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Introduction and Overview

The leaders of the fifteen member countries of the Economic Community of West African States (ECOWAS) had set a goal of achieving a monetary and currency union by the end of 2020. With 2020 proving to be an exceptionally difficult year, the timing has been deferred, but the leaders' aspiration to form such a union remains in place. While member countries have made progress toward this goal, there are many challenges to attaining the requisite degree of macroeconomic convergence and establishing an adequate institutional framework. Whatever the eventual timing, this is an ambitious goal and has potentially significant implications for economic integration within the region. It also has important lessons for the African continent as a whole, particularly as the continent takes on a more aggressive trade integration strategy.

Monetary unions, as such, are not an end in themselves. They are a means to an end. This book provides an overview of the literature on monetary unions, with a special emphasis on emerging and developing market economies and the challenges involved in ensuring the durability and stability of such unions. The particular challenges facing ECOWAS, given the differences in current monetary and exchange rate regimes among countries in the region, will be examined. With accelerated economic integration, monetary stability, and enhanced growth as the final objectives, this book studies how a monetary union could contribute to the attainment of these ends.[1]

Focusing on stability and growth as the overarching objectives, the book provides a detailed analytical evaluation of alternative exchange rate regimes and their relative benefits and complexities given the structure of the ECOWAS region. Although the book does not aim to flesh out the specific details of the monetary policy framework, the connection between exchange rate policy and monetary policy regimes is discussed in the context of currency unions. Some parallels are also drawn from other regions.

Finally, the book contains a discussion of the institutional framework as well as broader aspects of economic and political integration that will be required to underpin a stable and durable currency union.

ECONOMIC BACKGROUND

ECOWAS comprises a set of countries at different stages of development, as measured by per capita incomes. The fifteen countries span a wide range of per capita incomes, from US$400–US$700 per annum (Niger, Sierra Leone, and Togo) to about US$1,500 (Côte d'Ivoire, Senegal), with three significant outliers—Nigeria at US$2,222, Ghana at US$2,223, and Cabo Verde at US$3,599 (see table 1-1). Six of the fifteen could be regarded as middle-income countries (annual per capita income of at least US$1,000 per annum), while the others are low income. These differences remain quite large if one uses purchasing power parity (PPP) rather than market exchange rates to compare per capita incomes. In 2018, PPP per capita incomes ranged from US$1,081 in Niger to US$5,358 in Nigeria, US$5,735 in Ghana, and US$6,503 in Cabo Verde. Six countries have PPP-adjusted per capita incomes in the US$1,000–US$2,000 range.[2]

The proposed currency zone also has wide size disparities among its economies. Nigeria, which is now the largest economy in Africa, accounts for 66.7 percent of GDP in ECOWAS (at market exchange rates). Ghana and Côte d'Ivoire account for another 10 percent and 6.6 percent, respectively. The five smallest economies (Cabo Verde, the Gambia, Guinea Bissau, Liberia, Sierra Leone) together account for less than 2 percent of ECOWAS GDP. The disparities in terms of population are smaller—Ghana and Nigeria together account for 60 percent of the total population in the ECOWAS region. Along with Côte d'Ivoire, the three countries account for two-thirds of the ECOWAS population (for comparison, their combined share of ECOWAS

TABLE 1-1. Key Economic Data (2019)

Country	Per cap income (USD, current price)	Nominal GDP (USD billion)	Share of GDP (percent)	Population (millions)	Share of population (percent)	Growth and inflation in 2019		Growth and inflation 2009–2019 average	
						GDP growth (percent)	CPI inflation (percent)	GDP growth (percent)	CPI inflation (percent)
Benin*	1217	14.4	2.1	11.8	3.0	6.4	−0.9	4.5	1.2
Burkina Faso*	718	14.6	2.2	20.3	5.2	5.7	−3.2	5.7	0.6
Cabo Verde	3599	2.0	0.3	0.6	0.1	5.5	1.1	2.4	1.2
Côte d'Ivoire*	1691	44.4	6.6	26.3	6.8	6.9	0.8	6.0	1.4
The Gambia	755	1.8	0.3	2.3	0.6	6.0	7.1	3.0	6.0
Ghana	2223	67.1	10.0	30.2	7.8	6.1	7.2	6.5	11.4
Guinea	981	13.4	2.0	13.6	3.5	5.6	9.5	5.3	11.1
Guinea Bissau*	786	1.4	0.2	1.8	0.5	4.6	0.2	3.9	1.0
Liberia	704	3.2	0.5	4.6	1.2	−2.5	27.0	3.3	11.4
Mali*	924	17.6	2.6	19.1	4.9	5.1	−0.6	4.4	1.3
Niger*	405	9.4	1.4	23.3	6.0	5.8	−2.5	5.7	0.7
Nigeria	2222	446.5	66.7	201.0	51.9	2.2	11.4	4.2	11.8
Senegal*	1428	23.9	3.6	16.8	4.3	5.3	1.0	4.8	0.7
Sierra Leone	547	4.2	0.6	7.7	2.0	5.1	14.8	4.4	9.4
Togo*	671	5.5	0.8	8.2	2.1	5.3	0.7	5.7	1.5
Total		669.6	100.0	387.5	100.0				
Average	1258					4.9	4.9	4.7	4.7
Weighted Avg.	1986					3.4	8.7	4.6	9.6

