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**Exchange Rate  
Issues in the  
African Countries  
of the Franc Zone**

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by  
Elliot Berg  
Phillip Berlin

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7250 Woodmont Avenue, Suite 200, Bethesda, Maryland 20814

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## BACKGROUND NOTE

Controversy over African participation in the Franc Zone is not new. The costs and benefits of zone membership — or more properly, membership in the two monetary unions, the Union Monétaire Ouest Africain (UMOA) and the area covered by the Banque des Etats d'Afrique Centrale (BEAC) — have sparked lively debate for many years, as have membership's impact on economic performance, the appropriateness of the exchange rate, and the desirability of devaluation.

Recently, however, the debate has greatly heated up, especially over the exchange rate issue. Many observers, including representatives of major donor agencies, believe that the CFA franc has become increasingly overvalued since the mid-1980s, that this is now a major obstacle to structural adjustment and faster economic growth, and that an exchange rate adjustment (change in parity with the French franc) is essential. But not everybody agrees. Most analysts in France, many in Africa, and most responsible authorities in Franc Zone countries reject devaluation as inappropriate, probably counterproductive.

This note provides an overview of some of the major issues in the current debate. As in any such survey of complicated questions, oversimplification is inevitable. This is all the more true because the paper aims to be free of jargon and understandable to non-economists and to readers unfamiliar with the institutions of the Franc Zone.

We proceed as follows. Section One is introductory. It describes briefly the institutions of the Franc Zone and how they work. The second section considers the benefits and costs of the present arrangements. Section Three discusses the extent of overvaluation of the CFA franc. Sections Four and Five set out the major policy responses that are on the table. Section Four considers the case for devaluation of the nominal exchange rate — that is, changing the existing parity with the French franc. Section Five discusses present French and African policy: direct action on the real exchange rate by cost-cutting policies within the existing institutional framework, and improvement of competitiveness by reinforcing the institutions of the Franc Zone. In this section we also look at the more radical option of delinking from the Franc Zone and achieving autonomy in monetary and exchange rate policy. The last section is a brief excursion into political economy: who are the winners and losers in the existing arrangements and in alternative policies?

### INTRODUCTION: THE FRANC ZONE

The CFA Franc Zone is a unique system of monetary and exchange rate management. It is a currency union in which a group of independent states peg their exchange rates firmly and at a common level to an external currency. The African countries of the Franc Zone are grouped into the UMOA and the BEAC monetary unions, each with its own central bank, operating rules, and separate CFA franc, both of which have a common exchange rate of 50 CFA franc to 1 French franc. The two unions include 13 countries with 75 million people, an aggregate 1989 GDP of more than \$40 billion, and diverse economic structures and levels of development.<sup>1</sup> (See Annex A, Table 1.)

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<sup>1</sup> The members of the UMOA are Benin, Burkina Faso, Côte d'Ivoire, Mali, Niger, Senegal, and Togo. The BEAC zone is made up of Cameroon, Chad, the Central African Republic, the Congo, Equatorial Guinea, and Gabon.

The structure and operations of the Franc Zone are complex. Only a few key aspects are addressed here. A more detailed description is given in Annex B.

The main features are well known: free convertibility of the CFA franc, maintenance of a fixed parity with the French franc, and common management of external reserves. The convertibility of the CFA with the French franc is supported by the operations account, which is an overdraft facility in the French Treasury; it absorbs at the existing exchange rate whatever supply of CFA francs exists on foreign exchange markets.

The convertibility of the CFA franc has been maintained at the same parity for 45 years, despite differences in economic structure of member countries and hence differences in impacts of economic shocks. Such stability, and indeed the maintenance of convertibility over any length of time, requires joint adherence to fiscal and monetary discipline. Big budget deficits or excessively expansionist credit policies pursued by any member country would quickly enlarge its balance of payments deficit and show up in the country's foreign asset holdings in the operations account. Members with more prudent monetary and fiscal policies (or France) would end up financing those who are less prudent.

Thus the Franc Zone rules are designed to ensure that credit creation and aggregate demand within each monetary union are contained at levels consistent with exchange rate stability and minimum drawing on the operations account facility. The level of net foreign assets for each zone is taken as the principal policy target of the operation of each central bank. The main instruments to achieve stability in foreign asset holdings are, first, limits on rediscounting of private sector borrowing (central bank purchasing of commercial bank loans) and, second, statutory limits on advances to governments.

Each central bank sets global credit ceilings consistent with forecasts of GDP growth rates for the individual countries. These form the basis of annual ceilings for central bank rediscounting of private sector credit for each member country.

Shares in country rediscount ceilings are apportioned to individual commercial banks. Before this is done, however, provision is made for central bank lending to member government treasuries. Each year, each member government can borrow from the central bank no more than 20 percent of last year's tax revenues. This is the key to the maintenance of fiscal discipline within the two unions.

## **BENEFITS AND COSTS OF MEMBERSHIP**

In principle, the Franc Zone brings important benefits to its African members. The fiscal and monetary discipline that is encouraged should bring financial stability, with all of its positive consequences. Low inflation reduces uncertainty and the distortions associated with severe price instability. Similarly, the long history of exchange rate stability, the French guarantee of convertibility, and the fact that the agreement of all Franc Zone members is required to change the parity has given great credibility to macroeconomic policy and created an environment of stable expectations and low transaction costs, hence favorable to trade and investment.

The point merits elaboration. There is almost completely frictionless movement between currencies, not only within the zone but between France and the monetary union of which France is a member. Not only have exchange rates been stable for 45 years, but currency transactions are subsidized by France; no premiums or discounts are paid on transactions between any of the currencies involved. Even trading in banknotes enjoys the same exchange rate as large-scale interbank transactions. The rules

of the Franc Zone facilitate trade within the African part of the zone and among the CFA countries and all members of the European Community's (EC's) exchange rate mechanism.

Also, although freedom of financial flows among member countries is not as complete as it might seem (no interbank flows are allowed), financial markets are nonetheless more integrated than they would be without the existence of the zone; financial resources are permitted to flow to those markets where they can earn the highest rate of return.

An additional (small) advantage derives from economies of scale in management of the exchange rate arrangements — savings from pooling of reserves and reduced administrative costs.<sup>2</sup> Much more important, the monetary unions are part of a special relationship between France and its former colonies that brings international economic assistance and political support.

The main costs of Franc Zone membership are related to the fixity of the exchange rate and the related constraints on monetary policy. African member countries give up the right to use exchange rate changes (nominal devaluations) as an instrument of adjustment. The price for financial stability may therefore be slower adjustment to external or internal shocks, reduced competitiveness, and slower economic growth.

These are benefits and costs in principle. They set the framework for assessment, which has to include three elements: some discussion of the counterfactual — what would happen without the zone; some consideration of the broader, intangible benefits; and a review of the empirical evidence on economic performance.

Much of the judgment about the unions' benefits for their individual members depends on whether or not national central banks would have been able in the past or would be able in future to adhere to the same discipline (for example, regarding the limits on the monetization of government deficits) that is now imposed by the supranational writ of the two central banks of the zone. If one assumes that the national central banks can maintain this degree of fiscal discipline, the benefits of zone membership are less obvious.

In view of the persistence of the informal methods used to circumvent fiscal discipline among member countries of the zone (elaborated below), the national central banks of these same countries would hardly have been able to avoid more aggressive financing of government deficits than occurred in the recent past. Moreover, if the counterfactual includes the common conditions associated with severe loss of financial discipline — inflation, disruption in foreign exchange markets, exchange controls and all the rent-seeking it unleashes, aggressive protectionism, control over profit repatriation, and so on — then the regulatory structure of the Franc Zone obviously has much in its favor.

It would be misleading, in assessing costs and benefits, to neglect the crucial fact that monetary union is part of a web of cooperative relationships with France that entail other costs and benefits, many of them intangible. The costs are a reduction in economic sovereignty, a sense of lingering colonialism among some groups. Given the limited scope for autonomous policy in any small economy, it is hard to know how much weight to put on these costs.

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<sup>2</sup> However, the authors of one recent study argue that the pooling of reserves is a cost rather than a benefit for the smaller economies of the zone. M. Allechi and A.M. Niamkey, "Alternative Exchange Rate Policies for the CFA Franc," draft paper presented at the African Economic Research Consortium Workshop, Nairobi, May 1992.

These costs are in any case balanced by economic and political advantages that are part of the special relationship with France. French aid is substantial in volume and is allocated in favor of its former dependencies. Franc Zone countries enjoy especially high levels of assistance.<sup>3</sup> Emergency budget and balance of payments support, debt write-offs, and privileged access to French markets are other elements. Perhaps more important, France acts as the Francophone African friend in court at the World Bank, the International Monetary Fund, the EC, and elsewhere. These benefits might prevail even in the absence of monetary integration, but this is not certain; in any case, the level of French commitment would almost surely be less than at present in the absence of the monetary arrangements.

What has the actual comparative performance of the African countries of the Franc Zone been? The question has generated a small blizzard of writing in the past several years.<sup>4</sup> Some of the economic performance indicators on which many of these studies are based are shown in Annex A, Tables 2-5.

All observers seem to agree on two points. First, inflation has been very substantially lower in CFA countries than in other African countries, in low-income countries generally, or primary producers generally. This is true for all periods and by all measures, though there are variations within the zone and over time. The unweighted average inflation rate is lower than the weighted rate, which means that prices rose more in the bigger economies. And the differential in performance on inflation is more favorable to the CFA countries in the 1980s than in the 1970s. Prices rose on average only about 4 percent a year during the 1980s in the CFA zone, for example, compared with 17.3 percent in other Sub-Saharan African (SSA) countries.

The behavior of the underlying indicators shows why. In both the 1970s and the 1980s, average CFA zone budget deficits were lower than in other SSA countries, though higher than other low-income developing countries. Domestic credit in CFA countries also grew more slowly than in comparison groups of countries in the 1980s (though not in the 1970s).

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<sup>3</sup> French official development assistance amounted to 41.6 billion French francs in 1991, of which 32.5 billion (\$6.5 billion) was bilateral. Bilateral aid to Sub-Saharan Africa (the bulk of it to CFA countries) was 16.7 billion francs, of which capital assistance was 3.8 billion, policy-based lending 2.9 billion, debt relief and restructuring 4.4 billion, and technical assistance 5.6 billion (S. Michailof, "L'échec du développement en Afrique subsaharienne et l'évolution souhaitable des actions de la coopération française: Synthèse et Propositions," Groupe de Prospective, Coopération et Développement, Novembre 1992).

<sup>4</sup> J. Boughton, "The CFA Franc Zone: Currency Union and Monetary Standard," IMF Working Paper, December 1991, and "The Economics of the Franc Zone," forthcoming in *Policy Issues in the Operation of Currency Unions* (Paul Masson and Mark Taylor, eds.) 1992; E. Elbadawi and N. Majd, "Fixed Parity of the Exchange Rate and Economic Performance in the CFA Zone," World Bank Working Paper, January 1992; S. Devarajan and J. de Melo, "Evaluating Participation in African Monetary Unions: A Statistical Analysis of the CFA Zone," in *World Development*, Vol. 15 # 4, 1987, pp. 483-496; same authors, "Membership in the CFA Zone: Odyssean Journey or Trojan Horse," World Bank Working Paper, August 1990; S. Devarajan and D. Roderik, "Do the Benefits of Fixed Exchange Rates Outweigh Their Costs: The Franc Zone in Africa," World Bank Working Paper, October 1991; P. and S. Guillaumont, eds., *Stratégies de développement comparées: zone franc et hors zone franc*, Paris, 1988; same authors, "Participating in African Monetary Unions: An Alternative Evaluation," *World Development*, Vol. 16, # 5, 1988, pp. 569-70; and same authors with Patrick Plane, "Comparaison de l'efficacité des politiques d'ajustement en Afrique, Zone Franc et hors Zone Franc," Notes et Etudes #41, Caisse Centrale de Coopération Economique, Paris, Avril 1991.

