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Towards A Monetary Union in the Economic Community of West African States (ECOWAS): Prospects and Challenges"

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2006-11-15T13:35:59Z
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Chapter Three

Prospects for Forming a Monetary Union in West Africa

This chapter examines the prospects of forming a monetary union in West Africa, and assesses the economic performance of member states of the West African monetary zone during the second transition period, 1999-2003. It looks at steps taken by non-UEMOA member states in consolidating a monetary zone and highlights the institutions which have been put in place to accelerate the monetary integration process.

The need to create a zone of monetary stability in the sub region has long been recognized as a desirable step to boost intraregional trade, catalyze foreign investment and stimulate economic growth. This crystallized in the adoption of a monetary cooperation programme of ECOWAS in 1987. The Monetary Cooperation Programme was expected to achieve three principal objectives, namely, the improvement and strengthening of intra-regional trade, achievement of regional currency convertibility and establishment of a single monetary Zone.[1] To this end, a transitional period 1987-2000 was at first earmarked for the completion of the requisite legal, administrative and institutional framework for the realization of these objectives. However due to lack of political will and leadership, the policies and measures arrived at towards the creation of a common currency suffered several setbacks. The lack of commitment as reflected in the delays of member states' implementation of programmes resulted in several extensions of the dates for the implementation of major aspects of the programme.[2]

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[1] Emmanuel Ating. "West African Monetary Institute, Accra Ghana," *www.reservebank.co.za/internet /publications.nsf/adv/ffa8/acca2a2002256b6doo/c87/file/wami.pdf.*

[2] G.E. Ukpong, "Second Monetary Zone in ECOWAS: Issues, Progress and Prospects," *http://www. Centbank.org/out/publications/efr/rd/2002/efrvol40-4-4.pdf.*

Against this background, at the 22nd summit of the Authority of Heads of State and Government of ECOWAS in December 1999, a decision was taken to implement a two track approach to the integration programme, to accelerate the process in the sub-region. Under this approach, a second monetary zone comprising non-UEMOA countries was envisaged. Ghana and Nigeria held bilateral talks in December 1999 to discuss strategies and modalities for actualizing the objective. The meeting set up two technical committees, one on trade and the other on monetary issues to identify ways of accelerating programmes in each sector.[3] The technical committee on monetary issues held its first meeting in Accra, Ghana in January of 2000, during which models of monetary integration and the experiences of countries were discussed.[4]

Following consultations with the governments of Gambia, Guinea, Liberia and Sierra Leone on the issue, a mini summit of the Authority of Heads of State and Government of the six countries was held in Accra on April 20, 2000 at which the Accra Declaration on the creation of a second monetary zone was signed. The meeting also established a task force to work in the process. These countries agreed on stringent convergence criteria which included reduction of inflation, building up currency reserves, limiting central bank financing of government budget deficit and setting a maximum limit on deficit GDP-ratio. Institutional arrangements such as a convergence council, technical committees as well as the West African Monetary Institute were established. A three-year convergence programme terminating in 2003 was agreed.[5]

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[3] "The Second Monetary Zone in West Africa and the Future of a Single Monetary Zone in Sub Saharan Africa," *http://sceco.univ-aux.fr/cefi/collques/olawale%20ogunkola.pdf.*
[4] Ibid.
[5] "Progress Report on the Development and Application of Macro Economic Convergence Criteria and Creation of A Single Monetary Zone in West Africa," *United Nations Economic Commission For Africa, May 2003, 15.*

The creation of a stable monetary union among a group of countries must be preceded by the existence of certain economic conditions. These include the harmonization of macro policies, notably fiscal, monetary and exchange rate policies as well as institutional arrangements, involving the financial and payment systems. Since the integrating countries would naturally be at varying stages of economic development, a set of convergence criteria which must be met by each country is usually set. The West African Monetary Zone parameters are identical with the ECOWAS criteria agreed in 1999, and are also consistent with those of the UEMOA.[6] Two types of criteria were agreed to; the primary and secondary criteria. The criteria were introduced to reduce, if not eliminate the negative externalities that come hand in hoof with monetary integration and thus create the enabling economic conditions for macro economic stability in the union. The targets and schedule of primary and secondary criteria as shown in tables 5 and 6 below reveal two stages of implementation, while table 4 reveals the target for primary convergence criteria. The ultimate goal is that once established, the zone will be fused with the CFA zone.

[6] "Central Bank of Nigeria, Seminar of the Proposed, Second West African Monetary Zone (WAMZ), Lagos: Publication of CBN Training Centre, No 5, 2001.

Table 4

Targets for Primary Convergence Criteria.

Inflation	Single digit by end of 2000	No more than 5% by end of 2003
Gross Foreign Currency Reserves	At Least Three Months Worth of Imports	At Least Six Months Worth of Imports
Central Bank Financing of Budget Deficit	Not more than 10% of the previous year's tax revenue	Not more than 10% of the previous year's tax revenue
Ratio of budget deficit to GDP.	Not more than 5 %	Not more than 4 %

Source: West African Monetary Institute, Accra Ghana.

Table 5

The Actual State of Primary Convergence Criteria, 2000

Country	**Budget Deficit, GDP ratio excluding grants**	**Inflation Rates**	**Central Bank Financing of Budget Deficit**	**Gross Reserves, Annual Imports in Months**	**Number of Criteria Satisfied**
Benchmark	≤ 5%	< 10	≤10%	≥ 3 months	
Gambia	3.84%	0.8%	0.00%	2.94	3
Ghana	10.74%	40.50%	8.20%	0.53	1
Guinea	5.99%	7.20%	6.20%	1.15	2
Sierra Leone	17.30%	-2.75%	1.87%	1.62	2

Source: http://www.ecowas.int/wami-imao/.

