

Highlights

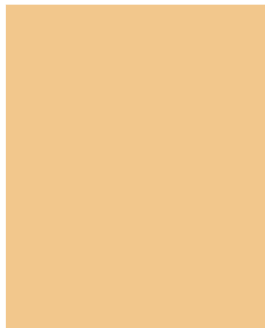
African nations are vigorously pursuing an integration agenda in order to participate effectively in the globalization process. African leaders therefore view regional integration as a conduit for achieving sustainable economic growth and development and reducing the level of poverty plaguing the continent. In view of the slow pace of continent-wide integration, they have provided a framework for the implementation of the integration agenda. This framework is enshrined in what is known by integrationists around the continent as the Abuja Treaty, which calls for the creation of a continent-wide African Economic Community (AEC) and lays out six stages for the implementation of the integration agenda. Included in this framework is the creation of a monetary union for the continent.

As the building blocks of the AEC, African regional economic communities (RECs) have or are in the process of establishing monetary unions. Monetary integration contributes significantly to deepening regional integration, especially for RECs aspiring to create common markets. The literature indicates that international trade and economic performance improve when a country enters into monetary cooperation arrangements such as monetary unions.

In line with the creation of monetary unions, several RECs have established macroeconomic frameworks that are underpinned by monetary and financial cooperation as well as the convergence of the economic structures and monetary policies of member States. Following the framework of the European Monetary Union, RECs have established targets for selected key macroeconomic variables that must be met by member States. Many RECs are close to achieving these targets, while others are struggling. However, most of the RECs are yet to achieve their monetary and financial integration objective.

Given the importance of monetary integration and convergence of macroeconomic variables in a regional economic area, the performance of RECs and their respective member States on these issues needs to be assessed to determine and measure the strength of regional integration in Africa. This is why ARIA-III focuses on monetary and financial integration in the various subregions of Africa.

As a follow-up to ARIA II, which focused on the rationalization of the RECs, ARIA-III explores the vast theoretical and empirical literature to gauge the performance



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of African RECs in the areas of monetary cooperation and macroeconomic convergence. In this regard, it uses parameters that are broader than the yardstick recommended under the Maastricht framework or the stability pact of the European Union. More importantly, it uses criteria that are consistent with the developmental objectives of the continent. ARIA-III also points out the challenges and constraints that member States face in realizing the goals and objectives of the RECs, and concludes with some policy recommendations.

Why macroeconomic convergence, monetary and financial integration?

The success of regional integration depends critically on member countries pursuing convergent macroeconomic policies. Misalignments of tariffs, inflation rates, exchange rates, debt-to-GDP ratios, rate of money growth and other vital macroeconomic variables between member countries would be disruptive to economic integration. In addition, these misalignments could lead to rent-seeking activities by governments and private individuals that could stifle legitimate investment opportunities. This could contribute to the demise of the economy of a member country, thereby weakening the whole integration process. It is therefore imperative that the process of strengthening regional integration should include guidelines for the convergence of the macroeconomic and trade policies of the entire regional space so as to strengthen the overall regional integration agenda.

It is also essential to strengthen and consolidate Africa's financial markets and institutions, in order to mobilize the financial resources needed to finance integration efforts such as infrastructure projects. These institutions also enhance the payment system and help facilitate trade within and outside the regional communities. In addition to improving the financial markets, efforts must be made to encourage the RECs to establish development banks in their regions, in order to assist member countries in financing infrastructure projects. However, the integration of financial markets in Africa requires the harmonization of national policies and procedures governing these markets and institutions across member countries.

The purpose of monetary cooperation amongst countries within a regional economic community is to establish a common monetary area with a greater measure of monetary stability, in order to facilitate economic integration efforts and foster sustained economic development. In this regard, monetary cooperation could be achieved if member States pursue convergent macroeconomic policies. For macroeconomic convergence to be successful, member States must meet the following minimum conditions:

- Efficient markets for products and factors of production
- Effective and efficient compensatory financing arrangements to make the domestic costs of coping with the ill-effects of economic liberalization bearable. In this regard, there should be an equitable sharing of the costs and benefits of integration among member States, taking into account the effects of macroeconomic exogenous shocks, external financing shocks, terms of trade shocks and adverse weather conditions
- Proper timing and sequencing of convergence variables
- Creation of enabling policies and environments that reduce risks.

The quest for monetary and financial integration of economies has been influenced by history. Since the breakdown of the Bretton Woods agreements in the early 1970s, policymakers have had to grapple with economic instability in international monetary arrangements. The 1980s in particular were characterized by an exceptional misalignment of the major currencies. The decade saw massive capital flight towards the United States and other industrialized countries from the developing world (particularly after debt crises and termination of new loans). Macroeconomic policies improved in the majority of developing countries in the 1990s, but the expected growth benefits failed to materialize, at least to the extent that many observers had forecast. In addition, a series of financial crises severely depressed growth and worsened poverty. The enormous costs of the financial crises in Asia, Argentina and Brazil at the end of the 1990s and the beginning of 2000s drove home the importance of stability.

