Abstract

Those with dissenting views regarding the structure of monetary union arrangement in the ECOWAS often argue that the macroeconomic convergence criteria have hampered the ability of countries in the region to stabilize their economies with appropriate counter-cyclical fiscal policy. We test the empirical merit of this assertion and found no support for this view. Instead, discretionary fiscal policy has become counter-cyclical in ECOWAS after the introduction of convergence criteria. In specifics, we found a switch from pro-cyclical fiscal policy making in the pre-convergence era (1995-2002) to a counter-cyclical fiscal policy
making in the convergence era (2003-2018) in the ECOWAS, and that policy makers in the region respond to initial conditions – apparently taking clue from past (initial) debt and past deficit. The policy import of our result is the need to: (i) introduce more flexibility in fiscal policy making through discretionary fiscal policy that balances the budget (against the constraints imposed by the convergence rules) over the business cycle; and (ii) adopt ‘discretionary fiscal deficit’ to monitor compliance (rather than gross deficit) because it represents effort made to correct excess deficit.

Introduction

The fiscal apparatus of the convergence criteria in the ECOWAS sub-region – modeled after the Maastricht fiscal policy rules and the Stability and Growth Pact (SGP) – is increasingly being regarded as an unnecessary straightjacket on national fiscal policy that could weaken the ability and/or motivation of ECOWAS countries to stabilize their economies through active counter-cyclical fiscal policy. The problem here is that if this presumption of the dissenting viewpoint is true, it could have long-run consequences on the investment and growth potential of these economies that go well beyond their implications for the cyclical properties of fiscal policy. The argument seems to have gained momentum after it became clear that many WAMZ and WAEMU economies have rather been unable to meet and sustain the convergence criteria despite clear attempts to implement the rules in the respective economies. The reasoning is that the satisfaction of the convergence criteria – an indication of shock synchronization under a common monetary policy – is a precondition for a successful launch of a common currency.

Over the past one and a half decades (2004-2018), there is not any single year for which either the entire WAMZ (six) or WAEMU (eight) countries were able to satisfy the

---

1 Wyplosz (2005) demonstrates that fiscal policy rules such as the ones imposed by the convergence criteria are bound to be counterproductive if they fail to recognize unforeseen circumstances such as cyclical downturns; this could occur when cyclical downturn increase deficit towards the limit set by the convergence criteria. Fiscal rule is defined, here, in the manner of Ter-Minassian (2010) as a standing commitment to specify numerical targets or procedural guideline for some key budget aggregates. While procedural rules are aimed at ensuring transparency and accountability in the budget process, rules are meant to ensure fiscal discipline, i.e., debt sustainability.

2 The macroeconomic convergence criteria (CC) were first adopted in ECOWAS in 1987 through Decision A/DEC.2/7/87 of the ECOWAS Monetary Cooperation Programme (EMCP). In the WAMZ area, CC came into force in November 2002 when the forum of Ministers of WAMZ countries decided to adopt the two sets of convergence criteria (primary and secondary) in order to facilitate the harmonization of fiscal and monetary policies (in the zone) in view of the proposed introduction of a common currency in the region now set for 2020. However, the quest for monetary unification in ECOWAS started earlier with the establishment of Economic Community of West African States (ECOWAS) at the Lagos Treaty in 1975.
Considering the 14 ECOWAS countries as a group, the best performing year over the 15-year period (2004-2018) was 2007 when seven out of the 14 ECOWAS countries managed to satisfy this criterion. This situation is more disturbing particularly for WAMZ countries where all Member States have persistently failed to meet this criterion over the preceding four consecutive years (2014-2018). While these developments have led to dissenting views and recurring postponement of the launch of the proposed single currency in the region, several contemporary researchers have argued for fiscal policy flexibility that is tied to business cycles (see, e.g., Wyplosz, 2005; Debrun et al., 2005; Wyplosz, 2002).

