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A. O. Adenuga
Central Bank of Nigeria, aoadenuga@cbn.gov.ng

K. K. Ogunjuiba
African Institute for Applied Economist, Enugu

M. E. Obiechina
Central Bank of Nigeria, meobiechina@cbn.gov.ng

A COMMON ECONOMIC SPACE FOR THE WEST AFRICAN MONETARY ZONE (WAMZ): IMPERATIVES FOR FINANCIAL SYSTEMS DEVELOPMENT[1]

AUTHORS

A. O. ADENUGA
Assistant Director
Research Department
Central Bank Of Nigeria, Abuja

K. K. OGUJUIBA
African Institute For Applied
Economics, Enugu

M. E. OBIECHINA
Senior Economist
Financial Markets Department
Central Bank Of Nigeria, Abuja

ABSTRACT

[illegible] century has provoked much reflection [illegible] community on ways to strengthen the [illegible] important [illegible] exploring the [illegible] for [illegible] [illegible] region is needed in facilitating economic integration, growth and poverty reduction as well as the need to balance financial innovation and economic stability. The paper concludes with strategies for promoting integration in the region that would ultimately create an open and integrated market among the WAMZ countries. This will leverage further opportunities for economic operators, promote trade and investment, and reinforce economic cooperation, reforms and competitiveness of the region.

INTRODUCTION

Regional integration is now widely accepted as indispensable for expanding economic opportunities in Africa. Bigger markets permit better exploitation of economies of scale, while factor mobility across borders and the coordination and harmonization of monetary and fiscal policies would facilitate faster economic growth and greater welfare for the participating countries. African countries consider regional integration the most direct route to fast, broad-based development and an effective way to overcome the limitations of small internal markets. They also perceive regional integration as a rallying platform for establishing African unity. Resilient, well-regulated financial systems are essential for macroeconomic and financial stability in a world of increased capital flows. Most African countries, particularly those in sub-Saharan Africa, have recently undergone extensive financial sector reforms. In any economy, the financial sector is the hub of productive activity. It comprises an effective network of banks and other financial institutions and a wide range of financial instruments.

The path to a single economic space cum integration is a continuum of actions; a process not an event, starting with sharing information, moving to sharing processing facilities, to harmonizing laws and regulations, and eventually to unified licensing and inspection of institutions and the introduction of a common currency, with the ultimate objective of achieving a single financial space. However, financial intermediaries and financial systems in the WAMZ suffer from diseconomies caused by small scale challenges and raise a pertinent question as to how they would support a single economic space. It is possible to overcome, at least in part, such diseconomies by opening up financial systems. Nonetheless, the financial system in the sub-region could be designed to foster integration and act as a catalyst to increase openness in financial services

[1] *The views expressed in the paper are those of the author and do not in any way represent the official position or thinking of the Central Bank of Nigeria. The author acknowledges the comments and criticisms of anonymous reviewer.*

markets in order to create greater opportunities to citizens of member countries.

Economists have debated on the nature of the growth-poverty nexus: whether and to what extent economic growth leads to poverty reduction. Furthermore, there were questions over whether financial sector development can bring direct benefits to the poor. The last two decades, however, have seen the emergence of a consensus on the vital importance of financial sector development in facilitating real growth and supporting poverty reduction, and this has been backed up by a large body of empirical studies providing evidence of the causal linkages from financial sector development to economic growth and poverty reduction. While the benefits from a common economic space vis-à-vis financial integration are substantial, the process of integration is by no means easy. Indeed, there are a number of costs and difficulties that countries face on the road to the creation of a single financial space. From a political perspective, there is a loss of sovereignty inherent in all phases of integration as countries cede elements of decision-making, including control over financial policy. This also has important economic consequences as the loss of control over aspects of monetary and exchange rate policy and the capital account have implications for the ability of governments and central banks to manage shocks to their economies and their countries' external competitiveness. Furthermore, there is the risk that benefits may not be distributed equally among countries[2]. Lastly, there is the risk that unless it is accompanied by increased competition, regional financial integration may result in only efficiency gains (and profits) for financial institutions, yet do little to improve access to financial services for the majority of the population.

The WAMZ programme is a fast track initiative to economic and monetary integration in West Africa, adopted by the authority of Heads of State and Government of Economic Community of West African States (ECOWAS) at its Summit in Lome; Togo in December 1999. It was agreed at the Summit that a second monetary zone, WAMZ, should be established which would eventually merge with the West African Economic Monetary Union (WAEMU) to create a single ECOWAS monetary union. The WAMZ reaffirms financial sector development as one of its core areas of operations in the coming years in support of inclusive and sustainable economic growth, regional integration, and poverty eradication in ECOWAS.

The main objective of the paper therefore is to examine the imperatives for financial system development in a common economic space for the WAMZ. Accordingly, following the introduction, the paper is divided into five sections. Section two discusses opportunities, risks and vulnerabilities in the WAMZ, while theoretical framework and literature review is contained in section 3. Section 4 presents macroeconomic performance of WAMZ countries. Discussion on a common economic space and strategies for integration in the WAMZ are covered in section five, while the paper ends with summary and conclusion in section six.

(2.0) Opportunities, Risks and Vulnerabilities in the WAMZ

Macroeconomic stability, monetary and financial integration are crucial for successful regional cooperation and integration. Both processes make decisive contributions to the creation of an enabling environment for economic growth, promotion of trade and boosting of investor confidence. The strengthening and deepening of the financial sector, including the establishment of vibrant capital markets, will amongst others, facilitate the flow of funds and help anchor macroeconomic policies. In addition, strong national and sub-regional capital markets play a catalytic role in attracting FDI and promoting cross-border investment flows. The policies should be situated within the socio-political, technological and international development setting of the countries, and the region at large. When these policies are conceived in a wider economic space, possibilities for enhanced economic gains and growth are likely to be optimized and resources more efficiently used. Concerning labour market mobility, the ECOWAS protocol guaranteeing free movement of persons within the sub-region is partially being implemented, and albeit at a slow pace. The protocol on residents and establishment, including freedom to seek gainful employment has not been fully implemented. Indeed, non-citizens are given a maximum of 90 days stay and the permit clearly states that employment is prohibited[3]. There are varying levels of exchange control in the WAMZ countries and little liberalization of capital accounts. Unfortunately, both the controls themselves, and the residual bureaucratic processes, are distorting the financial markets and their capacity to provide effective service to economic growth. Inter-bank markets are relatively underdeveloped. National markets exist to some extent, but are likely limited by the degree of confidence the banks are prepared to place in one another. Although a full-fledged

[2] For example, there is concern among the smaller countries in ECOWAS that the benefits of integration will primarily accrue to Nigeria, while similar fears are present in the EAC with regard to Kenya, and in the SADC with regard to South Africa.
[3] The existence of all these encumbrances has limited labour mobility in the WAMZ.

cost-benefit analysis has not been undertaken, but preliminary analysis suggest that the costs of losing exchange rate flexibility in the WAMZ are generally limited.