History tells us that the world has not always been faced with monetary instability. In the 1950s and 1960s, the economies of the most developed capitalist countries (North America, Western Europe, Japan and Australasia) and those of many developing countries performed very well. That period, commonly designated as “the Golden Age”, witnessed low unemployment, low inflation and rapidly growing living standards, which were underpinned by the monetary arrangements entered into at the famous meeting in Bretton Woods in 1944, the penultimate year of the Second World War. Insofar as it eliminated the spectre of global economic insecurity that predominated in the 1930s, the meeting was extremely successful.

In the second half of the 1960s and through the 1970s, however, the whole structure of profitable growth began to show signs of weakness. The oil crisis, the Vietnam War, political instability and labour unrest all combined to exert enormous pressure on the existing international monetary arrangement. Following many attempts to safeguard the system, the Bretton Woods agreement was abandoned and the major economies switched to a “regime” of flexible exchange rates. However, the move to flexible exchange rates brought with it persistent misalignments and wild gyrations. Such disorderly behaviour caused serious problems for developing countries in

the management of their currencies and external debt, and was often an important factor in major emerging-market crises.

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To address the fluctuations in exchange rates and to minimize their vulnerability, some countries, with the support of the IMF, established currency pegs – typically linking their currency to the dollar. Unfortunately, the remedy was in most cases worse than the disease, sparking a number of very serious currency crises, starting with the Asian financial crisis of 1997-98, and culminating with the serious economic recession of Argentina following the collapse of its currency board. Clearly, there are lessons to be learned about currency management from these episodes.

One way of dealing with persistent fluctuations in exchange rates is for a group of countries to adopt a system of fixed exchange rates or to enter into monetary cooperation arrangements. In the extreme case, a monetary union could be established among the countries, but for monetary cooperation to be effective, the literature suggests that the following conditions should be met:

- The economic structures of the member countries should be sufficiently congruent. The importance of this criterion is to ensure that they face the same vulnerability to asymmetric shocks.
- Degrees of incongruence in economic structure can be tolerated if there is a high level of wage flexibility amongst the member countries, such that asymmetric shocks could be absorbed.
- There should be considerable labour mobility across member States so as to ease the costs of asymmetric shocks.
- Production and exports of member States should be widely diversified.
- Member States should be very open to trade and should trade heavily with each other.

Although monetary union has its costs and benefits, the theoretical and empirical evidence suggests that, if established and sustained, regional currencies among developing-country groupings can bring considerable benefits, similar to those expected from the introduction of the euro. They can reduce the cost of doing business within a region and eliminate exchange rate spreads and commissions in currency trading associated with intraregional trade and investment. Furthermore, a supranational central bank can reduce the influence of populist national politics on monetary policy, but still be accountable to member countries. Unlike dollarization, such an arrangement would also bring benefits in terms of seigniorage.

The European Union experience with monetary union

The European Union (EU) remains one of the most successful examples of integration in the world. Experiences drawn from the Union could be very informative for African RECs aspiring to establish a monetary union. However, the road to European monetary union was not easy; it took over four decades and involved a step-by-step process of block expansion. In reality, European monetary integration can be traced as far back as the Treaty of Rome, where it was acknowledged that the exchange rates of member countries should be regarded as a matter of “common interest”. The revaluation of the Dutch guilder and the German mark in 1961 prompted discussions on how the customs union could be extended to the monetary domain. Although a *Committee of Central Bank Governors* was created in the mid-1960s to coordinate monetary policy in the Union, it was not until 1969 that the European Council reaffirmed its intention to move ahead to full economic and monetary union. This decision was motivated by the instability of the dollar and by fears that a disorderly revaluation of European currencies would endanger the European Economic Community (EEC).

The next step was the formation of a study group of high-level officials chaired by the Prime Minister of Luxembourg, Hon. Pierre Werner, in 1970. The Werner Plan envisaged the creation of a European monetary union by 1980. It suggested that the monetary union should be achieved in stages, with each step leading ever closer to the ideal of fixed intra-European exchange rates. Along the way, the participating member States would also establish patterns of coordination in other fields of economic policymaking in order to facilitate the convergence of national currencies and to reap other cooperative benefits (e.g. through greater intraregional trade).

However, the collapse of Bretton Woods made it difficult to establish the monetary union in 1980 as many of the European economies faced a number of challenges. In the era of floating exchange rates that prevailed just before the collapse, the failure by central banks to support the US dollar affected European economies adversely in two ways. Not only did European exchange rates tend to appreciate against the dollar, thus damaging the competitiveness of European currencies (especially that of Germany), but they did so at different speeds, thus upsetting the pattern of exchange rates within Europe and making currency relationships volatile and unstable.