Those with dissenting views regarding the structure of monetary union arrangement in ECOWAS are quick to point to two major related issues. First, they contend that the convergence criteria could constrain the use of fiscal policy in the future monetary union precisely when the countries in the region need it the most, having lost their autonomous monetary policy (see, e.g., Alby 2018; Gali et al., 2003; Allsopp & Vine, 1996 for EMU experience). If this presumption is true, it simply means that rule-based fiscal policy targets such as the ones imposed by convergence criteria may potentially constrain the ability of ECOWAS countries to implement counter-cyclical fiscal policies upon the launch of a common currency in the region. The problem appears even more compounded by the fact that fiscal rules do not consider cyclical conditions in the economy.

While fiscal deficit is the amount by which government’s expenditure exceeds government’s revenue, the term discretionary deficit (also called structural deficit or cyclically adjusted deficit in the parlance of fiscal surveillance) is not synonymous with total deficit. For clarity, we stick to the term discretionary deficit which refers to the component of total fiscal deficit that is due to the deliberate policy decision of the government (see, Mourre et al., 2013).

Academic research has exposed the limit of policy discretion and rules. Time inconsistency problem, due to Kydland and Prescot (1977) has traditionally created deficit bias in fiscal policy, as well as inflation bias in monetary policy. To eliminate time inconsistency, the emphasis is now on incentives and institutions (e.g., Monetary Policy Committee to implement flexible inflation targeting and the proposed Fiscal Policy Committee to achieve fiscal discipline, i.e., debt sustainability). This has worked well in monetary policy through flexible inflation targeting in which the monetary policy committee is given clear mandate of price stability as its long-run target while exercising discretion to stabilize output in the short run. Success stories of flexible inflation targeting include Federal Reserve Bank of New Zealand, US Federal Reserve, Bank of Japan, and European Central Bank (see Svensson, 2003). This approach when applied to fiscal policy – as suggested by Debrun et al. (2005) and Wyplosz (2005: 65), among others – would entail an independent and accountable fiscal policy committee (fiscal council) with the task of achieving debt targets and the authority to recommend annual deficit to eliminate deficit bias; but this is yet to gain attention within the policy circle. Time inconsistency phenomenon also possesses the risk that fiscal rules might constrain the ability of countries to implement counter-cyclical discretionary policies.
A second and related argument often made, as Gali et al. (2003) demonstrate, is that recession can be deepened by efforts to raise taxes and cut spending when cyclical downturns increase deficits toward the benchmarks set by the convergence criteria. Therefore, the need to balance the budget against the constraints imposed by the convergence rules over the business cycle may imply a pro-cyclical fiscal policy that could rather amplify economic fluctuations in a future monetary union of WAMZ and WAEMU economies. In this regard, a common notion that is generally held is that monetary unions in-the-making must be guided by the lessons of the EMU – such as the financial and sovereign debt crisis in Greece, Spain, Portugal, Ireland, and Italy; the failure of the Stability and Growth Pact (SGP); and, more recently, the exit of Britain from European Union, the so-called Brexit5 (Sissoho et al., 2015). While these arguments may have become part of received wisdom, there is very scanty empirical evidence to support them.

This paper seeks to investigate the extent to which constraints associated with the convergence criteria may have impacted the ability of governments of ECOWAS countries to conduct counter-cyclical fiscal policy and to understand how member countries have used discretionary fiscal policy as a stabilizing tool over the past two decades. The study of how national governments in the ECOWAS sub-region have used discretionary fiscal policy as a stabilization tool is unique for several reasons. First, as properly designed and implemented fiscal rules could help strengthen the credibility of government’s commitment to macroeconomic convergence and foster sound counter-cyclical fiscal policy, understanding the role of discretionary policy in economic stabilization becomes compelling and apt for countries in the sub-region.

