

FINANCIAL INTEGRATION IN THE WEST AFRICAN MONETARY ZONE

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The West African Monetary Zone (WAMZ), the second monetary zone, emerged from the efforts of the Economic Community of West African States (ECOWAS), to revitalise the process of economic and monetary integration of the countries in the West African sub-region. The second monetary zone comprising of The Gambia, Ghana, Guinea, Nigeria and Sierra Leone was established in 2000.

The rationale for the establishment of the WAMZ was that it was unrealistic to expect the CFA franc, a regional convertible currency with its external anchor to be treated the same way as the other national currencies as envisaged under the EMCP. Rather, the other countries with independent national currencies should come together to form a second monetary zone, which would make it easier to merge the two zones instead of merging ten different currencies at the same time, a la EMCP.

The Statute establishing the West African Monetary Zone (WAMZ) also made provisions for the setting up of the West African Monetary Institute (WAMI) with the mandate to undertake the technical preparations for the introduction of the Eco in the WAMZ and the establishment of the West African Central Bank (WACB).

The commencement of the WAMZ monetary union was predicated on the attainment of a set of primary and secondary convergence criteria². Due to the inability of member countries to satisfy the agreed set of convergence criteria on a sustainable basis, the launch date for the monetary union has been postponed thrice (January 2003, July 2005 and December 2009). The prior technical issues relating to financial integration among others was also not fully addressed.

The financial sector must be adequately prepared to promote financial inclusion and sustain a changeover to a new currency. The sector itself is at the heart of market economy, playing a major role in intermediating savings and investments. The depth and quality of an integrated financial market can also enhance a broad range of choices for savings, investments, thereby facilitating economic growth within the currency area.

Integration of the financial markets in the WAMZ in particular, would allow adjustment to asymmetric shocks. In other words, as noted by De Grauwe (2000), an integrated market provides a risk sharing mechanism for risks occasioned by a negative shock. Negative shocks in one area of the Zone could be mitigated by a compensating variation in the other parts.

The financial sector, in particular, the money market, is also an important transmission mechanism for implementing monetary policies. An integrated financial market is therefore, essential for an efficient and effective monetary policy, as it ensures an even distribution of liquidity and similar levels of short-term interest rates across the currency zone. However, on the side of caution, financial integration poses the challenge of engendering financial contagion arising from the pass-through effect of an external shock.

The WAMZ programme seeks financial integration through five main components, namely: full capital account liberalisation; cross-listing of stocks; regional currency convertibility /quoting and trading in WAMZ currencies; banking

supervision; and cross-border payments systems. This paper attempts to assess the extent of integration in the financial sector based on the benchmark stipulated under WAMZ Action Plan of 2005 referred to as the Banjul Declaration. The paper will also provide evidence on the extent to which financial indicators show how far or nearer to having a seamless financial system and suggest the areas requiring policy intervention.

To do this, the paper is organised in 6 sections. Following the introduction, section 2 discusses the evolution, structure and developments in the WAMZ financial sector. Section 3 present the analysis of core issues relating to the extent of financial integration using both the benchmarks of the Banjul Action Plan and quantitative measures of financial integration based on the assumption of one price. In section 4, the paper discusses the relevance of coordinated cross-border supervision in the aftermath of crisis and liquidity pressures. Section 5 identifies barriers to financial integration, while section 6 concludes the paper.

Evolution and Structure of the WAMZ Financial Sector

In the era prior to the late 1990s, the WAMZ financial sector was generally characterised by repression as a result of controls, which were intended to bring about development in certain preferred sectors. The sector was characterised by state-owned financial institutions, which dominated the banking industry. These institutions became distressed following the

accumulation of non-performing assets and bailout failures. This led to their privatisation in the aftermath of financial sector reforms that embodied liberalisation. The phenomenon saw a rapid growth in the number of institutions, especially banking.