Table 6

The State of Secondary Convergence Criteria 2000

Country	Domestic Arrears	Fiscal Receipt GDP Ratio	Salary, mass/total Receipt	Real Exchange Stability	Positive Real Exchange Rate	Public Investments from within	No of Criteria Satisfied
benchmark	0%	≥ 20%	≤35%		+	≥20%	
Gambia	N/A	300.000.000.00%	233.33%	75.61	12.00	0.00%	2
Ghana	7.70	4.74%	1230.81%	0.00	-362.00	1273.34%	1
Guinea	161.00	209.89%	0.00%	0.00	-175470	0.03%	2
Nigeria	N/A	28.10%	14.20%	0.00	0.00	22.00%	3
Sierra Leone	0.00	191.16%	16.29%	0.00	-14865	8.43%	3

Source: http://www.ecowas.int-imao

Tables 5 and 6 above reveal that all countries in the second monetary zone, at the end of the year 2000 satisfied the criteria on central bank financing of budget deficit. All the countries except Ghana met the condition on inflation rate. The budget deficit-GDP ratio proved difficult for most of the countries. More difficult was the condition on gross foreign currency reserves that was only satisfied by Nigeria. The secondary criteria were difficult to meet by these countries.

The prospects for convergence according to the set timetable were not met at the end of the transition period. According to the 2001 mid year convergence report, macro economic outcomes for the first half of the year indicated a modest improvement towards economic convergence. The slippages and general elections in the Gambia in the same year presented challenges for macro economic stability during the second half of 2001. Ghana seemed to have implemented strong reforms but the results of these measures did not lead to the achievement of most of the convergence

targets because of the serious economic declines experienced in 2000. In 2001, Guinea had problems with central bank financing of the budget, which was higher than the target. For Nigeria, the continued firmness in oil prices minimized the level of deficit financing for the year. For its part, Sierra Leone experienced higher rates of inflation as a result of reconstruction efforts after the civil war.

Evaluating the progress towards the establishment of the second monetary zone from these criteria is less desirable unless their trends are incorporated into the analysis, especially since the West African Monetary Institute depends on the reports of member states for its activities. Apart from playing the possibility of making data sing, effects of exogenous shocks on these variables cannot be ruled out. The effects of development on the international oil market could explain the recent trends in the figures for Nigeria. Even if all the targets were met at the end of the transition period, the level of achievement would not have been comparable to what was obtained in the CFA zone.[7]

The Role and Functions of the West African Monetary Institute

In a bid to facilitate the creation of the West African Central Bank and the introduction of a common currency, an interim institution, the West African Monetary Institute was set up in Accra, Ghana in 2001. The institute which undertakes the technical preparations for the establishment of a common West African Central Bank started operations in March 2001. In accordance with its status, the institute is mandated to per form the following functions; The monitoring of the state of convergence criteria among member states, harmonization of regulations on financial markets, promotion of the developments in the payments systems in the second

[7] R.D Asante and Paul Robert Masson, "The Pros and Cons of Monetary Union in West Africa," *Finance and Development, IMF Quarterly Magazine,* March 2001, Vol 38, No1.

monetary zone and preparing the background for the issuance of the new currency to be issued by the West African Central Bank.

The Monitoring of the State of Convergence among Member States

The West African Monetary Institute monitors the state of macro economic convergence of the member states vis-à-vis the prescribed benchmarks which include the primary and secondary convergence criteria and submits an analysis of developments in the participating countries, to the decision making body of the zone which is the convergence council. The convergence report contains recommendations on policy measures needed to achieve the required convergence in the participating economies. These reports are submitted to the convergence council on a quarterly basis for consideration.[8]

The institute ensures that regulations on financial markets in all members including laws relating to both bank and non-bank financial institutions are harmonized in order to create a level playing field for all economic operators within the zone. The WAMI equally ensures the harmonization of monetary policy, banking regulations and accounting practices of all the participating countries of the West African Monetary Zone. This would allow comparability and the formulation of a common monetary policy for all six countries. In order to ensure effective banking in the zone, WAMI makes proposals on an institutional framework for a centralized supervisory authority.[9]

Furthermore, the institute promotes the development of the payment's system in the second monetary zone to facilitate the implementation of a common monetary policy.

[8] "The West African Monetary Institute," *Agreements, Statutes and Other Provisions of the West African Monetary Institute, 2000.*
[9] *The Role and Functions of the West African Monetary Institute,* West African Monetary Institute. Accra Ghana.

This requires close collaboration with the central banks of member states and the West African Bankers Association (WABA) to implement a payment's system infrastructure that would allow the interlinking of all participatory countries. This would facilitate the smooth execution of monetary policy operations and efficient transfers within the zone. The institute also studies the issue of exchange rate parities within the Zone and recommends the appropriate exchange rate mechanism and appropriate bands of fluctuations for currencies in the zone. It is responsible for determining the value of the currency and the conversion rates of national currencies into the common currency when it comes into being.[10]

It is charged with the responsibility of preparing for background work on the new currency to be issued by the West African Central Bank. The would include the name, determination of par value, denominations that would facilitate the printing of the new bank notes and coins by the West African Central Bank. The institute is tasked with the drawing up of the legal framework of the central bank and related institutions, proposals for selecting the headquarters, modalities for contributing to the capital, the physical infrastructure and drawing up guidelines for hiring of key officers.[11]

In line with some of the above mentioned objectives, the institute undertook multilateral surveillance missions to member countries of the West African Monetary Zone in March 2004 to review macro economic developments and access progress towards convergence in 2003. According to its findings, monetary aggregates accelerated in most of the countries while the inflation rates tended upwards.[12] Its

[10] " The West African Monetary Institute, The Meetings of the West African Monetary Institute, Study Reports of the West African Monetary Institute," Vol 1, 2000.
[11] "The West African Monetary Institute," *Press Release:* "A Second Monetary Zone in West Africa to Energize the Integration Process and Economic Activity in the Sub Region", May, 2001.
[12] "WAMI News," *A News Bulletin of the West African Monetary Institute* Accra, Ghana Vol 4, No2 2004.

report for the year 2003 stated that economic growth was slow in most of the countries. However in the Gambia, the economy grew by 8.0 per cent compared with a growth rate of 2.3 per cent in 2002. The exchange rate of the Dalasi continued to be under pressure while the inflation rate remained high at 17.6 per cent. The rapid growth in monetary aggregates in the Gambia followed monetary accommodation of fiscal operations of government by the central bank. The Gambia that satisfied two primary convergence criteria in 2002 could only satisfy one at the end of 2003. The level of reserves could finance up to four months of imports, a drop from 5.5 months in 2002, but a comfortable level relative to the benchmark of three months.[13] The Gambia thus satisfied one of the six secondary convergence criteria in 2003.