Part of the solution envisaged by the EEC to address the situation was the creation of the European Monetary System (EMS) in 1979. The EMS, which was in place from 1979 to 1999, was supposed to allow member States to harmonize their monetary policies. However, in the absence of monetary integration, intraregional free flow of trade and investment remained vulnerable to currency rate fluctuations, especially

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modern capital-intensive investments that were generally large-scale and involved long-term uncertainty and risk. The free movement of labour also remained exposed to many hazards, as incomes earned in one currency could not be compared with incomes in another currency within the region.

Launching of the euro

The successful launching of a single currency for the European Union, the euro, has rekindled the desire of regional economic communities to create monetary unions. The introduction of a single currency has provided Europe with an autonomy that would not otherwise exist, because no single European country has the same autonomous capacity to manage demand in an era of floating exchange rates. It is therefore important for countries engaging in monetary integration to ensure that the necessary macroeconomic and fiscal conditions are met.

In drawing lessons from the European experience, it is very important to evaluate the relative performance of the euro since its creation, taking into account several factors, including the following:

- European monetary union has taken a long time, starting with the ERM in the 1970s, and the path has been bumpy, with some countries such as France, United Kingdom and Sweden suffering serious crises in the 1990s. Accordingly, any developing country taking a similar path needs to be careful to avoid costly macroeconomic mistakes.
- Evidence suggests that macroeconomic performance has been modest under the discipline of the euro. The experience of the first seven years demonstrates that membership has its benefits, but that these benefits are not free. Being part of a currency union requires discipline, and the loss of the exchange rate as an instrument for coping with economic shocks can be costly. Within the euro area, some members such as Ireland are thriving while others, especially the southern member States, are struggling and will face painful adjustments in the future. For instance, Ireland and Portugal have experienced marked real exchange appreciation, but with very different consequences for export growth. There has been real depreciation in both Germany and France, but only Germany's exports have flourished.
- It is important to note that differential shocks will occur less frequently in a monetary union, because trade between the industrial nations of the EU is largely intra-industry trade. However, there is the potential that specialization under integration could increase shocks.

Convergence criteria

The successful transformation into a monetary union requires member States to follow convergent macroeconomic and monetary policies. This is why the Maastricht Treaty of 1991 stipulated that the transition to the final stage of monetary union was conditional on a number of “convergence criteria”, and that a country could join the union only if:

1. Its inflation rate is no more than 1.5 per cent higher than the average of the three lowest inflation rates among the EU member States
2. Its long-term interest rate is no more than 2 per cent higher than the average observed in these three low-inflation countries
3. It has joined the exchange rate mechanism of the EMS and has not experienced a devaluation during the two years preceding the entrance into the union
4. Its government budget deficit is not higher than 3 per cent of its GDP (if it is, it should be declining continuously and substantially and come close to the 3 per cent norm, or alternatively, the deviation from the reference value (3 per cent) should be exceptional and temporary and remain close to the reference value [Art. 104c (a)])
5. Its government debt should not exceed 60 per cent of GDP (if it does, it should “diminish sufficiently and approach the reference value (60 per cent) at a satisfactory pace” (De Grauwe, 2005: 143).

The designers of the treaty clearly thought that the main danger was that fiscal policy might indirectly put pressures on monetary policy. For instance, if a country got into trouble servicing its debt, the central bank might be led to ease monetary policy to lower the treasury’s interest costs and prevent a financial crisis.

But the key question is whether the criteria adopted in Europe were the right ones. The evidence suggests strongly that they placed excessive emphasis on inflation. On a theoretical level alone, in an environment of zero inflation (and many European countries have moved close to such a situation), there is likely to be more real wage rigidity, making adjustments to asymmetric sectoral shocks more difficult and leading to higher rates of unemployment. Tensions were particularly evident between the French and the German governments on this issue. In fact, as we have seen earlier, these different perspectives on the way to achieve monetary union pre-date the Maastricht plan, with Germany’s traditional emphasis on maintaining low, possibly negligible, rates of inflation, something very much compounded by the impact of German reunification in the early 1990s.

Financial integration

Financial integration involves a process whereby a country's financial markets become linked or integrated with those of other countries or with those of the rest of the world. In fully integrated markets, all forms of barriers are eliminated to enable foreign financial institutions to participate in domestic markets. In such an environment, domestic banking networks, equity and other types of financial markets are linked to their foreign counterparts.

There are several ways in which a country's financial markets could be integrated. It could occur through membership in a regional integration community where formal protocols have been established to link up the financial markets of the community. In this arrangement, the regional integration community would remove or minimize restrictions that impede the flow of capital, and harmonize all financial rules, regulations and taxes between member countries.

Financial integration could also occur through the penetration of foreign financial institutions into domestic markets, in the absence of formal integration agreements. For example, developed countries allow foreign participation in the banking and insurance markets and pension funds, securities trading abroad and direct borrowing by domestic firms in international markets. These activities are possible because domestic laws permit the operation of foreign financial institutions in the domestic markets.

