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# The eco-currency, expectations and business growth in West Africa

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# THE ECO CURRENCY: EXPECTATIONS AND BUSINESS GROWTH IN WEST AFRICA

**Abstract**

*The introduction of the ECO has the potential of enhancing trade within the WAMZ member states in the medium to long-term. However, the quest for a common currency must be driven by economic fundamentals, rather than political expediency. Consequently, there is need to ensure macroeconomic convergence and homogeneity of the financial and product markets before the ECO is introduced. Looking backward, the disappointing track record of the WAMZ countries in taming inflation and pursuing prudent fiscal policy, does not give hope for the stability of the ECO, if and when it is introduced. To this end, the business community in Nigeria may be better-off with the naira, than embracing the ECO. Between 1999-2003, the naira depreciated by 8.3 per cent in the DAS, compared with the permissible 15 per cent provided under the WAMZ exchange rate mechanism protocol.*

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## INTRODUCTION

Regionalization and monetary unions are global phenomena with serious challenges on the macroeconomic management of the integrating economies. Prominent experiments in regionalization include: the European Economic Community which has produced the Euro-zone, the association of the South Asian Nations (ASEAN), with the Japanese Yen as the dominant currency, and the North American Free Trade Agreement (NAFTA), with the US dollar as the common currency of choice.

In Africa, three major common market initiatives have also evolved. These are: the Economic Community of West African States (ECOWAS), the common market for Eastern and Southern Africa (COMESA), and the Southern African Development Community (SADC). A common currency and a common central bank represents the very last stage of economic integration. All things being equal, a common currency is likely to expand the frontier of trade and enhance the welfare of the citizens of the integrating communities, because of the inherent economies of scale.

This assertion has strong empirical and theoretical support. It was Adam Smith (1776), who noted centuries ago that it was not by the benevolence of the baker that we eat bread. Rather, bakers who strive to enhance their self interest, unwittingly, enhance the welfare of all consumers of bread. Trade is beneficial to all and the use of common currency enhances the benefit of trade by the elimination of exchange risks and transaction costs.

The ECOWAS was established in 1975 with the primary objective of forging economic integration in the sub-region. A critical element of the integration programme is the adoption of the ECOWAS Monetary Co-operation Programme (EMCP), in 1987. The programme aimed at achieving a single monetary zone with a common currency and a common central bank. The failure to achieve this objective gave rise to the creation of the so-called ("fast-track") second West African Monetary Zone (WAMZ), in 1999. The WAMZ project was championed by Presidents Olusegun Obasanjo of Nigeria, and Jerry Rawlings of Ghana. The WAMZ comprises largely the Anglophone West African countries of:

Nigeria, The Gambia, Ghana, Sierra Leone and Guinea[1]. Because of the civil war in Liberia, the country is not a full member of WAMZ, but it maintains an observer status. It was originally envisaged that the WAMZ project will culminate into the establishment of a monetary union with a common currency and a common central bank (the West African Central Bank WACB), by end 2oo4. This commencement date has been shifted to mid-2005. The WACB shall be responsible for the issuance of the common currency to be called the **ECO**. The WACB shall also be responsible for the formulation of monetary policy in the WAMZ.

This paper shall examine the pros and cons of adopting the **ECO** in the WAMZ. Specifically, we shall ascertain if the **ECO** shall be good for business in the sub-region. To accomplish this task, the paper is structured in six sections. Section two which follows shall discuss the conceptual framework of a monetary union and the evolution of the monetary union in West Africa. Section three examines the implications of a single currency on business development. Section four x'rays the convergence criteria and fundamentals of a sustainable monetary union, section five examines the score-card and performance of the WAMZ countries, while section six concludes the paper.

## 2.0 Conceptual Framework

The elimination of exchange risks and transaction cost were the core considerations which influenced Mundell's (1961), seminal work on the Optimum Currency Area (OCA). Generally, countries derive economic gains under a monetary union when the real benefits of permanently fixing their exchange rate under a common

1. Though a francophone nation, the Republic of Guinea is a member of WAMZ because of historical and political reasons.

currency, outweigh the real costs associated with flexible exchange rate.