Ghana recoded a modest increase in the growth of real GDP from 4.7 per cent in 2002 to 5.2 per cent in 2003.[14] Fiscal operations of government resulted in a net repayment of 5.0 per cent of the previous years tax revenue vis-à-vis a programmed zero net borrowing from the central bank. As a result, the growth in monetary aggregates was significantly contained and the exchange rate of the Cedi was stabilized. However, inflationary pressures persisted during the following increases in the prices of petroleum products early in the year. Inflation increased from 15.2 per cent in 2002 to 23. 6 per cent in 2003. In the external sector, Ghana recorded substantial gains with a strong export performance, following improvements in the world market prices of cocoa and gold. The country's external reserves rose to the highest levels in thirty years at 4.0 months of import cover against 2.3 months in 2002.[15] Ghana's performance on the convergence scale also improved significantly from zero compliance in 2002 to compliance with two primary criteria in 2003. It

[13] "Report of the Multilateral Surveillance Mission to the Gambia," *WAMI News Bulletin*, Vol 4, No1, 2004, 13.
[14] "Report of the Multilateral Surveillance Mission to Ghana," *WAMI News Bulletin*, Vol 4, No1, 2004, 13.
[15] Ibid., 13.

satisfied the criteria on central bank financing of fiscal deficit and reserves/import cover. It therefore satisfied three of the six secondary convergence criteria in 2003.

Guinea's real output growth contracted from 4.2 per cent in 2002 to 2.1 per cent in 2003. This was largely accounted for by the crisis in the energy sector and low manufacturing capacity utilization. Following low revenue performance and high government expenditure, monetary developments were expansionary.[16] Part of the fiscal deficits of government was financed from borrowing from the central bank. Inflation assumed an upward trend while the slow movement in the exchange rate tended to reduce the competitiveness of the external sector. External reserves declined significantly from 2.1 months of imports in 2002 to 1.8 months in 2003.[17]

Guinea which satisfied one primary convergence criterion, inflation in 2002 did not satisfy any of the four primary convergence criteria in 2003. Her performance on inflation was particularly worrisome as the country had historically achieved a low single digit inflation rate. However in 2003, inflation stood at 14.8 per cent, up from 6.1 per cent in 2002.[18] It satisfied one of the six convergence criteria in 2003.

The rate of Nigeria's economic growth estimated at 4.3 per cent at the end of 2003 was slightly lower than the 5.0 per cent real GDP growth in 2002. Economic growth continued to be propelled by oil receipts and agricultural output. Following expansionary fiscal operations in the latter part of 2003, the depreciation in the exchange rate of the Naira and an increase in the prices of petroleum products, inflationary spiral exacerbated with domestic prices, rising from 12.2 per cent in 2002 to 23.8 per cent in 2003. Budget deficits were largely contained during the year. The resort to the central bank for credit resulted in Nigeria narrowly missing the criterion

[16] "Report of Multilateral Surveillance Mission to Guinea," *WAMI News Bulletin,* Vol 4, No 1, 2004, 14.
[17] Ibid.,14
[18] Ibid., 14.

on central bank financing for fiscal deficit at 10.3 per cent against the target of 10 per cent of the previous year's tax revenue. At the end of 2003, it satisfied two of the four primary convergence criteria on budget deficit/GDP ratio at 2.9 per cent, an improvement of over 5.4 per cent in 2002 and reserves/import cover at 6.5 months against 9.9 months in 2002.[19] Nigeria satisfied three of the six secondary convergence criteria in 2003.

Sierra Leone's GDP growth rate was estimated at 6.5 per cent in 2003 compared with 6.3 per cent in 2002. The improvement in mining and agricultural activities and construction were largely responsible for the slight increase in the rate of economic growth. The government was under considerable fiscal pressure as a result of the shortfall in donor inflows to bridge the budget gap.[20] The financing of the budget had to be accommodated by the central bank that offered credit to the government to the tune of 25.4 per cent of the previous year's tax revenue. The domestic money market was under considerable liquidity while the external sector was also under pressure following shortfalls in donor inflows and structural export constrains. As a result of these developments, the Leone was under considerable pressure, depreciating by 14.9 per cent compared with a depreciation of 0.9 per cent in 2002 when it was relatively more stable. At the end of 2003, the Leone depreciated by 15.5 per cent against its central parity rate in the West African Monetary Zone exchange rate mechanism, compared with the fluctuation band of ± 15.0 per cent. The Leone was thus out of the West African Monetary Zone Exchange Rate Mechanism (ERM) at the end of December 2003. Sierra Leone did not satisfy any of the four primary convergence

[19] "Report of Multilateral Surveillance Mission to Nigeria," *WAMI News Bulletin,* Vol 4, No 1, 2004, 15.
[20] "Report of Multilateral Surveillance Mission to Sierra Leone," *WAMI News Bulletin,* Vol 4, No 1, 2004.

criteria in 2003 compared to 2002 when it satisfied three criteria.[21] The country did not also satisfy any of the six secondary convergence criteria in 2003 compared with the attainment of two secondary convergence criteria in 2002.

Overall, the West African Monetary Zone countries except Nigeria failed to satisfy the criterion on budget/deficit ratio. All the countries of the zone missed the target on inflation. Guinea and Sierra Leone could not satisfy the benchmark of three months at the end of 2003. The convergence process which improved from an overall score on the primary criteria of 45 to 50 per cent in 2001 dropped to 40 per cent in 2003.

Apart from these set of convergence criteria, there are also other critical issues that the West African Monetary Institute is yet to address. It is for instance still not clear if all the WAMI member countries will proceed with monetary integration whether or not they achieve the WAMI prescribed convergence criteria. Furthermore, details are not clear with respect to the planned merger of the two monetary zones in July 2005. The ECOWAS central bank governors adopted a three-phased approach to an ECOWAS wide monetary integration programme. There have been little or no attempts to reconcile the positions of central bank governors with those of the WAMI. The entire integration process has thus been criticized on several fronts. It has for instance been asserted that although the project has been described in some detail, it is unclear how the list of planned policy measures can be reconciled with the time table of a monetary union of the non-UEMOA countries and the overall monetary union in July 2005.