Whether a country chooses to integrate its financial markets formally or informally, it needs to create an enabling environment that would attract foreign participation. To this end, steps that the country could take include the harmonization of rules and regulations governing its domestic financial markets, and the creation of standards and benchmarks similar to those of international markets.

However, for financial integration to be effective in Africa, it needs to be achieved through the regional economic communities. Formal financial integration at the level of the RECs would allow small African economies to increase their financial links with the rest of the world. An African regional economic community could harmonize the standards and regulations governing financial markets in the region, so as to attract foreign participation. Such an effort could lead to the creation of a large financial market that would support Africa's regional integration agenda, particularly in the area of economic development. Indeed, smaller African countries cannot achieve such economic impact by themselves unless they are linked up through the financial markets of the regional economic communities.

The strengthening of African financial markets through integration with world financial markets would also lead to the promotion and strengthening of trade and invest-

ments. The presence of foreign financial institutions in African countries strengthens the ties between the countries involved, since financial services linked to trade and investment flows are facilitated by the same financial institutions.

The benefits of financial integration

The benefits of financial integration include: more opportunities for risk sharing and risk diversification; better allocation of capital for investment; and potential for higher economic growth.

- **Risk sharing:** Financial integration provides an avenue for firms and households to share financial risk, which through financial integration, also leads to specialization in production across the regions. Financial integration promotes portfolio diversification and the sharing of idiosyncratic risk across regions due to the availability of additional financial instruments.
- **Improved capital allocation:** Financial integration results in a better allocation of capital, because an integrated financial market removes all forms of impediments to trading of financial assets and flow of capital, thereby allowing for the efficient allocation of financial resources for investments and production.
- **Economic growth:** Deeper financial integration leads to stronger economic growth, as financial resources become available for economic activities as a result of financial development. Financial integration also facilitates access to investment opportunities and an increase in competition between domestic and foreign financial institutions. This in turn leads to improved efficiency of financial institutions as financial resources are released for productive activities. In addition, financial integration leads to increased availability of intermediated investment opportunities, and consequently stronger economic growth.

There is ample evidence in the literature that financial integration or financial development leads to stronger economic growth. In any economy, financial institutions help to: (1) lower uncertainty by facilitating the trading, hedging, diversification and pooling of risk; (2) allocate resources efficiently; and (3) mobilize savings. These functions affect economic activity through capital and technology accumulation. It should be pointed out that risk-sharing opportunities make it possible to finance highly risky projects with potentially very high returns, because they enhance financial markets and permit risk-averse investors to hedge against negative shocks. Financial integration also allows project owners with low initial capital to turn to an intermediary that can mobilize savings to cover their initial costs. These avenues indicate a strong link between financial institutions and economic growth.

Africa's experience with monetary cooperation

Africa has been pursuing monetary cooperation for some time now. During and after colonization of the continent, some countries sought monetary cooperation with others. The French and British colonies entered into common monetary arrangements, which were not based on common economic drivers, but were created purely for administrative convenience and seigniorage considerations. Monetary cooperation between countries within the British colonies was through currency boards. The colonial currency was pegged to and backed by the pound sterling. The colonies earned their seigniorage revenues from interest payments on investment of the reserves in British Government securities. The French colonies of Africa used the franc, which was also pegged to the French franc. Unlike the currencies used in British colonies, the franc was backed by a “convertibility guarantee” of the French Treasury. In addition, the governments of the colonies were restricted by how much they could lend.

The British and the French monetary cooperation arrangements were not the same. The British currency boards were rooted in English central banking and therefore performed functions similar to those of the Bank of England. As expected, the French currency boards followed the guidelines and principles of French central banking. Hence, like the Banque de France, the currency boards in the colonies lent significantly to the local banking system, as the currencies were backed by the French Treasury.

Post-colonial independence saw the monetary arrangements in English-speaking African countries dismantled, replaced by sovereign currencies. However, the franc-based monetary unions in West and Central Africa continued to function for many years after the countries attained their independence. The exceptions are the Democratic Republic of Congo and Guinea, which issued their respective currencies after independence.

Presently, the monetary cooperation arrangements of the RECs are aimed at establishing a common monetary area with a greater measure of monetary stability, in order to facilitate economic integration and development among member States. As a result, some of the RECs are taking measures to eventually create a monetary union, including the following:

- Liberalizing the exchange rates of the member States to facilitate trade and capital movements within the region
- Harmonizing the economic, fiscal and monetary policies of the member States, in order to reduce currency misalignment, and establishing a consultative and coordinating machinery

- Achieving convertibility within the region of member States' national currencies
- Mobilizing financial resources for trade expansion and development projects and programmes
- Reducing the cost of exchanging currencies in intra-REC trade and improving the transparency of prices, so as to promote intra-REC trade and investment flows
- Improving price stability and allocation of resources within the region
- Developing a coordinated management strategy that will promote national actions towards monetary and fiscal policy harmonization.

As indicated earlier, the RECs are carrying out these programmes to eventually create a monetary union and a common market within which goods, services, capital and persons would move freely.