Second, in view of the inability of most WAMZ and WAEMU countries to satisfy and sustain the convergence criteria, understanding how the convergence-related benchmarks have impacted their capacity to pursue counter-cyclical policy will inform policy for countries in the ECOWAS sub-region and supply lessons for the future monetary union of WAEMU and WAMZ. Third, although there is some knowledge of how the constraints imposed by fiscal rules could impact the capacity and/or motivation of countries to implement active counter-cyclical fiscal policies (see, e.g., Gali et al., 2003; Allsopp & Vines, 1996 for the EMU countries, and Chang et al., 2002 for Asia countries), there is scarcely any robust empirical evidence on this for ECOWAS countries. Laziness

There is little or no knowledge of how the convergence related benchmarks have impacted the ability of national economies in the ECOWAS sub-region to maintain and increase public investments and raise capital stock. Little is also known of how

---

5 The SGP failed due to non-compliance by Member States to the MT tenets in the ex-post introduction of the Euro that resulted from poor fiscal policy supervision (Sissoho et al., 2015). Britain successfully exited the EU in 2020.
convergence related constraints on fiscal policy may have impacted the ability of countries in the zone to use fiscal policy for economic stabilization. Therefore, as any convergence-induced restriction on counter-cyclical fiscal policy making could have a long-run effect on the countries’ growth potentials, it becomes important to thoroughly investigate whether and how the convergence benchmarks may have made fiscal policy pro-cyclical.

We use insights from stylized facts and carefully specified regression estimation equations to investigate the discretionary fiscal policy reaction to output gap, investment and lagged discretionary deficit, and a debt stabilization motive, among other drivers of cyclical condition. We estimate a fixed effect model and account for structural break (in 2002) in the full year specification using and interactive output gap dummy for 14 ECOWAS countries over the period 1995-2018. Data retrieved from IMF fiscal monitor on debt and fiscal balance are used in the analysis, while data on other macroeconomic indicators are collected from the World Development Indicators (WDI) and UNCTAD. The main results of the study show that, against the presumption of the dissenting viewpoint, fiscal policy has rather become counter-cyclical in ECOWAS following the introduction of the convergence criteria.

Overall, we find broad support indicating that the convergence criteria have not made fiscal policy less counter-cyclical in the convergence era in ECOWAS. There is evidence of a switch from pro-cyclical fiscal policy making in the pre-convergence era (1995-2002) to counter-cyclical fiscal policy making in the convergence era (2003-2018). Discretionary fiscal policy is also found to respond negatively to initial debt and initial deficit suggesting that fiscal policy making in the pre-convergence era could be one that takes clue from initial debt and initial deficit rather than one that focuses explicitly on achieving a rule-based fiscal benchmark/target such as the one set by the convergence criteria.

To be clear, a statement of what our result implies – or do not imply – is in order. We make no claim that the countries that utilize discretionary fiscal policy do so because of the constraints imposed by the convergence criteria. What our result clearly shows is that the constraints associated with the convergence criteria have not made fiscal policy pro-cyclical. Instead, we found evidence to the contrary, namely, that fiscal policy has been more counter cyclical in the convergence period in the ECOWAS. The baseline result generally survives well under different robustness checks. The coefficient of output gap remains counter-cyclical both for the convergence era (2003-2018) specification and the full year (1995-2018) model that accounts for structural break. One key implication of our result for policy is that national governments should consider more flexibility in fiscal policy making – against the constraints imposed by the convergence rules – through discretionary fiscal policy that balances the budget over the business cycle, rather than annually. There is also a clear need for the ECOWAS convergence council to adopt ‘discretionary fiscal deficit’ which represents real effort
made to correct excess deficit in their assessment of member countries’ compliance with the convergence benchmarks.