It is equally not clear how the convergence criteria are to be applied, in particular whether failing to meet them will preclude participation in either the second monetary union or the full monetary union. Finally, details are lacking on how the two

[21] Ibid.,16.

transitions, one toward the second monetary union and the other toward the full monetary union are to fit together. Based on the above facts, doubts have been expressed with respect to the achievement of the targets set by the fast-track programme. The 2003 deadline was postponed to July 2005, yet it is still over optimistic to think this deadline can be met. In the week that three hundred and two million people of twelve European sovereign states scrapped their individual currencies to adopt a single currency, the Euro, President John Kuffuor of Ghana outlined his government's regional policy by pledging Ghana's commitment to the ECOWAS dream of adopting a single currency in the shortest possible time.

Convergence criteria provide a true yardstick to evaluate the extent of commitment to sound macro economic policies and success in making macro economic adjustments. It is therefore important that economic statistics and concepts in the sub region are designed and harmonized to give meaning to these criteria. For example there should be no ambiguity in the definition of the budget deficit for central governments whether it is measured to include subverted agencies and the distinct assemblies. Should consumption and production subsidies be explicitly budgeted for, and included or excluded from the criteria? How do we account for a lot of divergence that exists in the methods of consumer price indices and national accounts?[22]

These questions on statistical measurements aside, there is need to harmonize the accounting systems, banking regulations, budget nomenclature, and the legal framework for public accounting and practices. In this way they will weave the fabric for efficient functioning of financial and other institutions within a competitive regional economic space. It goes without saying that an efficient financial market and

[22] Chris Itsede, , " Seminar on the Proposed Second West African Monetary Zone," Central Bank of Nigeria, *Publication of Cbn Training Centre* No5. 12, 2001.

integrated financial system will be vital for the effects of monetary policy that the common central bank can pursue to be transmitted through the economies of all member countries within the common currency zone and the exchange rate mechanism.[23] While with monetary integration in particular, the single currency project has been placed on a fast track, as a vehicle for economic integration in the ECOWAS sub region, the barriers to the movement of goods and people across the sub region remain formidable and need to be lowered if not removed to give real meaning to the Trade Liberalization Scheme (ETLS) and other protocols on immigration, trade and communications signed by ECOWAS member countries. Otherwise, the benefits of integration will be elusive.[24]

Perhaps more worrying is the decision by the Authority of Heads of State and Government of the West African Monetary Zone to the effect that the name of the common currency, for the second monetary zone will be jointly decided by the competent authorities of the WAMZ and the CFA Franc zone. This decision was taken despite the fact that the Convergence Council of Ministers of the WAMZ which is a subordinate body to the Authority of Heads of State and Government of the zone had earlier recommended the Eco as the name of the WAMZ common currency. On the face of it, the decision of the Heads of State of the WAMZ makes economic sense given the fact that there is no need to establish a currency for the WAMZ countries only to change it later when an ECOWAS wide currency is introduced.[25]

In reality however, the implication of this decision has turned the entire WAMZ project on its head. This is especially so given the fact that WAMZ is supposed to help convince the UEMOA member countries the non-UEMOA countries are indeed

[23] Ibid., 13.
[24] Paul Acquah, Speech Delivered by Dr Paul Acquah, Governor of the Bank of Ghana at the Bank of England/WAMI Workshop on Monetary Union, Accra January 2002.
[25] Lawan Gana, "Implementation of the ECOWAS Integration Process," *Federal Ministry of Cooperation and Integration in Africa, 2002.*

serious about monetary integration in West Africa and thus accelerate the ECOWAS wide integration process. Furthermore it is difficult to see how the Francophone countries will agree to the name of a new currency without the explicit permission of France. This will certainly complicate the negotiations.

Monetary Management

Virtually all countries of the zone currently practice monetary targeting as a technique of monetary management. Monetary management under the West African Central Bank will be a different ball game. According to Article 7 of the Bank's statutes, the primary objective of the Bank shall specify the annual inflation target.[26] In other words, the West African Central Bank which shall determine a common monetary policy for the entire zone shall practice inflation targeting as a technique for monetary management. The existing central banks shall thus abandon their present monetary targeting approach for inflation targeting. This could have legal/institutional implications in some countries where the central bank is not the statutory agency charged with monitoring aggregate price developments.[27] The challenge is for countries to take a look at the approaching scenario and adopt measures to align with it.

Surprisingly, the Statute of the West African Central Bank is silent on the role of the headquarters in licensing of banks. But Article 16(vi) empowers the national branches of the West African Central Bank with licensing regulation and supervision of financial and credit institutions.[28] In this circumstance, it is not clear what shall be the jurisdiction of a bank license issued for instance by the Gambian branch of the

[26] "Treaty of ECOWAS," *www.sec.ecowas.int/sitecedeao/english/stat-1.htm.*
[27] Chris Itsede, "Seminar on the Proposed West African Monetary Zone," Central Bank of Nigeria, *Publication of Cbn Training Centre* No 5, 13.
[28] Ibid., 14.

West African Central Bank. Would it have a zone-wide application or will it be limited to the geographical confines of the Gambia? What implications does this have for unification of the bank system implied by monetary union? Only Nigeria operates an explicit scheme in the West African Monetary Zone. How will this affect banks in Nigeria vis-à-vis those in other countries of the zone.[29]

Fiscal dominance resulting from excessive deficits financed through money creation is the bane of macro economic stability in West Africa, hence the failure of West African Monetary Zone countries to achieve convergence criteria. Under Article 23, the West African Central Bank is prohibited from lending to central governments, regional, local or other public authorities or undertakings of member states. Put differently, the days of ways and means advances under-writing and direct purchase of debt instruments including treasury bills and treasury certificates will soon be a thing of the past. This is a wake up call for fiscal authorities to begin now to learn the wholesome art of balancing the books.[30]

The technicalities involved in the monetary integration process in the community have created a debate regarding the forms to be take by fiscal reforms. In the EU, the Maastricht Treaty describes an excessive deficit procedure that would apply to countries in the monetary union, intended to limit general government deficits to 3 per cent of GDP and gross debt of 60 per cent of GDP. These provisions which allowed for the possibility of sanctions that might include denial of access to EU regional or structural funds were supplemented by more precise commitments by Euro area countries. The stability and growth pact provides for fines imposed on countries

[29] Ibid., 14
[30] Ibid., 15

running excessive deficits which were not due to exceptional circumstances, in particular, those not due to a sharp or sustained downturn in economic activity.[31] The debate in Europe was centred on whether it was desirable to restrict fiscal policy in this way and whether other criteria, such as clinically adjusted deficits would have been preferable. Opponents have pointed to the need for greater fiscal flexibility in response to shocks in a context where other shock absorbers (fiscal transfers between countries, labour mobility etc) were modest. The operation of automatic stabilizers to cushion cyclical fluctuations could be inhibited, especially if countries started at fiscal positions that were close to the 3 per cent deficit ceiling.[32]

