COSTS AND BENEFITS ANALYSIS OF MONETARY INTEGRATION IN WEST AFRICA

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Abstract: The primary motivation for establishing a Monetary Union (MU) derives from the desire to deepen an existing regional integration arrangement. This study examined the costs and benefits of MU. Generally, the benefits of MU accrue from macroeconomic efficiency gains: reduced transaction costs; increased competition; reduced risk and uncertainty, and policy credibility enhancement. However, the costs relate largely to the macroeconomic management difficulties occasioned by the loss of national monetary and exchange rate policy autonomy.

A country, which participates in a monetary union, renounces a very important instrument of economic policy. This abandonment of monetary and exchange rate policy would trigger a host of other domestic economic management policy options. These are significant costs that could discourage a country from unionizing. Yet, given the political will to implement decisions, commitment, and sincerity of purpose, the gains and opportunities that await integrating countries outweigh the perceived costs.

Keywords: Monetary Union, Regional Integration, Ecowas, Costs and Benefits

1.0 Introduction

The globalization that is changing the economic landscape was preceded by a discernible trend in the realignment of economic relationships by nation-states after the end of World War II. The phenomenon of regional economic integration arrangements cut across most regions of the world regardless of the geographical or income brackets of the integrating nations. From Asia to Europe, North to South America, the formation of regional economic blocs almost took on a life of its own. Not to be left in the lurch, Africa set up a number of sub-regional and continental initiatives aimed at unifying its economic space. Coming closer home, the Economic Community of West African States (ECOWAS) was established with fanfare in May 1975. The ultimate objective of ECOWAS was to create a common market in the sub-region. Underpinning the drive to a common market was a sub-program to establish a common currency among the sixteen integrating states. Despite the fact that the sub-program of monetary integration was accorded special status and attention by the Authority of Heads of State and Government, no appreciable progress has been made toward realizing the lofty objective. The reasons adduced by commentators for the bad shape of the ECOWAS monetary integration scheme have been eloquently articulated elsewhere to warrant detailed examination in this limited space. Faced with the failure of the common currency project, ECOWAS countries had to cling to their national currencies most of which have since regressed from a state of over-valuation to that of persistent depreciation in value. Yet it is a truism that in general, countries with weak national currencies often experience financial fragility regardless of what form of exchange rate regime they adopt. This realization, among others, has prompted many developing countries to consider regionalization of their currencies. A few others have opted for dollarization. However, the focus of this paper will be on regionalization rather than the dollarization of national currencies.

PART II

2.0 THEORY OF MONETARY INTEGRATION

Monetary integration is the monetary unification of participating member countries in an economic union and involves the adoption of a common currency, coordinated exchange rate policies, and harmonization of fiscal and monetary policies (Nana-Sink-am, 1978). This can only be envisaged during the final stages of the five-stage process of economic integration. Corden (1972) emphasizes that the concept of monetary integration essentially involves the following:

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i) An exchange rate union, i.e. this is an area within which exchange rates bear a permanently fixed relationship to each other even though the rates may, in unison, vary relative to non-union currencies; and
ii) Convertibility – the permanent absence of all exchange controls, whether for current or capital transactions, within the area.

The adoption of fixed exchange rate margins among the currencies of member states, or the adoption of a common currency, the pooling of foreign exchange resources, a common central bank, factor mobility, and harmonization of monetary and fiscal policies are the defining features of a durable monetary union.

2.1 Models of Monetary Integration

Monetary integration can simply be defined as the **existence of a single monetary zone with a high degree of monetary stability in the furtherance of economic integration.**

Monetary integration may also be viewed as a continuum of arrangements ranging from what economists have dubbed **optimum currency area**, to a full-blown **monetary union**. It could take the form of a limited convertibility arrangement whereby the currencies in the zone, through some exchange mechanism, are fully convertible into one or the other at immutably fixed exchange rates. However, such convertibility is restricted to the region.