Our paper is related, in a broad sense, to three different strands of literature: the large literature on discretionary fiscal policy and automatic stabilizer (Alagidede & Tweneboah, 2015; Arai, 2011; Afonso & Rault, 2010; Prohl & Westerlund, 2009; Alesina et al., 2008; Auerbach, 2002; Lane, 2002; Afonso, 2000; Hercowitz & Straweznski, 1999; Areaza et al., 1999); the literature on macroeconomic convergence and the political (and economic) business cycle (Tarawalie et al., 2013; Sissoho et al., 2015); and more closely, the literature investigating the discretionary (and cyclical) response of fiscal policy to drivers of cyclical conditions such as Gross Domestic Product (GDP) growth, output, or some variants of its measures – such as output gap (Gali et al., 2003; Chang et al., 2002; Wyplosz, 2002, Fatas & Mihov, 2002; Ballabriga and Martínez-Mongay, 2002; Lee & Sung, 2007; Afonso, 2000). Our study is an improvement and extension to some of these studies in a few dimensions. First, by following the standard International Monetary Fund (IMF) (same as Organisation for Economic Co-operation and Development (OECD) procedure to decompose total fiscal deficit into its discretionary and automatic components, we depart from many past contributions that utilize cyclically unadjusted deficit (total fiscal deficit). Thus, we can adequately capture and identify in a precise and more comprehensive manner the discretionary reactions of fiscal policy to economic conditions (from the cyclical or automatic responses) in our estimated empirical fiscal policy rule.

Second, by also incorporating debt (and not merely expressing discretionary deficit as a function of the output gap or lagged discretionary deficit as in Afonso et al. [2010]), we are better able to account for a debt stabilization motive of the fiscal authority. Finally, our methodology goes a step further by accounting for a structural break in the fixed effect model in view of the introduction of convergence criteria in 2002. By incorporating an interactive dummy for a structural break, we can avert specification bias by controlling for the differences in slope and in the intercept of our regression model in the pre-convergence and convergence periods in ECOWAS.

**ECOWAS and the political economy of poor convergence**

To better understand the contemporary ECOWAS convergence experience, we set out with the discussion of the ECOWAS Monetary Cooperation Programme (EMCP) which provides the needed legal framework for the adoption of the convergence criteria and for the establishment of convergence council that monitors compliance.

Since ECOWAS was formed in 1975, its major vision has remained to create a regional economic space having a single market and common currency (the proposed eco)
that would accelerate the pace of her economic development (Saka, 2015; Qureshi & Tsangarides, 2006; Jebuni et al., 1999). In this regard, ECOWAS in July 1987 adopted the ECOWAS Monetary Cooperation Programme (EMCP) with the specific objectives of: (i) strengthening and improving sub-regional payments systems under the West African Clearing House (now West African Monetary Agency - WAMA) which is needed for the proper functioning of the single market; and (ii) establishing a single monetary zone, a common central bank and then a common currency.

The EMCP contained a set of macroeconomic convergence criteria that member countries were expected to observe prior to the emergence of the monetary union. The rationale for adopting the convergence criteria is to ensure convergence and synchronization of economic policies and fundamentals among prospective Member States to be able to manage the perceived challenges to the future monetary union of WAMZ and WAEMU countries – including differences in performance of macroeconomic fundamentals and disparity in shock affecting the economies. Table 1 shows the sets of primary and secondary convergence criteria for the ECOWAS sub-region, the WAMZ and the WAEMU areas.