Progress on monetary cooperation arrangements in Africa

In recent years, some RECs have produced blueprints for the establishment of monetary unions. For example, ECOWAS is working hard to have a common currency. It hopes to start with a common currency zone for Nigeria, Ghana, Gambia, Guinea and Sierra Leone, which would be merged with the UEMOA franc zone at a latter date to create an ECOWAS currency. SADC, COMESA and EAC all have plans to establish common currencies.

Part of the programme of the RECs includes guidelines for macroeconomic surveillance that member States have to respect for key macroeconomic variables. Accordingly, most of the RECs have put in place a multilateral surveillance mechanism to ensure coherence and convergence of macroeconomic policies through compliance by member States.

The convergence criteria established by the RECs include agreed targets for macroeconomic variables such as budgetary balance, inflation and public debt and are divided into primary and secondary criteria. Although the principles are the same, the criteria vary somewhat from REC to REC.

The RECs have established statutory organs with responsibilities for carrying out and monitoring the macroeconomic convergence activities in the RECs. Despite the challenges, some RECs have succeeded in enhancing monetary cooperation,

promoting discipline and setting up regional payment systems and clearing houses within the communities.

Although there has been considerable progress, the RECs face significant challenges, which they are addressing through measures that include capacity-building and technical assistance to member countries, harmonization of statistics and seminars and workshops to sensitize member States. Furthermore, although all the member States of the RECs have committed to macroeconomic stability, most lack effective legal enforcement mechanisms to ensure that the objectives of macroeconomic convergence are met.

The assessment shows that although there are some successes, African countries are experiencing enormous difficulties in achieving the desired macroeconomic convergence criteria set by their regional economic communities. Whereas some Member States, particularly those that belong to monetary unions (CEMAC and UEMOA), have done well in maintaining relatively low single-digit inflation, most countries are posting double-digit inflation and consequently struggling to achieve their desired inflation targets. Similarly, most of the countries have not been able to achieve the desired fiscal targets, partly due to negative external shocks, large budget deficits, lack of reliable statistics and poor growth performance.

This raises the issue of the relevance of the convergence criteria. For the coordination of macroeconomic policies in the RECs to succeed, African countries should have a clear sense of their own development objectives and strategies and be fully committed to these goals. Member States should muster the political will to mainstream regional monetary and macroeconomic objectives into their national development strategies.

To sum up, monetary arrangements between African countries provide a unique opportunity to regain some of the macroeconomic autonomy (“policy space”) that was lost during the debt crisis of the 1980s. One step forward would be for national authorities to be more responsible in macroeconomic policy-making, and set their own priorities for exchange rates, fiscal policy and interest rates. However, experience from the European countries and the broader international system shows that such policies of coordination engender many risks. Policymakers need to be fully aware of those risks and the possible costs of mistakes before embarking on a project of monetary coordination.

African countries will have to follow a different trajectory. Neither the experience of the EMS nor the Maastricht criteria (which stress macroeconomic convergence in inflation, interest rates, budgetary policies) for achieving monetary union are appropriate. A more pro-growth macroeconomic framework needs to be designed and implemented. This can be achieved only through greater macroeconomic coordina-

tion between African countries. But there is a whole set of preconditions that need to be met, including the consolidation of the fiscal tax base. As a way of gaining revenue, independent monetary policy is at present too valuable a mechanism for most governments to contemplate its liquidation. A second priority is to accelerate the degree of trade integration by removing barriers to trade between partners. A greater synchronization of economic cycles is required, and the most immediate way to achieve this is through trade integration. There are good reasons to doubt official statistics pertaining to intra-African trade flows; if informal trade flows are counted, the true degree of integration is much higher than is commonly thought. Nevertheless, far more progress needs to be made in dismantling both procedural and structural trade barriers. In the European case, the initial customs union was achieved ahead of schedule in the 1960s. Similar progress is required in Africa before moving to the next step of macroeconomic policy coordination.

It is also important to note that although economists have undoubtedly made progress in their understanding of the costs and benefits of monetary union, a consensus view on this issue is still far off. Nevertheless, the theoretical and empirical evidence reviewed here suggests that, if established and sustained, regional currencies among developing country groupings can bring considerable benefits and reduce business transaction costs within a region.

Developments on regional financial institutions in Africa

Strong financial markets play an important role in supporting economic development, because developed financial markets and institutions enhance the exchange of goods and services, the mobilization of resources (both domestic and international), the efficient allocation of factors of production, and the diversification of risk. The economic literature shows strong evidence of a positive relationship between developed financial markets and economic growth.

A well-functioning economy needs a financial system that moves funds from people who save to people seeking productive investment opportunities. In other words, a sound financial system acts as a conduit for sustainable economic growth. Economic theory indicates that the main role of financial markets and institutions is to minimize the costs of information and transactions. Consequently, saving rates, investment decisions, technological innovation and long-run growth rates depend crucially on the level of financial development.