The financial system in the WAMZ still remains fundamentally fragile and vulnerable to several external risks, including: the high dependence on primary products; economic mismanagement, (especially fiscal imprudence); weak institutions; and political uncertainty. Given the large size and role of government in the region, fiscal indiscipline is the single most important threat to these economies. The development of monetary union as well as the willingness of member states to facilitate progress towards a common market in financial

services by harmonizing legal and regulatory frameworks, are clearly hampered by the heterogeneous nature of WAMZ. There are enormous disparities in the size and sophistication of the economies of the members. Furthermore, the member states are not geographically contiguous, which limits the impetus for regionalization and harmonization which would have been provided by significant intra-WAMZ trade in goods and services (as can be seen in the East African Community where trade routes and geographical contiguity are clearly providing an incentive for progress). Payments System Project which is key and fundamental for any meaningful integration is not moving at the same speed across the WAMZ.

Furthermore, the WAMZ capital market in general is still very much rudimentary. In both Ghana stock Exchange (GSE) and Nigeria Stock Exchange (NSE), stock prices are regulated and only a margin of plus or minus 5.0 per cent is permitted for price fluctuations. The two exchanges are yet to engage in trading or listing relationship although each of them has such relationship with other exchanges (GSE with London Stock Exchange and NSE with Johannesburg Stock Exchange). The Gambia and Guinea are at the preparatory stage of establishing stock exchanges, having passed through a conceptual stage of setting up stock exchanges. A legal framework to establish the Conakry Stock Exchange and a Securities and Exchange Commission was passed in 1997 but it is yet to be operationalized. The Gambia is still undertaking a comprehensive study for an exchange. The Sierra Leone Stock Exchange (SLSE) which was inaugurated in July 2007, commenced operations in 2009 with one company listed. Ghana and Nigeria have functional Securities and Exchange Commissions while Sierra Leone is in the process of enacting a legislation to set up a Commission. The Gambia and Guinea are expected to embark on the process of establishing securities and exchange commissions after setting up stock exchanges. As was the case in Ghana and Nigeria before the establishment of the Securities and Exchange Commission (SEC), in the other WAMZ countries, the central banks are playing the typical role of SEC as regulators of the capital market. Each of the central banks has a unit that carries out capital market regulation.

Financial sector stability in the region would depend on policy credibility, founded upon a reliable judicial system, transparency, and well-defined institutional responsibilities. Legal and regulatory enforcement are needed in the region to ensure action is taken against those that violate their prudential and financial regulations, and act as a credible deterrent for all market participants. Large informal sector with a preponderance of low-income households in the region poses another challenge[4]. Inflationary pressures, which have slipped to double digits over the past years; high cost of doing business in the region; inadequate infrastructure; lack of standardization; and weak capacity of both institutions and personnel in the financial sector have added to the fragility and underdevelopment of the financial systems in the sub-region. Another factor possibly reducing the impetus for integration is the enormous disparity in levels of economic development between the WAMZ members, which is creating an element of fear that further integration of the financial markets would only result in a one-way stream of outward investment from Nigeria (and to a much lesser extent Ghana), with smaller countries' domestic financial institutions being unable to take advantage of access to the Nigerian and Ghanaian markets due to their small size and lack of access to capital. The rapid expansion of Nigerian banks into WAMZ countries, the total absence of banks from other WAMZ countries in Nigeria and the very high barrier to entry posed by Nigeria's minimum capital requirement for banks and insurance companies all tend to support this fear and would tend to undermine support for further integration in the form of further opening of non-banking financial markets. Most recently, Ghana has imposed discriminatory minimum capital requirements on foreign-owned banks in order to protect Ghanaian-owned banks: by end-2009 foreign banks must have GHC 60 million (about US$ 43 million) in capital whereas Ghanaian banks have until end-2010 to have GHC 25 million (US$ 18 million), and until end-2012 to meet the GHC 60

[4]*These households have limited access to demand-oriented financial services such as savings, loans, and insurance, often resulting in vulnerability to adverse shocks*

million requirement. In Guinea, Gambia and Liberia, there is still a high sense of uncertainty surrounding the legal and regulatory framework for business activity which also raises the perception of the risk associated with investment[5].

(3.0) Theoretical Framework and Literature

Over the last decade, empirical studies assessing various regions and time periods have supported the notion that both financial intermediaries and markets play a key role in economic growth. Moreover, numerous studies have found that better developed financial systems ease the financing constraint faced by enterprises, particularly small firms. Hence, the preponderance of evidence suggests that financial systems do not merely respond to economic growth, but induce the necessary environment for economies of scale. Research has increasingly found financial development to have a causal effect in stimulating economic and productivity growth. Over time, the development of a financial system works to reduce market inefficiencies and failures. In a well-functioning financial system, financial contracts, markets and intermediaries act to reduce the costs of acquiring information, enforcing contracts, and making transactions. Financial instruments and institutions, in turn, influence the allocation of financial resources within an economy in favor of the more efficient use of capital. Thus, a developed financial system is better equipped than an underdeveloped one to perform the following functions: producing information and allocating capital; monitoring firms and exerting corporate governance; trading, diversification, and risk mitigation; mobilizing and pooling savings; and easing exchange of goods and services.