**Table 1: Convergence criteria in ECOWAS, WAMZ and WAEMU**

<table>
<thead>
<tr>
<th>ECOWAS</th>
<th>Primary Criteria</th>
<th>Secondary Criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Average annual inflation rate ≤ 5%</td>
<td>1. Non-accumulation of domestic and external arrears and settlement of all outstanding arrears</td>
<td></td>
</tr>
<tr>
<td>2. Overall fiscal deficit including grants/GDP ratio ≤ 3%</td>
<td>2. Tax revenue/GDP ratio ≥ 20%</td>
<td></td>
</tr>
<tr>
<td>3. Central Bank financing of the budget deficit ≤ 10% of previous year’s tax revenue</td>
<td>3. Wage bill/tax revenue ≤ 35%</td>
<td></td>
</tr>
<tr>
<td>4. Gross reserves ≥ 6 months of import cover</td>
<td>4. Internally funded public investment/tax revenue ≥ 20%</td>
<td></td>
</tr>
<tr>
<td>5. Positive real interest rate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Real GDP growth rate ≥ 7%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>WAMZ</th>
<th>Primary Criteria</th>
<th>Secondary Criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Average annual inflation rate ≤ 10%</td>
<td>1. Non-accumulation of domestic and external arrears and settlement of all outstanding arrears</td>
<td></td>
</tr>
<tr>
<td>2. Overall fiscal deficit including grants/GDP ratio ≤ 3% (or overall fiscal deficit excluding grants/GDP ratio ≤ 4%)</td>
<td>2. Tax revenue/GDP ratio ≥ 20%</td>
<td></td>
</tr>
<tr>
<td>3. Central Bank financing of the budget deficit ≤ 10% of previous year’s tax revenue</td>
<td>3. Wage bill/tax revenue ≤ 35%</td>
<td></td>
</tr>
</tbody>
</table>

*continued next page*
Thus in 2000, the six WAMZ Member States adopted the two sets of convergence criteria (primary and secondary) that are meant to ensure convergence in critical macroeconomic variables in the economies. The WAEMU countries are also expected to observe these sets of critical convergence criteria – being a signatory to the ECOWAS Monetary Cooperation Programme (EMCP).

In the WAMZ area, however, a perceptive stylized review of the multilateral surveillance operations conducted by WAMI to assess WAMZ Member States’ compliance with the convergence criteria reveals that most of the countries in the zone find it difficult to satisfy and sustain their performance on the convergence scale. This has led to the postponement of the launch of the common currency for over four times from the initial date of 2003 to 2005, and then to 2009, 2015, and 2020. Zooming in on the compliance profile of the WAEMU countries, we also see just a similar disappointing narrative.

---

6 The ability to meet the convergence criteria (CC) – a set of lower and/or upper limits or target – has become the basis for admission into a regional economic bloc (Egwaikhibe & Ogunleye, 2010). WAMI was established in 2001 for the overarching mandate of undertaking technical preparation for the launch of a common currency. No similar institution exists in the WAEMU region to ensure compliance with the convergence criteria. In fact, as Alby (2018) notes, the Convergence Criteria have been adopted but are apparently not binding for WAEMU countries despite being signatory to the ECOWAS Monetary Cooperation Programme in 1987).
Table 2: Highlight of ECOWAS compliance level on the convergence criteria pendulum