Experience from the European Community shows that its financial integration was undertaken in a gradual manner and was implemented through a coordinated proc-

ess of legislation among the member countries. The goal was to create a legislative framework that would allow greater integration of financial markets, without giving up the public-policy interests of each Member State with regard to rules, market stability and consumer protection. The creation of a *single market programme*, or a European economic system, was based on the principle of home-country control, regulatory competition and minimum standards harmonization. Under the home-country-control principle, primary supervision was left under the direct control of national authorities. However, national laws were not fully harmonized and home-country rules were accepted to govern the cross-border provision of services. Integration of financial markets in Europe has brought several benefits to the regional market in the form of greater exposure to international competition, improved efficiency in financial intermediation, more efficient capital utilization, the development of the financial industry itself, and better fiscal discipline.

African countries can draw important lessons from their European counterparts. To this end, the financial integration of the markets and institutions of developing countries, including those of Africa, requires the following:

- Clearly defined long-term aims beyond sectoral efficiency, including economic development and global competitiveness;
- Recognition that minimum harmonization of regulatory frameworks and cross-border financial activities requires reform of public administration, particularly regarding tax treatment, banking and insurance legislation, and joint supervision of securities markets; and
- Commitment to a considerable degree of fiscal harmonization and economic coordination, in order to avoid financial crises that would hinder effective financial integration.

Although some forms of financial development have taken place in Africa in recent years, financial market activities remain very shallow, as capital markets are characterized by low capitalization and liquidity. Most financial instruments issued on the financial markets in Africa have very short maturities. Bank financing continues to be concentrated at the short end of the term structure. Consequently, the spread between lending and deposit rates and the ratio of non-performing loans remain high, indicating a weakness in the financial market structure on the continent. Furthermore, only a limited number of financial instruments are issued on the financial markets, making it extremely difficult to hedge against financial market risk.

RECs need to carry out financial integration programmes to complement their monetary integration efforts. The economic literature demonstrates that deeper integration of financial markets strengthens the transmission of monetary shocks as well as monetary policy across the member countries of a monetary union. Weak forms of financial integration have differential effects on monetary policy in the countries

of a monetary union. Similarly, because of the differences it generates in propagation mechanisms, lack of financial integration implies cross-country divergence in response to union-wide shocks. This in turn increases the costs of participation in a monetary union, thus making a clear case for financial integration to match the process of monetary integration.

However, effective financial integration in Africa can only be achieved through the regional economic communities. Formal financial integration at the level of the RECs would allow small African economies to increase their financial links with the rest of the world. An African regional economic community could harmonize standards and regulations governing financial markets in the region and thereby attract foreign participation. Such an effort could lead to the creation of a large financial market that would support Africa's regional integration agenda, particularly in the area of economic development. Smaller African countries cannot achieve such economic impact by themselves unless they are linked up through the financial markets of the regional economic communities.

The strengthening of African financial markets through integration with world financial markets would also lead to the promotion and consolidation of trade and investments. The presence of foreign financial institutions in African countries fosters deeper ties between the countries involved, because these institutions facilitate financial services linked to trade and investment flows.

Recognizing the need for pooling their financial resources, African regional economic communities are starting to establish subregional capital markets to overcome the limitations of the fragmented capital markets in respective African countries. The RECs recognize the need for the integration and consolidation of financial markets as a vehicle for the promotion of economic development on the continent. Furthermore, financial integration would enhance competition, promote efficiency and productivity and facilitate the flow of information. The RECs are pursuing strategies of financial integration through programmes of harmonization of regulatory and legislative frameworks and policies, promotion of cross-border investments and cross-border listing of securities. Overall, regional financial integration is expected to serve as a step towards the establishment of stronger links with financial systems and capital markets in more developed countries. To support their integration and development agenda, some RECs have established institutions to support regional financial cooperation. Regional development banks operate in CEMAC, COMESA, EAC, ECOWAS, UEMOA and UMA.

The role and functions played by the financial institutions include: collecting of deposits and granting of loans to individuals and enterprises; transmission of stock exchange orders and management of interactions between financial institutions

through the central bank; financial intermediation on short-term and long-term considerations, and receipt of public funds.

The Maghreb Bank for Investment and External Trade has been established to operate in the Arab Maghreb Union (UMA) zone. The Bank supports the economic integration agenda of the UMA region by financing agricultural and industrial projects in which the member States have a common interest. It also provides finance to facilitate trade, to undertake projects at national and regional level, and to assist poorer members in each region. It also aims to mobilize investments for other bankable projects and promote trade and related payment arrangements. UMA is also in the process of establishing a foreign investment bank for Maghreb countries. In SADC, the South African Development Bank serves the interests of all community members.