2.2 Concept of Optimum Currency Area

Mason and Taylor (1993), defined an optimum currency area as a geographical area in which a single currency circulates as the principal medium of exchange. Here, the advantages for internal trade of further expanding the area of fixed exchange rates equal the costs of giving up the freedom to devalue or revalue. For instance, the South African currency, the rand, circulates freely in Swaziland and Mozambique side by side with the national currencies of the two countries. In other words, even without a formal monetary integration treaty, economic, social, geographical or historic fundamentals can enthrone one currency as the pre-eminent medium of exchange and store of value in a region. At the apogee of the Nigerian economic boom in the late 1970s and early 1980s, the naira, despite the then prevailing regime of exchange controls, was freely traded on the West African coast.

A priori, the wider the optimum currency area, the greater the gains from the use of a single currency in the integrating zone. But certain factors related to macroeconomic shocks limit the size of the area (Mundell, 1961).

For instance, unless labor and capital can freely move between two integrating countries, a fall in demand in one country could eventuate unemployment in the other in the absence of a flexible nominal exchange rate.

Assume that wages and prices are sticky downwards. The only way to affect real exchange rate depreciation would be through an adjustment in the nominal exchange rate.

But in real life, labor mobility is impeded by such factors as immigration restrictions, language and cultural barriers, foreign exchange, and fiscal barriers. In other words, the internalization and sustainability of the net benefits in an optimum currency area are driven largely by the degree of diversification of the economies of the integrating countries. In this context, it was not surprising that the ascendancy of the naira on the West African coast in the late 70s and early 80s collapsed with the first waves of severe shocks to the Nigerian economy, given the similarity of the production profiles of West African economies.

2.3 Concept of Monetary Union

A monetary union may be viewed as **an area within which exchange rates bear an immutable relationship to each other**. If there are several currencies in the integrating zone, these currencies must be fully convertible one into the other at permanently fixed exchange rates, thereby effectively creating a single currency. This could be affected through an exchange rate mechanism such as the effective European Exchange Rate Mechanism or the ineffectual ECOWAS Exchange Rate Mechanism.

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A full-blown monetary union is usually characterized by a common currency, common monetary and fiscal policies, a common pool of foreign exchange reserves, a harmonized credit policy, and a common monetary authority or central bank.

The case for monetary union is based on the grounds that the standard function of money as a medium of exchange and store of value is more effectively performed as the cost of conversion and forward cover are eliminated and hence, realizing real saving.

Thus, there would be zero transaction costs related to exchange rate variability arising from the use of different national currencies for intra-regional trade and investment.

Cooper (1990), advocates a single global currency area to minimize transactions costs on international trade. Concerning intra-regional trade flows within the currency zone,
McKinnon (1963), postulates that the higher the level of intra-regional trade within a common currency area, the greater the cost-saving from the currency union as a result of a reduction in transactions costs.

Proponents of monetary union have also based their argument on the degree of openness of the integrating economies. It is contended that open economies (like WAMZ economies) are suitable candidates for fixed exchange rates vis-à-vis their trading partners. Assume a fall in demand for the country's exports. Further, assume that the economy is at full employment. In order to maintain external equilibrium, resources must be shifted from the production of non-traded goods to the production of traded commodities.

Another important issue relevant to the discussion of monetary unions is the conduct of fiscal policy by the integrating countries. In a monetary union, national fiscal actions or inactions could impact tremendously on other union members. In fact, this possibility is one of the nightmares of integrationists. It carries with it the risk of low inflation countries importing inflation from countries with high rates. This could make the low inflation countries to demur on decisions to advance the cause of regional integration (Itsede, 2001). Hence, the need for policy coordination to minimize these externalities. But what manner of policy coordination is necessary to address the externalities? The answer depends on whether the problem is excessive budget deficits or over-restrictive fiscal policy. In the case of the former, setting ceilings on budget deficits may do the trick, but in the case of the latter, moral suasion would appear appropriate. Here lies the imperative of putting in place an appropriate structure and mechanism for economic policy coordination among the union members.

Part III

3.0 GAINS FROM INTEGRATION

The gains from the monetary union could be quite enormous:

3.1 Monetary Policy Management

A monetary union entails the establishment of a supranational central bank managed by nationals of the integrating countries. This means that the integrating countries would lose their cherished sovereignty over the determination of monetary policy. Britain has yet to reconcile itself with this reality. Hence it's a refrain to the Euro scheme. As a consequence, monetary policy management is centralized at the regional level, thus insulating it from the influences of populist national politics. Indeed, it should be difficult for one country to unduly influence the monetary policy of the common central bank. For instance, in spite of Germany's preeminent role in the European Central Bank (ECB) (with headquarters in Frankfurt, Germany), it could not get the ECB to lower interest rates to help combat high German unemployment. How much pressure could Luxembourg bring to bear on the ECB? In this context, it is important that the regional monetary authority enjoys autonomy in the performance of its functions and still remain accountable to the polity through an appropriate structure.