<table>
<thead>
<tr>
<th>S/No</th>
<th>Converge. Criteria</th>
<th>Summary of Performance</th>
<th>No. of WAMZ countries satisfying criteria (years)</th>
<th>No. of WAEMU countries satisfying criteria (years)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Fiscal deficit cri.</td>
<td>ECOWAS, as a sub-region, performed abysmally poor on fiscal deficit criterion.</td>
<td>4 (2007)</td>
<td>4 (2005)</td>
</tr>
<tr>
<td>2</td>
<td>Months of import criterion</td>
<td>WAEMU surpassed the benchmark consistently over the entire review period of 1995-2018 while WAMZ persistently failed to meet the criterion. The situation for WAEMU is understandably clear given that the elimination of exchange rate risk (via the CFA-euro peg) also eliminates or, at least, reduces the risk of a balance of payment crisis. This helped ensure that the WAEMU economies can build sufficient foreign reserve needed to meet this convergence criterion.</td>
<td>4 (2014)</td>
<td>8 (2002-18)</td>
</tr>
<tr>
<td>3</td>
<td>Growth rate criterion</td>
<td>WAEMU has never been able to meet the 7% growth benchmark notwithstanding the recent impressive growth scorecard of Cote d’Ivoire. WAMZ managed to meet this criterion only twice in 2012 and 2013. Prior to 2014, WAMZ surpassed WAEMU on growth rate criterion led mainly by high growth in Nigeria and Sierra Leone.</td>
<td>3 (2012, 2013)</td>
<td>1 (2013-18)</td>
</tr>
<tr>
<td>4</td>
<td>Inflation criterion</td>
<td>The absence of exchange rate risk (made possible by the CFA-euro peg) is associated with low inflation in WAEMU. Thus, over the entire 10-year period, all eight WAEMU countries satisfied and sustained the inflation criterion. On the other hand, the WAMZ countries have never met this criterion as a group since the convergence criteria were adopted in 2002.</td>
<td>0 (2005-18)</td>
<td>8 (2005-18)</td>
</tr>
<tr>
<td>5</td>
<td>Debt: Outstanding domestic and external debt/GDP ≤ 70</td>
<td>ECOWAS did not also do well on the debt criterion.</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Source: Author
In terms of the months of import criteria, the WAEMU has done impressively well by continually surpassing the ‘external reserve > 3 months of import’ benchmark, but this is not too surprising given that as a member of the CFA zone, the risk of a balance of payments crisis is eliminated de facto, if the guarantee by the French Treasury of unlimited convertibility of the (African Financial Community) CFA franc is ensured. According to Seck (2013) and as recently alluded in Alby (2018), this is a big advantage for these countries that are basically exporters of primary commodities. Considering the case of Ghana and Cote d’Ivoire, for example, that have a similar economic structure as exporters of primary commodity (cocoa), this scenario is succinctly demonstrated in the spectacular deterioration of Ghana’s macro-financial situation during a period when Cote d’Ivoire remained resilient even in her post-electoral crisis in late 2010 and early 2011. Looking at WAMZ countries, Nigeria has particularly benefited from the prolonged favourable crude oil prices with a peak of financing over 12 months of imports in 2008. On the flip side, Guinea’s poor performance in this criterion, especially in recent times, has particularly been driven by the prolonged macroeconomic weakness of the economy.

Interestingly, a careful stylized account of the regional growth performance could provide important insights into the convergence assessment. GDP growth rate in the WAMZ area consistently surpassed those of the WAEMU area in the period preceding the year 2014, i.e., between 2006 and 2013. And this was led mainly by the growth rate in Liberia, Nigeria and Sierra Leone during the 8-year period. However, a reversal

7 However, the experiences of the WAEMU countries have shown that the currency peg has also produced a number of undesirable consequences—economic ‘bads’. For example, (i) the intra- and inter-regional trade (between WAEMU and CEMAC) is low and hardly exceed 10% of total trade flows despite the currency peg and the absence of tariff barriers among the countries, (ii) FDI inflow is also low despite the visibility provided by absence of exchange rate risk which is provided by the currency peg (see Alby, 2018).
started in 2014 when the average GDP growth rate in WAEMU – led mainly by the growth rate of Cote d’Ivoire – began to surpass those of WAMZ. Over the past half-decade (2014-2018) WAEMU’s GDP growth rate has continually exceeded the average GDP growth rate in the WAMZ area. The highest regional GDP growth rate was recorded in 2013 at 8.5%. More recently, the WAMZ region has witnessed rather unimpressive growth performances as the growth rate for the zone dipped to -1.0% (led mainly by the slowdowns in Sierra Leone) and 3.2% in 2015 and 2016, respectively, from an average of 8.0% and 8.5% in 2012 and 2013, respectively. As of 2018 and 2017, the WAMZ growth rate stood at 4.2% and 4.6%, respectively, compared to the higher GDP growth rate of 6.1% and 5.7% over the same periods in the WAEMU area.