The inflation performance has been good despite weaknesses in financial discipline that became apparent over the last decade. Slippage in monetary policy came from three directions: government nonpayment of bills (arrears), crop credits, and public enterprise borrowing.

Unpaid bills need no comment. Less obvious was the financing of crop credits. Loans were granted by commercial and development banks (often under government pressure) to finance export crop marketing. Banks in effect provided for the working capital needs of state marketing agencies. They also subsidized loss-making agricultural subsectors, with preferential interest rates. These marketing credits were supposed to be self-liquidating over the course of the year, and hence were not counted against credit ceilings for the year in which they were granted.<sup>5</sup> State enterprise borrowing, similarly, sometimes escaped inclusion in credit ceilings.<sup>6</sup>

The second point on which there is general agreement is that until the mid-1980s (or perhaps the early 1980s), CFA zone countries' economic performance by most measures was superior to that of other African countries. Put in its most prudent form, the general conclusion from this research is that membership in the CFA zone did not hurt economic growth performance between the early 1960s and the early 1980s, though growth was slower than in non-African developing countries. This is evident from the growth rate data presented in the statistical tables (Annex A, Tables 1.2-1.5). It is verified in the econometric analyses contained in all the cited studies. Moreover, the CFA growth performance was comparatively better in the 1970s than in the 1960s. And what was true for GDP growth was true for most other measures — rates of investment, export growth, and exchange rate stability, for example.

Differences emerge in assessments of performance in the 1980s, though analysts agree that there has been a deterioration in all indicators other than inflation rates. Devarajan and de Melo conclude:

After 1981, changes in the world environment and persistent current account deficits meant that CFA countries needed to adjust their economies along with most other developing countries. Our statistical results show that they did not adjust by as much as they needed to. Furthermore, their growth performance was disappointing. Under every estimate, zone members' GDP growth rates fell behind those of their counterparts, including the other African states. Finally, the burden of adjustment appears to have fallen disproportionately on expenditure reduction in general, and investment reduction in particular — an ominous sign for future growth.<sup>7</sup>

Devarajan and Rodrik develop a model in which countries minimize welfare losses due to gaps between real and potential growth and departures of inflation from a target rate. They postulate a trade-off between fixed exchange rates and real growth. In their model, CFA zone welfare could be increased by a shift to more flexible exchange rates if the authorities accept higher inflation to get more growth. Their simulations indicate that a 1.5 percent higher annual inflation rate could have increased output

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<sup>5</sup> This was not only a source of monetary slippage but also a major factor in destroying the liquidity of a number of CFA banking systems in the 1980s. Unpaid crop credits stayed on the books of lending institutions, at uneconomic interest rates, because governments were unable to repay.

<sup>6</sup> Moreover, as is well known, loans to the public enterprise sector were frequently for unproductive and low-priority expenditures. Yet when maintenance of net foreign asset positions required credit cutbacks, private sector non-crop marketing activities bore the burden, because governments would not force state-owned enterprises to the wall by taking away their credit lines. In this way the monetary arrangements have contributed to slow growth.

<sup>7</sup> Devarajan and de Melo, 1990, p. 14.

growth by 1 percent. The choice for price stability, they conclude, has been a "bad bargain" for the CFA countries, reflecting an "excessive anti-inflation bias."<sup>8</sup>

Other recent studies reach more tentative conclusions about the post-1985 decline in CFA country economic performance. James Boughton of the IMF argues that much of the criticism of Franc Zone performance is based on experiences in a few countries only, notably Cameroon and Cote d'Ivoire.<sup>9</sup> In Cameroon, the real effective exchange rate appreciated by 38 percent between 1982 and 1987. In Côte d'Ivoire a similar degree of appreciation occurred between 1985 and 1988. He points out, however, that some of the smaller countries such as Togo and Gabon, avoided real appreciation during the 1980s. He also concludes, from a comparison of CFA zone countries with their neighbors, that the CFA countries had better growth rates despite more severe terms-of-trade shocks. He paints a generally positive picture, arguing that there is no evidence of a trade-off between stable prices and economic growth.<sup>10</sup>

Along the same lines, the argument in the Elbadawi and Majd paper is perhaps not so persuasive as it appears. This paper compares CFA with non-CFA Africa on five performance indicators (real GDP growth rate, growth rate of exports, investment-to-GDP ratio, domestic savings-to-GDP ratio, and the external debt-to-GDP ratio.) The paper focuses not on the levels of each indicator but on their changes. But this puts the CFA countries in a harsher light than their actual performance calls for, because they did relatively better in the earlier periods.

In fact, the absolute numbers given in the Elbadawi-Majd paper for 1982-1989 do not make the CFA countries' performance look so bad: their rates of GDP growth, investment rates, and savings rates are better than those of non-CFA countries, although export growth and debt ratios are worse. As for the other indicators in the paper, these are policy indicators rather than performance measures. And, in any case, for five of the six indicators, the CFA countries did better (improved more or deteriorated less) than the other African countries. Only in real effective exchange rate (REER) levels did they do worse. It is true of course that in growth rates and export growth the CFA countries did worse in the 1986-1989 years.

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<sup>8</sup> It should be noted that this conclusion depends on the assumption that there is a trade-off between price stability and growth. But as Boughton points out (Boughton, 1992), it is not evident from the empirical record that there has been such a long-term trade-off. The gains in question are short term, flowing from quicker adaptation to terms of trade variability. Moreover, the Devarajan-Rodrik argument assumes that with autonomy, CFA policy makers would have followed the appropriate exchange rate policies in response to terms of trade shocks. They note that this is perhaps a dubious assumption. Finally they assume (implicitly) that all the gains from the special relationship with France, and especially aid flows, would remain unchanged.

<sup>9</sup> James Boughton, "The Economics of the CFA Franc Zone," in *Policy Issues in the Operation of Currency Unions* (P. Masson and M. Taylor, eds.), forthcoming.

<sup>10</sup> Boughton compares performance of the CFA zone with 10 contiguous countries, all of which manage their exchange rates. Five of them independently float their currencies (Gambia, Ghana, Nigeria, Sierra Leone, and Zaire), two have managed floats (Guinea-Bissau and Mauritania) and three are pegged (Algeria, Libya, and Morocco). He finds that on average the CFA countries had only one-fifth the inflation of the comparators in the 1980s (4.2 percent a year compared with 26 percent). Growth rates were slightly higher in the CFA countries (2.5 percent a year against 2.0 percent) despite the fact that they experienced more severe external shocks during the decade. Although current account deficits were a little higher, debt service problems were no greater than those of the neighbors. The paper is generally upbeat: the real costs of price stabilization are believed to be low. (Boughton does not specifically consider the argument that general deterioration occurred in the latter half of the 1980s, not in the decade as a whole.)

Guillaumont, Guillaumont, and Plane have approached the problem somewhat differently.<sup>11</sup> They address the question: have stabilization/adjustment programs been less effective in the CFA zone than elsewhere in Africa. They define a set of 21 adjusting countries consisting of those with at least three adhered-to IMF agreements in the 1980s. Six of these are CFA countries, mainly from UMOA: Côte d'Ivoire, Mali, Niger, Senegal, Togo, and Central African Republic. These six are compared with 13 non-CFA countries (Guinea was dropped because of lack of data, and Liberia because its exchange rate was not managed), broken into two sub-groups: six with relatively low inflation and relatively smooth adjustments of their nominal exchange rates — less than 20 percent a year (Gambia, Kenya, Malawi, Mauritius, Mauritania, and, barely, Madagascar); and seven with high inflation and high rates of depreciation of nominal exchange rates — more than 20 percent a year (Ghana, Uganda, Somalia, Sudan, Tanzania, Zaire, and Sierra Leone).

Among their findings are the following:

- Over the period 1979-1988, average real exchange rates of Franc Zone countries depreciated less than in the other African countries: -1.7 percent a year compared with -5.4 percent in the other African countries and -3.1 percent in the "moderate devaluation" subgroup. Between 1984 and 1988 the comparison became much more unfavorable for the CFA countries. On average, the CFA group had an annual fall in real exchange rates of -0.1 percent, whereas in the comparison group of other African countries the average decline was -15.8 percent. They thus confirm the relative appreciation of the CFA franc.
- Agricultural prices were much more favorable in the Franc Zone countries. Average prices paid to export crop producers rose 1.6 percent a year between 1979 and 1988, and 2.3 percent in the period 1984-1988. Elsewhere in Africa they declined during the same periods by 6.3 percent and 9.2 percent a year. Food crop prices were also more favorable to producers in CFA countries, rising for example by 2.6 percent per year during the period 1984-1988 in CFA countries, although they were down 5.9 percent a year in the comparator countries.
- Budget deficits rose more in the CFA countries between the early and middle 1980s, but the average was still less than half the average in the comparator countries.
- Budget expenditures did not fall much in any of the countries. But the CFA countries cut a bit more than the others: between the intervals 1981-1984 and 1985-1987, the ratio of expenditures to GDP fell from 27.2 percent to 25.6 percent in the CFA zone adjusters, whereas it only fell from 25.8 to 25.2 for the others.
- Growth performance was better in the non-CFA countries. In 1979-1988, growth in the six adjusting CFA countries was only 1.4 percent a year compared with 1.9 percent for the comparators. Between 1984 and 1988, the CFA group had average growth of 3.0 percent, the other group 3.4 percent. (The under-20 percent devaluers had better growth — 4.5 percent a year.)

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<sup>11</sup> Patrick Guillaumont, Sylviane Guillaumont, and Patrick Plane, "Comparaison de l'efficacité des politiques d'ajustement en Afrique, Zone franc et hors Zone franc," Caisse Centrale de Coopération Economique, Notes et Etudes # 41, Avril 1991.

Investment rates fell in the CFA countries from 17.1 percent of GDP in 1981-1984 to 15.6 percent in 1985-1988, though they fell a bit less in the comparison countries — from 17.8 percent to 16.7 percent. Differences between subgroups are not significant except for the low devaluation non-CFA countries, whose investment ratios remain near 20 percent on average.

The pattern is not the same in all the CFA countries; Cameroon and Côte d'Ivoire have had the worst real exchange rate performance, and their economic circumstances are least satisfactory. Estimation of the costs of the Franc Zone arrangements clearly is sensitive to choice of comparators and choice of base and terminal years. Data are weak, and recent data scarce; most of the analyses rely on 1989 data at best — usually estimates, not actuals. Because concern about overvaluation and lack of competitiveness has become especially intense in the past three or four years, analyses based on 1987 or 1988 numbers may be missing much of the story.