Those in favour of the stability and growth pact point to the fact that it takes into account cyclical down turns in evaluating whether financial sanctions would be applied as well as allowing a degree of discretion to the council of finance ministers.[33] Moreover, its intended role is to force countries to have reduced fiscal deficits before the down turn occurs. Countries which in good times ran fiscal surpluses would have substantial room to let the automatic stabilizers operate and to perform discretionary fiscal expansion.[34] In ECOWAS, there is also a potential need to respond to shocks using fiscal policy, judging by the experience of cyclical fluctuations in the CFA Franc zone. However, the challenge of achieving fiscal sustainability is more demanding in many of the countries in the region than in the Euro area, so that the room for manoeuvre for increased budget deficits in the downturns is smaller. This suggests that the cost of potentially limiting the operation of counter-cyclical fiscal

[31] Paul Masson and Catherine Pattillo, "Monetary Union in West Africa: An Agency of Restraint for Fiscal Policies?" *Journal of African Economies*, Vol 11. No 3, 2003, 95.
[32] Horst Toman "Economic and Monetary Integration," *http;//www.wiwiss.fu-berlin.de/wz/tomann/Tomann/bham/seminarfebruary2005.pdf.*
[33] Buti Franco and H. Ongena, "Fiscal Discipline and Flexibility in EMU: The Implementation of the Stability and Growth Pact," *Oxford Review of Economic Policy,* vol 14, 84.
[34] Paul Masson and Catherine Pattillo, *"Monetary Union in West Africa: An Agency of Restraint for Fiscal Policies?"* Journal of African Economies, Vol 11 No 3, 2003, 398.

policies in ECOWAS may be less at least in the margins. ECOWAS countries have also agreed to ceilings on fiscal deficits. However many countries currently exceed those limits.[35]

The experience with convergence in UEMOA is somewhat longer dating back to 1994. The current set of convergence criteria are a fiscal deficit (excluding grants and foreign finance investment), ceiling of zero, the elimination of payment arrears, a public debt ceiling of 7 per cent of GDP and a rate of inflation of at most 3 per cent of GDP. While the inflation rate has well been under the ceiling of 3 per cent despite considerable progress in the 1994-97 period, other criterion have generally not been met in recent years. There have until recently been no sanctions. Sanctions that include a prohibition on access to central bank credit or West African Development Bank loans were agreed by UEMOA members December 1999, but there is as yet no experience to assess the effectiveness, since their application began in 2003. Experience in Africa and the EU suggest that sanctions are difficult to apply, especially since countries unable to meet convergence criteria more often than not face unfavourable economic circumstances, making their neighbours unwilling to add to their woes.[36] In the non-UEMOA countries, the dangers of fiscal overshoots are considerably greater, judging from past experience, as seen in the table 7 below.

Fiscal indicators: Comparison of the Euro Area and ECOWAS, 1999 (as percentage of GDP).

[35] Ousman Dore and Paul Masson, *Experience with Budgetary Convergence in West African Economic and Monetary Union,* (Washington: IMF Working Paper), 2002.
[36] Paul Masson and Catherine Pattillo, "Monetary Union in West Africa: An Agency of Restraint for Fiscal Policies?" *Journal of African Economies,* Vol 11, No3, 2003, 298.

Table 7

	Government Expenditure	Government Revenue (a)	Overall Fiscal Position Including grants	Overall fiscal position excluding grants	Central bank advances (b)	Total	Public Debt Domestic (c)	External
Euro Area	47.6	46.0	-1.6		-	72.9		
UEMOA Benin	17.1	19.5	2.3	-1.1	-3.9	65.0	5.7	59.3
Burkina. F.	27.3	23.9	-3.4	-12.3	0.5	77.5	7.0	70.5
Cote d' Ivoire	21.9	19.0	-2.9	-3.5	1.0	139.7	20.9	118.8
Guinea B.	36.0	21.4	-14.6	N/A	3.9	N/A	N/A	364.4
Mali	24.5	20.6	-3.8	-8.0	0.2	121.4	4.6	116.8
Niger	16.1	14.2	-1.9	-8.0	0.4	103.9	11.7	92.2
Senegal	20.6	19.2	-1.4	-3.6	2.8	105.4	11.4	94.0
Togo	18.7	15.5	-3.3	-4.4	-	133.0	17.0	116.0
NonUEMOA Gambia	23.7	20.0	-3.7	-4.8	6.4	392.2	281.5	110.6
Ghana	26.2	18.0	-8.2	8.2	5.1	124.9	21.8	110.6
Guinea	15.5	12.5	-3.0	-5.1	2.1	68.1	0.9	67.3
Liberia	35.4	25.8	-9.6	0.4	-	N/A	N/A	N/A
Nigeria	29.2	20.8	-8.4	-7.7	11.3	122.4	27.7	97.8
Sierra L.	24.4	14.2	-10.3	-14.9	6.8	280.6	51.8	228.8

Sources: European Monetary Union, One Year on (OECD 2000) For the Euro Area, and IMF Staff estimates for ECOWAS.

(a)Including grants in the case of ECOWAS countries

(b) Defined as the change in the government's net position with central bank taken from the Bank de France, Franc Zone 1999, for UEMOA countries and IMF staff estimates for Non-UEMOA countries
(c) End- 1998 in case of UEMOA countries.

These countries have defined fiscal criteria that are some what loser than those of UEMOA. The ECOWAS criteria for 2003 as mentioned above include: inflation below 5 per cent, gross revenues of at least six months of imports, central bank advances no more than 10 per cent of tax revenue, and an overall fiscal deficit excluding grants no more than 4 per cent of GDP. And so far, no sanctions mechanism has been put in place nor has there been any indication that they would be applied rigorously to screen countries from participating in the West African monetary zone. On the contrary, the evident political determination in Nigeria and Ghana to proceed with a monetary union suggests that meeting the criteria will not be applied rigorously. This raises the danger that the monetary union may not be entirely successful, in that either countries that join may be forced to withdraw later or that the central bank will follow expansionary policies because of pressures exerted on it by profligate states.