Taking the country-specific experiences into account, it is evident that the Member States have performed poorly over the preceding half-decade. This has generally been attributed to the lingering effect of declining commodity prices. The real GDP growth rate moderated in The Gambia to 2.2% in 2016 from 4.3% in 2015 and 4.8% in 2013. This had resulted from adverse weather conditions, the decline in foreign exchange reserves resulting from fall in export, and the uncertainty that surrounded the 2016 general election in The Gambia (Sissoho, et al., 2015). Similarly, the growth rate was sluggish in Ghana over the period 2014-2016; an exception was in 2017 and 2018 when growth in Ghana surpassed those in all other WAMZ economies. This is mainly on account of an increase in the production of gold and oil and gas in the recent history of Ghana. Over the past four years, Nigeria’s growth rate has been unimpressive as the economy witnessed a persistent decline in growth, from 6.3% in 2015 to a negative growth rate of -1.6% in 2016 when the country plunged into recession. Nigeria’s 2016 economic recession was orchestrated by plummeting price of crude oil (the major source of foreign exchange) which resulted in a drastic drain of the country’s foreign exchange reserve. Modest recoveries have been made with Nigeria posting a growth rate of 0.8% and 1.9% in 2017 and 2018, respectively.

Overall, the recent modest growth rate in the WAEMU area has been led mainly by Cote d’Ivoire whose growth rate has consistently surpassed the threshold ‘real GDP ≥ 7%’ for a period of seven consecutive years. Notwithstanding Cote d’Ivoire’s consistent impressive real growth scorecard over the six-year period (2013-18), the ECOWAS region’s growth scorecard has been abysmal.

The situation for the inflation criterion is not different. Due to the absence of exchange rate risk implied by the CFA franc’s peg to the euro and the resultant low inflation associated with such stability in the exchange rate, the inflation criterion was assigned different benchmarks for the WAEMU and WAMZ area particularly as countries in the later zone generally operates free float exchange rate systems (annual inflation ≤10% for WAMZ and ≤3% for WAEMU). While the WAEMU region has been able to satisfy the WAEMU’s inflation criterion over the past decade (2009-2018), the WAMZ area has never met WAMZ’s inflation criterion as a group.
Figure 2: Trend of total fiscal deficit, cyclical deficit and potential deficit in ECOWAS (1995–2018)

Notes: While the cyclical component of the total fiscal deficit is scaled on the left-vertical axis, the potential component and the actual fiscal deficit are scaled on the right-vertical axis. Total fiscal deficit is measured in billions of Local Currency Units (LCU).

Figure 2 comprises of 14 panels (A to N) for the 14 ECOWAS countries in our sample. Each panel plots the trend of total fiscal deficit and its corresponding cyclical and potential components retrieved via Hodrick-Prescott’s filtering approach. The green lines with box-annotations indicate the cyclical component of the total deficit of the respective economies. On the other hand, the blue solid line and the red line that trails them (annotated with a star) depict the total fiscal deficit and the potential fiscal deficits, respectively. Expectedly, potential deficit trails the total deficits across the countries. By simply eyeballing Figure 2, it can be seen that despite the adoption of convergence criteria since 2002, the total deficit has persistently increased in all 14 ECOWAS countries. The rate of increase appears to be high irrespective of the relative
size of the economies. This clearly alludes to the preponderance of negative fiscal balance earlier reported and also explains the large and rising debt stock (in $US). Expectedly, this is so because debt simply represents the accumulation of yearly deficits.

**Conclusions and lessons for policy**

The macroeconomic convergence criteria have been described as an unnecessary straitjacket that can hamper the ability and motivation of ECOWAS countries to stabilize their economies through active counter-cyclical fiscal policy. This study tests the empirical merit of this assertion. In specifics, we investigate whether and how the convergence related constraints may have made fiscal policy pro-cyclical in ECOWAS and how the countries in the region may have used discretionary fiscal policy as a stabilizing tool over the past two decades.