Data Source: IMF World Economic Outlook (October 2019 and April 2020).

Notes: Weighted averages are weighted by 2019 nominal GDP in U.S. dollars. Asterisks indicate members of WAEMU.

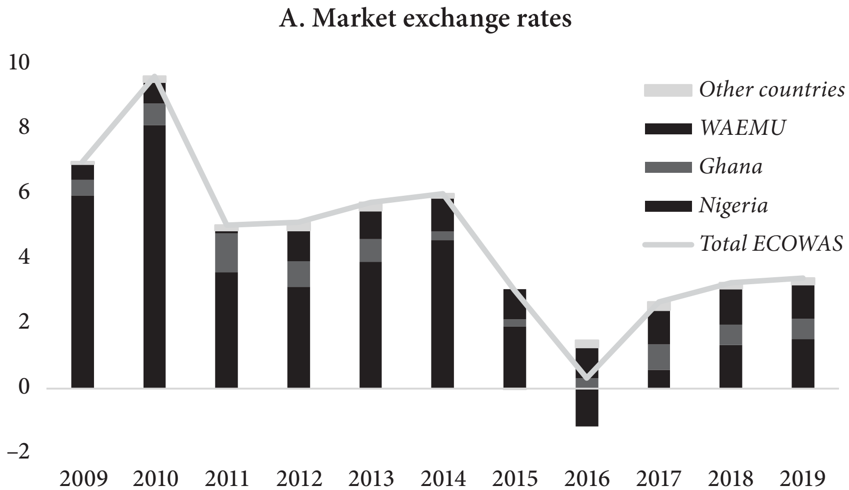
GDP is 83 percent). Six countries (Cabo Verde, the Gambia, Guinea Bissau, Liberia, Sierra Leone, Togo) have populations below 10 million and, together, account for 7 percent of the total population in ECOWAS.

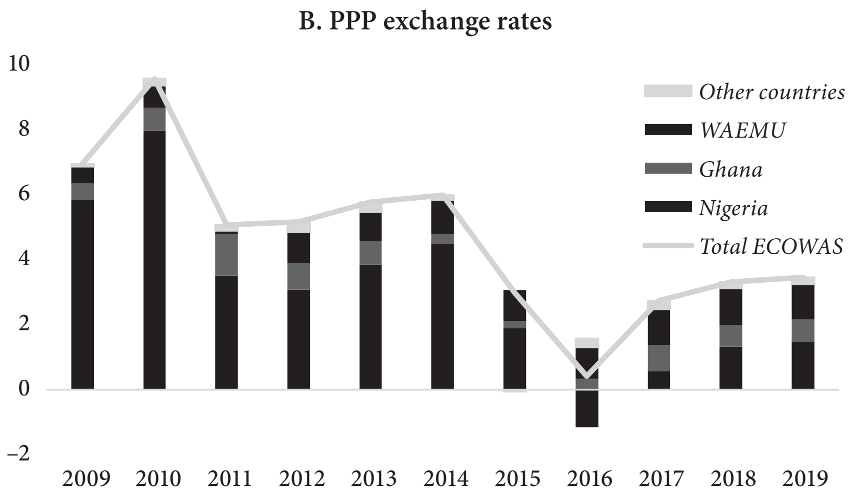
The ECOWAS region has experienced relatively robust growth over the last decade (see table 1-1). The cross-sectional mean of annual GDP growth over the period 2009–19 was 4.7 percent, with Ghana's annual growth rate of 6.5 percent topping the group. In 2019, most countries had growth in the 5–6 percent range, although Nigeria registered only 2.2 percent growth, and Liberia's economy experienced a contraction. The COVID-19 pandemic has adversely affected growth in 2020 in all of these countries.