Although the financial sector is thin³ in The Gambia, available field data from Central Bank of The Gambia (CBG) show that even as a small country, by 2008, it has 11 banks, including an Islamic Development Bank with a total of 44 branches. Majority of the banks are foreign owned. With provisional approval given to additional 5 banks, the total would increase to 16 by 2009; its insurance sector currently has 9 insurance companies, while micro-finance is becoming more prevalent, with about 62 microfinance institutions (5 finance companies; 57 credit unions and village savings and credit associations - VISACAs) operating in the country.

In Ghana, reforms resulted in a shift of the financial sector away from a shallow⁴ and distressed banking system with largely foreign and public banks. Private banks emerged to foster and enhance financial intermediation, while insurance business is an important source for risk mitigation and alternative investment outlet. The Bank of Ghana (BoG) Annual Report (2007), reports that the total number of major banks is 24, and were all in compliance with the minimum capital requirement for universal banking business. ARB Apex Bank provides banking and non-banking support to the rural and community banks (RCBs). The total number of rural and community banks stood at hundred and twenty six at the end,

2007. There were 35 insurance companies, 41 Non-bank Financial Institutions in operation, comprising 21 Finance companies, 14 Savings and Loans companies, 4 Leasing companies, 1 Mortgage Finance company, and 1 Discount House, which was granted approval to change its status to a Finance House.

In Guinea, WAMI field survey indicates that there are 8 commercial banks, but services are concentrated in the capital, Conakry, with branches and subsidiaries of foreign or regional banks contributing. Recently, as in the other member countries, the micro-finance sector has also begun to evolve.

In Nigeria, the number of banks ballooned from just over 10 banks in 1980 to over one hundred banks by 1995. Buoyed by reforms in 2006, the Nigerian financial system comprised among other institutions, 24 deposit money banks (DMBs), 5 discount houses (DHs), seven hundred and nine microfinance banks (MFBs), one hundred and twelve finance companies (FCs), 93 primary mortgage institutions (PMIs), 5 development finance institutions (DFIs) and 77 insurance companies (CBN Annual Report, 2007).

In Sierra Leone, the banking and financial landscape has expanded, with 13 commercial banks (10 are foreign banks) with a total of 58 branches, 2 discount houses, 6 community banks, about 10 insurance companies, and several other financial outfits including 8 microfinance institutions, and a recently opened mortgage finance institution fully owned of National Social Security and Insurance Trust

(NASSIT) (BSL, 2007). Microfinance institutions in Sierra Leone are however, not licensed by the Bank of Sierra Leone but are monitored by MITAF and there are no prescribed capital requirements.

The upsurge in the number of financial institutions in some countries led to the development of capital markets as alternative sources of financing investments. Insurance markets also evolved as a means for galvanising synergy for risk mitigation and recently, as a counterfactual investment source to the banking and stock markets. Obviously, the growth of these financial institutions has not been symmetric across the member countries.

The distribution of deposit-taking (commercial) banks in the UEMOA and WAMZ that constitute the 15 ECOWAS member countries as at December 2007 is shown in Table 1a. The rapid growth of the industry in the last few years had been largely informed by a number of factors, namely, the regulatory reforms that engendered cross-border establishment of bank subsidiaries located in other African countries; the consolidation in the Nigerian banking industry arising from increased capital requirements, which have engendered the synergy for these banks to seek additional markets in other West African countries; and the expansion in pan-African banking groups – like Ecobank and United Bank for Africa.

The localisation of the cross-border subsidiaries had been influenced by direction of trade and perceived market interest (see Table 1b). Notwithstanding, the available data present an erroneous view of

the actual size of the banking industry in the two regions as the minimum capital base of the banks differs among the countries in West Africa. Ranging from Nigerian banks, with a minimum of approximately US\$200 million to US\$2 million in the WAEMU member countries, Nigerian banks dominate the banking industry in the region – 6 in The Gambia, 5 in Ghana, 1 in Guinea and 6 in Sierra Leone as shown in Table 1b.

In spite of the significant growth of the banking sector, financial depth has largely remained steady over the last decade as table 2 describes. With increased growth in the economies of most of the WAMZ countries, numbers suggest weak intermediation in the banking sector. At this level, further efficiency in the intermediation process is expected especially, for Guinea, Nigeria and Sierra Leone.