Paul Masson and Catherine Patillo point out that a number of issues should be kept in mind in designing fiscal restraints to maximize the likelihood that they can contribute to limiting deficits, and try to prevent the negative outcomes discussed above. First the countries should agree that the restraints define the most relevant fiscal deficit concept and that the deficit is measured properly.[37] Secondly, monitoring of compliance with fixed restraints should recognize the scope for circumvention of rules through illusory fiscal adjustment and creative accounting. Fiscal adjustments in many countries with World Bank/ IMF programmes relied heavily on decumulation

[37] Paul Masson and Catherine Pattillo, "Monetary Union in West Africa: An Agency of Restraint for Fiscal Policies?" *Journal of African Economies* Vol 11, No3, 2003, 398.

of government assets (through fiscally motivated privatization, cuts in public investment and operations and maintenance spending), and expenditure postponement or accumulation of hidden liabilities.[38] Milesi-Ferreti developed a model illustrating that fiscal rules are more likely to lead to creative accounting rather than real fiscal adjustment when the budget process is not transparent.[39]

The experience of the CFA zone during the 1980s demonstrates that this is a relevant concern for a potential West African Monetary Zone. Thus efforts to improve the transparency of fiscal policy will be important to ensure that adherence to fiscal restraints translates to actual fiscal adjustments. Thirdly, it is not clear that a sanctions mechanism is a feasible way to deter violations of fiscal restraints. The credibility of a policy in which the union imposes sanctions on its members, either small or large countries is questionable as is the likelihood that a sanctioned member would pay its fines.[40] There is no real concrete experience with the application of sanctions either by ECOWAS or the two CFA Franc zones, but ECOWAS has a history of commitments by member countries, that were not honoured (such as eliminating internal barriers to trade and labour mobility and paying dues to the community organizations). In the Euro area also, the excessive deficits procedure seems unlikely (given the rather flexible interpretations applied to countries that exceeded the 3 per cent ceilings) to lead to sanctions except in egregious circumstances. It may therefore be effective to consider a system where a country's union membership is temporarily suspended if it is deemed to be in serious violation of the rules.[41]

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[38] Ibid., 399.
[39] Guan Maria Milesi- Ferreti, *International Financial Integration* (Washington: International Monetary Fund, 2003).
[40] Paul Masson and Catherine Pattillo, "Monetary Union in West Africa: An Agency of Restraint for Fiscal Policies?" *Journal of African Economies* Vol3 No 11, 2003, 400.
[41] Paul Masson and Catherine Pattillo, "Monetary Union in West Africa: An Agency of Restraint for Fiscal Policies?" *Journal Of West African Economies* Vol3 No 11, 2003, 401.

The member states of West Africa in particular Ghana and Nigeria have shown renewed commitment towards the formation of a West African Monetary Union. Several positive steps have been made in this regard. The ECOWAS Monetary Cooperation Programme was put in place to improve and strengthen intra regional trade and promote regional currency convertibility. Stringent convergence criteria were agreed upon in order to reduce inflation and build up currency reserves the most significant initiative was the formation of the West African Monetary Institute in Ghana in 2001 which ultimately has to lay the groundwork for the creation of the West African Central Bank. While such achievements are laudable technical difficulties continue to impede progress in the community. A good number of the convergence criteria could not be met within the within the stipulated time frame set by members of the West African Monetary Zone. It came as no surprise therefore that the deadline for the launching of the new currency was postponed from 2003 to July 2005.

The Optimum Currency Areas Theory and Monetary Integration in ECOWAS.

The theory of optimum currency areas was pioneered by Robert A Mundell in 1961. Conceived during the Breton Woods system of fixed international exchange rates, it was Mundell's proposition that balance of payments disequilibria would remain an integral feature of the international economic system as long as fixed exchange rates and rigid wage and price levels prevent the terms of trade from fulfilling a national role in the adjustment process.[42] This theory advocated a system of many floating currencies organized around an optimum currency area, an area Mundell defines as "the region." Due to the impracticability of organizing currencies

[42] Robert A. Mundell, "A Theory of Optimum Currency Areas" *American Economic Review*, Vol 51, No 4, 1961658.

around any basis other than the nation state, the theory of optimum currencies may have a limited practical application in particular to nations intending to form a currency union or to other economies in a state of transition.[43] His thesis forms the basis for analyzing the costs and benefits of the creation of a currency union.

In simple terms, an optimum currency area can be seen as a geographic area in which a single currency circulates as the principal medium of exchange. Here the advantages of 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 Rand circulates in Swaziland and Mozambique side by side the Metical and Lilangeni respectively. In other words, even without a formal monetary integration treaty, economic, social, geographical or historic fundamentals can enthrone one currency as the pre-emptive medium of exchange and store of value in the region, as is the case with the Franc zone. At the apogee of the Nigerian economic boom in the late 1980s, the Naira, despite the then prevailing regime of exchange rate controls, was freely traded on the West African coast.[44]

A priori, the wider the optimum currency area, the greater the gains from the use of a single currency in the integrating zone. However certain shocks in the integrating region may limit the size of the area. For instance unless labour 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 effect real exchange rate depreciation would be through an adjustment in the nominal exchange rate. But in reality, labour mobility is impeded by factors like immigration

[43] Paul Kenny "The Theory of Optimum Currency Areas," *Student Economic Review* SER, Vol 17, 2003, 1.
[44] Chris Itsede, "The Challenge of Monetary Unions, Gains and Opportunities" *http://www.centbank.org/ Out/publications/efr/rd/2002/efrvol40-4-3.pdf.*

restrictions, language and cultural barriers, foreign exchange and fiscal barriers.[45] Put differently, the internationalization 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 regard it came as no surprise that the ascendancy of the Naira on the West African coast in the late 1970s and early 1980s collapsed with the first waves of severe shocks to the Nigerian economy, given the similarity of the production profiles of West African economies.

The optimum currency area centres on the magnitude and distribution of shocks and the alternatives to monetary and exchange rate policies in dealing with asymmetric shocks. In this respect Olawale Ogunkola advances that the first step in the analysis of a monetary union is the magnitude and nature of shocks that face members of a proposed monetary union. The nature of such shocks may be symmetric, asymmetric or idiosyncratic. Thus the first order condition for a stable and viable monetary union is the symmetric nature of shocks.[46] West African countries are primary producers and hence the terms of trade shocks facing them are likely to be large and asymmetric.

