# Regional currency areas: lessons from the West African sub-region and Nigeria's policy stance

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## 1. Introduction

Regional economic integration, simply defined, is an agreement among contiguous nations to allow for the free flow of ideas, investment funds, technology, goods and services, and free movement of persons within the region in which a single large market subsists with the benefits of comparative advantage and economies of scale. Regional economic cooperation has gained momentum partly as a strategy to cope with global economic problems and partly to enhance domestic economic growth and development. As many countries are not strong enough on their own to cope with the rapid changes in the global economy, groups of countries use regional integration to achieve the necessary conditions for sustainable growth and development.

The major potential cost of economic integration is the uneven sharing of gains from the integration process, but compensation schemes are usually designed to equalise the gains over time. Other costs include loss of discretionary use of macroeconomic policy instruments for stabilisation purposes by individual members of the union and a partial loss of sovereignty. In the case of Nigeria, macroeconomic policy is tailored to accommodate the sub-regional objectives of regional integration and the introduction of a single currency while considering national interests vis-à-vis the convergence criteria.

Monetary integration as a major policy in the economic integration process usually involves the establishment of convergence criteria, a common central bank, a unified monetary policy, and a single currency (or at least a mechanism by which all the national currencies of the group are made convertible to each other).

The objective of this paper is to discuss the experience of regional integration efforts in the West African sub-region and Nigeria's policy approach. Section 2 discusses international experience in monetary integration while Section 3 presents regional integration efforts in West Africa, focusing on the planned second monetary zone of the Economic Community of West African States (ECOWAS). Section 4 highlights Nigeria's monetary and financial policies towards achieving the agreed convergence criteria. The paper ends with some concluding remarks.

## 2. International experience in monetary integration

In the past, several monetary unions have been formed and while some were successful, others failed. Currently, the euro area is the most well known monetary union. This area, comprising Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain, evolved over a long period, from 1957 when it was only a customs union. With the direction provided by the Treaty of Rome, the union progressed with the formation of the European monetary system and an exchange rate mechanism in 1979. It was strengthened with the signing of the Maastricht Treaty in 1992, which mandated member countries to comply with a number of convergence criteria in order to enhance macroeconomic stability.[2]

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2 See the paper by Strauss-Kahn in this volume, and in particular the chronology on page 55, for further information.

## 3. Regional integration in West Africa

There are two prominent monetary unions in Africa. The West African CFA zone, known as WAEMU, comprises Benin, Burkina Faso, Côte d'Ivoire, Guinea Bissau, Mali, Niger, Senegal and Togo. WAEMU and the Central African CFA zone, known as CAEMC, comprises Cameroon, Central African Republic, Chad, Equatorial Guinea, Gabon, and the Republic of the Congo. They operate almost identically. They were established by France and survived after independence, unlike their counterpart in the anglophone countries, which was broken up after the independence of the members.

The WAEMU and CAEMC countries each use a single currency (a variant of the CFA franc) and have a common central bank, Banque Centrale des Etats de l'Afrique de l'Ouest (BCEAO) and Banque des Etats de l'Afrique Centrale (BEAC), respectively. The CFA franc was pegged to the French franc prior to 1999 and is now pegged to the euro. WAEMU has a common pool of reserves which under an agreement are kept with and managed by the French Treasury. WAEMU is required to hold external assets at least equal to 20% of its sight deposits. Policy actions are required if that threshold is not being met. A regional council of ministers and the BCEAO decide on monetary targets based on input from national monetary authorities. Monetary financing of governments is limited to 20% of the previous year's budgetary revenues while both current and capital account convertibility is operated in principle but with occasional restrictions. Capital mobility is low in practice.

### The Economic Community of West African States (ECOWAS)

ECOWAS was founded in 1975 by all the West African countries, and includes both the francophone (WAEMU) countries, the anglophone countries (the Gambia, Ghana, Guinea, Liberia, Nigeria and Sierra Leone) and Portuguese-speaking Cape Verde. The ECOWAS Monetary Cooperation Programme (EMCP) is the most prominent scheme for monetary integration in the west African sub-region. It was originally scheduled for between 1991 and 1994, but was extended to the year 2000. It was further extended in December 1999 to 2004.