Nonetheless, the broad conclusions from these studies coincide, with only a few dissenters. The CFA zone has enjoyed relative price stability and at little apparent cost in terms of sacrificed growth until the late 1980s. In the past decade, its real exchange rate has become misaligned, reducing the competitiveness of its members. Economic performance has worsened since 1985, though just how much worse it has been depends on choice of comparator countries and on the periods covered. It is certain, though, that investment rates have fallen more than in comparator countries, that GDP growth in the CFA countries has slowed relatively more or increased less. Most critical, many countries in the zone face acute problems of competitiveness and seem able to maintain external balance only with relatively large inflows of foreign assistance.

### HOW OVERVALUED IS THE CFA FRANC?

Despite its easy usage, the term "overvaluation" is not easy to define or measure. One common and relatively straightforward measure is not available to the CFA countries: the gap between the official rate of exchange and that prevailing in parallel markets. There are no parallel markets for the CFA, given its continuing free convertibility.

Overvaluation (like undervaluation) is usually defined in terms of a departure from an ideal exchange rate, one that induces "fundamental equilibrium" in a country's balance of payments. The "equilibrium rate of exchange" is one that brings about internal balance (indicated by a low rate of unemployment and moderate inflation) and external balance (a viable medium-term balance of payments position). This ideal rate should also take into account the need to encourage economic growth.

Some people define the equilibrium exchange rate a little differently: as a rate sustainable without extraordinary measures, that will achieve and sustain a given growth rate. In practice, overvaluation (or undervaluation) is usually defined in terms of changes in exchange rates in a given country relative to other countries, as compared with relative rates during some normal period, when the balance of payments situation of the country in question was satisfactory. The early 1970s are often taken as an equilibrium period in much of SSA.

The most commonly used measure of exchange rate disequilibrium (overvaluation) is departure of the real effective exchange rate from its level in the base period. This measure is derived by first measuring changes in the nominal exchange rate (so many CFA francs to the dollar in 1992 compared

with 1985, for example). This is put in the form of an index. If the nominal rate was 500 to the dollar in 1985 and 250 in 1992, then the nominal exchange rate index is 50.

But this does not mean much because it does not account for domestic inflation. So a real exchange rate is derived by deflating the nominal index by a price index, either wholesale or consumer prices. If prices in the reference CFA country had doubled between 1985 and 1992, the real exchange rate would be unchanged: the 1992 nominal exchange rate index would be 50, the price index deflator 200, the real index 25.

But to really begin to understand whether and by how much the currency in question has become overvalued, more has to be known, notably what has happened to prices in countries that are trading partners or competitors. So another index is needed, one that shows average price changes in these trading partner countries.<sup>12</sup> This is done by weighting each partner country's price change by its relative importance in the trade of the reference country. The REER is then calculated by dividing the reference country's real exchange rate index by the trade-weighted external price index.<sup>13</sup>

The REER measure has significant weaknesses. Perhaps most important is the choice of the equilibrium year(s), the base period from which exchange rates are said to have become over- or undervalued. One illustration of the hazards this presents is the use of 1985 as a base period in much World Bank and other analysis. Any comparison using that period is certain to be unfavorable for the CFA countries. Most non-CFA African country REER devaluations took place after 1984, and it was in 1985 that the dollar was at its highest against the French franc (and hence the CFA franc). (See Annex A, Figure 1.)

Problems of weighting and choice of deflators have already been alluded to. Weights are based on recorded trade figures that strongly understate parallel or informal trade across frontiers. This is especially important for countries such as Nigeria and Gambia, which should be weighted much more heavily in trade-weighted indexes than is the custom. Also, the use of consumer price indexes opens the door to many errors because it is so imperfect a proxy for price movements of tradeable goods.

Finally, a given index number for the REER does not tell how much devaluation (or upward revaluation) is called for, because the target has to be achievement of fundamental equilibrium, not parity with some past equilibrium. Differential movements in terms of trade or economic recession in the home country create new equilibrium rates.

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<sup>12</sup> The appropriate index is a matter of contention. The wholesale price index is the best measure of prices for export goods and import substitutes ("tradeables"), because it does not include domestic services. But in many countries there is no wholesale price index, so the Consumer Price Index is used as a proxy.

<sup>13</sup> In the derivation of the REER and its explanation, the real exchange rate step is often skipped. The REER is calculated by multiplying a nominal exchange rate index by the ratio of domestic to external price changes. Thus if the nominal exchange rate has remained constant while the reference country's prices have risen say 50 percent more than the weighted average price of its trading partners, then the REER is 50:  $(100/.50)$  — the nominal exchange rate index (100)  $\times$  the relative price-change index (domestic price index over trade-weighted partner price index) say  $150/100 (= .50)$ . So the REER has appreciated by 50 percent. If the nominal exchange rate depreciated by 25 percent, say from 300 CFAF to the dollar to 225 to the dollar, and domestic prices rose 50 percent more than partner prices, then the REER index would have appreciated by 37.5 percent  $(.75 \times .50)$ .

All of this said, what do the data on REERs show? We have already made some reference to the numbers. Figure 1 in Annex A shows REER movements for CFA and non-CFA countries from 1970 to 1990. Figure 2 in Annex A gives the same rates for six CFA countries between 1978 and 1990. The following are the main points:

- REERs appreciated for all groups of African countries between 1970 and 1980. The CFA countries' appreciation was a little greater than that of the other African countries but not much.
- In the first part of the 1980s the CFA depreciated significantly, whereas the non-CFA rates appreciated. The competitiveness of the CFA zone was much improved compared with the early 1970s.
- After 1984, average non-CFA real rates fell substantially — from about 115 (1980 = 100) to about 70 in 1989, or more than one-third.
- The REERs in the CFA zone did not all behave the same. Serious appreciation (loss of competitiveness) occurred in Cameroon, Côte d'Ivoire, and CAR especially, but Togo managed to cut its real rate by more than 20 percent. Overall, though, the REERs for the CFA zone indicate broad loss of competitiveness.

Other indicators of competitiveness exist, besides REERs. These other indicators are more concrete, more dramatic, and probably more revealing of the true state of affairs. One is the movement of terms of trade. Negative changes in terms of trade (deeper falls in export prices than in import prices) usually mean that the country's balance of payments position has worsened. To reestablish equilibrium, adjustment in the real exchange rate (a devaluation) is necessary and can be achieved through depreciation of the nominal rate. Hence, the extent of deterioration in terms of trade is an indicator of overvaluation.

Commodity price changes have been mostly downward for the CFA countries in the 1980s, though the record varies between countries and depends in part on years chosen for comparison. Thus the price of fish, Senegal's main export, fell by 18 percent between 1980 and 1990, but rose by 47 percent between 1985 and 1990 (See Annex A, Table 6.). Similar swings in export prices are found for the Sahelian exports of phosphate rock and cotton: overall deterioration over the decade but an improvement in the latter half. Cocoa, coffee, and palm oil prices in 1990 were all 40-50 percent below 1980 levels; they never improved over the decade.

Overall, 1980-1987 terms of trade changes ranged from minus 10 percent in Senegal (probably close to the average for the Sahelian countries other than Niger, which suffered a much sharper drop because of the collapse in prices of uranium, its major export) to minus 40 percent for the Côte d'Ivoire and minus 44 percent for Cameroon. The position of the oil exporters of the BEAC zone — Cameroon, Gabon, and Congo — was eroded by a drop of 20 percent in petroleum prices, mainly in the last half of the decade.

Another indicator is the extent to which CFA country manufacturing costs exceed those in competitive countries. A 1989 French study described the problems of tuna fish canning in Senegal.<sup>14</sup> Between the mid-1970s and the mid-1980s, Senegal fell from second to fifth place among world

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<sup>14</sup> J.P. Barbier, "Réflexions sur la Compétitivité, Comparaison Afrique-Asie," Caisse Centrale de Coopération Economique, Mai 1989.

exporters, and its share of the market fell from 12 percent to 6 percent. Thailand, which exported no canned tuna in 1976, had 44 percent of the world market by 1986. The Thai won market share from Senegal despite the fact that Senegalese canners enjoyed export subsidies (40 percent of value added) and preferential entry to the EC market. The main reasons were these: labor costs per kilogram of processed tuna were 50 percent lower in Thailand; transport costs from Senegal were 70 percent higher; and the Thai exploited markets for by-products more effectively.

The same study compared two cement plants of the same size and technology. Costs of production per ton were almost twice as high in Senegal as in France. One reason was that the Senegalese mill, which is newer, had higher depreciation costs. Another was that the Senegalese operation ran at only 30 percent of capacity, compared with 70 percent in France. Finally, the costs of fuel and power were five times higher in Senegal than in France, and labor costs (though not significant in cement production) were 40 percent higher per ton in Senegal.

Wage costs are generally high in the CFA zone. Table 7 in Annex A shows labor costs in manufacturing in relation to per capita GDP in Côte d'Ivoire, Senegal, and seven other countries. Wage costs in the two CFA countries around 1986 were some 60 percent higher than in Morocco, Malaysia, and Tunisia, and three to five times higher than in Ghana and Indonesia.

High costs are particularly evident in relative civil servant salaries. In 1987, the average monthly salary of civil servants in nine CFA countries was 133,000 CFA (or 10 times the per capita GDP), as compared with 35,000 CFA in a sample of six non-CFA countries (3 times their per capita GDP). The numbers are shown in Table 8, Annex A.

Relative costs in agriculture point in the same direction of reduced CFA zone competitiveness. Wage labor costs in agriculture in Ghana are said to be much lower than those in neighboring CFA countries — perhaps only a third as high.<sup>15</sup> And comparative studies of production costs of major export crops in Asia and some CFA states indicate similar disparities. Thus one study in 1990 compared five oil palm plantations (Palminindustrie in Côte d'Ivoire, Socapalm in Cameroon, two in Malaysia, and one in Indonesia.)<sup>16</sup> The Ivorien plantation had average costs that were four times those of the Indonesian competitor and more than twice those of the Malaysians. The Cameroonian plantation was even less competitive; its unit costs of production were estimated to be five times higher than those of the Indonesian plantation, for example.

Many factors explain why Asian plantations were cheaper producers — better rainfall, younger trees, more productive labor, cheaper and better supervision, better organization (no small-scale farmer operations as in Côte d'Ivoire), and others. But especially in the Indonesian case, the relative movement of exchange rates entered in an important way. This is even clearer in a later study of 11 rubber plantations in Indonesia, Malaysia, Côte d'Ivoire, Cameroon, and Zaire.<sup>17</sup> Here, too, relative costs

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<sup>15</sup> Cited in Nicolas Van de Walle, "The Decline of the Franc Zone: Monetary Politics in Francophone Africa," *African Affairs*, #90 (1991), p. 393.

<sup>16</sup> R. Hirsch and J.F. Benhamou, "Etude comparative des conditions techniques et économiques de production: de l'huile de palme en Afrique et en Asie, Résumé et conclusions générales," Caisse Centrale de Coopération Economique, Juin 1989.