Figure 1-1 shows that Nigeria has been a major contributor to growth in ECOWAS over the last decade. The two panels of this figure show that, whether measured at market exchange rates or purchasing power parity (PPP) exchange rates, the relative importance of Nigeria to overall GDP growth is substantial. Figure 1-2 confirms that Nigeria accounted for two-thirds of overall ECOWAS GDP growth over the period 2009–19. Excluding the four recent years, 2016–19, when growth in Nigeria was negative or weak, this share rises to three-fourths. Ghana has accounted for about 14 percent of overall ECOWAS growth, while the contribution of the WAEMU countries was 13 percent over the period 2009–15, but rose to 20 percent if the subsequent four years are included.

These disparities in size and levels of economic development, as well as in the structures of their economies, pose some important challenges—both technical ones and in terms of governance—in creating a unified monetary zone for ECOWAS. Moreover, eight of the ECOWAS countries are already conjoined in a long-standing currency union—the West African Economic and Monetary Union (WAEMU), which, in turn, is part of the CFA franc zone.[3] The CFA franc is pegged to the euro. One other ECOWAS country (Cabo Verde) has a currency that is also pegged to the euro, while the remainder have a broad range of monetary and currency arrangements. This diversity adds a number of technical and operational challenges to creating a well-functioning and durable monetary union that can deliver economic benefits to the people of the ECOWAS community. At the same time, it should be recognized that the countries of the ECOWAS region represent one of the more integrated regional blocs on the continent. Another perspective on the issues discussed in this book is that they are about ways to build upon and intensify this integration.

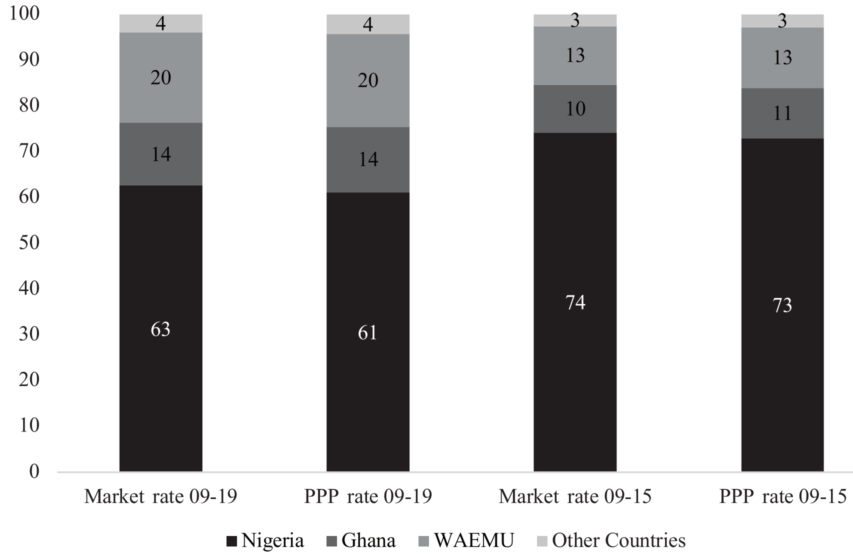
FIGURE 1-1. Decomposition of Annual ECOWAS GDP Growth (in percent)





Notes: This figure shows aggregate real GDP growth in ECOWAS, along with the growth contributions of key countries and country groups. Panel A is based on real GDP growth in constant 2010 U.S. dollars at market exchange rates. Panel B is based on real GDP in constant 2011 U.S. dollars at PPP exchange rates.

FIGURE 1-2. **Decomposition of Total ECOWAS GDP Growth (in percent)**



Notes: This figure breaks down aggregate real GDP growth in ECOWAS over the indicated periods into contributions of key countries and country groups. The first and third columns are based on real GDP growth in constant 2010 U.S. dollars at market exchange rates. The second and fourth columns are based on real GDP in constant 2011 U.S. dollars at PPP exchange rates.

ANALYTICAL FRAMEWORK

The literature on optimum currency areas (OCA) has identified some key criteria for a successful currency union, including the symmetry or similarity of shocks across countries, mobility of factors of production, openness to trade and finance, and degree of economic diversification. Each of these criteria will be analyzed in the upcoming chapters. Countries within a currency union can benefit from the "halo" effect stemming from one or more strong anchor countries that have disciplined macroeconomic and structural policies. This can reduce borrowing costs, macroeconomic volatility, and vulnerability to external shocks. For countries with high inflation and weak central banks that lack credibility, there are benefits to giving up autonomy over monetary policy, particularly if joining a currency union also increases fiscal policy discipline. Similarly, pooling foreign exchange reserves among currency union members can reduce individual countries' exposure to capital flow volatility.