The specific objectives of the EMCP were to be implemented in three phases. In the short term, the aim was to strengthen the existing payment mechanism of the West African Clearing House through the settlement of outstanding payment arrears in the clearing mechanism; introducing new payment instruments such as the traveller's cheque; introducing a credit guarantee fund facility to support the clearing mechanism; and removing all non-tariff barriers that tend to restrict the use of national currencies to effect payments for some current transactions such as hotel bills and air tickets.

In the medium term, the EMCP was expected to achieve limited regional convertibility of national currencies by removing existing restrictions on their use. In the long run however, the ultimate goal of the EMCP is the establishment of a single ECOWAS monetary area involving the use of a common convertible currency, the establishment of a common central bank, the pooling of foreign exchange reserves and the negotiation of an external convertibility guarantee with an appropriate international agency. To facilitate these objectives, member states were to embark on an economic policy reform programme to achieve macroeconomic convergence. The policy reform programme was to embrace:

- realignment of exchange rates and the adoption of a market-based exchange rate policy;
- removal of exchange control regimes; and
- minimising of fiscal deficits and their financing through the rationalisation of government expenditure and tax reform.

The short-term objectives of the EMCP have not been fully achieved, as exemplified by the failure to clear the arrears in the clearing house mechanism, the delay in introducing new payment instruments, the problems with the newly introduced ECOWAS traveller's cheques and the unwillingness of members to remove non-tariff barriers to intraregional trade and other transactions. The medium- to long-term objectives of the EMCP have also not been fully attained, leading to the deferral of the establishment of the single monetary zone.

### Achieving the ECOWAS single monetary zone: the second monetary zone option

The failure of the ECOWAS integration process to make significant progress since its inception in 1975 was one of the motivating factors behind the "fast track" approach to monetary integration in the sub-region. It was generally felt that the non-existence of parallel and competing monetary arrangements in the sub-region had been a major factor militating against the movement towards a single monetary zone.

On the one hand, the CFA zone has appeared to be a solid arrangement, especially with the backing of France and the European Union. On the other hand, the countries outside the CFA zone have different national currencies. The challenge of accelerated integration in the sub-region has therefore fallen more on these latter countries. Consequently, the political commitment to renewed economic cooperation spearheaded by Ghana and Nigeria since December 1999, and accepted by Guinea, the Gambia, Sierra Leone and Liberia, made the idea of the fast track approach to integration a feasible proposition. The idea has crystallised into the formation of the West African Monetary Zone (WAMZ) with the aim of merging it with the CFA zone in 2004.

At a mini-summit of heads of state and government of member countries in Bamako in late 2000, the critical decisions were adopted with the intention to formally establish the West African Monetary Zone, with a common central bank, and to introduce a single currency in the zone by 2003. The West African Monetary Institute (WAMI), domiciled in Accra, Ghana, was set up as an institutional vehicle to establish the WAMZ and make necessary preparations for the emergence of the common central bank and the introduction of a single currency as planned. It became operational in January 2001.

### Some recent decisions on the West African Monetary Zone

At the meeting of the Convergence Council of Ministers and Central Bank Governors of the WAMZ in Accra, Ghana, on 20 June 2002, the following decisions/recommendations were made to move the WAMZ project forward:

- A strong West African central bank system should be established with authority to undertake monetary policy for the Zone.
- The foreign exchange reserves and liabilities of the member countries of the WAMZ should be fully pooled to back the common currency of the WAMZ when it is introduced.
- Member countries should take steps to accede to the IMF General Data Dissemination Standard to harmonise statistical data and methodologies.
- As the criterion on central bank financing of government budget deficits is critical, with implications for fiscal discipline and the conduct of monetary policy of the WAMZ, WAMI should conclude its study on the subject for consideration at its next meeting.
- As the movement in exchange rates is an indication of economic fundamentals and the performance of an economy, WAMI should undertake a study on the exchange rate parities existing among the member countries' currencies, to determine if they could guarantee competitiveness of the component economies of the WAMZ.
- When a review of the WAMZ exchange rate mechanism band is undertaken (after it has been operating for six months), a narrower band should be prescribed to provide the required discipline. All member countries that have not formally written to WAMI on the adoption of the exchange rate mechanism should do so without further delay.
- Member countries that have not paid their contributions to the Stabilisation and Cooperation Fund should do so by the end of June 2002.
- All member countries should redouble their efforts in sensitising the various interest groups to the WAMZ programme, as this is critical to the success of the WAMZ project.
- The earlier decision on ECO as the name of WAMZ common currency was reiterated. This is without prejudice to the ongoing efforts on the name of a common currency for ECOWAS.
- The option of a single central bank for the WAMZ, with the present central banks becoming branches, was reaffirmed. It was noted that the Governors would closely study the draft amendment to the Statute of the WACB for discussion at its next meeting.