Table 1a: Distribution of Commercial Banks in West Africa

WAEMU		WAMZ +Liberia & Cape Verde	
Benin	22	Cape Verde	23
Burkina Faso	13	The Gambia	11
Guinea Bissau	2	Guinea	8
Mali	14	Liberia	5
Niger	9	Nigeria	24
Cote D Ivoire	18	Ghana	24
Senegal	14	Sierra Leone	13
Togo	11		
Total	103	Total	108

Source: Staff Compilation

Table 1b: Cross-Border Banking in WAMZ – Locations of Subsidiaries

	Home Supervisor	The Gambia	Ghana	Guinea	Nigeria	Sierra Leone
Stanchart	UK					
Ecobank	TOGO					
GT Bank	NGN					
Intercontinental	NGN					
First International	GMB					
Stanbic	ZAF					
Zenith	NGN					
United Bank for Africa	NGN					
Oceanic Bank	NGN					
Access Bank	NGN					
Skyle Bank	NGN					
Bank PHB	NGN					

Table 2: Level of Financial Depth in the WAMZ

	2000	2001	2002	2003	2004	2005	2006	2007	2008	Average
broad money supply (in percent of GDP)										
Gambia	368	361	485	459	443	443	443	443	443	422
Ghana	267	269	314	320	327	331	329	329	329	308
Guinea	108	113	126	150	174	162	148	130	116	14.0
Nigeria	221	194	234	215	207	189	210	221	229	210
Sierra Leone	164	182	193	202	183	176	175	176	178	182

Source: WAMI

In the non-bank financial sector, the institutions are numerous and bridge the gap between the formal sector and the informal sector. Regulation of the non-bank financial sector is diverse and associated with the level of sophistication of the financial system. Usually undertaken by the central banks, finance ministries and specific agencies set for this purpose.

Stock exchanges have also evolved. Ghana, Nigeria and Sierra Leone have established stock exchanges. On the Ghana Stock Exchange (GSE), both equities and debt securities are listed on the exchange, with government bonds dominating the debt offerings. On the equities side, as at the end of December 2007, the GSE had about 34 quoted firms. Liquidity on the GSE, expressed as the percentage of market capitalisation traded in a given year Anglogold Ashanti, accounting for high proportion of the market's capitalisation. Sierra Leone Stock Exchange is now operational with a single company listed.

The Nigeria Stock Exchange (NSE) is categorised into the first and second tier markets. As at March 3, 2009, there are two hundred and thirteen equity and debt securities listed on the exchange, with government bonds dominating the debt offerings. As in the other Exchanges, the SEC is the apex government regulatory agency of the capital market, while NSE is a Self Regulatory Organisation with members paying for their supervision.

The Insurance sector in the WAMZ consists of licensed life and non-life insurance companies, as well as licensed insurance brokers and loss adjusters. The market

consist over one hundred and fifty life and non-life companies. The Gambia has 9 insurance companies with a total industry gross annual premium as at December 31st 2007, of \$7.3 million. At this level of operation, these insurance companies would find it challenging making cross border in roads into either Nigeria or Ghana markets. The capital requirements for insurance companies in Nigeria differ significantly from those of The Gambia, Ghana, Guinea, and Sierra Leone. The requirement for The Gambia is less than \$0.68 million. The capital is respectively \$1.0 million and \$2.5 million for direct insurance and re-insurance in Ghana, while for Nigeria, it is around \$17.0 million, \$25.0 million and \$83 million, respectively for life, non-life and re-insurance. In Sierra Leone, it is put at about \$80 000. This regulatory arbitrage poses competitive difficulties for entry into the Nigerian and Ghanaian markets, and perhaps a stumbling block to the realisation of free entry and the promotion of cross-border trade in services.

Analysis of the Extent of Financial Integration in the WAMZ

One important feature of the Banjul Declaration Action Plan for financial integration is to promote similarity of access, rules and treatment to all 'potential market participants' as the cornerstone towards full integration of all financial instruments.