<sup>17</sup> R. Hirsch, "Etude comparative des coûts de production du caoutchouc dans les grandes plantations en Afrique et en Asie. Tome I: Version resumée et conclusions générales," Caisse Centrale de Coopération Economique, Decembre 1990.

were strongly in favor of the Indonesians and, less dramatically, the Malaysian producers. Outputs from African plantations in Côte d'Ivoire and Cameroon were generally two to two-and-a-half times more costly per kilogram of final product (rubber) than those of Indonesian plantations. Many factors again explain the cost differences, but in 1990 the exchange rate factor evoked particular comment. The author concludes (p. 16):

The fact that Asian costs are generally lower should be no surprise. Remember that all costs here are converted into U.S. dollars. The comparison thus incorporates some drastic exchange rate fluctuations. In the past five years (1986-90), the dollar appreciated by 59.4 percent against the Indonesian rupee, 9.1 percent against the Malaysian ringgit, 664.8 percent against the zaire while it depreciated by 32-33 percent against the CFA franc. It is clear that this evolution of parities is one of the main causes of the growing gap between Asian and African costs since 1986.

Taking movements in terms of trade, the movement of REERs, and all the anecdotal evidence together, rates of overvaluation ranging from 30 to 75 percent have been suggested by different observers. The consensus estimate seems to be 50 percent. But this high a rate of estimated overvaluation applies more to Cameroon, Côte d'Ivoire, and CAR than it does to Togo, Burkina Faso, Niger, or Chad. There is in general a more moderate rate of overvaluation in the Sahelian continental countries than in the coastal CFA members.

Also, things can change fairly fast. Between November 1992 and January 1993, after all, the French franc depreciated by some 15 percent with respect to the dollar. So some depreciation of the CFA has already occurred, though the fact that 70 percent of total trade of African CFA countries is with countries belonging to the EC's exchange rate mechanism limits its extent. In any case, we cannot rule out some repetition of the early 1980s, which saw a sympathetic depreciation of the CFA franc as the French franc was devalued against other major currencies.

### WHAT TO DO: THE CASE FOR DEVALUATION

The case for a change in parity between the CFA and the French franc begins with a strong emphasis on the two sources of disequilibrium noted above: adverse changes in the terms of trade, which demand adjustment, and lack of competitiveness of the CFA economies. Negative arguments form a major part of the case: there is no better alternative option available to restore equilibrium and make these economies truly competitive.

#### The Nonviability of Mock Devaluations

One of the common alternatives put forward, and occasionally tried, is to adopt policies that mimic a devaluation, that is, to increase import duties and subsidize exports more or less proportionally. This raises the relative prices of internationally traded goods (tradeables), and should have the same desirable effects as a devaluation — an improved balance of payments as a result of increased attractiveness of exports and import substitutes. However, experience with attempted solutions along these lines shows few successes.

A mock devaluation was tried in Senegal, with assistance from the World Bank. It proved difficult to manage. Originally subsidies were given, based on total value of exports. This tended to

favor existing exporters and proved costly, so the basis of subsidy determination was changed to value added. But value added is hard to calculate, especially for small enterprises, and also hard to control. Exporters and potential exporters, moreover, were not stimulated to expand their sales abroad by the subsidy scheme. The amount was unknown in advance, and payments were likely to be late and often uncertain. Subsidies continued to be absorbed mainly by traditional exporters. The budgetary impact of the scheme became a source of preoccupation for the financial authorities, and enthusiasm for it declined. It continues, but is no longer pushed, and exporters appear to give it little weight.

For a time in the late 1980s in Senegal there was in effect an informal, partial mock devaluation: rice was taxed heavily and groundnuts subsidized. Unfavorable world price movements and rising budget costs brought the groundnut subsidy to an end, and the high tariff on rice induced smuggling from neighboring countries, making the policy unsustainable.<sup>18</sup>

A tariff-cum-subsidy scheme was also adopted in the Côte d'Ivoire in the mid-1980s. According to one analysis it succeeded in stimulating exports.<sup>19</sup> The Ivorian authorities were not convinced of its cost-effectiveness, however, and bowed to budget pressures to drop the program in 1988.

In the Central African Republic, also, government tried to deal with an appreciating nominal exchange rate, strong nominal devaluations in Nigeria and Zaire, and deterioration in its terms of trade by subsidizing traditional exports and imposing steep duties (average 58 percent) on imports. But because of limited administrative capacity and other factors, this led to fraudulent import of Zairian coffee to benefit from these subsidies, as well as unmanageable demands for exemptions and extensive smuggling.

### **Resistance to Cuts in Nominal Wages**

In the absence of productivity increases, a return to competitiveness requires reductions in real wages. This can be done, contrary to popular opinion. It has in fact been done in SSA, including the CFA countries. Changes in the statutory minimum urban wage rate (SMUG) are shown for 10 CFA countries and several others in Annex A, Table 9. The table shows a pattern of continuing declines in real rates dating from 1970. Rates fell from 20 to 40 percent in the 1980s in all the countries except Ghana and Mali.

However, declines were fewer and much slower in the period 1985-1989, and increases took place in six countries during that period. The reason is that inflation rates were much lower toward the end of the decade. It was the relatively high inflation of the 1970s and early 1980s that allowed real

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<sup>18</sup> One of the problems in Senegal and elsewhere has been that donor agencies are generally unwilling to push for increased tariffs on imports, despite the fact that increased ad valorem protection has long been understood to be the formal equivalent of devaluation in goods markets when levied in conjunction with appropriate export subsidies.

<sup>19</sup> John L. Newman, V. Lavy, R. Salomon, and P. de Vreyer, "Firms' Responses to Relative Price Changes in Côte d'Ivoire. The Implications for Export Subsidies and Devaluations," World Bank Working Paper, December 1990.

wage cuts: nominal wage increases lagged rising consumer prices as apparent money illusion prevailed.<sup>20</sup>

The same finding applies to civil service wages. Between 1975 and 1985, a period of relatively high inflation in most of the continent, real salary rates were cut by more than 50 percent in most African countries for which data is available.<sup>21</sup> But after 1985 in the CFA countries, civil service real salary rates seemed to stabilize. Again, the lesson is clear: real wage cuts can be achieved, but only in inflationary conditions.

Directly reducing real wages by cutting nominal wages seems to be a rare event in the modern world, in Africa or anywhere. This makes wage adjustment in the CFA zone extremely difficult; price rises in France and the CFA countries have been very small since the mid-1980s, and in some cases consumer price indexes have even fallen. (See Annex A, Figure 3.)

The classic case of an attempted cut in real wages by cutting nominal wages in a stable price environment occurred in Côte d'Ivoire in 1990. Government tried to slash nominal rates by 15 to 40 percent. Riots and demonstrations ensued, and government backed down. A similar effort was made in the late 1980s in Gabon, in the framework of a World Bank structural adjustment loan. Government found the agreed-to wage cut impossible to implement.

### How Devaluation Works

The basic mechanism for currency devaluation is straightforward. A devaluation of the nominal rate (which is what a cut in parity with the French franc is) can be expected to have a number of effects that will bring about external balance and greater competitiveness of the economy.<sup>22</sup> It is worth underlining at the outset that we are talking about nominal devaluations that are effective, which means that ensuing increases in domestic price levels are not so great as to offset the initial changes in relative prices. Fiscal and monetary policies thus have to be restrictive, to prevent inflationary annulment of the nominal devaluation.

Devaluation then can have the following positive impacts:

- It will reduce the trade deficits of the CFA countries, in the following ways:
  - By expenditure reduction. Nominal devaluation has a negative wealth effect because the domestic price rise it induces shrinks the real value of assets denominated in local currency. (This trend has to be offset by possible positive wealth effects accruing to local holders of assets denominated in foreign currencies.) This will lead to reduced expenditure on tradeables, as on all goods, and hence a fall in the trade deficit.

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<sup>20</sup> In Senegal, the real SMIG fell by 20 percent between 1980 and 1985, then remained unchanged for the next five years.

<sup>21</sup> See D. Robinson, *Civil Service Pay in Africa*, ILO, 1990, and E. Berg et al., *Rethinking Technical Cooperation*, UNDP, 1993.

<sup>22</sup> See S. Edwards, *Exchange Rate Misalignment in Developing Countries*, World Bank Occasional Paper, 1988, for more extended discussion of definitional issues and the macroeconomics of devaluation.

- By inducing expenditure switching. The nominal devaluation will alter relative prices: it raises the domestic currency prices of tradeable goods (exports, imports and import substitutes) relative to domestic (non-tradeable) goods, inducing shifts in domestic spending away from tradeables.<sup>23</sup>
  - By a rise in export receipts in local currency. The increased receipts will be shared between the state and exporters, depending on price policies. To the extent that exporters receive higher prices that are not counterbalanced by higher input prices, production for export will be increased. (Because SSA countries produce small shares of world output of most of their exports — cocoa being the main exception — they are mainly price-takers. Therefore, increased output should lead to higher export proceeds.) To the extent that government revenues benefit, other taxes that discourage economic activity can be cut, or growth-inducing expenditures can be increased. (The new money can of course also be wasted on low-priority activities.)
  - By import-substitution. Import substitution will be encouraged not only by the shift in relative prices, but also by the greater efficacy of protectionist policies. The burden of protection is no longer placed so heavily on tariff or non-tariff barriers, which are ineffective because they lead to increased smuggling.
- The positive impact on government resource availability will be reduced by the rise in payments on debt denominated in foreign currencies. But the higher domestic currency receipts from foreign assistance should more than balance this in the CFA zone, given the relatively high aid inflows and the recent debt forgiveness.
  - The direct and indirect inflationary impacts of the devaluation will allow socially acceptable reduction of real wage levels (and hence increased competitiveness) by the operation of money illusion: wage earners will accept nominal wage increases that are below consumer price increases, whereas they fight bitterly against real wage cuts that are effected by nominal reductions. Overall equity effects should nonetheless be positive. Farm incomes will rise because these are mainly agricultural exporting countries. Real incomes of formal sector urban wage earners will fall, but such workers remain a favored class in these economies.
  - Perhaps the most important impact is on long-term competitiveness. An exchange rate closer to basic equilibrium gives entrepreneurs and capitalists a more static-free set of price signals, allowing them (and not bureaucrats and politicians) to discover true long-term dynamic comparative advantage.

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<sup>23</sup> Examples of the different classes of goods and services subsumed under the heading *Tradeables* in the CFA zone context include cereals, livestock, some manufactures (textiles, garments), dairy products, red meat and poultry, sugar, cotton, tree crops, many fruits. Nontradeables are some food crops (tubers such as cassava), electric power, telecommunications, insurance, port services, transportation, housing and other constructions, all trade and — most important — government services from general administration to teaching.

## **ALTERNATIVE STRATEGIES: THE PRESENT APPROACH REINFORCED**

The official view in France and among almost all CFA member country spokesmen is that devaluation is a bad idea. This opinion appears to be shared by most concerned officials and intellectuals. They support the present policy of dealing with lack of competitiveness by pushing down domestic real wages and prices. In effect, they seek to lower real rates of exchange without changing parity. In recent months a new feature has been added: programs aimed at reinforcing monetary integration by more intensive economic cooperation.

The resistance to nominal devaluation (a change in parity) and the associated preference for this alternative approach have their analytic roots mainly in negative and second-best arguments. Advocates do not see the alternative approach as a high road to adjustment and growth, only a surer, less risky one. A variety of arguments are put forward to defend it.

### **Devaluations work poorly in African conditions for structural reasons.**

These points are familiar from Economic Commission for Africa writing and many other sources.<sup>24</sup> Price changes by themselves are not effective instruments of policy. The main causes of sluggish supply response in agriculture are structural obstacles — lack of good transport, research, extension, credit, access to modern inputs, incomplete markets for land and capital, and frequently noncompetitive output markets.