- The country that would be eventually selected by political considerations to host the headquarters of the WACB (Ghana, Nigeria and Guinea have applied) was urged to be committed to implementing open sky policy as defined in the Yamoussoukro Agreement.

### Rationale for the West African Monetary Zone

The need for the second monetary union arose largely as a result of inadequate political will to forge a strong monetary integration between the CFA zone and the non-CFA zone under the aegis of the EMCP. The emergence of the WAMZ as a successful monetary union is thus likely to prevent a total collapse of the EMCP. It may indeed facilitate the movement towards a single monetary zone in the sub-region since negotiations will take place between two groups of countries in contrast to the current situation characterised by uncertainties about the integration process of the sub-region. Even if the eventual merger of the two monetary zones takes more time to materialise than presently envisaged, the convergence of the two groups of countries will be less cumbersome than the convergence of many countries with various currencies.

The primary economic policy objectives of WAMZ are to ensure price stability, sound fiscal and monetary conditions and a sustainable balance of payments in the member states. To this end, the WAMZ is enjoined to adopt a regional economic policy for the zone through effective coordination of member states' economic policies, conduct the regional economic policy in the context of an open market economy and specifically design and implement common monetary and exchange rate policies in the zone.

The WAMZ is also to put into force a multilateral surveillance system to ensure close coordination of member states' economic policies and sustained convergence of economic indicators of member states. To undertake this function, the key institutions of the WAMZ - the Convergence Council, Technical Committee, WAMI and the West African Central Bank - are to formulate broad guidelines for the design of economic policies of member states.

### Macroeconomic convergence criteria of the West African Monetary Zone

It is planned that the WAMZ would merge with the CFA zone in January 2004 in accordance with the EMCP, thus creating the long-awaited single monetary zone in the sub-region.

However, before this goal is realised, the member states of the WAMZ are to comply with some convergence criteria, which will ensure macroeconomic stability and reasonable growth in the member states. The quantitative primary convergence criteria are:

- single digit inflation rate by 2000 and 5% by 2003;
- budget deficit (excluding grants) of not more than 5% of GDP by 2000 and 4% by 2002;
- central bank financing of budget deficit to be limited to 10% of previous year's tax revenue; and
- gross external reserves to cover at least three months of imports by end-2000 and six months by end-2003.

In addition, there are six secondary criteria, which will be observed in support of the primary criteria. These are:

- prohibition of new domestic debt arrears and liquidation of all existing arrears;
- tax revenue to be more than 20% of GDP;
- wage bill to be less than 35% of total tax revenue;
- public investment to be more than 20% of tax revenue;
- maintenance of real exchange rate stability in the context of an exchange rate mechanism; and
- maintenance of positive real interest rates.

## 4. Nigeria's policy for fulfilling the convergence criteria

The Central Bank of Nigeria, with effect from the 2002 fiscal year, adopted a medium-term monetary policy framework. Unlike earlier programmes, which were designed for one year, the new programme is for a two-year period, from January 2002 to December 2003. The shift is in recognition of the fact that monetary policy actions affect the ultimate objectives of policy with a substantial lag. Thus, the current shift will free monetary policy implementation from the problem of time inconsistency and minimise overreaction to temporary shocks.

The primary objective of monetary policy in 2002-03 is the achievement of price and exchange rate stability. Specifically, monetary policy shall seek to subdue inflation to a single digit figure over the two-year period. Consequently, the central focus includes the effective control of anticipated liquidity injections that may arise from excessive government spending during the pre-election years of 2002-03 in order to minimise their negative effects on domestic prices and the exchange rate.

