

Monetary Integration in West Africa: History, Theory, Policy

By Youssef El Jai

Summary

Prior to the colonial era, money issuance in West Africa depended on slave trade. With the advent of the colonial rule, silver coins were imported then progressively imposed as a tool of coercion. The post-colonial trajectory was different for former British and French colonies. While the former regained their monetary sovereignty, the latter continued under a monetary union under the auspices of France. The proposal of the Eco as a single currency for ECOWAS is therefore a whole new step for some countries and a simple exercise of adaptation for others. Hence, a bold policy agenda is needed if the currency union is to be a success.

I. The Monetary History of West Africa

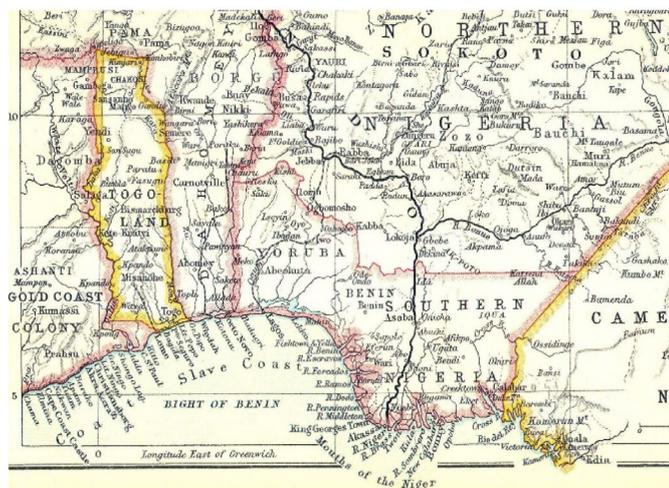
The evolution of money in the pre-colonial era in West Africa was strongly related to the pattern of overseas trade. Throughout the eighteenth century, the slave trade was, unfortunately, a major aspect of international exchanges. It represented for the West African region, covering Senegambia, Sierra Leone, Benin, Nigeria, Upper Guinea and the inland regions, an important source of revenue and the main way to obtain currencies (Johnson, 1970).

- Cowrie shells were among the most used commodities in monetary transactions on the Slave Coast. Two main forms co-existed, the *Cypraea moneta* (money cowrie) from the Maldive Islands and the *Cypraea annulus* (gold ring cowrie) from Zanzibar. Cowries

were particularly popular because of their small size and divisibility and thus fitted the profile of fiat money as we know it. Also, they carried small risks of hyperinflation as their supply depended on trade at a high cost of shipping. Within Africa, their value increased when going further from the coast (Hogendorn and Gemery, 1988).

- Metals and other materials such as cloth were also used as currencies, although to a lesser extent given their intrinsic uses as commodities. Copper manillas (bracelets) were used in the Niger Delta. Iron was extensively used along the Upper Guinea coast and the Senegambia region. As for Gold, it was smuggled from Brazil to West Africa and exchanged for slaves, who would exclusively work in gold mines on the other side of the Atlantic. Cotton cloth and guinées cloth were used in the Senegal area.

Figure 1: West Africa The Slave Coast on a John Bartholomew & Co



Relying on trade also limited the scope for profit, given competition on the money market. Cowries from the Maldives were essentially controlled by a foreign monopoly market but came with high contingent costs. The use of these commodities as currencies also responded to supply and demand. In the nineteenth century, as the slave trade was abolished, the demand decreased significantly, leading to a fall in wealth. With the rise of commodity exports, currency imports increased again. East African cowries rose exponentially relative to Maldivian cowries and induced a significant depreciation of the market rate (Hogendorn and Gemery, 1988).

With the arrival in West Africa of the French and British, coercive rule implied substitution of primitive currencies by colonial currencies (see for example Ofonagoro, 1976). This led to a major loss of value that was never compensated. The banking system, as established, was dominated by foreign-based banks, and favored expatriates' firms over small incumbent indigenous producers. Also, the coercive imposition of silver coins was a way to impose tax collection (Schuler, 2003). Money supply, in its new form, continued to depend mainly on trade. Commodity exports from colonies to France and Britain had as their counterpart silver coins in the forms of the French franc and the pound sterling. However, soon after, colonial rulers started producing silver coins at relatively low cost but with the face value of a domestic franc or pound. Issuance followed the presentation of export receipts denominated in sterling, serving as proof of truthfulness of transactions. Currency earnings were only possible if the trade balance was

in surplus. In the British zone, established in 1912, the West African Currency Board (WACB) handled monetary creation and regulated money issuance. Also, under a very restrictive arrangement, seigniorage profits accrued for the most part to the British rulers, and only a small part went to the colonies (Hogendorn and Gemery, 1988). In the French colonies, money issuance was first delegated to private banks, which had as their main prerogative preservation of a one-to-one peg with the French franc (Schuler, 2003). La Banque Occidentale handled money issuance and guaranteed parity until 1955.

