Recommendations

The findings of this study are from few individual from Arusha city. The study shows that:

- There is a need to explore several monetary union models, make a design of the integration process, put into place a mechanism of implementing the single currency integration in a gradual manner
- There is a need to extend the study will be extended to the other two regions Dar es Salam, Mwanza, Morogoro, Dodoma and Nzanzibar. After the whole country of the Tanzania is covered, this study should be replicated in other EAC country members: Burundi, Kenya, Rwanda, and Uganda.
- Last, a study should be conducted on the risks and consequences related to single currency comparing to the Euro in European Community.
- More studies need to be done to shed light on the prospect of a single currency for EAC.
- Policies for single currency for EAC must be done after conducting possible studies related to monetary union unit.

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