The review of developments shows that on capital account liberalisation, most countries of the WAMZ are reforming their capital accounts to attain full liberalisation. With The Gambia having fully liberalised capital accounts, other

countries are at various levels of liberalisation. In terms of efforts toward an integrated regional capital market, cross listing of stocks is limited. Listing and regulatory requirements of stock exchanges in Ghana and Nigeria are in the process of harmonisation. The integration process in the existing exchanges is progressing satisfactorily.

On the issue of facilitation of currency convertibility in the zone and to enhance efficiency in intra-regional trade financing, the WAMZ Convergence Council in May, 2007 approved that commercial banks and other private sector financial entities operating within member countries of the zone may now commence the quoting of WAMZ member countries' local currencies. Overall, progress is slow and challenged by the absence of guarantee from the central banks to buy net holdings of their currencies.

In the area of banking supervision, various reforms and developments have been undertaken in the member countries, towards ensuring the stability of the financial system and the laying of the foundation for effective harmonisation in accordance with international best practice.

In The Gambia, as part of the financial sector reform, the Central Bank of The Gambia (CBG) introduced risk-based supervision. In order to keep the financial sector sound and robust, Ghana had taken a number of important steps, including signing into law a Credit Reporting Act and Anti-Money Laundering Act. The Banking Act has also been amended to take care of off-shore banking activities in Ghana. The minimum capital requirement for banks has been raised and

staggered. It is expected that domestic banks (banks with capital originating from domestic sources) will raise their capital to €25 million by 2009 and €60 million by 2012, while foreign banks must achieve the €60 million target by 2009. Beginning from 2008, all financial institutions were required to comply with the International Financial Reporting Standards (IFRS).

In the case of Guinea, the Central Bank of Guinea has been undertaking a number of steps towards enhancing financial sector soundness and stability. The Banking Statute was revised and promulgated into law on July 4, 2005, in order to harmonise the banking supervision regulations with the Basel Core Principles.

In order to ensure full compliance with the Basel Core Principles, Nigeria has proposed: to amend the Banking and Other Financial Institutions Act (BOFIA 1991); introduce risk-based supervisory model as well as consolidated supervision; and put in place arrangements to ensure that banks implement policies and procedures to address country risk. In adherence to its policy of the risk-based rule, the CBN requires that when it is lending to deposit money banks, such credit is backed by 100% government securities. In order to strengthen the operational capacity of banks and the resilience of the sector, the BSL raised the minimum capital requirement of banks from Le 9.0 billion to Le 15.0 billion (equivalent to about US\$5.1 million) with compliance spread over a period ending December 2009.

Analysis of the State of Financial Integration in the WAMZ

For the purpose of this analysis, financial integration is defined within the context of the law of one price. The law suggest that if markets are well integrated, financial assets that have identical features should show the same price – notwithstanding their geographical location. In this analysis, the level of integration is measured by cross-country dispersions of lending and deposit rates as well the spreads that are related to the geographical location of the services. Interest rates represent the price of comparable financial products and an increase in integration should lead to a higher convergence of prices and yields across countries.

Convergence of Interest Rates

There is evidence of price convergence in the run-up to creating a single economic space (Figure 1). There is an indication of significant reduction in cross-sectional dispersion in lending rates in the region. Volatility in the interest rate differentials has also been observed to be narrowed from an average of 9.8 standard deviation units between 1990 and 2001, to 3.3 standard

deviation units between 2002 and 2006.

In spite of the progress made, it is expected that the current level of savings (both personal and institutional) in the region will have to be engendered to help to narrow the margins. This can be achieved by encouraging greater use of regional retail payments as well as the diffusion of corporate risks associated with holding long liquidity positions.