Following independence, the WACB remained active until the British decided to put an end to it, leaving the floor open for the independent countries to create their own currencies. In the French West African colonies, the CFA monetary arrangement continued even after independence. Monetary integration was a means of maintaining the link between the colonies and Europe, but little had been done to harmonize the internal structure of the currency union. Intra-regional trade was weak and not at the level one would expect in the absence of transaction costs. De facto, after its former colonies gained independence, France remained the main player in central banking in the CFA zones. The established system has always worked according to strict rules on the independence of the Banque Centrale des Etats d'Afrique de l'Ouest (est. 1955). Under the supervision of the French Treasury, 100% of the reserves had to be kept in an operation account, which guaranteed the fully convertibility of the CFA Franc with the French Franc, and then with the euro. This limit would eventually be cut to 65% after West African leaders formed a common front for reform of the monetary arrangement (Duchaussoy, 2018), and further cut to 50% in 2005. The arrangement went through multiple reforms and the debt crisis in the 1980s had serious implications for the peg. Heavily indebted countries underwent strict programs of structural adjustment mainly based on competitive deflation. However, in 1994, the devaluation, which had been first discarded by the French and the West African leaders (Nubukpo, 2007), was deemed necessary.

Moving forward to the early 2000s, the West African Monetary Zone (WAMZ) was established by six countries: Nigeria, Liberia, Sierra Leone, Guinea, Gambia, and Ghana, with the goal of forming a currency union in the Economic Community of West African States (ECOWAS) that would be called the Eco. On multiple occasions, the introduction of the new currency was delayed, because

of the evident lack of convergence within the area and the delays in implementing reforms that were deemed necessary for starting this union. In 2020, however, French President Emmanuel Macron and Ivorian President Alassane Ouattara jointly announced that the countries of the WAEMU would soon have their own arrangement under the name of the Eco, a currency union that would be enlarged in the medium term to countries outside the West African franc zone.

II. An ECOWAS Currency Union

a. A (very) brief leap into the theoretical foundations of monetary integration

As explained in the previous section, historically, different forms of money were common in different West African countries. Although, one cannot label these as currency unions, they can be considered as a prelude to unionization. Mundell (1961)¹ was the first to propose the idea of optimum currency areas, or regional communities that share some of the optimal characteristics necessary to have a common currency. These were, according to Mundell (1961), business cycle synchronization, flexibility of wages and prices, free mobility of people and capital, and the presence of a risk-sharing mechanism. Consider a world of two countries, with region A and B in country 1 and C and D in country 2. Suppose a shock hits both countries. Regions A and C, which prior to the shock had the same productive structure and industrial specialization and trade intensity, react in the same manner. Regions B and D also react symmetrically and have the same characteristics. Then, theoretically, from a cost-benefit perspective, each pair of regions would be better-off with its own common currency.

Delving into game theory, one can also think of monetary integration as a game with two possible outcomes: either players can interact non-cooperatively, each maximizing its own benefit, with the negative externalities this implies (considering that unionizing is a better outcome), or they can cooperate and work towards a common objective to reach a better outcome. However, even in theory, the outcome remains conditional on the assumptions we make on the outcomes of the game and on our beliefs about what is good and bad in our

situation. These biases, if we may call them so, influence greatly the decision-making.

b. The empirics of monetary union in West Africa

While in theory everything is possible, in practice those biases have important policymaking implications. From an ex-ante perspective, one can consider that, unless the conditions for monetary integration are fulfilled, going for the cooperative solution would be unfeasible and unwarranted. From an ex-post perspective, one also could argue that monetary integration can be a vector of economic integration and the harmonization of the productive structures (Frankel and Rose, 1998; Zouri, 2018).