The study relies on the fixed effect (FE) model estimated separately for the pre-convergence period (1995-2002), the convergence era (2003-2018) and the full year period (1995-2008) for the 14 ECOWAS economies in our sample. We test the existence of structural break in our panel data model and account for it in the full year specification using and interactive output gap dummy. As we are interested in testing whether the constraint on fiscal policy associated with the convergence criteria (CC) effectively constrained counter-cyclical policy making in ECOWAS countries, we investigate whether there is a significant change in the coefficient of the output gap (a1) in the convergence period (2003-2018) in relation to the pre-convergence era (1995-2002) in the ECOWAS countries.

The key results are as follows: (i) we found a switch from pro-cyclical fiscal policy making in the pre-convergence era (1995-2002) to counter-cyclical fiscal policy making in the convergence era (2003-2018) in ECOWAS. This result appears to align with past trend in the European Union where fiscal policy was found to be mildly pro-cyclical in the pre-Maastricht EMU era (1980-1991) but turned out to be counter-cyclically in the post-Maastricht EMU era (1992-2002); (ii) the size and significance of the coefficient representing output gap (a1) declined (for the full-year result) suggesting that counter-cyclicality in the full year may have been attenuated by our earlier finding of pro-cyclicality in the pre-convergence period; (iii) discretionary fiscal policy responded negatively to initial debt and initial deficit suggesting that fiscal policy making in the pre-convergence era could be one that simply takes clue from initial debt and initial deficit rather than one that focuses explicitly on achieving a rule-based fiscal benchmark/target such as the one set by the convergence criteria.

In conclusion, we make no claim that the countries that utilize discretionary fiscal policy do so because of the constraints imposed by the convergence criteria. What our
result clearly shows is that the constraints associated with the convergence criteria have not made fiscal policy less counter-cyclical. Instead, we found evidence to the contrary. In particular, fiscal policy has been more counter-cyclical in the convergence period in ECOWAS. As noted, whether the observed counter-cyclical trade-off is a result (consequence) of the constraints associated with the convergence criteria or of other factors – or in indeed, a rationale for it – remains a subject of further research. Most interestingly from our finding that policy makers apparently take clue from initial deficit and debt in setting discretionary fiscal policy in both the pre-convergence and convergence periods in ECOWAS, the switch to counter-cyclical fiscal policy making in the convergence period may not be uncorrelated with the constraints imposed by the fiscal rules.

From the above insightful results of the study, the following key policy lessons could be gleaned:

(i) **Account for business cycle in setting discretionary policy:** Our finding – against the presumption of the dissenting viewpoint regarding the structure of monetary union arrangement in ECOWAS – that discretionary fiscal policy has actually been counter-cyclical in the convergence period clearly suggest the need to introduce more flexibility in fiscal policy making through discretionary fiscal policy that endeavours to balance the budget (against the constraints imposed by the convergence rules) over the business cycle.

(ii) **Promote sound borrowing policies:** Our finding of a clear trend towards a decline in the coefficient of output gap in the convergence era relative to the pre-convergence era, not only suggests a drive towards counter-cyclical fiscal policy making for countries in the region, but also the potential to improve compliance with the convergence criteria. And so, national governments in ECOWAS should harness this potential by accelerating the implementation of different legal instruments adopted by the Community such as the promotion of sound borrowing policies.

(iii) **Adopt the use of discretionary fiscal policy to monitor compliance:** The use of discretionary fiscal policy (a departure from the tradition of relying on the total fiscal deficit) should be adopted by the Convergence Council in monitoring compliance with the convergence criteria. This is necessary to adequately capture action taken to correct excessive deficit.
References


Mission

To strengthen local capacity for conducting independent, rigorous inquiry into the problems facing the management of economies in sub-Saharan Africa.

The mission rests on two basic premises: that development is more likely to occur where there is sustained sound management of the economy, and that such management is more likely to happen where there is an active, well-informed group of locally based professional economists to conduct policy-relevant research.

www.aercafrica.org