The major advantages of belonging to a common monetary union can be briefly itemized as follows:

- Achievement of low inflation rate arising from the pursuit of prudent monetary and fiscal policies for which common currency areas are known for;
- To reduce transaction costs in trade with member countries;
- To eliminate the cost of printing and maintaining a separate national currency;
- To remove discretion from monetary and fiscal authorities;
- To keep the exchange rate from being kicked around as a political football by vested interest that want depreciation or over valuation, to enhance rents.

However, a country may choose not to join a monetary union for several reasons including:

- If it wants to have an independent monetary policy;
- If it wants to use the exchange rate as a begger-thy-neighbor instrument to capture employment from other countries;
- If it wants to use monetary expansion or inflation tax to finance government expenditure;
- If it does not want to sacrifice the use of seignorage to achieve a balance budget.
- If it does not want to accept the degree of integration implied by the OCA agreement in terms of common standards, labour code, tax legislation etc.

Overall, it seems that the advantages of belonging to a common monetary union generally outweigh the disadvantages and this explains why monetary unions are becoming increasingly very popular in recent times.

## 2.1 The Eco Currency

A common currency is the ultimate objective of the optimum currency area theory as postulated by Mundell (1961). By definition, an optimum currency area represents a geographical space in which a single currency is the legal tender, Mason and Taylor (1993). Like the **Euro**, the WAMZ **ECO** is envisaged to be introduced as a virtual currency in 2005, thereafter, it will circulate as a legal tender in tandem with the national currencies of the WAMZ member states for a specified period most likely, one year. Before the **ECO** becomes a legal tender, it will first serve as a unit of account, or a numeraire; against which member national currencies are measured. A key process of achieving a common currency is the adoption of an exchange rate mechanism, which ensures that the exchange rate of the integrating national currencies fluctuate within the acceptable band against the chosen intervention currency. The WAMZ protocol requires member countries to manage their national currencies within the band of plus/minus 15 per cent of the US dollar, beginning April 2002. With the **ECO** unit of account determined per national currency and the exchange rate mechanism fixed, the introduction of the **ECO** as a legal tender and store of value has now become a certainty, provided the convergence criteria are met by the WAMZ member countries.

## 3.0 The Convergence Criteria

The WAMZ protocol requires the member countries to meet specified primary and secondary convergence criteria, before the introduction of the common currency. This is to ensure that the markets[2] and macroeconomic conditions of the member states are similar in order to guarantee that the internal and external value of the common currency remain stable in the medium-to-long-term.

The primary convergence criteria include;

(a) Price stability: defined as a single digit inflation rate,

(b) Sustainable fiscal balance,

(c) Limiting central bank financing of government budget, and

(D) Maintaining adequate external reserves.

These criteria are to be attained and sustained within a specified time frame as outlined below:

- Price stability through single-digit end-period inflation by 2000 and 5 per cent or less by 2003;
- Sustainable fiscal policy regime through reducing the budget deficit/GDP (excluding grants) ratio on commitment basis to 5% or less by end-2000 and 4% or less by end-2002,
- Limiting central bank financing of government deficit to 10% or less of the previous year's tax revenue, and
- Sufficient gross official reserves to cover at least 3 months of import cover by 2000 and 6 months of import cover by end-2003.

2. Besides macroeconomic convergence, it is also imperative that the labour, financial and goods markets of the memb er countries are to some reasonable degree homogeneous.

In addition to the primary convergence criteria, six secondary criteria were specified as follows:

- Prohibition of new domestic arrears and liquidation of all existing arrears
- Tax revenue to be more than 20% of GDP
- Wage bill to be less than 35% of total tax revenue.
- Public investments to be more than 20% of tax revenue
- Maintenance of real exchange rate stability in the context of an exchange rate mechanism of plus/minus 15% parity bond
- Maintenance of positive real interest rates.

### 3.1 Convergence Process

The actualisation of the common currency, is strongly predicated on the achievement of the convergence criteria by the WAMZ member countries on a sustained basis, as well as the attainment of homogeneity in the labour, financial and goods markets.

## 4.0 Assessment Of Compliance With Wamz Convergence Criteria

Based on end-2003 assessment of the performance of the WAMZ countries, it is evident that no country achieved all the four primary pillars of convergence (table 1). The Gambia and Sierra Leone have progressively declined in their performance track record, meeting 2 and 3 criteria respectively, in 2002 and slipping to 1, apiece in 2003, while Ghana, improved from zero compliance in 2002 to achieving 2 of the criteria in 2003. Guinea moved from 1 to zero while Nigeria maintained its compliance level at 2, having met 3 criteria in 2000.