There are both theoretical and empirical evidence suggesting that the development of the financial sector accelerates economic growth. Bagehot discussed the relationship between the sector and economic growth in the 19th century. Schumpeter (1934) stressed the role of banking sector as a financier of productive investments and in that way, as an accelerator of economic growth. Most of the relevant theoretical models have been, however, developed after the birth of endogenous growth theory. Basic AK developed after the endogenous growth theory; find three ways by which the development of the financial sector can affect economic growth. First, it can increase the productivity of investments; secondly, more efficient financial sector reduces transaction costs and thus widens the share of savings and productive investments. Thirdly, financial sector development can affect savings rate, either upwards or downwards (Pagano, 1993). Greenwood and Jovanic (1990), Levine (1991), Bencivenga and Smith (1991) as well as Saint-Paul (1992) have constructed theoretical models in which an efficient financial market improves the quality of investment and accelerates economic growth. In the model of Green and Jovanic (1990), financial intermediaries' prime task is to channel funds to the most profitable investments. Higher rates of return on capital to be earned promote growth and economic growth provides the means to implement costly financial structures. Financial sector also improves the liquidity of investments. In the model of Levine (1991), the stock market improves firm efficiency because they eliminate the premature liquidation of the firm capital. In case of liquidity shocks, the investor can sell the shares to another agent. Both of these ways accelerate economic growth. In the model constructed by Bencivenga and Smith (1991), the financial sector increases the liquidity of investments and decreases the premature withdrawal of investors, which are harmful to economic growth. If the financial markets work properly, investments to the non-liquid objects which are more productive to the economy increases.

According to Saint-Paul (1992), productive growth must be achieved through a greater division of labour and specialization of enterprise. The greater specialization causes a bigger risk. The role of the financial market is to support enterprises in specialization by permitting investors to hedge by holding diversified portfolios. Without deepening of the financial market, specialization would be too risky for an individual investor and there would be efficiency loss in the system. Blackburn and Hung (1996) have found a two way causal relationship between growth and financial development. Without intermediation, every single investor should individually monitor a project and the costs of monitoring would duplicate. If the financial sector is developed, the monitoring task can be developed into an intermediary. In this case, transaction costs are reduced and bigger share of savings can be allocated to investments. This accelerates economic growth. Blackburn and Hung (1996) further show how a country can be trapped in a vicious circle of low economic growth and low financial development. This happens if the initial technical development of the country is very low and new designs too are low. Harrison (1999) argues that economic growth increases banks activities and promotes entry of more banks. This entry shortens the

[5] *Property rights and contracts in these countries have not yet been enforced, opening the door to corruption.*

average distance between banks and clients and lowers transaction costs in the system. According to the endogenous growth theory, the higher the savings rate, the higher the economic growth. The development of the financial sector can affect savings in three ways. First, by reducing idiosyncratic risks, financial markets might lower the level of precautionary savings by households and thus the growth rate Tsuru (2000). Secondly, a reduction in rate of return risk by portfolio diversification can have ambiguous effects on savings Tsuru (2000). Thirdly, by lowering liquidity constraints, the development in the financial sector can lower savings rate.

The relationship between economic growth and financial sector has been one of the most heavily researched topics in development economics. Hundreds of scholarly papers have been written to conceptualize how the development and structure of an economy's financial sector affect domestic savings, capital accumulation, technological innovation, and income growth, or vice versa; and to empirically test these linkages including identifying directions of the causality and their relative importance using cross-country; country-specific; and industry-firm, and project-level data. Several authors have surveyed this large literature (see, for example, Honohan 2004a, 2004b; DFID 2004; Levine 2004; and Andrianova and Demetriades 2008). Earlier literature suggests significant disagreements on the finance-growth nexus. For instance, Joan Robinson (1952) argues that "where enterprise leads, finance follows", meaning that finance does not cause growth, but rather, it responds to demands from the real sector. Nobel Laureate Robert Lucas (1988) also dismisses finance as an "over-stressed" determinant of economic growth. On the other hand, Nobel Laureate Merton Miller (1988) argues "that the financial markets' contributions to economic growth is a proposition too obvious for serious discussions." Schumpeter (1911), Gurley and Shaw (1955), Goldsmith (1969), and McKinnon (1973) all saw the importance of the finance-growth nexus in understanding economic growth. Finance has a prominent role in the endogenous growth theory, through its positive impact on the levels of capital accumulation and savings (Romer 1986) or of technological innovation (Romer 1990, Grossman and Helpman 1991, and Aghion and Howitt 1992).

Recent literature suggests the emergence of a consensus on the vital importance of financial sector development in facilitating and sustaining growth. The last two decades have witnessed an explosion of empirical studies testing the finance-growth nexus using cross-country and other data and new econometric tools. Despite the absence of complete unanimity of results, a number of observations, backed by empirical evidence, have emerged. Levine (2004) summarizes these as follows: (i) countries with better functioning banks and financial markets grow faster; (ii) there is existence of simultaneity bias (i.e., the reverse causality) does not seem to support this conclusion; and (iii) better-functioning financial systems ease the external financing constraints that impede firm and industrial expansion, suggesting that this is one mechanism through which financial development matters for growth. Economists believe that the most important role of the financial sector in facilitating growth is to reduce transaction costs. This is achieved through a number of specific functions that the financial sector performs. On the basis of an extensive survey of the literature, Levine (2004) identified and summarized five key functions that a financial system provides in facilitating growth:

1. **Mobilizing and pooling savings:**

Savings mobilization as a process of agglomerating capital from diverse savers for investment is very costly. Mobilizing savings involves overcoming transaction costs and informational asymmetry problems. Financial systems that are more effective at pooling the savings of individuals promote economic development by exploiting economies of scale and overcoming investment indivisibilities. With large, indivisible projects, financial arrangements that mobilize savings from many diverse individuals and invest in a diversified portfolio of risky projects facilitate a reallocation of investment toward higher return activities with positive implications for economic growth.

2. **Producing information ex ante about possible investments and allocating capital:**

Individual savers face high costs of acquiring and processing information on firms, managers, and market conditions, which could prevent capital from flowing to its best uses. Financial intermediaries reduce information costs through specialization and economies of scale and thereby improve resource allocation and accelerate growth. Improved information also helps to identify the best production technologies and those entrepreneurs with the best chances of successfully initiating new goods and production processes. Stock markets may also stimulate the generation of information about firms. As markets become larger and more liquid, agents may have greater incentives to expend resources in researching firms because it is easier to profit from this information by trading in big and liquid markets.

3. Monitoring investments and exerting corporate governance:

The degree to which the providers of capital (shareholders and creditors) can effectively monitor and influence how firms use their capital and induce managers to maximize firm valuethat is, to resolve the "agency problem" arising from the separation of ownership from control through effective corporate governance mechanismshas important implications for savings, decisions for allocating the savings, and their utilization. Good corporate governance helps improve the efficiency with which firms allocate and utilize resources and makes savers more willing to finance production and innovation. Although there are countervailing arguments, many believe that monitoring and disciplining by creditors (banks or bondholders), shareholder activism exercised by institutional investors (such as banks, pension funds, etc), threat of takeovers and market for corporate control, threat of insolvency, and capital market competition, among others, are effective mechanisms for strengthening corporate governance (Zhuang et al. 2000).