The stance of the Bank's monetary policy is non-accommodating, while a more competitive financial environment is being fostered to enhance greater access to credit for the real sector. Furthermore, continued effort is being made to improve the payment system to strengthen further the effectiveness of monetary policy. The broad measure of money supply (M2) shall continue to be the intermediate target of monetary policy with an average growth rate of 15.2% during the two-year period. This translates to 15.3% in 2002 and 15.0% in 2003.

To achieve the objectives of its monetary policy, the Central Bank of Nigeria has continued to rely on market-based techniques in the management of the Bank's balance sheet. The primary instrument of policy will continue to be open market operations, supported by reserve requirements and discount window operations for enhanced effectiveness. Other policy instruments include the cash reserve requirement, the liquidity ratio, the discount window and the use of the Bank's certificates to mop up excess liquidity in the system.

Other policy issues of interest to Nigeria include the interest rate, remittance of value added tax and duty collections. In addition to these, other factors are the determination of banks' cost of funds and supporting poverty reduction initiatives of the government by ensuring adequate credit to the productive sectors, encouraging financial savings and private sector investment growth and improving the financial market environment.

To fulfil the convergence criteria of the WAMZ, macroeconomic policy is formulated to increase the rate of growth of real GDP, reduce unemployment, maintain price and exchange rate stability, promote a healthy balance of payments, reduce the lending rate and mobilise more savings.

Specifically, in order to reduce inflation to a single digit figure (as low as 5%), the central focus is on effective control of anticipated liquidity injections that may arise from excessive government spending. Periodically, the central bank determines target growth rates of money supply, which are compatible with overall policy goals. It relies mainly on open market operations and other policy instruments for liquidity management, primarily to control banks' reserves.

In order to keep the budget deficit (excluding grants) below 4% of GDP, some efforts have been geared towards boosting output and steps have equally been taken to rehabilitate the social and economic infrastructure. Also, interest rates have been fully deregulated, with the banks given the freedom to determine the structure of interest rates in consultation with their customers. The Central Bank of Nigeria, however, has retained its discretionary power to intervene in the money market to ensure orderly developments in interest rates that could enhance investment.

With regard to central bank financing of budget deficits, which has been limited to 10% of the previous year's tax revenue, the Bank has continued to insist that government borrowing from it should not exceed the statutory limit of 12.5% of the estimated current budget revenue and that should this occur, the market rate of interest should be applied. The policy of the Bank is against the inflationary financing of government deficits through the ways and means advances and, with the instrument autonomy granted to it, the Bank will continue to apply the traditional instruments to fine-tune the system to ensure compliance with this convergence criterion.

On the need to ensure that gross external reserves cover at least six months of imports, the Bank's policy has been based on quantitative rationing and risk management. These include: portfolio diversification; exchange rate policy; foreign exchange budgeting and balance of payments policies.

## 5. Concluding remarks

Regional economic cooperation among developing countries, especially in Africa, should be seen as a viable strategy to enhance domestic economic performance and as a credible means to economic survival in a globalising world economy. This explains why these countries embarked upon numerous regional economic cooperation arrangements, including monetary integration, in the past. Such arrangements were beset by many difficulties, which constrained the achievement of their basic objectives. Agreed policy packages and other actions were not usually executed with the political commitment required; as was the case in the execution of the EMCP. An added dimension in the execution of the programme was the inability to forge meaningful cooperation between the CFA franc zone and the rest of ECOWAS.

The initiative of the second monetary zone, by which these other countries would forge a monetary union which would later merge with the CFA franc zone, was therefore a welcome development. So far, it has been pursued with a reasonable degree of political commitment on the part of the member states. Apart from the political will demonstrated in the execution of the project, the economic potential of the zone is a great advantage. The zone accounts for over 70% of the population of ECOWAS, about 64% of its total GDP, about 66% of total exports and 60% of total imports of goods and services. Altogether, the zone accounts for about 76% of the gross foreign exchange reserves of the West Africa sub-region.

The challenges facing the establishment of the second monetary zone are daunting. As a result, member countries need to sustain their current economic policy reforms, implement faithfully the agreement and statutes of the zone and support the zone's institutions, particularly WAMI.

Nigeria, as a leading member of the zone, is trying hard to comply with the statutes of the zone and operate strictly on macroeconomic policies that will facilitate the realisation of the WAMZ and its eventual merger with the existing CFA zone.

## Further reading

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