3.2 Trade Effects

A major attraction of monetary integration is its trade-creating potential within and beyond the constituent states by removing some of the payments obstacles to trade.

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These include the union's regime of a stable exchange rate of the common currency. In such a fixed exchange regime, costs of money conversion, and forward cover required in a flexible exchange system are eliminated. The common currency thus constitutes a reliable anchor for businessmen in their trade contracts and position-taking on trade issues generally. It is thus not surprising that a great many economists and policymakers themselves have at one time or another blamed the low level of intra-ECOWAS trade on payments difficulties owing to the existence of inconvertible sub-regional currencies, widely fluctuating exchange rates, and competitive regional production profiles, amongst others.

The Treaty of Lagos provides for the elimination of tariff and non-tariff barriers between member countries of ECOWAS as well as rationalization and harmonization of trade policies with third parties. Yet after twenty-seven years of ECOWAS existence, tariff and non-tariff barriers remain considerable obstacles to intra-regional trade transactions. Corrupt border security officials, poor inter-modal transportation networks, and paucity of market information are, to my mind, the limiting factor to intra-ECOWAS trade expansion. As a result, the share of intra-ECOWAS trade in the total trade of the community has stagnated in the 10 percent region over the years.

Unless the integrating countries take urgent and practical measures (I believe they can do this) to deal a telling blow on the administrative impediments to intra-ECOWAS trade, the full benefits of monetary union would remain illusory. West African governments should muster the political will and technical sagacity to abolish legal and administrative dinosaurs that frustrate cross-border economic transactions in the region.

For instance, do West African countries need the Bretton Woods Institutions to demonstrate to them the enormous salutary effects of liberalizing the region's air space by adopting the concept of open skies before they do so? Just as the West African air space remains segmented, so are the national rail networks unconnected. It is too early to assess the impact of the recently launched **ECO MARINE** to link up the seaports in the sub-region. What is not in doubt is the great impetus that the development and linkages of the transportation infrastructure would give to intra-regional trade.

3.3 Capital Flows

Given the fixity of exchange rate under a monetary union arrangement, speculative capital flows would be eliminated, thereby relieving the authorities of frustration in their monetary control. (Mundell, 1973). All things being equal, a monetary zone with a supranational currency would be more stable and safer for capital mobility. Long-term interest rates would decline and be less volatile. This was the experience of Europe where interest rates declined in a number of countries – notably, Ireland, Italy, Portugal, and Spain. This development made it easier to reduce fiscal deficits and promote growth. Beautiful as this scenario seems, it has some qualifications given that the fixity of exchange rate may not be perfectly certain, depending on the particular evolutionary stage of a currency union. When the possibility of an exchange rate misalignment within the union threatens and the country concerned is discouraged from making a prompt decision due to probable overall reluctance of the union to disrupt the unified rate, it may be that speculative capital flows are larger than they otherwise would have been. In the West African sub-region which is fast becoming a caricature of Sub-Saharan African instability, the risk of volatility in portfolio flows in the near term cannot be discounted. It is necessary that thought is given to a possible panacea at this early stage.

3.4 Capital Market Gains

Monetary union involving a common currency is tantamount to the unification of the national capital markets of the integrating countries. This promotes market deepening, greater competition, and more investment opportunities for institutional and individual investors. Banks, brokerage firms, issuing houses, and other capital market operators can expand their operations rapidly for investible funds held by savers in cross-border accounts. Private firms and public entities issuing debt instruments would have a larger pool to tap into. For instance, the adoption of a common currency by members of the West African Monetary Zone (WAMZ) implies that the nationals of the Zone could freely trade on the Nigeria Stock Exchange and Ghana Stock Exchange without exchange rate or currency risks. Firms would not bother themselves sourcing foreign exchange to remit dividends to community investors.

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But would the stock exchanges, brokers, issuing houses, and other capital market operators require single or multiple licenses to do business across national borders in the Zone?