4. Facilitating the trading, diversification, and management of risks:

Financial systems help to mitigate the risks associated with individual projects, firms, industries, regions, and countries, etc. A financial system's ability to provide risk diversification services affects long-run economic growth by improving resource allocation and encouraging savings. Cross-sectional risk diversification stimulates technological innovation since engaging in innovation is risky, and the ability to hold a diversified portfolio of innovative projects reduces risk and promotes investment in growth-enhancing innovative activities. Besides cross-sectional risk diversification, financial systems also improve inter-temporal risk sharing and smoothing across generations. Further, financial systems enhance liquidity, reduce liquidity risks, increase investment in longer-term, higher-return, but illiquid assets, and promote economic growth.

5. Facilitating the exchange of goods and services:

A financial system facilitates transactions in the economy, both by physically providing the mechanisms to make and receive payments and by reducing transaction and information costs as described earlier. Therefore, the financial sector facilitates trading of goods and services, and promotes specialization, technological innovation, and growth. Transaction and information costs may continue to fall through financial innovation. More specialization requires more transactions, and more transactions lead to greater specialization. In this way, markets that promote exchange encourage productivity gains. There may also be feedback from these productivity gains to financial market development, and thus spur economic development in the long run.

The discussion on a single economic space is premised on financial, economic and monetary integration, which is essentially predicated on the Optimum Currency Area (OCA). The OCA is a useful starting point for any discussion on regional integration vis-à-vis a single economic space. It addresses the central question of whether a monetary union should be pursued. Mundell (1961) defines the optimum currency area as a region in which factors of production are internally mobile but internationally immobile, so as to facilitate the intra-regional redistribution of resources in response to demand shifts. Kaboub (2001) describes it as the "optimum geographical domain with means of payment either as a single common currency, or several currencies whose exchange rate values are immutably pegged to one another with unlimited convertibility for the purposes of both current and capital transactions, but whose exchange rates fluctuate within a band against the rest of the world".

The first characteristic of an OCA is price and wage flexibility, which was the basis for Friedman's argument in favour of flexible exchange rates. The second is that of financial market integration, suggesting that a successful currency area must be sufficiently integrated in financial trading. The third characteristic is that of factor market integration. This includes internal factor mobility, both inter-regional and inter-industry mobility. The fourth is the integration of the goods market, suggesting that a successful currency area must have a high degree of internal openness that could be measured by the marginal propensity to import, or the ratio of tradable to non-tradable goods in production or consumption.

An OCA requires a close coordination of national monetary authorities or even the creation of a supranational central bank, which implies the surrendering of the national sovereignty over the conduct of monetary policy. Other characteristics include factor mobility, especially, capital and labour, and the integration of the goods market. In recent times, issues of symmetry and asymmetry shocks have also been raised in the empirical literature. Generally, based on available quantitative and qualitative assessments, the monetary union arrangements in Africa does not satisfy the OCA textbook conditions when measured against the following criteria: income structure; product market flexibility; labour market mobility; degree of openness, intra-trade relations; and asymmetric terms of trade shocks.

The theoretical underpinning of policy convergence essentially comes from the analysis of policy making in an integrated region (De Grauwe, 2000). A simple example would suffice to clarify the argument. Suppose that countries A and B achieve some form of monetary integration (i.e. a system of fixed exchange rates or a currency union) so that they implement a common monetary policy. Assume also that policy makers in country A are conservative, preferring low-inflation equilibrium to one with high inflation in the inflation-unemployment trade-off. Policy makers in country B are liberal and prefer the equilibrium with low unemployment (and hence high inflation)[6]. Country A will push for a conservative stance, while B opts for a liberal one. The resulting policy conflict has two implications. First, there will be a political-economic problem of aggregation of heterogeneous preferences. Second, the preferred monetary policies under autarchy will likely differ from the actual common monetary policy under integration. Thus, for one of the two members of the union or may be even for both there will be the temptation to abandon the initiative, unless some kind of compensation mechanism is engineered. For instance, economic integration is expected to produce macroeconomic stability in the form of low inflation. However, if the participation of a country B (with a preference for a high-inflation equilibrium) shifts the common monetary policy in favour of high inflation, then the anti-inflation gains would be smaller and a country like A would be worse off than under autarchy. Similarly, countries with large fiscal deficits, being more likely to use inflationary finance, are likely to make the common monetary policy less conservative.

(4.0) Macroeconomic Performance of Countries in the WAMZ

Accordingly, the WAMZ have introduced both a primary and secondary convergence criteria to make the economies of their members move in lockstep toward the goal of policy harmonization for the ultimate establishment of a monetary union. The criteria established to measure the convergence of the real and financial variables in the member countries include the budget deficit ratio, inflation rate, central bank financial or liquidity ratio, external reserves, level of exchange rate variation and movements, tax revenue ratio, public sector wage/tax revenue ratio and public investment/GDP ratio. The convergence policies also provide for financial integration to allow the WAMZ countries to develop and harmonize their money and capital markets, in order to ease payment systems and provide credible sources for medium- and long-term securities to stimulate investments. Howbeit, both monetary and fiscal policies of the region must be properly articulated and implemented in a coordinated, predictable manner, because of their overarching importance for macroeconomic stability, domestic resource mobilization and economic growth, (see tables that follow).