Banking Sector Pooling of Resources

Theoretically, a larger market should, result in a more competitive environment, with the development of stronger credit institutions, that are able to offer a wider and more complex array of financial products and services. Manna (2004)⁵ have shown that the enlargement of a market correlated with a change in the competitive advantages of the firms in initial markets, changes in equilibrium market shares are expected and more efficient banks will ultimately gain a larger equilibrium market share. Reports commissioned by the EU, for

Figure 1: Convergence of Nominal Interest Rates Spread in the WAMZ

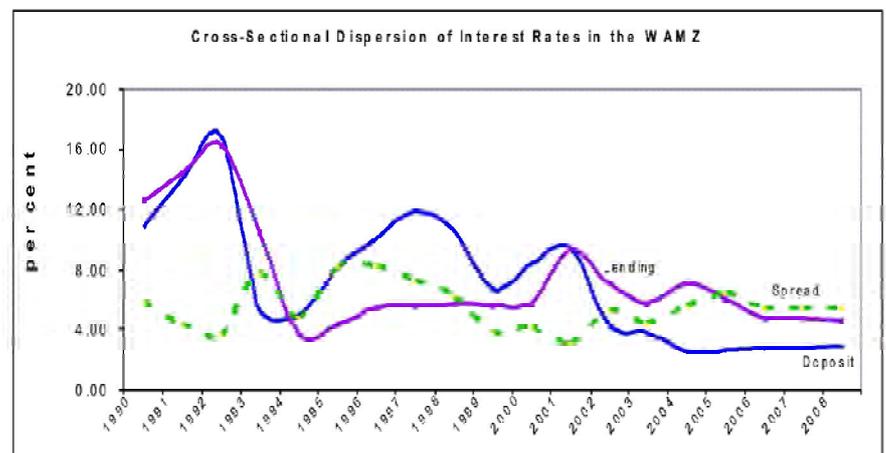


Figure 2: Bank Branch Density in the WAMZ

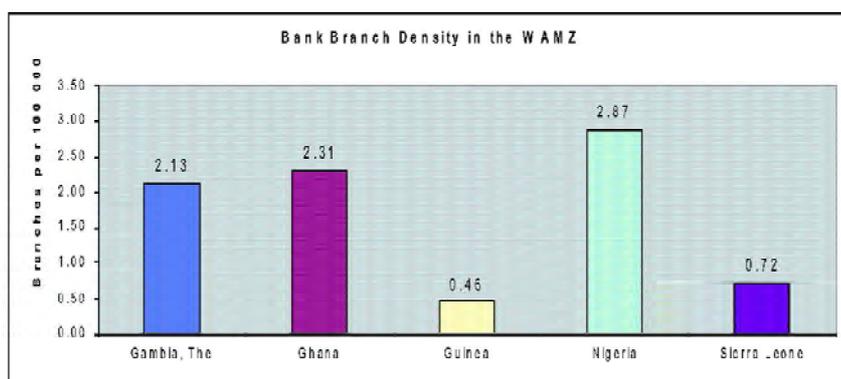
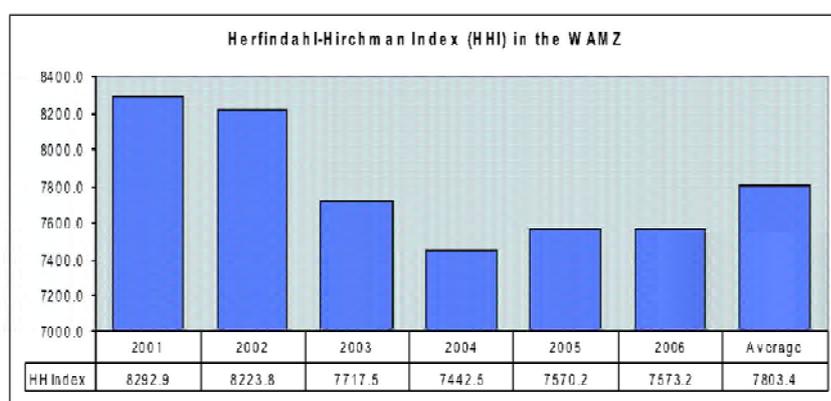


Figure 3: Herfindahl-Hirschman Index in the WAMZ



example have stressed this relationship between market size and efficiency.

It is expected that as banking markets evolve into a single market, domestic banks begin to compete and branch network expands, the most efficient ones will gain market shares at the instance of the inefficient ones. Cross-border flows of deposits may respond in tandem with the new competitive conditions, reflecting a transition from the old to the new equilibrium. Banking sector indicators for the WAMZ reveal that bank density (Figure 2)⁶ is low at between 1 to 3 banks branches to 100 000 persons, and poses a challenge for the efficient use of funds. Similarly, the HH Index (Figure 3), using the relative country

market shares in the total WAMZ banking assets, suggest a very high degree of bank concentration in the WAMZ, with Nigeria contributing an average of 88% in the last 6 years.