The combined effect of increased competition and an enlarged market could result in a fall in long-run interest rates which is a critical condition for sustained economic growth. In fact, the viability and growth of some domestic capital markets would be somewhat limited without opening their doors to the regional possibilities.

In order to ensure a safe, level, and viable playing turf, a unified capital market should have a common regulatory framework with common rules, standards, and ethics that would guide cross-border investments within the integrating zone.

3.5 Seignorage Gains

We have huge seignorage gains (and losses) from the issuance of a common currency, especially if monetary integration results in a significant expansion in intra-union trade. We also need a large amount in the printing of a union currency would entail a relatively lower unit cost of printing compared to printing national currencies. Everything considered, opportunities for seignorage, profit from the issue of interest-free currency, abound more in a monetary union than in a national economy. Logical as this issue seems, I must point out that it is a tricky one that could make or mar a monetary union.

What is the enormity of the problem? **It is estimated that seignorage contributes about 0.5 percent of the gross domestic product of most countries (**Hausmann, 1999).

The issue at stake concerns one of the principal sources of income to a central bank in a developing economy. Since regionalization of currency printing would wipe out this source of revenue to the national economies, it is important that an acceptable modality for apportioning seignorage gains is agreed at the initial stage. Not even the advanced economies of Europe failed to negotiate this corner with due caution.

The EU compromise was to phase in an agreed formula for distributing seignorage gains.

So, how will seignorage be distributed by the West African Central Bank?

Would the formula be related to a capital subscription to the Bank or based on some other criterion?

3.6 Saving on Foreign Exchange Reserves

Monetary union implies saving on foreign exchange reserves by union members.

The importance of this benefit is not very clear in the early stages of a currency union when the members may not be so sure of the future course of events. However, it will become increasingly significant with greater cooperation among the member countries of the currency union. Depending on what was pooled and how well it is managed, union members experiencing temporary balance of payments problems could seek accommodation in a special fund rather than resort to the costly international financial markets. Ultimately, the members would be completely liberated from having external reserves for transactions internal to the union, just like states within a country. How much reserve saving can be realized in the early stages of currency unification depends on the degree of substitution of union tradable for those of third parties, and the level of intra-union capital flows.

PART IV

4.0 OPPORTUNITIES

The set of opportunities derivable from a monetary union relates to the gains of the arrangement.

4.1 Foreign Exchange Management

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A monetary union involves the pooling of foreign exchange reserves of participating member countries. The management of the pooled reserves resides in the central monetary authority or common central bank. The synergy gained from pooled reserves affords the regional central bank a wider range of options to diversify and rationalize its investment portfolio with a view to maximizing earnings from the investments of reserves.

Other factors that are important in the pooled reserves calculus include the adequacy of the funding, the bases of common decision making, and the operational characteristics. The adjustment mechanism through which the pool would function, regulation of access to resources, replenishment, and constitution, equalization of adjustment burdens are critical elements that should not be over looked. Specifically, it is important to agree on what should be pooled at the outset.

Should member countries surrender all their foreign reserves holding or part of it on Day Zero? If it is partial surrender, what is the optimal fraction? If reserves (assets) must be pooled, what about external debt and contingent liabilities on the cut-off date?

4.2 Enhanced Financial Deepening

Immense opportunities (and threats) to financial institutions abound in a monetary union. Although somewhat similar, the financial systems of the integrating countries in West Africa are at varying stages of development and sophistication. While the enlarged financial services market would open up greater possibilities to financial firms with a competitive edge, it would expose market laggards to the ruthless winds of change occasioned by monetary integration. For instance, only the Nigerian financial system currently embraces the full universal banking (UB) concept. Although in Ghana, both commercial and merchant banks compete for deposits and market similar products, they do not offer the full menu of UB services. Nigerian banks that are already practicing UB would have a head start over their counterparts in the Union. The integration of the market would throw up opportunities for them to use their present UB experience to a competitive advantage. Conversely, Nigerian banks would have to brace up to the challenges that would be posed by Ghanaian banks and bureau de change which use relatively advanced techniques in the interbank foreign exchange market. The net gains or losses to financial services providers will depend largely on their competitiveness, production, and adaptability to the sweep of the inexorable current generated by monetary union.