In 2009, the Nigerian monetary policy was aimed at maintaining single digit inflation. However, the single-digit inflation criterion was not met as the inflation rate still remained double digit (see table 1 above). There was however, an improvement in the level of inflation as the rate declined from 15.1 percent at end-December 2008 to 12.0 percent in December 2009. The slow down in the inflation was attributed largely to the decline in global food and fuel prices. Nigeria's performance on the single-digit inflation criterion has been mixed over the years. The rate of inflation was in double digit from 2001 to June 2006, when the rate dropped to 8.5 percent. The country sustained this performance by maintaining the rate at 6.6 percent by end-December 2007 and 9.7 percent in May 2008. The fiscal deficit/GDP ratio stood at 3.3 percent during the review period slightly higher than the 3.0 percent provided in the 2009 budget. The level of deficit was below the bench mark of 4.0 percent, but significantly higher than the 0.2 percent attained in 2008. The current trend is expected to reverse to a deficit of 3.1 percent in 2011 given the current prudent fiscal policy stance of the government. The country's performance with regard to this criterion has been consistent

Table 1: Primary Convergence Criteria - Nigeria

Primary Criteria	Target	2001	2002	2003	2004	2005	2006	2007	2008	2009
Inflation Rate (end period)	Single digit	16.5	12.2	23.8	10.0	11.6	8.5	6.6	15.1	12.0
Fiscal Deficit/GDP (%) excl. grants	≤ 4%	-3.2	-3.9	-2.0	-1.2	-1.3	-0.6	-0.6	-0.2	-3.3
Central Bank Financing of fiscal deficit as % of previous year's tax revenue	< 10%	0	0	37.6	0	0	0	0.0	0.0	0.0
Gross External Reserves (Months of Imports)	≥ 3	8.9	6.2	4.9	11.6	11.0	17.3	14.8	17.2	17.7
Criteri(um)a satisfied		3	3	2	3	3	4	4	3	3

Sources: Nigerian Authorities & WAMI Staff

[6] *After controlling for shock asymmetries, the two countries would tend to have different policy preferences or objectives.*

throughout the convergence period with an exception in 2003, when a performance of 37.6 percent was recorded. It is expected that the country will maintain her attainment of this criterion, provided the current fiscal policy stance of government is sustained. Nigeria's gross external reserves as at end-December 2009 stood at US$42.4 billion, capable of providing 17.7 months of import cover. Even though there was huge depletion of reserves during the review period, due to falling oil revenue, the achievement of this criterion was sustained.

With respect to the primary convergence criteria, indicative data (table 2) shows that Ghana met two of the criteria: namely central bank financing of fiscal deficits and gross external reserves in months of import cover. Central Bank financing of fiscal deficit was zero, while gross external reserves approximated 3.9 months of imports cover[7]. Even though only two primary criteria were met, the performances of the other two criteria appear to be improving. Inflation fell to 16 percent from 18.1 percent in 2008, while the fiscal deficit as a percentage of GDP shrank to 12.3% from 18.6% in 2008. The Ghanaian economy recorded an end-of-period inflation of 16.0 percent, indicating that the single digit criterion was not met. However, this was an improvement when compared to 2008 end-of-period inflation of 18.1 percent. Considering the consistent decline in CPI inflation during the second half of 2009, there is some optimism that inflationary pressures will continue to ease in 2010 and it is likely that this criterion will be met, at least, over the medium term. Ghana also failed to satisfy the fiscal deficit criterion of not more than 4 percent of GDP. The recorded deficit, excluding grants, was 12.3 percent. This was an improvement on the 18.6 percent recorded at end 2008. Although this criterion has remained elusive for most WAMZ countries, Ghana has strengthened its policies in a bid to significantly reduce the deficits[8]. The rebasing, coupled with expenditure tightening and improvement in revenue mobilization, will enhance the prospects of achieving this target by end 2010. Performance with respect to Reserves criterion improved significantly during the review period with Ghana recording 3.9 months of import cover, up from 2.2 months recorded at end 2008. The WAMZ benchmark of 3 months of import cover was therefore met. The deficit incurred in 2008 was financed by the market through the issuance of three year Government bonds. The overall budget deficit was financed from domestic and external sources with 82.5 percent of the domestic financing coming from the commercial banks. With continuous increases in external resource inflows and their consequential relaxation of resource constraints on the economy, the deficit financing by the central bank would be kept within the WAMZ benchmark in 2010.

In The Gambia, inflation picked up significantly over the period 2002-2003, with annual average inflation rising from being single

Table 2: Primary Convergence Criteria Ghana

Primary Criteria	Target	2001	2002	2003	2004	2005	2006	2007	2008	2009
Inflation Rate (end period)	Single	21.3	15.2	23.6	11.8	13.9	10.9	12.8	18.1	16.0
Fiscal Deficit/GDP (%) excl. grants	≤ 4%	-13.2	-8.3	-7.5	-8.1	-6.9	-11.3	-15.6	-18.6	-12.3
Central Bank Financing of fiscal deficit as % of previous year's tax	<10%	0.0	12.1	0.0	27.7	0.0	0.0	0.0	38.7	0.0
Gross External Reserves (Months of Imports*)	≥ 3	1.4	2.7	5.0	4.6	4.0	3.7	3.9	2.2	3.9
Criteri(um)a satisfied		1	0	2	2	2	2	2	0	2

Source: Ghanaian Authorities and WAMI Staff

Table 3: Primary Convergence Criteria Gambia

Primary Criteria	Target	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Inflation Rate* (end-period)	Single Digit	0.2	8.1	13.0	17.6	8.0	1.8	0.4	6.0	6.8	2.7
Fiscal Deficit/Surplus/GDP (%) excl. grants	≤4%	0.3	-10.0	-9.1	-7.6	-8.6	-7.4	-2.7	-1.0	-3.3	-8.3
Central Bank Financing of Fiscal Deficit as % of previous Year's Tax Revenue	< 10%	0.0	30.7	76.1	63.1	0.0	0.0	0.0	0.0	0.0	0.0
Gross External Reserves (Months of Imports**)	≥3 Months	7.5	8.2	5.2	4.6	5.0	5.2	6.4	6.5	4.4	4.2
Number of Criteria Satisfied		4	2	1	1	3	3	4	4	4	3

* (2001 - 2005) based on old CPI, (2006-June and beyond) based on new CPI

[7]This was mainly due to sound macroeconomic management in a bid to restore macroeconomic stability following economic difficulties of 2008 that were exacerbated by uncertainties surrounding the presidential and parliamentary elections of 2008 and the change of government in the early part of 2009.

[8]The country is also rebasing its GDP in line with SNA 93 which might significantly improve the fiscal deficit criterion.

digit in 2000 to a spike of 17.6 percent in 2003 (table 3). In 2004 to 2006, the trend decelerated sharply averaging 3.3 percent attributed to a tight monetary policy coupled with an appreciating dalasi. However from 2007 to 2008, though still single digit, inflation accelerated somewhat recording above six percent. In 2009, inflation declined sharply to 2.7 percent attributed to a good harvest coupled with the tight monetary policy stance of the Central Bank. The fiscal deficit/GDP ratio indicated a deficit of 8.3 percent in 2009, well above the four percent ceiling. The major underlying factor that contributed to the widening of the fiscal deficit was the faster growth rate of spending than revenue. The current trend is expected to improve with government's commitment to fiscal restrain as well as its focus to domestic debt management.