**Table 1**

**COUNTRY COMPLIANCE WITH WAMZ PRIMARY CONVERGENCE CRITERIA**

| Country | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|
| The Gambia | 4 | 3 | 2 | 1 |
| Ghana | 0 | 1 | 0 | 2 |
| Guinea | 1 | 2 | 1 | 0 |
| Nigeria | 3 | 2 | 2 | 2 |
| Sierra Leone | 1 | 2 | 3 | 1 |

***Source: WAMI***

Specifically, (as shown in Table 2), The Gambia maintained a single digit inflation from 1999 until 2003 when inflation rose to 17.6 per cent. The Gambian inflation rate of 0.8 per cent in 2002 was the lowest since 2000. Guinea had equally maintained a low inflation rate since 1999 until 2003 when its lowest inflation rate of 1.1 per cent in 2001, soared to 14.8 per cent in 2003. Sierra Leone equally witnessed a high price level as its deflation of -3.4 per cent, rose to 11.3 per cent in 2003. The downward inflationary trend observed in Ghana in 2002 was reversed in 2003 when inflation rose from 14.8 per cent to 26.7 per cent. In Nigeria, inflation rose from 14.6 in 2000 to 16.5 per cent in 2001. It however, moderated to 12.1 in 2002, but rose again to 23.8 per cent in 2003. From Table 2, inflation remained a major problem of macroeconomic stability in the sub-region, especially in Nigeria and Ghana, the two largest WAMZ countries. This development has serious implication for the stability of the ECO.

**Table 2**
**PRICE STABILITY**

| Country | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|
| The Gambia | 1.7 | 0.8 | 4.5 | 8.6 | 17.6 |
| Ghana | 13.8 | 24.9 | 32.9 | 14.8 | 26.7 |
| Guinea | 6.2 | 7.2 | 1.1 | 6.1 | 14.8 |
| Nigeria | 0.2 | 14.5 | 16.5 | 12.2 | 23.8 |
| Sierra Leone | 36.7 | 2.8 | 3.4 | -3.1 | 11.3 |
| No of countries that | | | | | |
| Met the criteria | | 3 | 3 | 2 | 0 |

*Note: Price stability achieved by recording single-digit end-period inflation rate by 2000 and 5 per cent or less by 2003.*

The Gambia, which achieved the fiscal deficit/GDP target of 5% in 1999 and 2000, failed to meet the 4% requirement which was envisaged to be a consolidation over past performance.

**Table 3**

**FISCAL DEFICIT TO GDP**

| Country | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|
| The Gambia | 4.4 | 3.6 | 9.8 | 9.4 | 8.1 |
| Ghana | 7.7 | 10.1 | 13.1 | 7.9 | 7.7 |
| Guinea | 5.8 | 5.2 | 7.8 | 8.3 | 9.6 |
| Nigeria | 8.9 | 2.5 | 5.4 | 5.4 | 2.9 |
| Sierra Leone | 17.1 | 17.3 | 16.7 | 19.7 | 16.7 |
| No of countries that met the criteria | | 2 | 0 | 0 | 1 |

***Note:*** *Sustainable government fiscal position by reducing the budget deficit-GDP (excluding grants) ratio on commitment basis to 5% or less by end-2000 and 4% or less by end-2002*

***Source:*** ***WAMI***

Consequently, fiscal deficits as a ratio of GDP rose to 9.4, 9.8, and 8.1 in 2001, 2002, and 2003, respectively. Guinea's deficit position worsened from 8.3 per cent in 2002 to 9.6 per cent in 2003, while Ghana consolidated on the marginal success which it achieved the previous year, but remained 3.7 percentage points higher than the target of 4.0 per cent in 2003. Sierra Leone improved on its previous dismal performance as its deficit/GDP ratio declined from 19.7 per cent in 2002 to 16.7 per cent in 2003. With 2.9 per cent deficit/GDP ratio in 2003, Nigeria was the best performing member of the group