Established in 1984, the COMESA Clearing House provides foreign exchange support for the facilitation of intra-COMESA trade. The clearing house has been restructured in a number of areas, including: (i) transferring the clearing function to commercial banks, (ii) transforming the clearing house into a regional SWIFT centre and a hub for electronic money transfer among regional commercial banks, (iii) putting the new clearing house in charge of providing regional export guarantees against political risk. The PTA Reinsurance Company (ZEP-RE), which became operational in 1991, provides insurance coverage and re-insurance to investors in the region. The COMESA PTA Bank provides financing for trade and projects at national and regional level in the form of credit, credit guarantees and minority equity participation in joint ventures. The Bank also supplements the activities of national development agencies of member States through joint financing operations and the financing of development projects. Since its inception, the Bank has financed the manufacturing, agribusiness, tourism, mining, infrastructure and energy sectors of the REC.

In the ECOWAS region, the ECOWAS Fund for Cooperation, Compensation and Development (EFCCD), formed in 1975, serves as a source of finance for the compensation of revenue loss accompanying regional trade liberalization. The EFCCD is also responsible for the promotion of balanced regional economic development and providing support to less developed member States of the community. EFCCD has been reconstituted as the ECOWAS Bank for Investment and Development (EBID). The two subsidiaries of EBID are the ECOWAS Regional Development Fund (ERDF) and the ECOWAS Regional Investment Bank (ERIB), focusing respectively on public and private sector financing. The ECOWAS Bank Group (Ecobank) has also been established to strengthen regional financial cooperation. Ecobank, a parent holding company, has subsidiaries in twelve countries across West and Central Africa. Ecobank was established to provide commercial banking and other financial services to individuals and private and public sector organizations.

The ERDF is the major shareholder of Ecobank. The Ecobank Foundation, a philanthropic arm of the bank, is also involved in supporting scientific, cultural and humanitarian causes across the region.

In order to promote the creation of regional financial institutions, the RECs are making attempts to deregulate the financial environment through the convertibility of national currencies and the liberalization of capital markets; exchange rate controls and national banking laws. With respect to international standards, member States are making efforts to eliminate controls on capital transfer and capital repatriation.

Macro economic convergence: Empirical evidence from African countries

This study provides empirical evidence on the progress and prospects of the African integration process by assessing the level and rate of convergence of the macroeconomic and financial components in Africa. The macroeconomic component of integration relates to three complementary dimensions of convergence. First, it is assumed that true integration cannot take place unless economies of participating countries in an integration area deal with economic shocks harmoniously. As a result, assessing the presence of synchronous shock treatments and business cycles can provide useful evidence of the potential for deeper integration in a given REC. Second, for the economies in a given integration area to deal with economic shocks in a coordinated manner, macroeconomic policies among the countries involved need to be harmonized. Therefore, analysing the presence or absence of harmony and coordination in the macroeconomic policies of the economies trying to integrate is an important element in assessing the state of integration in African RECs. Third, the countries participating in the integration efforts should work towards the convergence of their per capita incomes.

The empirical results are discussed in great detail in Chapter V of this report. The empirical analysis employs sophisticated econometric methods using time-series data of macroeconomic stability indicators for selected RECs in Africa, namely: SADC, COMESA, ECOWAS, CEMAC and UEMOA.

The empirical analysis of these monetary and fiscal policy indicators shows strong evidence of the convergence of macroeconomic stability indicators (in particular, inflation and fiscal balance) for various RECs (SADC, COMESA, ECOWA, CEMAC and UEMO) in recent years. Although the analysis is limited to specific policy outcomes, it provides a positive indication that policy coordination in the

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RECs is achieving the desired macroeconomic outcomes. This would provide the necessary foundation for moving the RECs through the various phases of integration towards monetary unions.

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The empirical analysis also shows that greater macroeconomic coordination between African countries is required to achieve expected growth benefits. In this regard, the income convergence analysis indicates very little evidence that the countries in the various RECs are converging their per capita incomes, except those in UEMOA. However, more stringent testing based on economic growth theories shows very slow pace of convergence of the per capita incomes. Consequently, unless there is a major structural shift, it will take decades for most REC economies to converge and thus attain one of the expected outcomes of regional integration initiatives in Africa. There is the need for poor countries in the continent to be able to attain levels of development that overcome the disparities in per capita incomes. Clearly, as shown by the analysis to this point, the integration policies would have to address the lack or slow pace of convergence in per capita incomes. Although there appear to be positive developments in macroeconomic convergence for a number of RECs, member countries need to address the challenges posed by divergent macroeconomic policies, rules and regulations across RECs.

Overall, Africa has made significant strides in creating common regional economic spaces. Common policies are emerging in the areas of transport, telecommunications, water and energy. There is a growing trend in intra-REC trade, although much still needs to be done to promote greater intraregional trade and attenuate the constraints to regional international competitiveness. This will require closer amalgamation of trade and integration policies across RECs, in order to create more unified economic and market spaces, and actions to boost greater economic and production linkages anchored around the transformation of Africa's natural resource heritage in a mutually complementary and reinforcing manner.