Currency unions, if successful, have many potential benefits, which are described in chapter 2. Elimination of exchange rate risk within the currency union can have a positive effect on trade and investment flows within the region and, ultimately, growth. Indeed, as noted in chapter 3, the ongoing trade integration under the African Continental Free Trade Agreement initiative and policies to encourage factor mobility within ECOWAS could bode well for such a union.

There are also costs to forming a monetary union. With member countries having different production and economic structures, the loss of a key adjustment mechanism—independent currency and monetary policies—puts a significant burden on other policies. Fiscal transfers among countries, triggered by mechanisms to offset country-specific shocks, could spark political tensions if these are not mediated through a robust and trusted governance framework for the zone. Moreover, in the absence of adequate institutional safeguards and internal adjustment mechanisms (including labor and product market flexibility), the zone is only as strong as its weakest link.

Chapter 4 looks at the basic macroeconomic and structural prerequisites for a currency union. It will focus on the convergence criteria options, given the considerable differences in the structures of the ECOWAS economies. There is limited co-movement of GDP growth and inflation across ECOWAS countries. Terms-of-trade shocks are a key driver of economic fluctuations in most ECOWAS countries, accounting for a significant share of the variation in GDP growth and inflation. However, these shocks are not symmetric across the region, with a particularly strong asymmetry between the terms-of-trade shocks faced by Nigeria and WAEMU.

The conditions for an OCA are rarely fully met, even in existing currency unions, so ECOWAS is hardly an exception. Chapter 4 will look at other mechanisms that are essential for the currency union's ability to withstand aggregate shocks as well as shocks that affect countries asymmetrically. These mechanisms include (1) flexible product and labor markets, (2) labor mobility across countries and wage flexibility within countries, (3) mechanisms for sharing risk, and (4) a fiscal transfer system. All of these areas present major challenges for ECOWAS policymakers.

Initial conditions and congruence of macroeconomic conjunctures are also important for a successful currency union. ECOWAS leaders have determined a set of criteria—four main indicators and two ancillary ones—to assess macroeconomic convergence. Progress on meeting these criteria has been mixed. There are significant risks to moving forward with a currency union if the agreed-upon criteria are not met by all countries. This could reduce the credibility of the currency zone and would, at the outset, undermine the enforcement mechanisms intended to ensure consistency of economic policies across member countries. Moreover, as the world economy becomes more interconnected through trade and financial linkages, the potential vulnerability of ECOWAS member countries to external demand and financing shocks might need to be incorporated into a set of additional convergence criteria. The COVID-19 pandemic that ravaged the world economy in 2020, with particularly devastating effects on low-income countries, serves as an important cautionary note about shocks that could test the resiliency of a currency union.

Keeping all these caveats in mind, chapter 5 provides an analytical exploration of what alternative exchange rate regime and monetary policy framework might be suitable for an ECOWAS currency union. Based on the characteristics of ECOWAS economies, especially the high degree of exposure to terms of trade and other external shocks, a flexible exchange rate regime, along with a nominal anchor provided by an inflation targeting regime, would be a good option. This combination would help secure stability in the form of low inflation, with the flexible exchange rate providing a buffer against external shocks. Welfare calculations using a simple dynamic general equilibrium model bolster this conclusion.

This framework could be supplemented with a "leaning against the wind" option for exchange rate management. This option entails limiting short-term exchange rate volatility while not fundamentally resisting, through foreign exchange market intervention, market pressures pushing the currency in one direction or the other. Many emerging central banks, such as the Reserve Bank of India, explicitly or implicitly use this approach, recognizing that it can be counterproductive to resist sustained market pressures on a country's currency but that foreign exchange markets also tend to overshoot when market sentiments shift. The main objective of this approach is to use selective, symmetric, and temporary foreign exchange market intervention to mitigate such overshooting behavior and the policy complications resulting from it, while avoiding sustained, one-sided intervention.[4]

For all its benefits, such a regime is not without risks. A more flexible exchange rate and open capital account can make a developing economy more vulnerable to global financial cycles, including monetary policy spillovers from advanced economies that can trigger capital flow volatility. Exchange rate volatility can impose stresses on public finances and corporate balance sheets in the presence of significant levels of foreign currency debt. Fiscal dominance can also threaten price stability in the absence of a robust nominal anchor such as a fixed exchange rate.

