# Regional currency areas and use of foreign currencies: the experience of West Africa

Michael Ojo

#### 1. Introduction

In order to foster close economic interaction among the countries of West Africa, the Economic Community of West African States (ECOWAS) was established in 1975. ECOWAS pursued the objective of economic integration in the subregion vigorously but intraregional trade could not be stimulated. As a result, the West African Clearing House (WACH) was established to provide a multilateral clearing mechanism for trade within the subregion. Under this arrangement the use of foreign exchange was to be curtailed through the application of an artificial currency unit, the West African Unit of Account (WAUA).

The objective of this paper is to review developments in monetary cooperation in West Africa and highlight current initiatives aimed at facilitating the monetary cooperation programme of the subregion. The rest of the paper is organised into five parts. Multilateral clearing and payment arrangements in ECOWAS are discussed in Section 2, while the ECOWAS Monetary Cooperation Programme (EMCP) is the subject of Section 3. Progress of the EMCP is examined in Section 4, while the framework for a monetary union in the West African Monetary Zone (WAMZ) is presented in Section 5. Some concluding remarks are given in Section 6.

## 2. Multilateral clearing and payments arrangements in ECOWAS

As a means of providing a firm basis for monetary cooperation in ECOWAS and improving intraregional trade, the West African Clearing House (WACH) was established in 1975. The objectives of the WACH, which commenced operations in July 1976, were to promote the use of the currencies of member countries in subregional trade and to encourage the members of the Clearing House to liberalise trade and promote monetary and economic consultation among themselves. In the drive to simplify further the process of undertaking and measuring transactions under the WAUA was introduced. The WAUA is linked to the special drawing right of the International Monetary Fund. The WAUA is the benchmark for determining the relative strength of the currencies in the WACH payment and clearing mechanism. The smooth functioning of the WACH was contingent on the undertaking by member countries to generate unrestricted conversion of their national currencies into the WAUA for eligible transactions. This undertaking was intended to eliminate the problem of currency inconvertibility in the subregion, a phenomenon that had hindered intraregional trade and made the use for foreign exchange a primary means of settlement in the subregion.

In order to strengthen the multilateral settlement and clearing system in ECOWAS, make the subregional payment system more efficient, and eventually pave the way for the emergence of a single monetary zone in the subregion, the WACH was transformed into the West African Monetary Agency (WAMA) in 1996. Other factors that necessitated the establishment of the Agency were the operational inadequacies of the WACH, which hindered the attainment of the objectives agreed at its establishment after more than two decades. Moreover, the WACH mechanism was not very effective. The factors which constrained its performance included delays in crediting exporters' accounts owing to cumbersome documentation requirements by central banks; the absence of a short-term financing facility; the absence of trade promotion instruments like bills of exchange, traveller's cheques, etc. The most dismal aspect of the WACH's performance was its inability to promote the use of national currencies in intraregional trade.

Other schemes that were put in place to support monetary cooperation in the subregion included the ECOWAS exchange rate mechanism, designed to facilitate the achievement of a single monetary zone, ECOWAS traveller's cheques and a credit guarantee fund scheme. The exchange rate mechanism was to be implemented by the Monetary Agency. In order to ensure rapid regional

monetary cooperation, central banks in the subregion were expected to: ensure timely implementation of stipulated convergence criteria (market-determined exchange and interest rates and single digit inflation); remove all non-tariff barriers of a monetary nature; establish a credit guarantee fund and introduce ECOWAS traveller's cheques for transactions; develop an integrated regional capital market; resolve the settlement arrears in the clearing system and promote currency convertibility in the subregion. But these objectives have not been realised.

## 3. ECOWAS Monetary Cooperation Programme

To facilitate the establishment of a single monetary zone in ECOWAS, a viable monetary union was to be nurtured under the auspices of the ECOWAS Monetary Cooperation Programme (EMCP). The EMCP was adopted in 1987, with the general objective of a harmonised monetary system and the strengthening of the economies of member states in the process. The introduction and implementation of a set of convergence criteria was expected to pave the way for a system of exchange rate management that would culminate in the establishment of a single monetary zone and a common central bank that would implement the common monetary policy of the subregion.

Thus, under the EMCP, the West African Clearing House was to be transformed into a specialised monetary agency of ECOWAS to improve its payment mechanism and enhance intraregional trade. The achievement of regional currency convertibility is the intermediate objective of the EMCP, while the ultimate objective is the establishment of a single monetary zone for ECOWAS. A common convertible currency would subsequently be managed by a common central bank that would be the sole monetary authority in the subregion. In order to achieve these objectives, a number of measures were to be implemented. These included exchange rate realignment and harmonisation; adoption of an ECOWAS exchange rate mechanism; liberalisation of exchange controls and maintenance of fiscal discipline; and adoption of a market-oriented approach to monetary management. In specific terms, a set of primary and secondary convergence criteria was to be satisfied by member countries before they could join the monetary union. The primary convergence criteria are the maintenance of exchange rate variability between 5 and 10%; single digit inflation; budget deficit to GDP ratio of 3-5%; and a ceiling of 5-10% of the previous year's tax revenue on central bank financing of budget deficits.