The country had consistently achieved this criterion throughout the convergence period with the exception of 2001 to 2003 when a ratio ranging from 30.0 to 76.0 percent was recorded. It is expected that the country will maintain her attainment of this criterion if current fiscal policy stance of government is sustained. With 4.2 months of import cover in 2009, the country had maintained her performance of achieving a minimum reserve of 3 months since 2000[9].

The attainment and sustenance of single digit inflation rate in Sierra Leone as indicated above (table 4) has proved challenging since the commencement of the convergence process. The level of inflation for the past three years was more than the prescribed WAMZ convergence criterion of a single digit inflation rate. After emerging from a civil conflict that lasted for 11 years and which ended in 2002, the country has since been restoring public services.[10] Consequently, government fiscal operations have been in continuous deficit for the past ten years. Hikes in particularly, recurrent expenditure and the revenue shortfall due to a low tax collections weakened government fiscal balances. Fiscal deficit/GDP ratio recorded in 2009 was 10.5 percent. This was above the WAMZ-prescribed convergence criterion of 4.0 percent but compares favourably to the past three years[11]. Sierra Leone failed to comply with the criterion of central bank financing of fiscal deficit. Although there was a reduction in the net claims on government from the Bank of Sierra Leone, it was insufficient to comply with the WAMZ prescribed bench mark. The performance on the reserves criterion has been satisfactory over the years. The country has always accumulated reserves in excess of the benchmark 3 months of import cover since 2004[12].

The rate of inflation in Liberia, measured on year-on-year over the years (table 5) showed mixed development since 2004 oscillating between single and double digits threshold. In 2009, inflation was single-digit and met the WAMZ inflation criterion. Since 2006, the country has operated on the basis of a balanced cash budget benefiting from donor inflows[13]. With the anticipated issuance of Treasury bill instrument in the next budget cycle, 2010/2011, government could resume borrowing again. This however, is intended at financing infrastructure investment which will enhance the country's competitiveness and future fiscal sustainability[14]. Central Bank

Table 4: Primary Convergence Criteria - Sierra Leone

Primary Criteria	Target	2001	2002 Dec	2003 Dec	2004 Dec	2005 Dec	2006 Dec	2007 Dec	2008 Dec	2009 Dec
Inflation (End Period)	Single digit	3.4	-3.1	11.3	14.4	13.1	8.3	12.2	13.2	12.2
Fiscal Deficit/GDP (%) excl grants	≤ - 4%	-16.5	-11.7	-10.0	-8.6	-9.6	-8.6	-5.0	-7.9	-10.4
Central Bank Financing of Fiscal Deficit as % of previous year's tax revenue	≤10%	0.0	0.0	24.3	0.0	0.0	17.9	0.0	0.3	17.3
Gross External Reserves (months of imports *)	≥3 months	2.4	2.7	1.7	3.8	4.0	4.2	5.3	4.3	6.2
Number of Criteria satisfied		2	2	0	2	2	2	2	2	1
(*) In months of imports CIF										

Source: Sierra Leone Authorities and WAMI Staff

[9]The build-up in reserves was on account of substantial official transfers to the country from the World Bank as well as the African Development Bank for the purposes of direct budgetary support.
[10]The demand for public services i.e. health, agriculture, education, infrastructure, etc. is far greater than the revenues the authorities are able to mobilize.
[11]Fiscal restraint will ease pressure on T-bill yields and eventually generate fiscal savings for priority poverty reducing expenditures.
[12]The gross external reserves as of December 2009 equivalent to US$336.3 million, was sufficient to finance 6.2 months of imports.
[13] The Government is on the verge of reaching the HIPC completion point with the IMF which will secure the relief needed to free resources for development financing.
[14]Available data indicate zero percent financing of the government by the Central Bank. The country could sustain performance on this criterion.

financing of government fiscal operations is limited by legislation to a maximum of 10.0 percent of previous year's tax revenue which is consistent with the threshold set under the WAMZ criteria. Currently, the stock of external reserves in Liberia has achieved the WAMZ cut-off of 3 months of import cover[15].

(5.0) A Common Economic Space and Strategies for Integration in the WAMZ

(5.1) Benefits to Countries in the WAMZ from a Common Economic Space:

A common economic space would foster competition, access to wider market, larger and diversified investment and production, socio-economic and political stability and bargaining power for the countries involved. It can be multi-dimensional to cover the movement of goods and services (i.e. trade), capital and labour, socio-economic policy coordination and harmonization, infrastructure development, environmental management, and reforms in other public goods such as governance, peace, defense and security. The overall gains from the economies of scale of such an arrangement cannot be underscored. Financial sector development and growth within the sub-region can serve as an engine for economic growth in the following ways:

(i) Diversified source of external finance: In contrast to heavy reliance on sovereign debt and its attendance crisis and official aid flows, which are already shrinking, regional integration, allows access to more diversified source of external finance.

(ii) Global sharing of local equity risks: In contrast to the syndicated bank lending, international investors can share in the riskiness of local capital markets, especially through equity investments.

(iii) Reduction of cost of capital for local companies: Regional integration allows for local securities market risks to be shared internationally. Greater sharing of risks in the local capital markets through global holdings of local shares leads to reduction in the cost of capital for local firms. This leads to enhanced liquidity of the local market and capital mobilization by firms in response to the reduced cost of capital.

(iv) Reversal of capital flight: A common economic space would help to reverse capital flight (often an initial capital inflow and source of privatization capital). The evidence from other regions, such as Latin America and East Asia, suggests that financial globalization leads to large reversals of capital. Here it is important to recognize that the very measures that retain domestic capital are also those that help reverse capital flight. Given that sub-Sahara Africa experiences the largest share of stock of capital flight (relative to other regions), there is a potential for significant reversal, if the region is sufficiently integrated into the global financial economy.