Fundamental changes in the structure of the financial system have high prospects with the advent of a monetary union. The financial system will experience enhanced financial deepening through variegated instruments in the integrated money, insurance, and capital markets. This could lead to paradigmatic changes in the financial product mix as derivatives and other emerging funds' products become actively traded in the enlarged multi-national market.

Mergers and acquisitions are common features of the financial system as financial institutions reposition for the union market. With the enhanced scale of operations, the salutary effects of mergers spreading overhead costs of transactions more widely are enormous. The resultant low cost profile could induce a downward pressure on long-run lending rates, prices of products and services, thus enhancing the competitiveness of the financial sector and its employment generating capacity.

4.3 Payments Systems

A single currency requires a single integrated money market which in turn requires an efficient payment system. The international quality standard for payments systems is the **Real Time Gross Settlement** (RTGS). Ghana is the only country in the WAMZ zone that currently operates RTGS.

There is an urgent need to upgrade the payment systems of member states to the RTGS level so as to provide the necessary infrastructure for the smooth functioning of an integrated money market.

4.4 Banking Supervision

A basic issue that arises with the introduction of a common currency is whether banking supervision should be conducted at the community level or continues to be conducted at the national level, but subject to the directives

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of the common central bank or supranational supervisory authority. In the European Union, arguments for a centralized supervisory framework were not very strong. The Bundesbank believed in the principle that supervision should not be the responsibility of a central bank, arguing that occasional bank failures were inevitable or even desirable. Under the framework of WAMZ, a West African Financial Services Authority (WAFSA) will be established to perform this function in the long-run. This model should be relatively easy to integrate with a similar one operated by the Francophone countries in the region. Whatever happens, one thing is sure: **a new financial architecture is the hand maid of monetary union**

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Thus, it is clear that monetary union would entail the need to put in place a common legal and regulatory framework for prudential regulation of the banking system as one of the priority measures to be implemented. Another key issue is the question of deposit insurance.

As of now, only Nigeria operates a deposit insurance scheme in West Africa. It is important, therefore, that this matter is given due attention in the lead up to the monetary union. Then there is the issue of bank licensing. Would a license issued by WACB or other competent authority suffice for region-wide operation by the licensee?

4.5 The Real Sector

Monetary integration could affect an upward shift in the national production possibility frontiers as production structures change through changes in the scale and techniques of output and its geographical distribution. Market unification and dynamics could enable some industries to re-locate to "action areas" to reap the perceived benefits of the enlarged union market of about 150 million people and a great many federal, regional and local governments. Faced with a significantly enlarged market, producers in the various sectors would be encouraged to plan to take advantage of the opportunities for economies of scale. Integration could engender the proliferation of a great number of large scale cross-border industries by both nationals and foreign investors. Industries could become much more competitive in their pricing policies and much more prone to frequent restructuring in efforts to cope with enlarged and variegated demand profiles.

For enterprising producers and manufacturers, the large market and the protective walls it offers are a safe environment to learn the ropes in product research, development, packaging, and marketing which are necessary to compete effectively in the global market.

For meaningful trade to take place in semi-finished and finished products in the region, West African countries must establish and enforce common standards for assessing the quality of export products from the community. These standards must conform to international standards.

4.6 Factor Mobility

The cause of monetary integration would be better served by the movement of factors of production (Mundell, 1961) within the union. Such mobility would equilibrate the demand and supply of factors of production by shifting resources from surplus areas to deficit areas in the monetary zone. This could stabilize the wage rate and reduce the incidence of frictional unemployment. To aid this process in the West African sub-region, visas and entry permits have been abolished, right of residence and establishment endorsed, while a community insurance scheme (ECOWAS Brown Card) has also been instituted.

As stated earlier, a special program for the elimination of non-tariff barriers to trade (road check points, non-acceptance of local currencies for airport tax and hotel payments, etc) was adopted in 1992. Save for payment of airport taxes in local currencies, the other barriers continue to frustrate economic operators. The result is the persistence of the anachronistic practices of hoteliers charging ECOWAS citizens hard currency for the settlement of hotel bills and absurdly numerous checkpoints on transnational highways.