The EMCP had suffered from a number of problems, which delayed its consistent implementation. The major problems were the inability of member countries to adopt the desired policy frameworks that would lead to convergence, owing to inadequate political commitment to the EMCP; and the different stages of monetary harmonisation marked by the realities of the existence of the CFA franc zone group of eight countries. As a result the target date for the single monetary zone was shifted three times from 1992 to 1994, 2000 and 2004.

The target date for the realisation of ECOWAS Single Monetary Zone was once more shifted in January 2003 at the 26th Session of the Authority of Heads of State and Government of ECOWAS, in Dakar, Senegal. The exact date for launching the ECOWAS Single Monetary Zone would be determined in December 2005 at the Summit of the Authority of Heads of State and Government. At the Summit, the Heads of State and Government would review the progress made in the Second Monetary Zone and thereafter set a target date for ECOWAS Single Monetary Zone. The Heads of State and Government emphasised the need to enhance the convergence process through appropriate macroeconomic policies by the member states to build up the credibility of the proposed ECOWAS Single Monetary Zone, and ensure that its foundation was strong and would be enduring. In this regard, they urged member states to intensify efforts at meeting the convergence criteria, guided by the principles of good governance, through public finance reforms and the introduction of the appropriate structural reforms needed for the expansion of domestic production.

## 4. Accelerating the ECOWAS Monetary Cooperation Programme

In December 1999, the heads of state and government adopted a revised set of macroeconomic convergence criteria in furtherance of the objective of monetary integration. Member countries were urged to apply the necessary measures to ensure compliance before the 2004 target date for the establishment of a single monetary zone for the subregion, to the effect that any group of countries could implement the agreed policy measures under the EMCP at a faster pace without waiting for

everyone to be ready. The aim was to accelerate the pace of monetary integration. A comparable monetary zone to the existing WAEMU was to be created to push the process. It was also considered unfair to arrange a merger between an organised zone that is working and an unorganised coalition of countries.

On the basis of the Lomé Agreement of December 1999, Nigeria and Ghana entered into a bilateral strategic cooperation arrangement at a meeting held in Accra, Ghana in December 1999. The initiative referred to as the "fast track approach" to integration was meant to quicken the pace of integration of the two economies through cooperation in four critical areas: creation of a second monetary zone; free trade and borderless zone in the subregion; development of common infrastructures; and promotion of private sector participation in the integration process. The rationale behind a second monetary zone is that it would be easier to merge the two currencies of WAEMU and WAMZ than the present eight currencies existing in the subregion.

The West African Monetary Institute (WAMI), which commenced operations in Accra in March 2001, is to prepare the member countries for monetary union. In the process, it is to undertake technical preparations for the establishment of a common central bank and the introduction of a common currency. This entails monitoring macroeconomic performance and movement towards convergence of member countries, harmonisation of laws governing financial institutions in the member countries, sensitisation of the stakeholders of the WAMZ and analysis of the technical issues relating to: the design of an exchange rate mechanism; the design of a foreign exchange reserve management system; the design of a payment system; the design of and technical preparation for the introduction of a common currency; and the establishment of the common central bank as well as prescription of modalities for operating the Stabilisation and Cooperation Fund.

## 5. Framework of the monetary union

Preparation for monetary union has been tackled through the design of the policy and institutional frameworks and surveillance of member countries' economies to assess the state of macroeconomic convergence. The design of the relevant policy frameworks has progressed as scheduled. WAMI has been able to put in place the building blocks of monetary union through its comprehensive work programme. During the first 15 months of its operations, WAMI has designed the following major policy frameworks, which the relevant authorities of the WAMZ have adopted.

#### Monetary policy frameworks

The objective of monetary policy for the proposed common central bank, the West African Central Bank (WACB), would be price stability. As a result of the underdeveloped nature of the money markets and enormous data problems, the Bank would initially apply the traditional monetary targeting approach, with focus on control of reserve money. In the intervening period the necessary infrastructure would be developed to enable the process to move eventually to an inflation-targeting framework. Thus, an implicit inflation target would be the aim of policy in the short term while in the medium to long term, an explicit inflation-targeting regime would be applied.