Even if the observed shocks are significant and asymmetric, the stability of a monetary union among a group of countries may not be significantly affected if monetary and exchange rate policies were not preferred policy instruments in dealing with shocks prior to the formation of the union. When countries surrender sovereignty over monetary and exchange rate policies to a monetary union, the policies are no longer available to stabilize asymmetric shocks. Thus the availability and effectiveness of other policy instruments in addressing asymmetric shocks becomes

[45] Chris Itsede, "The Challenge of Monetary Unions, Gains and Opportunities,"*http://www.cenbank.org /out/publications/efr/rd/2002/efrvol40-3-3.pdf.*
[46] Olawale Ogunkola, "The Second Monetary Zone in West Africa and the Future of a Single Monetary Zone in Sub-Saharan Africa," http*.//scec.univ.aixfr/cefi/colloques/olawale%20gunkola.*

important. In other words, even if it is clear that real shocks are not symmetric, and that monetary and exchange rate policies used to be very important prior to the establishment of a monetary union, the next logical step would be to examine the availability and effectiveness of alternative adjustment mechanisms.[47] At this stage, the viability of a monetary union can be hinged on factors such as, a high degree of product diversification, a high degree of factor mobility among countries, and fiscal integration. These are usually envisaged as alternative adjustment mechanisms to monetary and exchange rate policies. Another prominent factor may be the pattern and direction of trade.[48]

A high degree of product diversification ameliorates the impact of shocks in that different products are affected in different ways and some effects cancel out. The output in West African countries is far from being diversified. The economies are dependent on natural resources (oil and agriculture). Any type of shock, affecting one of the products is capable of sending out adverse consequences on the whole region especially when such a shock affects the relatively large members of the union.

The optimum currency areas theory seen in this light is perceived as the standard tool to evaluate the adequacy of a currency union. This theory was designed purposefully for developed economies. In developing countries, it is not possible to disentangle the choice of countries to be included in a regional monetary union from the choice of the single exchange rate regime.[49] For instance, the CFA zone is both a regional monetary union and an area with a hard peg to the Euro. The latter feature may well be more adapted than the former for individual countries of the monetary area.

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[47] Olawale Ogunkola, "The Second Monetary Zone in West Africa and the Future of A Single Monetary Zone in Sub-Saharan Africa," *http://sec.unw.arsefr/cefi/colloques/olawale%ogunkola.*
[48] Ibid.
[49]Ibid.

The still low level of intra-regional trade in the whole of Sub-Saharan Africa for instance limits the scope for reduced transaction costs stemming from a regional monetary union. Indeed intra-regional trade accounted for only 8.4 per cent of ECOWAS exports and 13.1 per cent of its imports in 1997-1998.[50] This share was higher for UEMOA countries than for non-UEMOA ones. Including non recorded trade would raise this figure but it is unlikely that the final share would compete with the 42-43 per cent of trade carried out with the EU, except perhaps for Benin and Niger which act as intermediaries in Nigeria's external trade.[51] Hence a single currency would significantly reduce transaction costs only to the extent that the single regional currency is merged or at least pegged to the Euro as is the case with the CFA zone. Consequently, it has been argued that trade liberalization would be one of the preconditions for successful monetary unification with an independent single currency. It should be kept in mind that the scope of intra-regional trade is limited due to low market potentials, high transportation costs, similar factor endowments that is low capital and political instability.[52]

Simultaneously, the high specialization of most countries in the West African region in a few numbers of commodities (often different from one country to another as exemplified in table 8 below) yields a high cost of abandoning independent monetary policies.

[50] Agnes Benassy and Maylis Coupet "On the Adequacy of Monetary Arrangements in Sub-Saharan Africa,"*Centre de Etudes prospectives et d'informations internationales,* No 2003-11, 12.
[51] "Nigeria, June 1998: Trade Policy Reviews," *http;//www.wto.org/English/tratop-etpr-e/p75-e.htm.*
[52] David Cobhan and Peter Robson. *Regional Strategy for Trade and Growth in West Africa,* International Development Research Centre, 2001.

Table 8

Exports of non-CFA and CFA Zone Countries, 2001(%)

Benin	Cotton 65	Ghana	Cocoa 30 Aluminum, 15
Burkina Faso	Cotton 53	Guinea Bissau	Oil 49, nuts 45
Cameroon	Oil 46, Wood 13	Mali	Cotton 54, electric Electric circuits 19
CAR	Wood 38, Cotton19, Diamonds 19.	Niger	Uranium 56, Sheep 15
		Nigeria	Oil 87
Chad	Cotton,69, natural gum and resins 25	Senegal	Refined oil 16
			Crustaseans, 10
Congo	Oil 74		Groundnut oil 10
		Sierra Leone	Seats 29, diamonds 26
Cote d' Ivoire	Cocoa, 39		
		Togo	Cements 30, calcium And phosphates 20.
Gabon	Oil 77		
Gambia	Groundnuts, 34 Crustaceans 13		

Source: United Nations comtrade database.

The correlation of changes in trade is generally small between each country in the ECOWAS or UEMOA grouping. A fall in terms of trade in one country could be

adjusted for by a currency depreciation that raises export revenues in domestic currency, because the price of commodities is set in foreign currencies. This may no longer be the case if the domestic currency is pegged or merged into a single currency. The West African Monetary Zone project includes the creation of a fund in order to help individual countries to buffer adverse temporary shocks. But the limited size of this fund, it has been argued, would provide only limited support to smaller countries and it would not have any major effect for Nigeria.[53]

Although labour mobility among neighbouring countries can be viewed as relatively high, traditionally it has been reduced by administrative difficulties and military conflicts. Hence asymmetric shocks stemming from high specialization can be viewed as a major risk for the second monetary zone. However it should also be stressed that the high dependence on primary products also raises the costs of nominal exchange rate volatility against hard currencies since it directly transmits into unstable export income in local currency.[54]

In West African countries, dropping the nominal exchange rate as a policy instrument may show up less costly than the optimum currency areas claims. Countries in the region which have retained monetary independence have failed to build monetary credibility, which reduces the scope for macroeconomic stabilization through monetary instruments, whereas the CFA zone has been viewed as an "external agency of restraint." In this respect, a supra-national central bank could be a way of overcoming national credibility problems; its independence from national fiscal authorities could be easier to establish than in the case of a national central bank. This is a case where a regional "corner solution" (regional monetary union)