Moreover, just as exports are unresponsive to devaluation-induced price increases, imports are also price-inelastic. Raising the prices of tradeables, therefore, will not lead to much import substitution but to a higher import bill or further import compression, with contractionary effects on output.

### **Devaluation could easily erode financial discipline and will in any case create inflationary expectations.**

Abandonment of 45 years of exchange rate parity with the French franc is bound to have dramatic effects on inflationary expectations, especially in the light of the experience with central bank slippages during the 1980s. If the change in parity is accompanied by dissolution of the institutions of the Franc Zone, even past levels of monetary discipline will be difficult for national central banks to sustain. In any event, a change in parity would represent a shift in the fundamental rules of the game and would surely influence expectations and behavior of the major economic players, notably investors.

### **The success of nominal devaluation depends too heavily on money illusion.**

The argument is that wage earners will accept cuts in real wages more readily in an inflationary environment. It has been true in the past, judging from real wage behavior in the 1970s and 1980s. But the erosion of real wages in those decades was a slow process. It may be different with sharp, one-time

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<sup>24</sup> See Economic Commission for Africa, "A Framework for Transformation and Recovery in Africa," Addis Ababa, 1989. See also, F.G. Kiros, "Currency Devaluation in Africa: Framework of Analysis and Experience," in *Eastern Africa Social Science Research Review*, Vol. 2, June 1989, pp. 1-27.

cuts induced by a large change in parity. Successful reduction of real wage costs depends on strong government commitment to resist pressures to restore predevaluation wages. This commitment (or political capacity) has often been missing in past devaluations elsewhere and is not evident in many of the CFA countries.

**Efficiency-augmenting changes are most likely to be made when feet are in the fire.**

The main problem in the CFA zone is to regain competitiveness: this means productivity increases and cost reductions in all sectors of the economy, from the civil service and public enterprises to the main agricultural subsectors and service activities. It has to be done whether there is devaluation or not. Without devaluation, the incentive to make necessary reforms and productivity improvements is much stronger. Studies of the livestock sector have shown, for example, that much of the high cost of animal exports from the Sahel to the coast result from the high costs of transport and marketing, which can be reduced. The experience with cotton in Chad, Burkina, and Mali is another example: faced with declining world prices and low producer prices, the cotton sector was restructured, yielding high productivity gains.

**The difficulties of implementation, and the costs and risks of devaluation are too high.**

These difficulties are of various orders of importance. The simple act of changing parity requires unanimous accord of all members of the zone, a formidable obstacle. Reaching accord could scarcely be done without widespread signalling, which would cause massive capital flight and disrupt trade throughout West and Central Africa. If individual states pull out, institutional restructuring would require long periods of negotiation, which would place the monetary and trade regimes of many countries in great uncertainty.

The problem of working out alternative arrangements should all states wish to remain within the zone would still be formidable. By how much should the parity be changed? Can there be several groupings with different parities? This problem is magnified by the lack of systematic study and defined positions among member states; the subject has been treated as political dynamite so that public analysis and private debate have been limited.

The most significant risk is that the Franc Zone breaks up, unable to overcome these multiple challenges. Though this is regarded in some quarters as a forward step, allowing monetary and exchange rate policies that will lead to better adjustment and faster growth, it creates a new playing field and hence tremendous uncertainty about the economic environment and changed expectations about inflation in particular. Many French and Africans say that, after all, the performance of the Franc Zone countries in terms of economic growth has not been worse than other African countries, despite the fact that calls for devaluation were heard way back in the 1960s and early 1970s. It is better to stay the course than to launch ventures that could bring financial calamity.

Since 1990, joint French-African efforts have been under way to strengthen the monetary unions and build on their foundations a more extensive set of institutional arrangements that would move the Franc Zone closer to economic integration. These efforts include a regional approach to strengthening of financial institutions such as insurance companies and social security funds; creation of a regional

training and research facility in economics and statistics; and improvement of the judicial and legal environment by strengthening and coordinating company law in the zone.<sup>25</sup>

A 1992 report on French aid policy, drafted by a distinguished group of academics, practitioners, and government officials, applauds these efforts.<sup>26</sup> Institutional strengthening is seen as a sound first step to meaningful economic integration. The report notes also that it is "indispensable for the consolidation of the Franc Zone." Its conclusion on this matter is worth citing as a reflection of present consensus views in France.

Despite the slippages and lax administration of the (Franc Zone) central banks (which are hopefully a thing of the past), the monetary unions are the most noteworthy programs of regional integration. The advantages of the Franc Zone are well known: economic stability and monetary convertibility, control of inflation, etc. Even if there are questions about the present parity, the mechanisms of the Franc Zone that have survived three difficult decades have proved the efficacy. And the monetary instability of countries like Nigeria, which have experienced cycles of repeated devaluation, seems to some observers to be more an encouragement to speculation than to the development of a competitive industrial sector. Confronted with the growing destabilizing influence of the Nigerian giant, the Franc Zone could not avoid for long falling victim to a new disruption of its banking and financial systems, provoked by the non-respect of basic banking regulations or by recession of member country economies.

The survival of the monetary unions and achievement of the longer-term objective of monetary cooperation between Europe and Africa, which appears feasible financially and politically, requires that the institutions and regulatory systems in Africa be strengthened and restructured. Confronted with sounder economies and surer economic and financial institutions, the EEC could consider in the future limited convertibility agreements not only for Franc Zone countries but others as well.

The French and African objections to devaluation and their proposed substitute strategies rest on serious arguments and should be taken seriously. Opposition to devaluation by so many of the players involved is based primarily on these kinds of intellectual objections and on the kind of broader vision for the future of the Franc Zone outlined above. Of course, this doesn't mean they are convincing. Whatever one thinks of the structuralist arguments, for example, they cannot be interpreted to mean that prices don't matter. At worst, they mean that getting prices right is not sufficient to spur growth of output and exports. But it is usually necessary.

Furthermore, the concern about devaluations generating self-feeding inflation does not take enough account of the fact that exchange rate adjustments in these cases have simply followed domestic demand management, which has been inflationary as central banks monetized deficits. The CFA countries have restricted the accommodation of government deficits by statute and conferred on their two

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<sup>25</sup> For a description and analysis see P. Guillaumont and S. Guillaumont Jeanneney, "Les instruments anciens et nouveaux de l'intégration économique: leçons politiques de l'expérience africaine," CERDI, Clermont-Ferrand, Mai 1992.

<sup>26</sup> S. Michailof, in compendium of background papers prepared for study group on French aid to Africa. See the published volume, S. Michailof, ed., *La France et l'Afrique: Va-de-mecum pour un nouveau voyage*, Karthala, Paris, 1993, pp. 411-422 and 461-470.

supranational central banks the power to tie monetary creation to net foreign asset positions, thus creating a strong disposition toward equilibrium in foreign exchange markets. A major devaluation would bring this arrangement under pressure, but would not easily break it.

Moreover, the 1980s brought considerable experience with nominal devaluations that were effective — in other words, that led to reductions in real exchange rates. The fact that so many African economies have succeeded in this regard is indeed one of the sources of the CFA problem. The number of African countries that have managed to devalue and hold the line on accommodating monetary policy in the 1980s is about as great as the number of countries that have been unwilling or unable to prevent recourse to inflationary financing.<sup>27</sup>

Finally, the degree of misalignment in some of the leading economies of the zone is now so great, and the prospects of direct reduction of real costs (particularly labor) so doubtful, that it is hard to be optimistic about the chances for effective nondevaluation solutions. Similarly, the prospects for a quick turnaround in terms of trade, which would reduce pressure for cuts in absorption, are slim; falling export prices since 1985 have pushed down real incomes, and expenditures have to reflect more fully this unhappy reality. How this can be done without an inflation tax, such as is possible with devaluation, is not clear.

## HOW TO CHANGE PARITIES

If these kinds of considerations create a disposition toward devaluation, much still remains to be determined about its form and magnitude. We consider below some of the options.

### One-time Devaluation

Although not coming to terms with the problem of the different levels of real appreciation of the CFA franc among the 13 member countries, a one-time devaluation of the CFA against its reference currency, the French franc, appears to be the simplest single approach to the general overvaluation of the CFA franc.<sup>28</sup> The change in parity should be a fairly substantial one to minimize destabilizing expectations of further parity changes.

Any such parity change would have to be carefully managed through collateral policy actions to prevent offsetting internal changes in factor price levels from eroding the impact of the devaluation in real terms. This prescription, however, has to be tempered for those countries for which the CFA-wide devaluation is more than sufficient to offset the real appreciation of their currencies.

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<sup>27</sup> Gambia, Kenya, Madagascar, Malawi, Mauritius, and Mauritania are in the first camp. Ghana, Guinea, Uganda, Sierra Leone, Somalia, Sudan, Tanzania, and Zaire are in the second. But inflation rates have fallen since the late 1980s in the latter group — notably in Ghana.

<sup>28</sup> This assumes that the question of the unanimity among all member countries, including France, required for a change in parity can be resolved. It is known that there is already a considerable divergence of views on this matter among member countries of the zone.

The existing supranational currency standard inherent in currency union statutes should ease the problems because it constrains central bank accommodation of deficits and ties private sector credits to net foreign asset targets. This standard should help governments resist public-sector wage demands that would otherwise jeopardize the real impact of the nominal devaluation: for most countries of the zone, there is no way that their current budgets could accommodate new wage demands without increases in domestic borrowing, which Franc Zone statutes largely foreclose. The maintenance of strict credit limits would also help nongovernment employers in the formal sector (private and public enterprises) withstand wage demands in their sectors.

There is, however, no doubt that there would be a convulsive reaction in the public or state enterprise (nontradeable) sector, which could threaten governments and ultimately cause them to leave the zone. This is the fear of many Francophone analysts, and it is not easily answerable, although infusions of economic assistance could probably provide a palliative.

The problem may be somewhat less in those member countries — largely of the Sahel — where devaluation overshoots real appreciation. In these circumstances, monetary standards could be relaxed somewhat (for example, by temporarily raising government borrowing limits to 25 percent of the previous year's fiscal receipts or by relaxing lending restraints). Relaxing standards would permit some offset to real wage erosion without affecting the stability of the overall system.

Other approaches to devaluation suggest the use of several different exchange rates. These are briefly examined below. Unfortunately, these approaches cannot deal with the central problem of the ability of affected wage earners in the nontradeables sector to recover real wage losses.

### **Separate Exchange Rates for the Two Monetary Unions**

The simplest alternative to a single devaluation covering both zones would be to establish different exchange rates for each individual zone. This would be permissible under existing statutes — the two CFA currencies are now convertible only through the intermediary of the French franc — and should not pose difficulties in monetary or exchange rate management.