(v) Promotion and validation of capital market institutions: Financial integration in the WAMZ would enhance validation of the credibility of domestic capital market institutions (custodial, clearing, settlement, and brokerage services, information and accounting disclosures, etc. and regulations), as foreign investors demand world-class services. Governments will be under greater pressure to strengthen the rule of law, enforce contracts, and increase the growth of available information in response to international investor demands. Thus, a common space would expose the stock markets to the best practices and standards, and in turn puts pressure for reforms of the local stock markets.[16] This informational

Table 5: Primary Convergence Criteria Liberia

Primary Criteria	Target	2007	2008	2009
Inflation (End Period)	**Single digit**	11.7	9.4	9.7
Fiscal Deficit/GDP(%) ex cl grants	**≤ - 4%**	3.8	- 5.0	- 4.2
Central Bank Financing of Fiscal Deficit as % of previous year's tax returns	**≤ - 10%**	0.0	0.0	0.0
Gross External Reserves (months of imports c.i.f)	**≥3 months**	0.7	0.7	3.8
Number of Criteria satisfied		2	2	3

Source: Liberia Authorities and WAMI Staff

[15]The performance of Liberia on this criterion is largely linked to inflow from development partners and revitalization of the rubber, mining and agricultural sectors.

discipline has a positive externality over the entire financial sector, including the banking sector. It is, therefore, important that countries in the WAMZ do not put counter-productive restrictions in place by stacking odds against outside investors.

(5.2) Key Constraints to A Common Economic Space in the WAMZ

Regional financial integration process in the WAMZ is facing several challenges. With regard to formal integration arrangements; there is a substantial gap between the aspirations expressed in the treaties and the reality on the ground. The reasons are manifold but are usually attributed to lack of commitment towards enhanced integration which results in lack of supranational authority and weak regional coordination mechanisms.

The constraints inhibiting an integrated sub-region are discussed under the following sub-headings:

Macro-economic and Political Instability

Abrupt changes in the economic and political landscape of the region are major source of instability. High macro-economic and political instabilities within the WAMZ have lead to high volatility in the financial markets. Unfortunately, Africa is abundantly endowed with abrupt changes in government policies and political climate. These abrupt changes have adverse consequences in financial markets.

Inadequate Political Commitment

This is one of the most serious constraints to integration. There has been inadequate practical political will to effectively implement agreed programmes for economic integration. This is evident with a number of regional protocols, which have not been ratified for years in several Member States due to fear of the short-term political and economic problems.

Foreign Exchange Fluctuation

High currency exchange volatility is endemic to the region, creating an impediment to foreign investments. In view of the dearth of hedging mechanisms through derivative markets (forward, futures, and options), an indirect approach would be to increase the number of export-oriented companies on the stock exchanges.

Small Financial Market in the Region

Financial services in the WAMZ tend to be more limited in scope, more expensive, and of poorer quality. In some cases, there are too few institutions to make the market competitive and the institutions themselves are often too small to achieve economies of scale. Furthermore, the financial systems are more volatile because they have fewer opportunities to diversify their risks either geographically or by sector.

Lack of Financial Deepening and Credit to the Private Sector

The performance outcomes for the financial sector reforms have been discouraging or at times outright perverse. The desired effects on savings mobilization and credit allocation have not materialized. The financial deepening measures and the measures of private credit, the private credit/GDP ratios, have not show clear upward trend in the region.

Banking Instability and Dysfunctional Intermediation

The problems of the banking systems in the WAMZ remain severe after financial sector reforms. Many economies are characterized by banking systems with a heavy concentration of their assets in the short end of the market and excessive liquidity (Nissanke and Aryeetey 1998). Moreover, the portfolios of banking institutions continue to be dominated by an extremely high incidence of non-performing loans and excess liquidity. Such a weak banking system breeds instability and even undermines government policies, such as the conduct of monetary policy (Camen, Ncube, and Senbet 1996).

Banking Incentive Issues and Ill-designed Safety Nets

The size and scope of financial service activities in the region is limited by policy. **Absence of correct incentives is visible within the region.** The lesson for the region is to devise efficient and incentive compatible regulatory systems. This could be in form of provision of safety nets, such as explicit or implicit deposit insurance schemes.

Supervisory and Regulatory Failure

Supervision and regulation of the financial sector have remained grossly inadequate, and the quality of financial intermediation is either reflective of excessively high risk (leading to bank distress) or excessively conservative (leading to dearth of credit to the private sector). This requires a well developed and coherent legal environment that forces regulators to faithfully and obediently implement and enforce regulation.

(5.3) Strategies for Integration

It is generally accepted that common economic space increases economic growth and improves welfare provided that two conditions are satisfied:

(i) Bigger firms are created in the sectors exhibiting economies of scale and/or scope; and

[17]The focus on the development of the banking sector precludes opportunities for building up informational technology unique to risk capital (e.g., disclosure and accounting standards).

(ii) Competition is strengthened across the integrated area.

Financial systems development and opening within the context of a single economic space would amongst others, facilitate migration of capital in the long-run and cross-border financing of current account imbalances in the short-run, thereby reducing the costs of adjustment to shocks to demand and supply. Furthermore, it would allow extensive sharing of the risks associated with macroeconomic shocks across countries as it broadens the range of diversification by including foreign bonds and equities in individual portfolios. In view of the thrust of financial liberalization that has been directed to market opening recently, greater capital mobility through capital account liberalization and opening of financial services industries is designed to strengthen financial ties between individual countries, thereby promoting creation of integrated regional financial markets in the sub region. If this development indeed takes place, the West African Monetary Zone countries would be closer to monetary integration (Economic and Financial) than before.

Strengthening Domestic Financial Markets

The first prong of the strategy for achieving national aspirations should focus on strengthening the domestic financial markets. The strengthened financial sector shall be used as a catalyst to drive growth in the real sector.

Enhancing Integration with External Financial Markets

The second prong of the strategy focuses on enhancing integration with external financial markets, concurrently with strengthening the domestic financial markets. The plan is to focus on initiatives that would enable the financial sector to reinforce the expansion of Nigeria's export base. Simultaneously, it is also planned to adopt initiatives that support exchange rate stability and create an environment that attracts foreign direct investments (FDI) as well as drives integration with external markets. The integration with external markets should commence with the regional bloc and later expand to other global economic blocs.

Building Financial Infrastructure

Financial sector infrastructure comprises the framework of laws, regulations, supervision, and institutions which underpin the operation of financial markets. The strength of financial markets rests on the strength of their supporting infrastructure, and distortions and imperfections in infrastructure can consequently impede and distort the effective functioning of markets. The five key components of financial sector infrastructure to be addressed are: regulation, supervision, and financial reporting standards; securities markets; payments systems; the legal framework;. and, the availability of credit information.