[53] Paul Masson and Catherine Pattillo, "Monetary Union in West Africa, An Agency of Restraint for Fiscal Policies, *Journal of African Economies, 2002.*
[54] R.D.Asante and Paul Masson, "The Pros and Cons of Expanded Monetary Union in West Africa, *"Finance and Development www.imf.org/external/pubs/fandd/2001/03/*

may reconcile the needs for both flexibility against the rest of the world and credibility. Such regional solutions is to be valued against the alternative of a unilateral hard peg in the form of the CFA arrangement, which is likely more credible at the expense of flexibility.[55] The CFA arrangement, it must be stated, could hardly be adopted by the former British colonies given the strong involvement of the French Treasury. On the other hand, UEMOA countries will likely be very careful before giving up the CFA Franc which has proved efficient in bringing monetary stability in the zone.[56]

The theory of optimum currency areas cannot tell what the most appropriate exchange rate regime for a country or group of countries should be. This brings to light once again the choice of exchange rate regimes discussed in the first chapter. In the 1990s, a large number of empirical studies were carried out on whether Europe or a sub group of European countries would form an optimum currency area. One popular approach consisted in looking at the correlation of business cycles or at the volatility of bilateral real exchange rates between each pair of countries, in order to find out whether the shocks to the various economies were mainly symmetric or asymmetric.[57] There were two problems with this approach. First it did not assess the degree of symmetry of shocks, but rather the degree of asymmetry of the results of the shocks including economic policy reaction and perhaps nominal exchange rate adjustments. For instance a positive correlation of business cycles between two

[55] Agnes Benassy and Maylis Coupet, "On The Adequacy of Monetary Arrangements in Sub-Saharan Africa," *Centre de etudes Prospectives et d'information Internationales.* No 2003-11, 13
[56] Rohinton Medhora, *Lessons From UEMOA,* in R. Lavergne's (ed) *Regional Integration and Cooperation in West Africa, A Multidimensional Perspective* (IDRC: Africa World Press, 1997)
[57] M.J Artis and W. Zhang, "Core and Periphery in European Monetary Union: A Cluster Analysis," *Economic Issues,* Vol 6, 2001, 3.

countries could stem from appropriate contra-cyclical monetary policies in the face of asymmetric shocks.[58]

Similarly, low exchange rate volatility could be the result of an existing exchange rate arrangement rather than the outcome of symmetric shocks. To solve this problem, Tamin Bayoumi proposed a Vector Auto Regression (VAR) methodology based on the decomposition of shocks between the supply side and demand side.[59] The second problem was how to aggregate the various sources of information related to the optimality of one monetary union. To address this issue, Michael Artis and W.Zhang put forward a cluster analysis, which allows drawing country groupings by using an aggregate measure of economic distance. In the case of West Africa it can be noted that conditional volatility is lower for intra-CFA real exchange rates than for non-CFA ones. Outside the CFA zone, Nigeria seems to display highest conditional volatility.[60]

External shocks are a prominent source of macroeconomic fluctuations in West Africa and they are more detrimental to CFA countries than to non-CFA members supposedly due to the fixed peg to the Euro. D. Fieldings and K. Shields for instance find high correlation between inflation shocks among CFA members but they distinguish two CFA sub-groups as far as output growth shocks are concerned. Since the two subgroups do not coincide with the existing monetary unions, they conclude

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[58] Agnes Benassy and Maylis Coupet, "On the Adequacy of Monetary Arrangements in Sub Saharan Africa," *Centres des Etudes Prospectives et d' information Internationale.* No 2002-11, 13.
[59] Tamin Bayoumi and Barry Eichengreen, "Shocking Aspects of European Monetary Unification," *Http://1036%26context%3diber/cider+bayoumi+and+eichgreen4shocking+aspects+europeanmonetary+integration/hl=e.*
[60] Michael Artis and W. Zhang, "Core and Periphery on European Monetary Integration: A Cluster Analysis," *www.economicissues.org/archive/pdfs/4u6p2.rdf.4artis++wzhang+identifying+the+coreofemu &hl=en.*

that there may be a reason to redraw the internal boundaries of the Franc zone, if policymakers are particularly concerned about output growth shocks.[61]

Since economies in the ECOWAS include those with a fixed exchange rate and others using flexible exchange rate regimes, the volatility of the real exchange rate over the past cannot be used as a criterion for designing an optimum currency area.[62] To a lesser extent, real interest rates display the same caveat since both nominal interest rates are likely to be more correlated in the case of a hard peg, as is the case with the CFA. Secondly, unlike the anchor role of Germany in the European monetary integration process, there seems to be no evident leader among countries in West Africa. Nigeria no doubt has the largest economy in the region and could have played such a role but her position has been questioned due to poor political and monetary track record and her high dependence on oil exports.

According to Benjamin Cohen, the sustainability of a monetary union depends to an extent on the existence of locally dominant country (a leader) or on the existence of a genuine sense of community.[63] Within this taxonomy, the second monetary union in West Africa could be organized around Nigeria (the leader) or around the UEMOA. However a sense of community could well be weakened by the inclusion of Anglophone countries in the UEMOA, a Francophone dominated area. Although relatively small in number, the newcomers may not get the guarantee from the French Treasury and then the system would have to evolve either towards a more standard hard peg, a currency board or a more flexible regime.

The prospects for forming a monetary union in the region was furthered improved following the creation of the West African Monetary Institute which began operating

[61] Fieldings D. and K. Shields, "Modelling Macroeconomic Shocks in the CFA franc zone," *Journal of Development Economics 66*,
[62] Ibid.,16.
[63] Ibid., 16.

in 2001. A set of convergence criteria were put in place as bench marks for the economies of member states. At the end of 2000, all countries in the zone satisfied the criteria on central bank financing of government deficit. However the condition of gross foreign currency reserves was met by Nigeria alone. Following the 2003 Report of the West African Monetary Institute, only Ghana and Nigeria could satisfy at least three of the six convergence criteria put forward by member states for that year. This shows that overall, limited progress has been made towards monetary integration. The high specialization on a few number of commodities by member states in the region as pointed out in the analysis of the theory of optimum currency areas shows that member states would incur high costs by independent monetary policies. Hence asymmetric shocks stemming from high specialization can be viewed as a major risk for the proposed second monetary zone.