Further results from the proportion of banks assets to GDP in dollar terms has remained very low, relative to UEMOA's 30%, the EU's new entrants' 77% and the EU-15's 280% (Nnana, et al., 2007) that have been engendered by the single currency and the harmonised capital market.

On capital market integration, harmonisation and integration modalities, the Ghana Stock Exchange and the Nigerian Stock Exchange have considered harmonisation and integration modalities. In 2003, both Exchanges

signed a Memorandum of Understanding (MOU) covering several areas of cooperation. More recently, a technical committee for capital market integration by the GSE, NSE and BVRM has proposed varying options to harmonisation issues needed to integrate these markets.

The insurance industry in the WAMZ, although growing, its level of penetration of the insurance industry in Africa is limited. The Swiss Re Global Report for 2007 indicates that the Nigerian insurance industry marginally shows presence on the continent. With the rapid expansion and milestones achieved in the insurance industry in Ghana due to the existence of a flexible framework law, it is expected that soon, the country will raise its market share on the world front. In terms of penetration at the WAMZ level, a few insurance companies of Nigerian origin are making cross border expansions in order to leverage on the huge liquidity occasioned by the increased capital adequacy requirement to benefit from the markets of the other member countries; 6 and 2 Nigerian insurance companies have commenced operations in Ghana and Sierra Leone, respectively.

Financial Integration and Financial Contagion: Any Need for Coordinated Cross-Border Supervision in the WAMZ?

African economies, although were perceived to be insulated from the effects of shocks arising from the financial crisis, emerging trend suggests the continent is as vulnerable as other regions. While the size of the impact is yet to be quantified, the channels of impact remain liquidity

squeeze and the scaling down of capital inflows as well as the falling revenues due to the lull in the volume of exports arising from low demand abroad and declining export prices.

Okereke-Onyiuke, Ndi (2009) showed that the South African stock exchange lost 27% in 2008 and the rand slipped almost 30%. Nigeria's stock market – one of the two WAMZ Exchanges was significantly exposed to external dynamics, consequently, the all-share index dropped by 45.8% and the market capitalisation has weakened since the 2nd quarter of 2007. Equity market capitalisation fell from a high of N12.64 trillion on May 3 to a low of N6.21 trillion on December 16, before closing at N9.56 trillion on 31st December 2008. The reversal was due to the tightening of liquidity in the banking sector, arising from the decline in public sector spending, glut of stocks necessitated by off-loading by investors for gains. While several African stock markets plummeted in 2009, Ghana's stock market experience growth owing more to the inter-play of domestic conditions than external factors.

At the local level, the market was influenced by issues relating to margin pricing and recall of loans by banks that were hitherto used for the purchase of stocks, coupled with substantial de-investments by non-residents. This is reported as N812 billion (Ndidi Okereke, 2009).

The effects of the crisis on financial sectors of the WAMZ member countries indicate that ex post, under a single monetary policy and one currency would pose stability concerns. These recent developments in financial markets have brought to the fore main risks and challenges,

especially with cross border movement of institutions in the WAMZ. The need to strengthening cross-border coordination is paramount to forestall any negative impact of liquidity pressures and cross border coupling of financial systems. The recent developments in the Nigerian banking industry, which has the highest number of cross-border bank subsidiaries resulting in unprecedented response of massive use of tax payers' money to rebuild trust through recapitalisation, makes it imperative for such a framework.