Taking an empirical approach can be a good way to choose one or the other perspectives. A first strand of the literature focuses on the functional aspects of currency unions. Batté et al (2010) simulated the macroeconomic implications of a shock in an economy tailored for the CFA Franc Zone and in Nigeria, under two regimes: a peg and a flexible exchange rate regime. Their findings suggested that the Nigerian economy would react better with a flexible rate. They proposed that, given the size of Nigeria and its oil specialization, each country in ECOWAS should adopt a stabilization fund. Counter-cyclical interventions would smooth the fluctuations of commodity prices. This proposal appears very ambitious and perhaps raises serious practical concerns about its monitoring and governance. Debrun et al (2002) did the same exercise to identify the optimal size of a monetary union. Their results suggested that sharing a common currency brings benefits to all countries when Nigeria is not included in the sample. The inclusion of Nigeria, again putting the emphasis on the size of its economy, distorts the incentives for the monetary union on the fiscal side, and therefore leads to a less-favorable outcome for the West African Economic Monetary Union (WAEMU) countries (West CFA Franc zone). Conflicting policy objectives for the Nigerian economy and the other ECOWAS economies would therefore impose important trade-offs and excessive inflation. Debrun and Patillo (2010) performed a cost-benefit analysis to assess the suitability of ECOWAS for monetary union. They compared the benefits in terms of monetary stability with the costs in terms of exposure to idiosyncratic shocks, and found that Nigeria, and to a lesser extent Cote d'Ivoire, would benefit most. The benefits were however found to be

1. The reader can also refer to McKinnon (1963) and Kenen (1969).

very limited. Comparing their results with the impact of reforms to the macroeconomic framework, they found that the welfare benefits of reforms tend to exceed the gains from currency union².

Another strand of the literature focuses on the feasibility of a monetary union from the perspective of business cycle synchronization. Bayoumi and Ostry (1997), for example, identified the responses of ECOWAS countries to a supply shock and looked at the fluctuations of output, finding very asymmetric responses within the regional economic community (REC). Fielding and Shields (2001), and Cushing and Harvey (2016), did the same analysis for WAMZ with multiple shocks, and again failed to identify evidence of synchronicity. In a study for the Policy Center for the New South, El Jai (2020) conducted the analysis on ECOWAS with multiple shocks using the same methodology as Bayoumi and Eichengreen (1992). He failed to identify a common structure of responses to shocks in ECOWAS. However, his findings suggest the presence of a core of countries based on WAEMU, with strong correlated demand shocks and to a lesser extent supply shocks, and a periphery that consists of non-WAEMU countries. El Jai (2020) therefore concluded that the business cycle condition for formation of a currency union was not met.

III. Practical Aspects of an ECOWAS Currency Union

That said, true policymaking requires the taking of bold initiatives, of which moving forward toward deeper integration would certainly be one. The evidence provided so far on the possible shortcomings of an ECOWAS currency union provides valuable starting points and insights about what to do and what to avoid on the road to monetary integration.

In the early 2000s, some nominal convergence criteria were set. The goal was that each member state had to meet these in order to join the Eco currency union. Inspired by the treaty of Maastricht, the criteria can be split into two categories.

- **Primary criteria:**

- Each country would have to maintain stable inflation,

2. Welfare implications also depend on the prior in terms of inflation and output stabilization.

i.e. single digit inflation rate at the end of each year, with a 5% limit;

- A stable exchange rate;
- Fiscal deficits should not exceed 3% of GDP;
- Central banks would not finance more than 10% of the preceding year's tax collection;
- The total stock of gross external reserves should cover at least three months of imports.

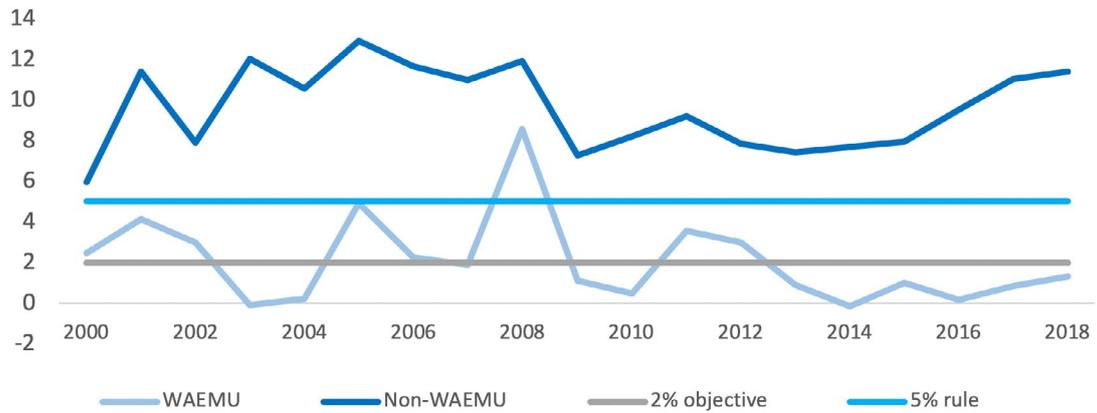
- **Secondary criteria:**

- The real interest rate has to be positive;
- Tax revenues should be at least 20% of GDP;
- Debt has to be sustainable and countries must not register any new domestic payment defaults;
- The public sector wage bill cannot exceed 35% of tax revenues;
- The ratio of public investment to tax revenues has to be at least 20%.