The main problem is that data are insufficient to determine which of the two CFA currencies is overvalued with respect to the other, because there is relatively little formal trade between the zones. Moreover, data suggest that the currency of Cameroon — the largest economy in the BEAC zone — is no less overvalued than that of Côte d'Ivoire, the largest economy of UMOA.<sup>29</sup>

### **A Restructuring of the Monetary Unions with Devaluation**

Many observers have noted that the Sahel region tends to finance the coastal countries. This occurs in at least two ways. First, internal capital flows within the two zones almost always flow from the Sahel to the coastal countries through zone money markets. This happens because investment in the richer countries at zone-wide interest rates is more attractive than in the Sahelian countries themselves, so that savings flow outward from the latter. Second, with the exception of Senegal, net foreign asset positions of the Sahelian countries are almost always in surplus. These surpluses are offset against the

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<sup>29</sup> Even if there were an observable difference in real appreciation levels, different rates between the two zones could work to destabilize the two currencies through impacts on expectations of economic agents.

deficits of the coastal countries in central banks' monetary programming, thereby allowing somewhat greater ease in credit limits for the larger coastal economies.

In addition, both Sahel and coastal economies are vulnerable to external shocks, but of different kinds, so that economic impacts are different. Thus the Sahel (including Senegal) is very exposed to drought (which often affects the entire Sahel region simultaneously), whereas the tree-crop agriculture commonly practiced in the coastal economies usually experiences swings in terms of trade that affect most of them together and the Sahel countries much less. Each of these phenomena justifies macroeconomic policy changes, which would not be appropriate for the (unaffected) parts of the zone. In the case of drought, some monetary or fiscal stimulation would ordinarily be called for; in the case of shifting terms of trade, stimulation would be called for in the short run and devaluation in the long run.<sup>30</sup>

One response to this situation might be the adoption of a relatively radical approach to the devaluation question: restructure the two existing zones into Sahelian and coastal regions, with a devaluation for the Sahelian currency of, say, half the amount set for the coast. This would permit a needed differentiation in monetary and fiscal policies (and lower interest rates for the Sahel as compared with the coast) and allow greater flexibility in policy responses to external shocks.

### **Pegging to the European Currency Unit**

Some commentators have suggested that the CFA franc should be pegged to the European Currency Unit (ECU) rather than to the French franc, presumably at a rate equivalent to the overall devaluation required. However, it is not clear what would be gained by this as long as separate currencies are maintained in the EC. Whereas a CFA-ECU peg would narrow fluctuations against other EC currencies and the dollar, it would do so only slightly. And it would require a substantial (and probably unacceptable) change in the management of the operations account and maintenance of convertibility, which now operates exclusively through the French franc.

Should Maastricht finally be implemented, then it would be necessary to tie the CFA franc to the ECU. This would necessitate changes in the treaties between France and the two currency unions and agreement by the EC member countries. There is no reason why convertibility of the CFA franc could not continue to be supported by the French treasury, as long as this did not give rise to significant budget deficits. At present, the issue does not seem worth losing sleep over.

### **Separate CFA Currencies**

More complicated and interesting issues are raised by analysts who argue that there is no advantage from the present monetary arrangements that cannot be improved on by the introduction of separate exchange rates, either pegged as now, or freely floating. There is a lot to be said for this position, because any devaluation it permitted could be tailored to the level of real appreciation experienced by each national economy of the zone.

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<sup>30</sup> Theoretically, separate currency zones for the Sahel and for the coastal countries would result in more nearly optimal common currency areas than under the present arrangement, because one of the major criteria for an optimal arrangement is similarity of economic structure.

Multiple rates would also permit a more flexible management of monetary policy in that monetary targets could be revised or adjusted more frequently in line with external shocks or unexpected changes in economic aggregates. If rates were freely floating, this would allow individual member countries far greater independence in deciding their own macroeconomic policies. It would probably also encourage competitive devaluations.

A. pegged rate system with 13 (potentially) separate rates, though not inherently unstable, ultimately would probably break down. We have to imagine multiple exchange rates for CFA1, CFA2, . . . CFA13, all pegged to the French franc, each with access to one of the two common overdraft (operations account) facilities ensuring its convertibility. Presumably, as the central banks' holdings of individual member countries' CFA francs accumulated beyond agreed limits, the erring member country could be called upon to tighten its monetary policies (or devalue, if flexible rates were used). Obviously, if its position were that of net creditor to the operations account, some monetary easing would be permitted.

Still assuming a fixed peg, to maintain the convertibility of each currency without a net drain on the common operations account, the central bank would be obliged to conduct six or seven individual monetary programming exercises per year instead of the single exercise it now performs. Such programming would probably be carried out by individual country units of the two central banks. Reconciliation and coordination would then be done by a central unit. Flexible rates would, of course, involve far greater complexities in central bank planning and programming.

As zonal solidarity gradually eroded with separate exchange rates and separate monetary policies, the supranational arrangements would increasingly come under question. Individual country units — even though under the direct responsibility of the governors — would be subject to increasing pressure from individual governments, and the role of the governor undermined. How long it would take for a Minister of Finance to insist successfully on doing things his government's way is a matter of speculation, but it is hard to believe that it would not ultimately happen. Although this would not necessarily portend the collapse of the system, it would surely become more and more politicized, at the very probable expense of tight monetary standards. A strong governor could probably stave off such politicization for a period, but not permanently. With politicization would come increased instability.

Another question is: what disadvantages would there be for the French in a much more complex system of separate rates? Apart from the fact that it would severely strain zonal unity and chances for a truly regional trading arrangement, it would also multiply administrative costs associated with maintaining and managing the operations account. This would be particularly serious if each individual CFA currency were convertible only into the other via the operations account, which would increase by multiples the difficulties of maintaining the arrangement. It is hard to see how it could last.

In summary, if the overvaluation question is to be addressed, it will probably have to be through a change in parity. And unless it is decided simultaneously to restructure the zone (into Sahelian and coastal regions, for example), it will be far more advisable to proceed with a single rate change and to make adjustments in monetary and fiscal policies in the countries for which a devaluation will overshoot the real appreciation of their rates.

## WINNERS AND LOSERS: THE POLITICAL ECONOMY OF REFORM

Exchange rate overvaluation in the CFA zone has benefitted the formal sector of these economies, and most particularly employment in the government and state enterprise sectors and heavily protected industrial enterprises. Yet most of the benefits of devaluation will accrue to agriculture and the informal or small-scale sector where the truly export-oriented and import-competing enterprises are found.

In agriculture, both food and export crops would become more profitable, meaning farmers in general would gain. In food production, however, the gains would go mainly to net sellers of foodstuffs; rural net buyers might be worse off if their farm and off-farm incomes fail to rise as much as real food costs.

Wage earners in agriculture would gain from a more appropriate exchange rate because an overvalued rate favors the use of production methods using imported inputs (which are relatively cheap) as against labor. Reduced intensity of import use would probably increase competitiveness and hence production.<sup>31</sup>

Demand for the goods of subsidized or protected industries of the nontradeables sector would fall off, and productive factors would far more frequently move out of these industries than into them.<sup>32</sup> New employment would be generated, but it would be at lower wage scales than those prevalent in the formal sector; at the same time, informal sector wage rates would tend to rise. Owners of capital invested in protected sectors would tend to lose as well.

In broad terms, then, it is reasonably clear who the winners and losers from a devaluation of the CFA franc will be. The economies of the member countries as a whole will gain, in that an appropriately pitched devaluation will permit a somewhat less restrictive monetary policy.<sup>33</sup> But it will be the informal or tradeables sector that gets a larger share of the growth pie. Conversely, those in the formal or nontradeable sector will clearly be the losers — on the employment side and in terms of real

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<sup>31</sup> See P. Kristjanson, M. Newman, C. Christensen, and M. Abel, "Export Competitiveness: Strategies for Sub-Saharan Africa," Abt Associates, July 1990.

<sup>32</sup> We described earlier the typical nontradeable goods and services, of which government services are the most important. For analytical purposes, nontradeables also include goods subject to high levels of protection, particularly quantitative restrictions, because these goods do not directly respond to exchange rate changes.

<sup>33</sup> These dynamic gains do not show up in static analyses, which show falling investment and GDP growth following devaluations. A simulation of devaluation impacts in Niger, apparently using a computable general equilibrium model, found that a 10 percent real devaluation led to a fall of more than half in the trade deficit. But declines in construction and in capital inflows led to a drop in GDP by .4 percent and a decline in real incomes of almost 4 percent, falling most heavily on better-off households. Real wages of skilled labor fell by more than 5 percent.

In a study of possible devaluation effects in Senegal, ground-nut growing households gain and rice consumers lose, which is no surprise. The authors are disposed to doubt the efficacy of devaluation on structuralist grounds and because of bad equity effects. They argue that price changes do not address the fundamental obstacles to increased production such as risk and interannual instability. They also worry that rising import prices (fuel, transport in general) will reduce rural access and increase price instability. (T. Reardon, V. Kelly, B. Diagona, and A. Fall, "Potential Welfare Impacts of Trade Regime Changes on Households in Senegal: Focus on Devaluation," paper presented at Seminar on West African Economic Integration, Dakar, December 4-7, 1992.)

consumption — because imports weigh more heavily for them than for other groups. For those in the nontradeable sector, the consumption basket — heavily weighted towards imports, particularly for civil servants — will rise in cost, whereas the benefits of increased growth rates will accrue to them only gradually.

But we need to go somewhat more deeply into micro-level effects to get a clearer picture. Thus, although civil servants will clearly lose in the devaluation, the presently unemployed and future entrants into the labor force should benefit as faster growth and lower real wages create new job opportunities.

Assuming that a devaluation does not lead to breakup of the monetary unions, the degree to which civil servants will be able to offset the impact of devaluation on their purchasing power by forcing wage increases is likely to be constrained by the 20 percent borrowing limit on member governments. In the major commodity exporting countries such as the Côte d'Ivoire it is possible, even likely, that some of the increase in commodity export revenues resulting from a devaluation would be allocated to meeting civil service wage demands or other financial demands.<sup>34</sup> This would, of course, work to frustrate the impact of a devaluation. Donors, and particularly France, would have to make strenuous efforts to ensure that such deviations were kept to a minimum.

Overall social effects, on balance positive, would nonetheless show some negative features. This is inevitable to the extent that absorption (aggregate expenditure) has to be cut back to accommodate to lower levels of real income resulting from changes in terms of trade. In any case, imports of food are important to many countries of the zone, and food prices will rise, reducing real consumption levels.

Even socially equitable relative income changes (such as losses by African civil servants) have a down side. It is true, as so often argued, that relatively well-paid wage employees usually support their extended families on their salaries. Income reduction would therefore mean some hardship not only for themselves, but for their extended families as well. But consumption patterns would tend to shift away from imported goods (such as rice and wheat) to local grains and other foodstuffs as well as import-substituting light manufactures, with positive effects on farmers, rural nonfarm employees and urban wage earners, and informal sector employees.

If the 20 percent borrowing limit held and governments were forestalled from diverting commodity export revenues, and if civil servants nonetheless managed (say through threats of social unrest) to force up their wage rates to compensate — in whole or in part — for their higher living costs, employment in the government sector would ultimately have to decline. Although this would create an even more privileged class of civil servants relative to the rest of the population, it could have an indirect benefit in obliging educated manpower to turn more vigorously to the private sector. There is, however, a clear danger that the 20 percent limit will be violated outright.

Although much formal sector employment outside central governments probably has to be categorized as part of the nontradeables sector as a result of government protection policies, this is not true for all such employment (in textile manufacturing, for example). In these cases, formal sector workers should benefit from a devaluation, though employment levels are more likely to rise than average wages. In any case, the shorthand conventional wisdom on these matters still holds: formal sector urban wage earners lose, and farmers (especially exporters), surplus food producers, and rural nonfarm income earners are the main winners.