4.7 Macroeconomic Policy Coordination

One of the first steps on the road to economic integration is the establishment of a credible mechanism for macroeconomic policy coordination. This is important given that the integrating countries have varying degrees of

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economic development and perhaps macro policy divergence on the eve of integration. Different countries have different levels of inflation, exchange rate, fiscal deficit, public debt, and external reserves. This is why integrating countries usually place in the front burner, agreement on a set of criteria by which the convergence of economies would be measured. But one problem encountered in macro policy coordination is the harmonization of the definitions and measurements of the convergence criteria. In the West African context, **efforts should be intensified to develop a Harmonized Consumer Price Index (HCPI) to enhance** the **inter-country comparison of price tendencies across the community.** Everyone should have the same understanding of what goes into the calculation of the deficit/GDP ratio.

Moving towards convergence requires hard decisions and difficult-policy choices.

In many instances, the most pressing reforms are the least politically popular, especially when politicians have their eyes on the next election. As a result, some countries participating in integration arrangements often don the toga of the regional agenda to push through politically unpopular (but economically sound) reforms.

Regrettably, the macro policy coordination mechanism in the region is very weak.

How many ECOWAS member states deliberately set their macroeconomic targets in consonance with the regional benchmarks to which they have committed themselves?

Where there were compelling needs to deviate from the targets, were other members consulted or notified? Indeed, experience has shown that national economic targets are seldom if ever, set and pursued with a conscious reference to the regional benchmarks.

How many national budgets of ECOWAS countries draw inspiration from the convergence criteria of the community? The result is that governments lose a good opportunity to inculcate the integration program on the public's consciousness. **The coordination mechanism ought to include some notional sanctions for countries that persistently miss the mark.**

Effective 1st April 2002, the exchange rates of the currencies of the West African
Monetary Zone (WAMZ), is expected to fluctuate within a band of ±15 percent under the Exchange Rate Mechanism (ERM). In other words, the fate of each currency is expected to be driven by its relative position within the agreed band. **Can we now claim that the exchange rates of the dalasi, cedi, franc, naira and leone are basically related to their movements within this band2?**

PART V

CONCLUDING REMARKS

A country that participates in a monetary union renounces a very important instrument of economic policy. With this abandonment of monetary and exchange rate policy would go a host of other domestic economic management policy options. These are significant costs that could discourage a country from unionizing. Indeed, they were among the vector of factors which Britain adduced for its non-participation in the Euro currency scheme. Yet, given the political will to implement decisions, commitment, and sincerity of purpose, the gains and opportunities that await integrating countries outweigh the perceived costs.

These include:

1. Boost to trade and investment flows;
2. Significant reduction in transactions costs of intra-regional trade;
3. Enhancement of efficiency in domestic and regional resource allocation;
4. Outward shift in national production possibility frontiers;
5. Enhanced seignorage gains;
6. Improved productivity through factor mobility;
7. Increased resource savings from the pooling of external reserves;
8. Improvement in the fiscal discipline;

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9. Market enlargement;
10. Opportunities for mergers and acquisition and firm re-engineering;
11. Financial deepening is driven by competition in the expanded money and capital markets;
12. Enhanced coordination of macroeconomic policies; and
13. Promotion of economic growth.

For the West African countries that are forging a monetary union to reap the benefits thereof, they must:
i) Demonstrate political will and commitment to implement agreed decisions;
ii) Popularize the process by making it participatory – let the various publics i.e., the organized business community, academia, trade unions, legislators, and NGOS, buy into and have a sense of ownership of the integration process;
iii) Strengthen the macro policy coordination mechanism;
iv) Agree on common, unambiguous definitions of concepts and measurements of vital parameters of the surveillance mechanism;
v) Take a holistic view of the process of monetary union by adopting sectoral measures in all aspects that feed into the integration agenda – trade policy, transportation, and administrative bottlenecks by getting on board all the relevant agencies and institutions involved in the process;
vi) Agree on common standards of assessing and measuring the quality of tradeable;
vii) Address the issue of licensing, and regulation of financial institutions;
viii) Reform and harmonize the regional payments system.

So where does all this leave us?

5.2 A Closing Thought

History informs us that time and again one person or a group of persons can **awaken** the public to the importance of an issue and set in motion epochal changes in the affairs of mankind. The challenge before us now is to lay out the practical modalities for realizing monetary integration in West Africa in a clear and compelling manner to both the general public and policymakers.

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