There are a number of significant operational challenges to combining into a union a set of countries that have disparate levels of economic development, different monetary policy frameworks, and fragmented factor markets. The economic dominance of Nigeria—by far the largest country in the proposed currency zone in terms of both GDP and population—and its inevitable role as the anchor country pose additional challenges. For instance, Nigeria might face some policy constraints since the overall stability of the currency union could depend on the credibility and discipline of its policies.

There are substantial differences across ECOWAS countries in terms of their present exchange rate and monetary arrangements, which could create some transitional risks. Moreover, the disparities in capital account openness could complicate the management of whatever exchange rate regime is chosen for the eventual currency union.

Chapter 6 examines how a common ECOWAS currency regime and monetary policy framework might function. The experiments and analysis in this section show that, based on the degree of divergence in current practices, it will be essential but challenging to develop a consensus among ECOWAS members about the relative importance of variables such as inflation, output gaps, and exchange rate fluctuations in setting policy rates. Even with a consensus on these issues, there could be difficulties in formulating a common set of monetary and exchange rate policies for ECOWAS. First, any policy rule for ECOWAS that takes into account relative country sizes will be dominated by economic conditions in Nigeria. Second, the differences in economic structures and effects of external shocks imply that optimal policy rules look quite different for Nigeria than for WAEMU and Ghana. Third, and following from the second point, the desirable policy rate settings for Nigeria are likely to be quite different from those for WAEMU and Ghana, which could make it complicated to use a common exchange rate regime and monetary policy framework.

BUILDING AND HARMONIZING RESILIENT POLICY FRAMEWORKS AND INSTITUTIONS

Chapter 7 makes the case that a strong institutional framework is needed to underpin the currency zone, in addition to harmonizing specific elements of institutions within each country. The main elements include:

- Uniformity of trade regimes; elimination of trade barriers
- Effective mechanism for gathering macroeconomic and other data
- A robust multilateral surveillance mechanism with "teeth" to deal with deviations from jointly agreed-upon criteria
- Harmonized and well-coordinated banking supervision and regulation
- Harmonization of capital and current account regulations
- Risk-pooling mechanism to deal with asymmetric external shocks
- Regional payment system

The recent experience of the eurozone suggests that a currency zone would be fortified by a broader economic union, including a banking union, a unified pan-zone financial regulatory system, and harmonized institutions underpinning the functioning of labor and product markets. These are long-term considerations for ECOWAS leaders. It is also worth considering the alternative approach taken by Asian economies, which have attempted to foster greater regional trade and financial integration without forming a currency union. Ancillary issues relevant for making growth in the ECOWAS region robust and sustainable, and for spreading the benefits of growth more evenly, include (1) regional financial market development and integration, and (2) raising financial inclusion through traditional as well as new technologies.

Another key challenge is related to the harmonization of monetary policy frameworks. The transition path to a common central bank will require a number of institutional and operational features to be determined and agreed upon in advance, particularly in order to build credibility for the monetary policy operations of the new central bank. These considerations, in addition to the monetary policy framework itself, include:

- Definition of price stability
- Measurement of economic activity, including output gaps and labor market outcomes, for the entire zone
- Governance, legitimacy, and accountability of a cross-national central bank
- Effective communication with market participants

Chapter 8 concludes and provides an overall assessment of the ECOWAS single currency project. It highlights the ambitious but potentially beneficial nature of the project as well as the significant costs, operational challenges, and transitional risks associated with it. With an unwavering commitment to building resilient policy and robust institutions, the overall objective of building a prosperous ECOWAS region is possible, and the currency union could be a desirable element of a strategy to promote growth and prosperity.

While the project took a backseat in 2020–2021 as Africa and the world had to turn attention to coping with the economic ravages wrought by the COVID-19 pandemic, the relevance of the issues discussed in this book has in fact been intensified by recent developments. During the pandemic, advanced economies used their central banks to provide extensive liquidity support to their economies and stave off an even deeper global economic crisis. African countries called for a $100 billion stimulus to respond to the pandemic, but lacked the tools to finance such an injection of capital into their economies. Would strong regional central banks or even a continental central bank have helped? The regional experience of the ECOWAS provides some indication of what would be needed to accomplish monetary integration. But it also highlights the difficulties the continent faces and some fundamental issues that must be resolved to promote resilience in the region and to foster alternative avenues to regional integration.