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<sup>34</sup> One very real problem for governments will be the higher CFA costs of debt service.

A good deal of informal sector employment is now engaged in services, particularly retail trade. This is to say that it has to be considered a part of the nontradeables sector. It is unlikely that this category of employment will directly benefit from a devaluation. However, the informal sector should benefit from faster growth in GDP induced by a relaxation in monetary policies, and the nontrade component of the sector will benefit from expansion of import-substituting activities.

A key question remains to be addressed: Are there economic interests at work that block exchange rate reform?

The French have limited economic interest in maintaining the present parity, or indeed in holding on to the Franc Zone. By the usual measures, their stake is minimal: the CFA countries take only 1.5-2 percent of French exports, and the market is shrinking. Investment is also a small share of France's foreign investment, and recent years have seen marked declines in net capital flows, which have been negative overall. A French investment organization estimated that capital outflows amounted to more than \$800 million in 1988.<sup>35</sup> Even on the negative side, the cost of financing deficits in the operations accounts is relatively minor compared to France's aggregate aid to Africa — perhaps \$100 million a year compared to its bilateral assistance to Africa of some \$3.5 billion in 1991.

Analysts of African political economy note that the regimes in CFA countries, like those elsewhere in Africa, draw their support from civil service workers and other middle income urban groups that have close ties to the state.<sup>36</sup> To satisfy these groups, the political leadership adopts cheap food policies, which in the coastal states at least result in cheap imports.

Thus the author of one recent analysis writes that African political and intellectual leaders almost all continue to express support for the maintenance of parity, and asks why this is so.<sup>37</sup> A big part of his answer is the benefits Franc Zone elites gain from the present arrangement and their fear of the consequences of change. Parity is maintained because it benefits the urban bourgeoisie. It allows them a lifestyle symbolized by the 500,000 bottles of French champagne that Cameroon imported annually in the early 1980s.

How much of that champagne was consumed by resident expatriates or smuggled to Nigeria is difficult to know. But that aside, the argument that the political elite feathers the nest of the urban bourgeoisie who are its principal support fails to explain a great deal — too much for it to be convincing. After all, real urban salary rates have fallen substantially during the past 20 years in much of SSA, including the CFA countries. In many countries, including especially a number in the CFA zone, rural-urban terms of trade moved in favor of rural areas in the 1980s. And most important, more than half the countries of SSA, whose sociopolitical structures resemble those of the CFA countries, undertook devaluations after 1984. How do theories of urban policy bias explain that?

Other explanations of African interest in maintaining the present parity are more plausible. One is the persistent and widespread skepticism in Africa about the effectiveness of devaluation in bringing about greater competitiveness and external balance. And probably more important is the

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<sup>35</sup> Conseil des Investisseurs Français en Afrique, "Perspectives pour les entreprises Françaises," in *Géopolitique Africaine*, Avril-Mai 1988.

<sup>36</sup> See for example, van de Walle, 1991, pp. 397 ff., and the works cited there.

<sup>37</sup> van de Walle, pp. 400-401.

unwillingness of responsible officials to risk the breakup of the Franc Zone and all its direct and indirect economic advantages of membership. Most Africans, like their French partners, do not really believe that devaluation will work. They do not want to run the risks that might follow a change in parity. Most African leaders look at the hazards of unprotected small country status in a rapidly changing world, and weigh heavily the economic and political advantages their countries draw from Franc Zone membership.

So on the African side, it is the high value placed on Franc Zone membership and an associated high degree of aversion to actions that put the relationship at risk, that explain resistance to a change in parity. Most Africans oppose devaluation not because they are serving urban interests, but because they think it is a poor solution technically and because they see retention of parity as in the long-run national economic self-interest.

Yet, for the French, only minor economic interests are served by retention of parity. For them the resistance to devaluation is mainly intellectual and sentimental. Most of their analysts see it as an ineffective instrument. But they too are reluctant to launch policy changes that might destroy the Franc Zone because of their strong commitment to *Francophonie*, and their engagement to maintain a special French role in these former colonial areas. On the French side it is the head and the heart, and not the wallet, that sustain resistance to devaluation and attachment to the Franc Zone.

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**ANNEX A**  
**TABLES AND FIGURES**

Table 1. CFA Franc Zone: Structure 1/

Region and Country <u>2/</u>	population		GDP		
	millions	percent of total	billions of U.S. dollars <u>3/</u>	percent of total	U.S. Dollars per capita <u>4/</u>
<u>West Africa (B.C.E.A.O.)</u>	<u>50.9</u>	<u>68.7</u>	<u>21.4</u>	<u>52.4</u>	<u>420</u>
Bénin	4.6	6.2	1.6	3.9	350
Burkina Faso	8.8	11.9	2.5	6.0	280
Côte d'Ivoire	12.1	16.3	7.2	17.5	590
Mali <u>5/</u>	8.0	10.8	2.1	5.1	260
Niger	6.9	9.3	2.1	5.2	310
Sénégal	7.2	9.7	4.7	11.4	650
Togo	3.3	4.4	1.3	3.3	410
<u>Central Africa (B.E.A.C.)</u>	<u>23.3</u>	<u>31.3</u>	<u>19.5</u>	<u>47.6</u>	<u>840</u>
Cameroon	11.5	15.5	11.5	28.1	1000
Central African Republic	2.8	3.8	1.1	2.7	390
Chad	5.5	7.4	0.9	2.3	170
Congo	2.1	2.5	2.3	5.5	1190
Equatorial Guinea <u>6/</u>	0.3	0.4	0.1	0.3	470
Gabon	1.1	1.5	3.6	8.7	3230
Total	<u>74.2</u>	<u>100.0</u>	<u>40.9</u>	<u>100.0</u>	<u>550</u>

Source: IMF, International Financial Statistics; World Bank (1991).

1/ Members since December 26, 1945, except as noted. Data are for 1989; details may not add to totals, owing to rounding.

2/ BCEAO - Banque centrale des Etats de l'Afrique de l'Ouest; BEAC - Banque des Etats de l'Afrique centrale.

3/ Converted at 319 CFAF = US\$1, the average value for 1989.

4/ Column 5 divided by column 4, rounded to nearest ten.

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1/ Members since December 26, 1945, except as noted. Data are for 1989; details may not add to totals, owing to rounding.

2/ BCEAO - Banque centrale des Etats de l'Afrique de l'Ouest; BEAC - Banque des Etats de l'Afrique centrale.

3/ Converted at 319 CFAF - US\$1, the average value for 1989.

4/ Column 3 divided by column 1 rounded to nearest ten.

5/ left in 1962 and rejoined in 1984.

Annex A, Table 2a: A Long-Term Comparison of Performance Indicators (GDP weighted, 1970s and 1980s)/1/,/2/

	Average 1973-81 (1)	Average 1982-89 (2)	% increase Decrease (-) (2)-(1)
Average Annual Real GDP Growth Rate (Percent)			
CFA (11)	5.7	1.6	4.1
UMOA (7)	4.0	1.4	2.6
BEAC (4)	8.2	2.0	-6.2
Others			
SSA (18)	2.8	1.3	-1.5
LIDC (25)	5.5	6.2	0.7
Average Annual Growth Rate of Real Exports (percent)			
CFA	7.0	-0.4	-7.4
UMOA	5.1	0.0	-5.1
BEAC	9.9	-1.0	-10.9
Others			
SSA	1.2	2.5	1.3
LIDC	7.6	8.9	1.3
Investment/GDP Ratio (Constant Prices)			
CFA	28.5	21.4	-7.1
UMOA	25.5	16.3	-9.0
BEAC	33.0	29.1	-3.9
Others			
SSA	28.0	15.7	-12.3
LIDC	25.7	27.1	1.4
Domestic Savings/ GDP Ratio (Constant Prices)			
CFA	23.0	20.5	-2.5
UMOA	16.5	11.6	-4.9
BEAC	32.9	34.1	1.2
Others			
SSA	20.9	11.7	-9.2
LIDC	17.9	15.2	-2.7
External Debt/ GDP Ratio (Current Prices) /a/			
CFA	35.9 (9.9)	71.9 (24.2)	36.0 (14.3)
UMOA	35.6 (10.3)	92.0 (27.6)	56.4 (17.3)
BEAC	36.2 (9.5)	51.8 (20.9)	15.6 (11.4)
Others			
SSA	15.0 (11.4)	58.3 (29.7)	43.3 (18.3)
LIDC	16.3 (21.1)	28.9 (33.9)	12.6 (12.8)

Source: Elbadaw and Majd, Jan 1992

Notes: (1) Number of countries in Parenthesis, (2) Missing data for some countries for some years. /a/ debt service ratios in Parenthesis.

Annex A, Table 2b: A Long-Term Comparison of Policy Indicators  
(GDP weighted, 1970s and 1980s)/1/,/2/

	Average 1973-81 (1)	Average 1982-89 (2)	% increase Decrease (-) (2)-(1)
Resource Balance as Percentage of GDP (Percent)			
CFA (11)	-4.2	-1.0	3.2
UMOA (7)	-6.6	-3.7	2.9
BEAC (4)	-0.4	3.1	3.5
Others			
SSA (18)	0.2	-1.3	-1.5
LIDC (25)	-1.7	-2.1	-0.4
Domestic Credit Expansion (Percent)			
CFA	26.7	7.6	-19.1
UMOA	28.4	3.4	-25.0
BEAC	25.1	11.8	-12.7
Others			
SSA	11.5	24.0	35.5
LIDC	31.0	37.7	6.7
Government Deficit GDP Ratio (Percent)			
CFA	5.2	6.2	1.0
UMOA	8.0	7.1	-0.9
BEAC	2.4	5.4	3.0
Others			
SSA	5.5	6.9	1.4
LIDC	3.2	4.5	1.3
Median of Annual Inflation (Percent)			
CFA	11.6	4.1	-7.5
UMOA	11.1	3.8	-7.3
BEAC	11.7	5.7	-6.0
Others			
SSA	14.0	17.3	3.3
LIDC	13.5	12.3	-1.2
Real Effective Exchange Rate (1980=100)/a/			
CFA	93.4 (8.5)	92.4 (7.7)	-1.1 (-0.8)
UMOA	94.8 (8.2)	88.5 (8.8)	-6.6 (0.6)
BEAC	92.1 (8.8)	96.3 (6.6)	4.6 (-2.2)
Others			
SSA	96.8 (15.7)	107.0 (28.9)	10.5 (13.2)
LIDC	108.4 (11.3)	104.8 (17.8)	-3.3 (6.5)

Source: Elbadaw and Majd, Jan 1992

Notes: (1) Number of countries in Parenthesis, (2) Missing data for some countries for some years. /a/ debt service ratios in Parenthesis.