**Reserve management** by the WACB would focus on the need for liquidity, safety and income in that order so that enough resources would be available to the Bank to intervene in the foreign exchange market to stabilise the exchange rate of the common currency and prevent it from appreciating in real terms. External reserves to be managed by the WACB would be pooled from member countries. The Bank would be required to undertake optimal selection of assets in a portfolio so that within a risk-return model, overall yield would be positive and contagion losses avoided.

A *supervisory institution*, to be known as the West African Financial Supervisory Agency would undertake banking and financial supervision in the WAMZ. However, an evolutionary approach would be adopted before the externalised model of banking supervision is adopted, at which period the agency would be established. The current system of banking supervision, warehoused in the central bank would be retained and would evolve to pave the way for the new agency.

The **payments system** for the WAMZ has two components, the development of national payment systems and multilateral (cross-border) payments among the member countries of the WAMZ. In order to improve the payment system, a real-time gross settlement system has been recommended for

adoption by member countries. In addition, telecommunications infrastructure would be upgraded. National and zonal payment committees have been established to address the problems of the payment systems in the various countries and bring them to the same standard.

In order to establish a regime of stable exchange rates and provide adequate support to efforts at macroeconomic adjustment, an **exchange rate mechanism** was put in place in April 2002. The ERM has an initial fluctuation band of ±15%. Market exchange rates are applied, while the reference currency is the dollar. The dollar was chosen because it is the currency of denomination for external transactions by member countries and their external reserves are also held in dollars. The ERM would be the basis for the WAMZ unit of account, which would be the numeraire for valuing transactions in the WAMZ. Its external value would be determined in terms of the dollar.

Central to the operations of the *West African Central Bank* (WACB), the future common central bank of the WAMZ, is pursuit of the objective of price stability, issuance of a common legal tender currency that would circulate throughout the zone and be well managed so as not to lose competitiveness. The currency would be backed by strong economic fundamentals once the convergence process is sustained and fiscal rules are applied to stem the phenomenon of fiscal dominance. Above all, monetary policy would be the sole responsibility of the WACB.

The WAMZ envisages the introduction of a *regional currency* to be legal tender in all member countries. This currency would be issued by the WACB or the common central bank that may evolve from the EMCP. The idea at the moment is to agree on a common name for the ECOWAS single currency. This would involve negotiation with the BCEAO/CFA franc zone in West Africa. As a result, the WAMZ may adopt a virtual currency model in the interim. The common currency idea was intended to eliminate the use of foreign exchange in intraregional trade. The use of foreign exchange for transactions outside the banking system is limited to the WAMZ. The practice is not widespread, although speculators hold foreign exchange to hedge against inflation. The currency board arrangement was not contemplated for the WAMZ because it falls short of the desired monetary union envisaged for the WAMZ. Furthermore, the discipline required in a currency board arrangement may be difficult to attain in the WAMZ at the moment. The 100% backing for money base would constrain economic growth and development and the member countries do not have enough foreign exchange to meet a wide range of national objectives. The scarcity of foreign exchange, the need to finance priority projects and make room for some growth makes the currency board option unrealistic for the WAMZ.

#### **Progress towards convergence**

The progress towards macroeconomic convergence has not been encouraging in the WAMZ. The member countries have failed to meet the prescribed macroeconomic convergence criteria. The assessment of compliance with the convergence criteria at the end of 2001 showed that two countries met three of the criteria, while two countries satisfied two criteria and one satisfied only one criterion. Although member countries have made efforts, there is need to do more if the process of convergence is to show sustained improvement. As a result of the status of convergence, which is not encouraging, movement to monetary union cannot be sustained. Since meeting the convergence criteria is a necessary condition for monetary union, all the stakeholders must show commitment to applying the right policy measures to achieve convergence so that the building blocks that have been prepared by WAMI can be implemented in a not too distant period.

### 6. Concluding remarks

With the existence of political will and the continuous application of structural adjustment and market-friendly policies, it is expected that member countries of the WAMZ will move gradually towards convergence in both policy areas and in the context of the quantitative convergence criteria. The consciousness that the subregional groups in Africa should be organised into functional monetary unions has been heightened by recent trends in globalisation and regionalism, the quest for African Union and the New Partnership for Africa's Development initiative. The subregional groups in Africa are to serve as the building blocks for the African Monetary Union. This and the new initiatives to develop Africa are contingent on sound macroeconomic fundamentals that should be nurtured at the subregional level.

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Indeed, the African Monetary Cooperation Programme to be realised in 2016 is predicated on subregional monetary cooperation. In this context, the WAMZ and WAEMU, and indeed the ECOWAS Monetary Cooperation Programme if successfully implemented, would provide an impetus for monetary cooperation at the continental level. The initiative of the African Central Bank, a laudable long-term objective, can only be realised through monetary cooperation at the subregional level.

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