Currently, not all ECOWAS countries fulfill these convergence criteria. The 2019 convergence report published by the REC showed that none of the countries fulfilled all the convergence criteria. In particular, on average, inflation has always been higher in countries outside of WAEMU, as shown by the graph below.

Meeting these criteria requires aligning on rules-based governance and achieving compromises. Some would argue that these measures, as restrictive as they seem and as arbitrary as they appear, would only perpetuate the current functioning of the WAEMU currency union. However, one has to see them as a necessary step in order to smoothly transition to a full-fledged monetary union. In particular, the lack of discipline within a monetary union can have spillover effects for members when a shock hits, as was seen in the euro crisis. It is clear that all the institutions and the global order always behave better when guided by a set of rules. Hence, a further step could be to agree on other ways to proceed to a sound currency union, setting rules that are beneficial for all and economically feasible.

Inflation: 2000-2018

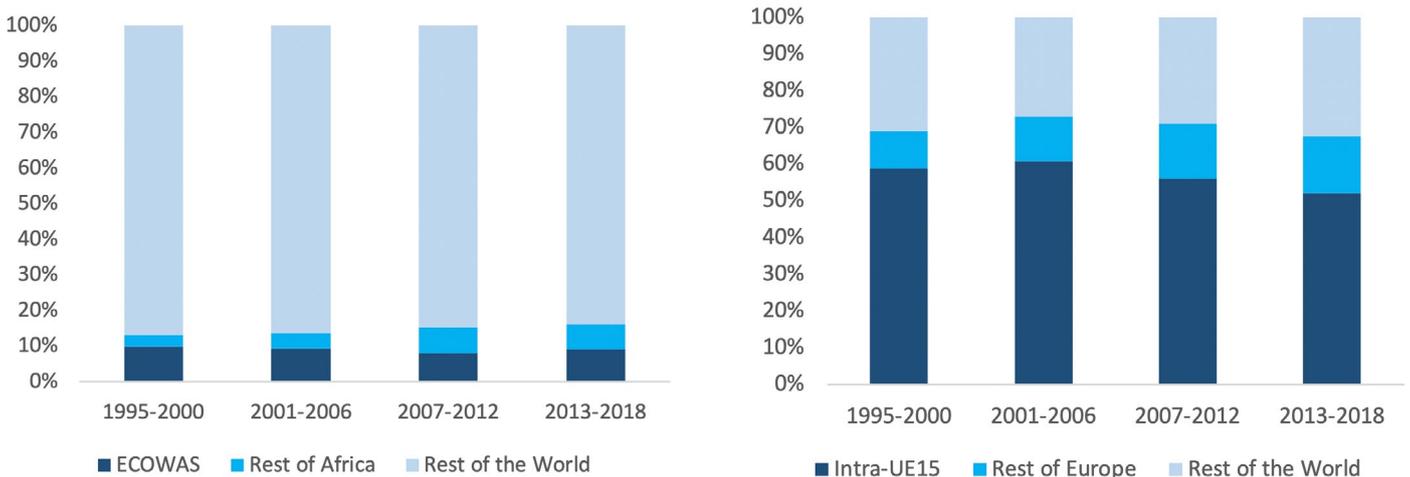


Source: IMF, WEO October 2019

Also, the trade patterns of the last 25 years translate into a lack of integration within the area, as most of the trade occurs outside of the African continent (see graph below). Two points should be raised. In a currency union, either trade linkages would increase as transaction costs related to currency conversion decrease, thus reducing total trade costs, or no change would happen, at least not

immediately. No change would be explained by the fact that the lack of intra-regional trade is not only caused by the currency cost of transaction factor, but is also caused, and most importantly, by structural factors related to the poor productive manufacturing structure and the lack of growth-enhancing infrastructure.

