

# Introduction



Regional integration is now widely accepted as indispensable for expanding economic opportunities in Africa. Bigger markets permit better exploitation of economies of scale, while factor mobility across borders and the coordination and harmonization of monetary and fiscal policies would facilitate faster economic growth and greater welfare for participating countries. African countries consider regional integration the most direct route to fast, broad-based development and an effective way to overcome the limitations of small internal markets. They also perceive regional integration as a rallying platform for establishing African unity. The OAU Charter and the Constitutive Act establishing the African Union define the anchoring ideals of African unity (OAU 1963; AU, 2000), while the Lagos Plan of Action and the Abuja Treaty establishing the African Economic Community (OAU 1980, 1991) spell out the economic, political and institutional mechanisms for attaining this goal. The treaties establishing regional economic groupings before and since independence, while reflecting the rich geographic and economic diversity of the continent, have pan-African dimensions.

Accordingly, African leaders have firmly committed themselves to accelerating regional cooperation and integration. Underlying this commitment is a belief that most African countries cannot achieve rapid economic growth and development in a reasonable time without first overcoming the constraints of small populations and economies. Of the 53 African countries, 38 (about three quarters) have populations of 15 million or less, while one third have populations of 3 million or less. Moreover, of the 46 least developed countries in the world, 31 are in Africa. Thus, the contribution of regional cooperation and integration to the promotion of intra-group trade, growth, development and social and political cohesion is unquestionable. Removal of border controls, harmonization of macroeconomic, sectoral and institutional policies and actions, liberalization of trade, free movement of people and capital are expected to result in more efficient use of resources as well as in productivity and income gains. Participating countries are expected to fare better with integration than without it. The productivity gains arising from economies of scale and cost-saving arrangements are also likely to strengthen internal as well as external competitiveness of products and firms. Economic gains in turn are likely to facilitate the process of political and social cohesion and unity.

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The launching of the African Union and the adoption of the New Partnership for Africa's Development (NEPAD), together with the keen interest of African countries to become effective members of World Trade Organization (WTO), all attest to the continent's drive to achieve economic and political integration and avoid global marginalization. It is an embodiment of Africa's will to accelerate its transformation as a continent of predominantly least developed and developing individual economies to a strong united bloc of nations built around the regional economic communities. The RECs were expected to evolve into free trade areas, customs unions and, through horizontal coordination and harmonization, to culminate in a common market and economic union embracing the entire continent.

Accordingly, the ultimate objective pursued by most RECs is to establish regional monetary unions and full economic communities. Several of them have therefore adopted formal frameworks to guide the transition process and to foster the harmonization and progressive convergence of national economic structures and macroeconomic policies. Following the experience of the European Monetary Union, a centrepiece of such harmonization frameworks is the definition of a set of macroeconomic policy convergence criteria that must be met by member States within more or less tight deadlines.

Harmonization of macroeconomic policies is one of the foundations of successful economic integration, for very compelling reasons. Inflationary pressures generated by budget deficits and excessive monetary expansion can undermine trade liberalization, leading to increased tariffs and/or tightening of non-tariff barriers (NTBs). Macroeconomic instability is also one of the prime factors that inhibit economic growth in developing countries. Lack of fiscal discipline and inadequate monetary instruments and policies contribute to macroeconomic instability and low economic growth.

Furthermore, the heavy burden of external debt and largely unsustainable debt service obligations, together with continued difficulties in the external economy, stifle the growth potential of African countries, limiting their ability to address persistent structural weaknesses. Most members of RECs are experiencing budgetary problems, albeit to different degrees. Although progress has been made with certain poorer countries benefiting from debt relief and cancellation initiatives, the overall debt burdens are onerous. Consequently, the fiscal environment tends to be characterized by large debt and high cost of debt servicing, low generation of revenue and high budget deficits.

Financial markets are largely underdeveloped in Africa. There are many currencies in circulation and the exchange rate regimes are not harmonized. Some countries have a fixed exchange regime while others have a flexible one. Some financial markets are deregulated while others remain heavily controlled. The ratio of banks to the

population is very low in many cases, indicating narrowness of the modern financial market that impairs the efficacy of monetary policy.

For all these reasons, macroeconomic stability, monetary and financial integration are crucial for successful regional cooperation and integration. Both processes make decisive contributions to the creation of a conducive environment for economic growth, promotion of trade and boosting of investor confidence, hence the importance of pursuing prudent fiscal, monetary, exchange rate and debt policies at the national level and of harmonizing these policies at the subregional and regional levels. Arguably, these policies should be situated within the socio-political, technological and international development setting of the countries, and indeed of the continent at large. When these policies are conceived in a wider economic space, possibilities for enhanced economic gains and growth are likely to be optimized and resources more efficiently used. The strengthening and deepening of the financial sector, including the establishment of vibrant capital markets, will also greatly facilitate the flow of funds and help anchor macroeconomic policies. Moreover, strong national and subregional capital markets would play a catalytic role in attracting FDI and promoting cross-border investment flows.

To this end, most RECs have made provisions in their treaties and protocols for macroeconomic policy harmonization as an important ingredient in achieving their integration-cum-developmental objectives in trade and other sectors. Indeed, Chapter VII of the Abuja Treaty establishing the African Economic Community is also devoted to the issues of money, finance and payment systems. Article 44 of the Abuja Treaty states that “member States shall, within a time-table to be determined by the Assembly, harmonize their monetary, financial and payments policies, in order to boost intra-community trade in goods and services, to further the objectives of the community and to enhance monetary and financial cooperation among member States.”

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

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The experience of the European Monetary Union has led many scholars to regard macroeconomic policy convergence as a key component of transition towards deep forms of integration. The theoretical underpinning of policy convergence essentially comes from the analysis of policymaking in an integrated region (De Grauwe, 2000). A simple example would suffice to clarify the argument. Suppose that countries A and B achieve some form of monetary integration (i.e. a system of fixed exchange rates or a currency union) so that they implement a common monetary policy. Assume that policymakers in country A are conservative, preferring low-inflation equilibrium to one with high inflation in the inflation-unemployment trade-off. Policymakers in country B are liberal and prefer the equilibrium with low unemployment (and hence high inflation). After controlling for shock asymmetries, the two countries would tend to have different policy preferences or objectives. Country A will push for a conservative stance, while B opts for a liberal one. The resulting policy conflict has two implications. First, there will be a political-economic problem of aggregation of heterogeneous preferences. Second, the preferred monetary policies under autarchy will likely differ from the actual common monetary policy under integration. Thus, for one of the two members of the union – or maybe even for both – there will be the temptation to abandon the initiative, unless some kind of compensation mechanism is engineered.

The problem can be further complicated. For instance, economic integration is expected to produce macroeconomic stability in the form of low inflation. However, if the participation of a country such as B (with a preference for a high-inflation equilibrium) shifts the common monetary policy in favour of high inflation, then the anti-inflation gains would be smaller and a country like A would be worse off than under autarchy. Similarly, countries with large fiscal deficits, being more likely to use inflationary finance, are likely to make the common monetary policy less conservative.

Following the above analysis, Chapter II provides a brief “progress report” on the developments in Africa’s regional integration. Chapters III and IV focus on the theoretical foundations of monetary and financial integration, drawing on the experiences of other regional economic groupings around the world. Chapter V provides empirical evidence of macroeconomic convergence in African RECs. Successes and failures of monetary and financial integration in Africa are documented in Chapters VI and VII respectively. Chapter VIII outlines the “way forward”.