

Abstract:

SOURCES OF REAL OUTPUT AND PRICE FLUCTUATIONS IN THE ECONOMIC COMMUNITY OF WEST AFRICAN STATES

Understanding the sources of fluctuations in real output and prices is essential to our ability to anticipate the challenges of an ECOWAS common currency. It is well-understood that an optimal currency area would require synchronization of business cycles so that economic shocks affecting all countries are similar, calling for a unified response in terms of monetary policy. Otherwise, it would be inefficient to have a common monetary policy as for instance, some countries may require tightening money supply, while others need expanding it.

The most frequently used model in investigating macroeconomic performance is the aggregate demand and aggregate supply model, which looks at the effects of technological changes, monetary and fiscal policy on real output and price levels. The model predicts that an aggregate supply shock has permanent effects, causing price to fall and real output to rise while an aggregate demand shock results in temporary increase in price and output. In a seminal paper in the literature, Blanchard and Quah (1989) uses long run restrictions to identify structural vector autoregressive. When output has a unit root, a change in output in one period leads to a change in the forecasted output of all the following periods. Using a two-variable vector autoregression of output and unemployment, Blanchard and Quah assume that unemployment shocks have no long run effects on output. Hence permanent output shocks are associated with aggregate supply shocks and transitory output shocks with aggregate demand shocks.

Using historical data from all member states on real output and prices instead of real output and unemployment rates, this paper first evaluates the Blanchard and Quah interpretation of permanent and transitory shocks to output as respectively aggregate supply and aggregate demand shocks, and derives policy implications for ECOWAS members in their attempt to set the groundwork for a common currency.