**Table 4**
**CENTRAL BANK FINANCE OF FISCAL DEFICIT**

| Country | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|
| The Gambia | 0.0 | 0.0 | 0.0 | 63.0 |
| Ghana | 57.9 | 0.0 | 12.1 | -5.0 |
| Guinea | 17.6 | 0.0 | 23.9 | 18.9 |
| Nigeria | 0.0 | 0.0 | 0.0 | 10.3 |
| Sierra Leone | 32.7 | 8.9 | 1.9 | 25.4 |
| No of countries that met the criteria | 2 | 4 | 3 | 1 |

***Note:*** *Limiting central bank financing of government budget deficit to 10% or less of the previous year's tax revenue*
***Source:*** *WAMI*

On this criterion, having operated at an average of 5.0 per cent since 1999.

With respect to the financing of deficits via the central bank, the member countries performed fairly well on this criterion in 2001 and 2002. However, in 2003, the situation reversed in The Gambia, Guinea and Sierra Leone as their central banks were involved in

## Table 5
## GROSS OFFICIAL RESERVES/MONTHS OF IMPORTS

| Country | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|
| The Gambia | 7.3 | 7.5 | 7.4 | 5.5 | 4.0 |
| Ghana | 1.4 | 0.8 | 1.5 | 2.3 | 4.0 |
| Guinea | 2.7 | 2.2 | 2.8 | 2.1 | 1.8 |
| Nigeria | 7.6 | 13.6 | 11.3 | 9.9 | 6.5 |
| Sierra Leone | 2 | 2.8 | 2.3 | 3.1 | 1.9 |
| No of countries that met the criteria | | 2 | 2 | 3 | 3 |

**Note:** *Sufficient level of gross official foreign exchange reserves by maintaining at least 3 months of import cover by 2000 and 6 months of import cover by end-2003*

**Source:** ***WAMI***

substantial financing of government deficits to levels higher than the target of 10 per cent stipulated under the protocol. Ghana financed her deficit mainly from domestic non-bank sources, in contrast to 2000, when a whooping 57.9 per cent of the deficit was financed by the central bank. Nigeria for the first time, overshot the target by 0.3 percentage point.

In 2001, only Nigeria and The Gambia met the target of at least 3 months of import cover. Guinea and Sierra Leone accumulated reserves that could cover 2.8 and 2.3 months of imports, respectively, in 2001 while Ghana recorded only 1.5 months of import cover for the same year.

Country performance with respect to the secondary convergence criteria, has been equally disappointing. Nigeria and Ghana met the 20.0 per cent tax revenue/GDP criterion in 2003, while The Gambia and Sierra Leone made considerable efforts at increasing the tax revenue/GDP ratio, although not meeting the convergence target. Guinea fell short of the target. Data on debt arrears remains scanty; hence, the performance of the member countries could not be objectively assessed. The wage bill/tax revenue criteria of below 35 per cent was met by the Gambia and Nigeria, while Guinea overshot by 1.7 percentage points. For Ghana and Sierra Leone, the wage bill/tax revenue ratio stood at 19.6 per cent and 59.7 per cent in 2003 from 57.2 and 63.2 per cent recorded in 2002, respectively. At 43.4 per cent in 2003, only Ghana met the public investments financed from tax revenue criterion, while Guinea and Sierra Leone at 12.1 per cent and 10.6 per cent respectively fell short of the minimum 20.0 per cent target. Real interest rates were largely negative for all countries due to the high inflation rates which they recorded.

## 5.0 LIKELY IMPLICATIONS OF COMMON CURRENCY ON THE BUSINESS ENVIRONMENT

### Trade Development

A single currency such as the proposed **ECO** has the potential of fostering trade within and beyond the constituent states. Its emergence will serve as a reliable anchor for business men for trade contracts. It is envisaged that the **ECO** would eliminate payments obstacles, and thus, enhance the current low level of official intra-ECOWAS trade. Given the parity in exchange rate under the monetary union arrangement, speculative capital flows would also be minimized if not fully eliminated. The common currency would also boost investments in the sub-region. The increased investment would in turn, enhance economic welfare by channelling savings to their most productive uses and geographical spaces.

Available statistics showed that the growth in official export in the West African sub-region averaged barely 2.3 per cent in the period 1991-2000. Specifically, it stood at 1.7 per cent for the period 1991 through 1999, and rose steadily to 7.9 per cent thereafter (ADB, 2001). Nevertheless, the West Africa official trade balance as percentage of GDP is expected to grow rapidly once the integration process is completed.