The regional supervisory philosophy should require a Memorandum of Understanding and an articulated plan to build a more resilient financial system. In order to create a regional financial environment that operates with less leverage, is immune to misaligned cross-border incentives, while prudential and regulatory oversight is strengthened, important steps to be taken for such a supervisory framework should ensure that:

- Crisis management is paramount and is institutionalised at the regional level to facilitate swift information sharing; provide guidance on issues of common interest; and to put in place enhanced guidelines to strengthen bank's risk management practices, in particular, Enterprise Risk Management (ERM). ERM gives a firm-wide risk management process to financial institutions as well as an integrated view of the range of risks, which they are confronted with;
- To put in place and streamline mechanisms for early intervention: stabilisation measures for ailing banks,

stipulating conditions under which they will be applied as well as Deposit Guarantee Schemes;

- To put in place periodic risk assessment reports. Assessments of micro-prudential trends, potential risks and vulnerabilities in the banking sector should be conducted and reported at least twice a year;

Some Barriers to Financial Integration in the WAMZ

In the banking sector, capital adequacy requirements vary significantly and would obviously create a regulatory arbitrage that serve as an obstacle to entry into, say, the Ghanaian and Nigerian banking industry, by banks from the other member countries. Secondly, there are great dissimilarities in the regulatory and supervisory arrangements across the member countries. Even with the prepared uniform banking statute by WAMI, domestication in country laws would be necessary to implement, and this has remained a challenge. There still exist dissimilarities in accounting reporting standards with only Ghana and Sierra Leone adopting the International Financial Reporting Standards (IFRS). The disparity in accounting reporting standards will undermine cost efficiency of cross-border subsidiaries of banks.

Thirdly, a recent study by the World Bank/WAMI(forthcoming)⁷, reveal that although, quite a number of the WAMZ member countries were at various stages of improving the flow of credit information through private credit bureau or central bank based credit risk management systems, no legislation exist that sanctions cross border sharing of credit information across the border.

One of the most obvious barriers to capital market integration in the West African region is the imposition of outright restrictions on foreign ownership of domestic equities. Controls on capital mobility also constitute a significant barrier to achieving the potential that a common capital market would have on catalysing economic growth and development in WAMZ.

An important obstacle to the cross-border trade in insurance services is the existence of fragmented legal framework for the practice of insurance. Getting at

harmonisation is becoming increasingly elusive, given the significant differences in capital adequacy requirements for the establishment of insurance companies.

Conclusions

The important challenge for financial integration is for the member countries to create the right environment to allow business to go unhindered in the WAMZ. Restrictions on capital accounts and all house-keeping regulations that encourage regulatory arbitrages will

have to be critically examined in order to provide a framework for harmony. These will be necessary for both the banking, insurance and capital markets to build on their potentials to increase inter-mediation, deliver effective service at both the domestic and regional levels.

There is also the need for the WAMZ authorities to harmonise the fragmented approaches to quality of supervision by concretising a uniform memorandum of understanding (MoU) for use in the sharing of supervisory information. ^{epi}

Footnotes

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² The four Primary Criteria are: single digit inflation, fiscal deficit/GDP ratio of not more than 4 percent, central bank financing of government fiscal operations of not more than 10.0 percent of previous year's tax revenue, and foreign exchange reserves to cover at least 3 months of imports.

The six secondary criteria cover the following: Non-accumulation of domestic arrears/liquidation of existing arrears; Tax/Revenue ratio of at least 20 percent; Salary Mass/Total Tax Revenue of not more than 35 percent; Public Investment from Domestic Receipts of at least 20 percent; Positive Real Savings Deposit Interest Rates; and Exchange Rate Stability (\pm 15 percent within the WAMZ ERM).

³ A thin financial sector is one where the markets are characterised by low liquidity, high spreads, and high volatility. It is a sector that is unlikely to accommodate small adjustments of demand and supply without significant price movements resulting to a volatility that can induce risk-averse transactors who face transaction costs to desert these markets completely.

⁴ Shallow in this sense implies very few banking institutions, dearth of instruments, weak inter-bank competition and generally highly regulated market with low liquidity.

⁵ Manna, Michele, 2004, "Developing Statistical Indicators of the Integration of the Euro Area Banking System," ECB Working Paper Series, No. 300, (January).

⁶ Defined as bank branches per 100,000 people

⁷ World Bank (2009) "Increasing Trade in Insurance and Banking Services in the West African Monetary Zone: Opportunities for Progress", Discussion Draft. Field studies for this report was conducted in late 2008

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