Full Adoption of Basel II and Implementation of International Financial Reporting Standards (IFRS)

The way forward for WAMZ countries is to agree on a regional reform agenda with benchmarks and a timetable for harmonizing prudential regulations, supervisory processes and practices such as:

1. Financial institutions supervised on a fully consolidated basis to inhibit the scope for regulatory arbitrage

2. Capital requirements tightened and allowing for liquidity risks

3. Agree on a tracking system to monitor progress and compliance with benchmarks

4. Decide on the objectives and responsibilities as well as the detailed institutional arrangements and set up a working group to develop those detailed instructions into a draft law

5. Set up working groups to:
   (i) develop a system for monitoring and control of market and other risks;
   (ii) streamline prudential limits and ratios;
   (iii) study the feasibility of a common accounting and reporting system; and
   (iv) define a process of early consultations and search for commonality among supervisors before issuing any new legislation, regulations, guidelines, directives or manuals, including the establishment of a legal sub-working group.

Statistical and Data Development

Build capacity for member countries to migrate to System of National Accounts 93 (SNA 93), Balance of Payments 5 (BP5) and other recent formats of monetary and fiscal statistics. Furthermore, provide key statistical base for WAMZ monetary union to do the following:

a. harmonizing the CPI and SNA framework;
b. a harmonised Regional Consumer Price Index for the WAMZ
c. an electronic database and data exchange system (real time).

Regulation and Supervision Reforms

The legal and regulatory basis of financial supervision supporting integration within the WAMZ should focus on the core components of all financial supervisory standards. The components should consist of the following categories:

- Regulatory governance,

which refers to the objectives, independence, enforcement, and other attributes that provide the capacity to formulate and implement sound regulatory policies and practices;

- Prudential framework, which refers to internal controls and governance arrangements to ensure prudent management and operations by financial firms; and

- Financial integrity and safety net arrangements, which refer to

- (a) The regulatory policies and instruments designed to promote fairness and integrity in the operations of financial institutions and markets; and

  (b) The creation of safeguards for depositors, investors, and policyholders, particularly during times of financial distress and crisis.

Developing a Supportive Regulatory Infrastructure

The need to increase financial sector competition in order to reduce costs and increase access implies the development of more flexible and uniform harmonized regulations and reporting requirements and uniform accounting standards conforming to IFRS. This would provide regulatory and supervisory cost reductions for institutions operating on a "virtual region" basis. Thus, it will improve the stability of each participating country's financial system by providing regulators with access to information about institutions' activities in other countries.

(6.0) Conclusion

(6.1) Summary

While the effects of the world financial crisis on countries in Africa continue to evolve, it has been observed that some African financial sectors have shown resilience in withstanding the effects of the crisis, benefiting from high capitalization and liquidity levels. The early effects of the crisis were evident in reduced capital inflows, with major markets such as Nigeria and South Africa experiencing larger net outflows than inflows. The higher net outflows increased demand for the dollar and other hard currencies, leading to the depreciation of several African currencies[17]. While some measure of recovery has since taken place in 2010, equity markets have seen substantial falls[18]. However, the credit crunch and increased risk aversion around the world have led to severe difficulties for the WAMZ in both trade financing and obtaining long-term funding in international markets at reasonable cost, as shown by the considerable widening of bond spreads since late 2007. Despite world-wide economic slowdown, the pace of economic activities in the WAMZ member countries remained relatively stable, although slower than in the previous years. Real GDP growth rate was estimated at an average of 5.8% in 2010, 5.5% in 2009, compared with 6.4% in 2008. The growth was underpinned by activities in the agricultural and services sectors in member countries.

In common with much of the rest of developing world, the sub region has very large needs for finance for infrastructure in the areas of transport, energy generation, and energy distribution. Normally, these needs would be met by using multilateral financing to supplement domestic budgetary resources. Lessons of experience have shown that strong political commitment at the highest level, coupled with the implementation of sound macroeconomic policies on sustained basis represent the necessary and sufficient success factors for the creation of monetary and economic unions, globally. A number of specific problems which have reduced the benefits of financial integration have been identified. Understanding the impact of financial development on economic growth and assessing the development of the financial sector in the WAMZ requires good measures of financial development.

(6.2) Conclusion

In conclusion, the financial sector of the WAMZ is relatively shallow, as evidenced by the current broad money to GDP ratio of less than 30 percent, vis-à-vis an average of 50 percent for Africa. Lessons of experience have shown that strong political commitment at the highest level, coupled with the implementation of sound macroeconomic policies on sustained basis represent the necessary and sufficient success factors for the creation of monetary and economic unions, globally. Evidence from other regional groupings suggest that expanded trade, macroeconomic stability, measured by: low rate of inflation and exchange rate stability, sustained growth and narrowing of fiscal balance, have become more entrenched in the regional groupings that have firmly established their economic and monetary union arrangements. The WAMZ needs both the intermediaries and the financial markets to support its development agenda. Both

[16]*Remittances were estimated to have declined between 4.6% and 7.8% during 2009.*

[17]*Merrill Lynch Africa Lions Index, which accounts for 15 African countries, experienced a 70 percent drop in the March-December 2008 period.*

market and intermediary-based systems have their own comparative advantages. Financial markets are better at financing new technologies and projects where there is little agreement on the management of firms, while intermediaries have developed expertise to distinguish between bad and good projects, making them very effective at mitigating moral hazard and adverse-selection problems between lenders and borrowers[19]. Countries in the region should therefore focus their attention on legal, regulatory and other policy reforms that encourage the proper functioning of both financial markets and intermediaries to support their long-term development agenda.[20]

It is our belief that there are good economic arguments for suggesting that the financial sector might generate important gains in terms of growth and social welfare, in effectively promoting a single economic space in the sub region. Financial sector development in the region is needed in facilitating economic integration, growth and poverty reduction. Evidence from Europe has shown that. An adequate and harmonized regulatory and institutional arrangements and an adequate supervisory framework should amongst others form the building blocks.

Finally, a certain degree of economic coordination as a step towards macroeconomic stability is also crucial in order to avoid financial crises that would hinder effective economic integration. In this respect, maintaining sound public finances and having a monetary policy geared towards achieving price stability are of the utmost importance as well as balancing financial innovation and economic stability.

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[19]However, the quantity and quality of financial services are very important.
[20]While there are obvious advantages to be derived from the integration of the financial markets, proper balance needs to be struck on how foreign financial institutions are allowed to operate in national markets.

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