A common currency in the West African sub-region would also assist in translating the informal trade transactions into formal trade, as the difficulties associated with currency convertibility are eliminated within the member states.

## Trade Indicators for West Africa (1990-2000)

(%)

| Years | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | Average |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Growth in Exports (%) | -8.2 | 14.4 | -6.2 | -2.6 | 22.1 | 33.9 | -5.5 | -28.9 | -3.5 | 7.9 | 2.3 |
| Growth in Imports (%) | 13.0 | 7.8 | 6.3 | -1.9 | 11.3 | 9.3 | 1.4 | 7.5 | -35.4 | 4.7 | 2.4 |
| Trade balance as % of GDP | 16.6 | 12.4 | 1.6 | 0.4 | 5.1 | 9.2 | 6.9 | 0.9 | 0.2 | 8.0 | 6.1 |

***Source:*** *African Development Report (2001), ECOWAS National Accounts (1995), ECOWAS Handbook of International Trade (1999) and International Financial Statistics (various issues).*

## 5.1 The ECO or The Naira?

Given the apparent inability of the WAMZ member countries to achieve sustained macroeconomic convergence to-date; the critical question to ask is: shall the Nigerian business community be better-off trading with the ECO, or the Naira? The objective to achieve convergence is to ensure that monetary and fiscal policy regimes in the member states are prudent, compatible and sustainable, without which price and exchange rate stability cannot be maintained, in the medium to long-term.

Looking backwards, WAMZ member countries have maintained a poor inflation record and fiscal policy regime. Given the influence of inflation on the stability of the real exchange rate on one hand, and the inability of most WAMZ countries to achieve a better inflation track record than Nigeria on the other hand, one can safely conclude that the business community in Nigeria is better-off trading with the Naira than embracing the ECO. It is noteworthy that between 1999-2003, the naira depreciated by 8.3 per cent against the US dollar, compared with the permissible 15 per cent depreciation under the WAMZ exchange rate mechanism protocol. For the Nigerian business community, 15 per cent depreciation represents too big a risk to accept.

## 5.2 Capital Market Growth

The emergence of the common currency will further deepen the financial sector particularly, the national capital markets of the integrating countries. The deepening of the capital market will usher in greater competition and create additional investment opportunities for institutional and individual investors. By implications, operators in this market could freely trade on the Nigeria and Ghana Stock Exchanges without exchange rate or currency risks. Therefore, operating firms would have no need to source foreign exchange in their bid to remit dividends to community investors. However, in order to reap these benefits, it would be necessary to establish a unified regulatory framework, common values, standards and ethics for cross border investment transactions.

### 5.3 Reserve Management

The ECO is expected to improve the foreign reserves of the WAMZ members. Although, the realization of an efficient reserve management would depend on the amount of reserves pooled and how well it is managed. To date, there is no reason to be too optimistic that the stock of reserves in the WAMZ member states would become robust. Only Nigeria has managed to maintain a reasonable stock of reserves which can cover six months of imports. Against this backdrop, it is doubtful if the ECO can become a strong reserve currency. Emperical studies have also shown that a robust external reserve position is an important determinant for attracting foreign direct investments. It is likely that the Zone may not be too attractive to foreign investors, at least, in the short-term and until sound macroeconomic management is enthroned.

## 6.0 Conclusion

The ECOWAS sub-region consists of 15 sovereign nations, with 8 national currencies. The major currency unit in terms of circulation in a wider geographical space is the CFA Franc the common currency of the francophone nations. The stability of the CFA franc has been predicated on the positive intervention of the French Treasury. In the absence of sustained convergence, the stability of the **ECO** may not likely endure, given the wide swings which have characterized the macroeconomic performance of the

WAMZ countries, as well as the absence of an anchor economy. As available data reveal, the reform policies of the WAMZ member states have been implemented in fits and starts and in ways that have sustained macroeconomic divergence, rather than convergence. Despite the difficulties being encountered at achieving macroeconomic convergence, the introduction of the ECO represents a sound political decision, but a doubtful economic proposition given the very poor track record in macroeconomic convergence by the member countries.

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