The way forward

Monetary cooperation

Most of the participating countries of the RECs are not able to attain the conditions of macroeconomic convergence. The assessment carried out in the report indicates that most African countries have great difficulty in achieving the desired macroeconomic convergence criteria set by the regional economic communities. The analysis shows that most African countries are registering double-digit inflation and therefore are not able to achieve the desired inflation targets or the desired fiscal targets.

Among the reasons given for the poor performance of the countries are negative external shocks, large budget deficits, lack of reliable statistics and poor growth performance.

Africa's ability to achieve monetary union remains very difficult. This raises the question of the appropriateness of the convergence criteria for Africa. As argued in the report, a macroeconomic convergence mechanism is needed because the success of regional integration hinges critically on member countries pursuing convergent macroeconomic policies. Misalignments of key macroeconomic variables could hamper the regional integration process. It is therefore imperative that the process of strengthening regional integration should include guidelines for the convergence of macroeconomic and trade policies of the entire regional space so as to strengthen the overall regional integration agenda. It is therefore important that the macroeconomic convergence criteria established by the member States should:

- Ensure that member States create an environment with economic conditions that are favourable for the achievement of the set targets
- Ensure that the convergence targets are met at all times and that convergence is sustainable
- Ensure that the convergence criteria are coherent and holistic, drawing on the development objectives of the RECs and member States
- Ensure that implementation of the criteria is simple, transparent and consistent with broad, national and regional objectives
- Ensure that the convergence criteria are all satisfied on the basis of current data.

However, for the coordination of macroeconomic policies in the RECs to succeed, African countries should have a clear sense of their own development objectives and strategies and be fully committed to these goals. Member States should muster the political will to mainstream regional monetary and macroeconomic objectives into their national development strategies.

Financial cooperation

Africa needs to strengthen its financial markets and institutions in order to mobilize the financial resources needed to finance its integration projects. These institutions are important vehicles for the payment systems and help facilitate trade within and outside the regional communities. There is also the need to encourage the RECs to establish development banks in their regions that would support member countries in financing infrastructure projects.

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Stronger financial markets contribute significantly to economic growth by promoting domestic savings and increasing the quantity and quality of investments. The markets also act as vehicles for wealth generation, as individuals are able to invest in additional financial instruments according to their risk preferences and liquidity needs, and help boost the national savings rate. Firms also use the financial markets to raise capital at lower cost. In countries that have advanced markets, firms use the markets more than the banks for financing and therefore reduce the risk of a credit crunch. Hence, sound functioning financial markets influence economic growth by boosting savings amongst individuals and financing the activities of firms.

Financial markets also ensure the efficient allocation of resources, with poor-performing firms generally under the threat of a takeover. Such perceived threat provides an incentive for management of the poor-performing firm to try to maximize the value of the firm and fend off any attempts by another group of investors to take control of the firm. In this regard, financial markets foster corporate discipline and ensure the efficient allocation of productive assets and the efficient use of managerial resources.

African stock markets are small and illiquid, with infrastructure bottlenecks and weak regulatory institutions. Despite the challenges they face, the markets have financed a number of companies, thereby contributing to economic growth. It is therefore imperative that the RECs and national policymakers design policies that would support the deepening of the markets in Africa. Some of the suggestions proposed in the literature include:

- **Need to promote a stable macroeconomic environment:** A stable macroeconomic environment is needed for the development and strengthening of the stock market in Africa. Sound macroeconomic environments and sufficiently high income levels, including GDP per capita, domestic savings and domestic investments, are key factors for the promotion and development of financial markets.
- **Need to increase automation:** By increasing the level of automation, financial markets in Africa would be more efficient, and their trading activities and liquidity would benefit accordingly.
- **Demutualization of exchanges:** All financial markets would have to be demutualized. This means that the legal status, structure and governance of stock exchanges would be changed from non-profit to profit-making ventures.
- **Integration of African financial markets:** In order to overcome the challenges of fragmented markets, African financial markets need to be fully integrated. Merging stock exchanges (the extreme form of integration) would increase the volume of trade. An integrated regional stock exchange

in Africa will be a powerful source and driver of capital flows to Africa. A prerequisite for a successful integration of the markets is that trading laws, accounting standards, legislations, rules, listings, trading days, settlement and reporting standards would all have to be harmonized.

- **Need to promote institutional investors:** It is important that institutional investors are encouraged to participate in the financial markets in Africa, because they are effective in promoting efficient market practices and financial innovation. As well, this group of investors encourages greater transparency and integrity in both primary and secondary markets, seeks lower transaction costs, and promotes efficient trading and settlement facilities.
- **Need to have sound regulation and supervision:** Regulation and supervision are typically aimed at preventing exploitation by some investors. Protecting the rights of investors helps eliminate the problem of information asymmetry.
- **Need to encourage foreign participation:** Private capital flows such as foreign direct investments, remittances and portfolio investments are crucial for the development of financial markets in Africa. Capital account restrictions need to be removed to attract cross-border investments. However, capital account liberalization should be preceded by trade liberalization and domestic financial liberalization, to minimize financial market risks.

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