Evolution of the intra-regional trade flows



Source: UNCTAD

Furthermore, on the technicalities of the future currency union, there has to be discussion among policymakers to decide the set of objectives that each country expects. Indeed, as explained by our game-theory example and by the empirical simulations in the literature,

conflicting objectives can be a major obstacle to the good functioning of the union. Transparency about the common objectives should therefore be made clear from the beginning. In particular, West African countries should be sure to avoid some of the mistakes made by

the Europeans when gathering around the euro. The Eurozone was built on a principle of endogenizing the convergence criteria, making them objectives to attain rather than pre-requisites for joining the monetary union. However, as noted by Stiglitz (2016), important aspects of solidarity were not taken into account in the build-up to the switch to the euro. Perhaps the confidence that prevailed then, in a time of great moderation, induced a form of myopia on the part of the European policymakers, which prevented them from foreseeing the possibility of a crisis that would threaten the very existence of the common currency. ECOWAS countries should therefore bear in mind that, even if monetary policy is set as the common tool, the coordination of fiscal policies and the development of common risk-sharing mechanisms at the union level would be necessary to smooth adverse shocks.

Another important aspect concerns the exchange rate regime in which the common currency, the Eco, will evolve. So far, countries within WAEMU have been in a fixed-exchange rate regime pegged to the euro. This arrangement has many drawbacks but also comes with significant advantages in terms of stability of the exchange rate and prices. The Banque Centrale des Etats d'Afrique de l'Ouest consolidates its credibility from the credibility of the European Central bank and as a corollary, maintains low inflation regime. Although we do not know much about the vision of the Ecowas member states, it seems likely that the Eco would evolve under a flexible exchange rate. This implies controlling the transition towards flexibility by properly addressing all the stakeholders, especially the banking-dominated financial system. Communication about the further steps is therefore key and the current global environment of low inflation, should it last for the medium term, offers an opportunity for action³. Unless this gradual approach is followed, WAEMU countries, as well as Cabo Verde, will face the adverse effects of successive depreciations, which occur when the timing of transition is not properly sequenced, bearing in mind that these countries depend on manufactured imports.

On another note, the standing of the largest country of the union is also a key matter, as is the case for Germany within the Eurozone. In the West African case, that country happens to be Nigeria. With an economy that provides 65% of total ECOWAS GDP, one might wonder

how to find the right balance between the Nigerian influence on the business cycles and the objective of the future union. In the German case, the credibility of the Bundesbank and the stability of the Deutschemark were two major components of the smooth transition from the adoption of the euro in 1999 to its issuance as fiat money in 2001. The Nigerian case poses significant problems. Officially, Nigeria's Naira evolves today under a flexible exchange rate regime. But in practice, the country has a dual exchange rate regime because of the presence of vast black market for currencies. Restrictive laws on exchanging the national currency give the wrong incentives. Also, successive currency manipulations have blurred the market perception of the Naira, making it difficult to properly evaluate the current level of the exchange rate. This might be one of the most important pre-requisites to be clarified prior to unionizing.

A final element also draws from the European experience. The creation of the Eurozone was the crowning of a long period of peace-making. Europeans, after being at the center of World Wars, decided to perpetuate peace through an institutional process. The Eurozone, in that spirit, can be considered as one of the most valuable proofs of success of that work on peace, despite all the setbacks it has experienced. In Africa, the image is hardly the same. Many countries in ECOWAS face instability in the Sahel⁴ and even internal political instability. At the center of attention, Mali, a member of WAEMU that has been dogged by ethno-nationalist conflict for years, with important spillovers for the entire Sahel region. True, creation of a currency union might boost stability. However, that seems very unlikely as the viability of institutions requires a minimum of stability. The tensions in the Sahel, with their economic consequences (Uneca, 2017), would translate into a succession of temporary shocks, that in the case of a union would have spillover effects on the other countries.

3. See <https://www.lesechos.fr/idees-debats/cercle/fin-du-franc-cfa-comment-reussir-la-nouvelle-union-monnaire-1161110>.

4. The reader might refer to "Les conflits dans la région du Sahel et leurs conséquences pour le développement", by Abdelhak Bassou <https://www.policycenter.ma/sites/default/files/OCPPC-PB1733.pdf>.

Conclusion

Prior to the colonial era, money issuance in West Africa was very dependent on trade and in particular slavery. Despite its abundant stock of rare metals, West Africa mainly relied on imported cowries as fiat money. With the advent of colonial rule, silver coins were imported, then progressively imposed as a tool of coercion. The post-colonial trajectory differed between former British and French colonies. While the former regained their monetary sovereignty, the latter continued under a monetary union under the auspices of France. The

proposal of the Eco as a currency for ECOWAS is therefore a whole new step for some countries and a simple exercise of adaptation for others. Theory has shown us that there are benefits to unionizing, and empirical evidence has helped us understand which conditions are optimal for the functioning of a currency union. For the considerations of real convergence, rules-based leadership, and geopolitical risk must all be considered before launching the union. Most importantly, countries have to be clear about the pursued objectives, and must work transparently toward reaching them.

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