Annex A, Table 3: A comparison Between the 1970s and the 1980s

	1973-81	1982-89
Average Annual Real GDP Growth Rate (Percent)		
CFA (11)	3.7	2.6
Other		
SSA (20)	2.7	2.0
Low Income (41)	4.4	2.9
Primary (52)	4.6	3.9
Real total Investment/Real GDP		
CFA	24.3	18.9
Other		
SSA	20.3	17.8
Low Income	21.6	19.8
Primary	22.5	19.4
Debt/GDP (Debt Service/Exports in Parenthesis)		
CFA	30.6 (7.7)	62.5 (19.2)
Other		
SSA	28.6 (9.7)	70.5 (20.9)
Low Income	26.0 (13.0)	58.4 (22.3)
Primary	24.9 (15.1)	56.4 (25.2)
Average Annual Inflation		
CFA	12.0	4.3
Other		
SSA	24.3	29.7
Low Income	18.4	33.3
Primary	24.4	44.9
Real Exchange Rate (1980=100)		
CFA	107.0	108.0
Other		
SSA	115.0	147.0
Low Income	103.0	121.0
Primary	103.0	119.0
Average Annual Export Growth Rate		
CFA	6.8	1.5
Other		
SSA	1.9	2.6
Low Income	4.9	5.0
Primary	4.8	7.6

Note: Unweighted averages. Number of Countries in Parenthesis.  
Source: Devarajan and de Melo, 1990

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Annex A, Table 4: A Closer Look at the 1980s

	1982-85	1986-89
Average Annual Real GDP Growth Rate (Percent)		
CFA (11)	3.5	1.8
Other		
SSA (20)	1.0	3.0
Low Income (41)	2.4	3.4
Primary (52)	4.8	2.9
Real total Investment/Real GDP		
CFA	21.3	16.6
Other		
SSA	18.4	17.1
Low Income	20.7	18.8
Primary	20.6	18.2
Debt/GDP (Debt Service/Exports in Parenthesis)		
CFA	58.0 (16.1)	67.1 (21.5)
Other		
SSA	57.1 (17.1)	83.5 (24.9)
Low Income	49.3 (19.5)	67.6 (25.0)
Primary	47.1 (22.4)	65.9 (27.9)
Average Annual Inflation		
CFA	8.6	1.0
Other		
SSA	26.2	35.7
Low Income	19.5	50.4
Primary	28.9	64.6
Real Exchange Rate (1980=100)		
CFA	115.0	100.0
Other		
SSA	124.0	177.0
Low Income	109.0	136.0
Primary	106.0	136.0
Average Annual Export Growth Rate		
CFA	3.0	0.1
Other		
SSA	0.1	5.0
Low Income	1.2	8.8
Primary	7.6	7.7

Note: Unweighted averages. Number of Countries in Parenthesis.

Source: Devarajan and de Malo, 1990

Annex A, Table 5: A Short-Term Comparison of Performance Indicators  
(GDP weighted, 1982-85 and 1986-89)/1/,/2/

	Average 1982-85 (1)	Average 1986-89 (2)	% increase Decrease (-) (2)-(1)
Average Annual Real GDP Growth Rate (Percent)			
CFA (11)	2.9	0.4	-2.5
UMOA (7)	1.1	1.7	0.6
BEAC (4)	5.6	-1.7	-7.3
Others			
SSA (18)	-0.2	2.8	3.0
LIDC (25)	6.4	5.9	-0.5
Average Annual Growth Rate of Real Exports (percent)			
CFA	3.4	-4.4	-7.8
UMOA	0.0	-0.01	0.0
BEAC	8.6	-11.0	-19.6
Others			
SSA	0.5	4.4	3.8
LIDC	6.4	12.3	6.7
Investment/GDP Ratio (Constant Prices)			
CFA	24.7	17.7	-7.0
UMOA	17.9	14.6	-3.3
BEAC	35.1	22.4	-12.7
Others			
SSA	17.7	13.7	-4.0
LIDC	26.7	27.3	0.6
Domestic Savings/ GDP Ratio (Constant Prices)			
CFA	25.6	14.4	-11.2
UMOA	11.7	11.4	-0.3
BEAC	46.9	18.9	-28.0
Others			
SSA	10.9	12.4	1.5
LIDC	24.0	25.0	1.0
External Debt/ GDP Ratio (Current Prices) /a/			
CFA	64.7 (20.6)	81.1 (27.8)	16.4 (7.2)
UMOA	90.1 (33.3)	94.0 (41.6)	3.9 (8.3)
BEAC	41.8 (17.2)	61.8 (26.2)	20.0 (9.0)
Others			
SSA	32.8 (26.6)	84.0 (35.1)	51.2 (8.5)
LIDC	25.3 (23.0)	32.4 (27.6)	7.1 (4.6)

Source: Elbadaw and Majd, Jan 1992

Notes: (1) Number of countries in Parenthesis, (2) Missing data for some countries for some years. /a/ debt service ratios in Parenthesis.

## Annex A Table 6

Changes in World Prices of Selected Commodities, 1980-90  
 (Percentage Changes in U.S. Dollar Prices)

	1980-85	1985-90	1980-90
Uranium 1/	-40	-38	-63
Cocoa beans	-13	-44	-51
Palm oil	-14	-42	-50
Coffee	-6	-39	-42
Gold	-48	+21	-37
Petroleum 2/	-3	-18	-20
Fishmeal	-44	+47	-18
Phosphate rock	-27	+19	-13
Cotton	-28	+20	-13
Beef	-22	+19	-7
Logs	-30	+55	+7

Source: Boughton, 1991

1/ Data for Uranium are from Commodity Research Bureau (1990), updated to 1990 on the basis of the uranium component of the U.S. producer price index.

2/ Petroleum data from 1985 are an average price of crude in world trade; earlier data are Saudi Arabian export prices.

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## Labor Costs in Manufacturing and Per Capita GNP

Country	Average Labor cost per worker	
	CFAF (1,000s per month)	As a multiple of GNP per Capita
Côte d'Ivoire	149	5.9
Senegal	136	8.7
Morocco	87	4.3
Malaysia	85	1.3
Tunisia	80	2.0
Mauritius	50	1.2
Ghana	38	2.8
Indonesia	29	1.7
U.S.A.	784	1.7

Cost of labor to enterprises (including both salary payments and charges paid by employers) derived from national data. Per capita GNP for 1986 derived from the 1988 World Development report. The US figures refer to 1987; they were provided by the US bureau of Labor Statistics.

## Annex A Table 8

## GDP Per Capita and Cost of Civil Servants, 1987

Country or average for Country Group	GDP per capita yearly	Cost of civil Servants /a	
		monthly (CFAF thousands)	as multiple of per capita GDP
Senegal	202	152	9
Average, 3 CFA countries Burkina Faso, Chad, Mali, Niger, Togo, Benin, Senegal, Côte d'Ivoire	135	133	10
Average, 6 non-CFA countries Zaire, The Gambia, Guinea, Ghana, Mauritania, Morocco	124	35	3
Malaysia	543	140	3
Industrialized Countries (France 1989)	4795	503	1.3
U.S.A.	5460	641	1.4

Source: National Statistics

/a Government expenditure on civil service divided by number of civil servants.

**Annex A Table 9**  
**Real Minimum Wages**

	Percentage Changes			
	1970-80	1980-85	1985-89	1980-89
Benin	-47.0%	-5.8%	-8.8%	-14.1%
Burkina	27.3%	-11.1%	8.0%	-4.0%
Cameroon 1/	-28.6%			
Central African Republic	-28.2%	-40.6%	-9.0%	-46.0%
Chad	-11.8%	-28.3%	11.4%	-20.1%
Côte d'Ivoire	-4.0%	-16.2%	5.9%	-11.3%
Ghana	-68.5%	64.4%	-27.3%	19.6%
Kenya 2/	4.3%	-33.5%	0.4%	-33.2%
Mali	-6.9%	8.3%	29.1%	39.8%
Mauritania 3/	6.9%	-35.5%	-17.1%	-46.5%
Niger	34.4%	8.3%	4.4%	-20.0%
Senegal	18.6%	-35.6%	-12.6%	-23.1%
Tanzania	-14.0%	-38.5%	-5.4%	-41.9%
Togo	-18.0%	-24.8%	-4.9%	-28.5%
AVERAGE	-9.7%	-15.1%	-2.0%	-17.6%

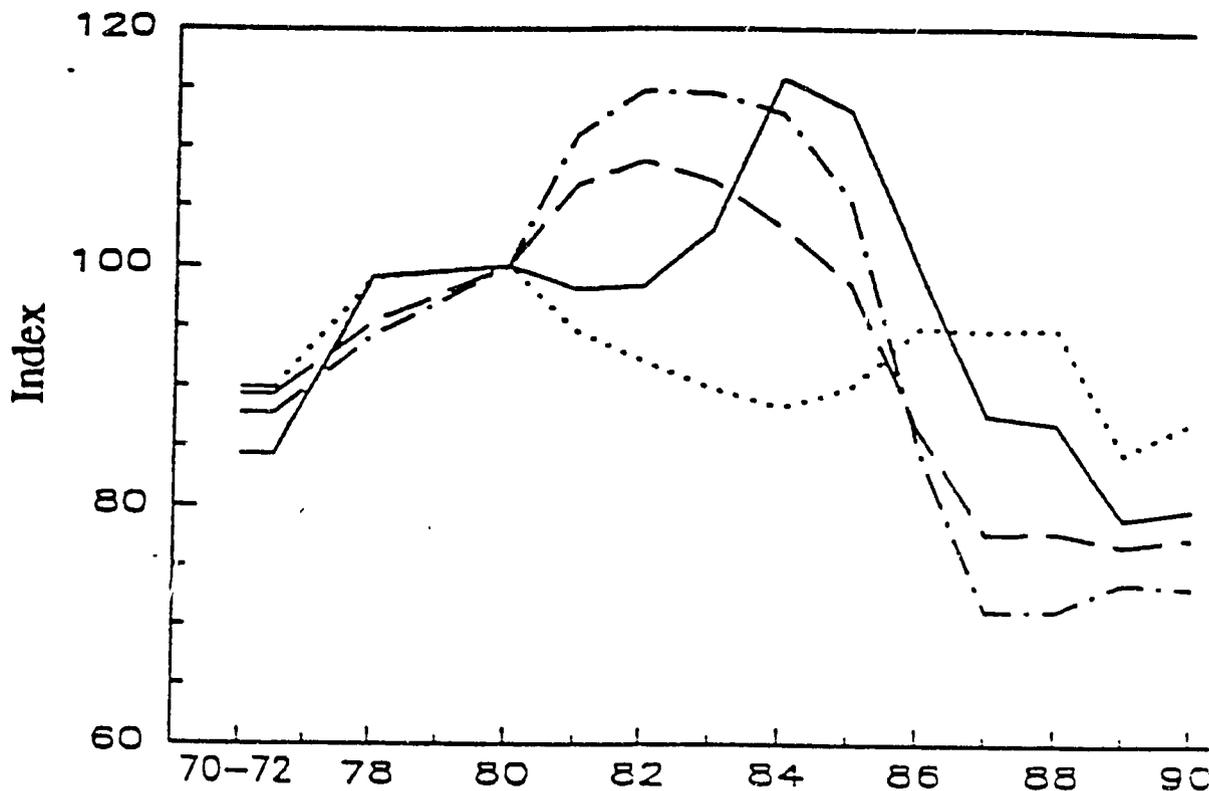
1/ 1970-80 figure is for 1970-79.

2/ 1970-80 figure is for 1972-1980. 1985-89 and 1980-89 figures for periods ending in 1988.

3/ 1970-80 figure is for 1970-78; 1980-85 figure is for 1978-86; 1985-89 figure is for 1986-89; 1980-89 figure is for 1978-89.

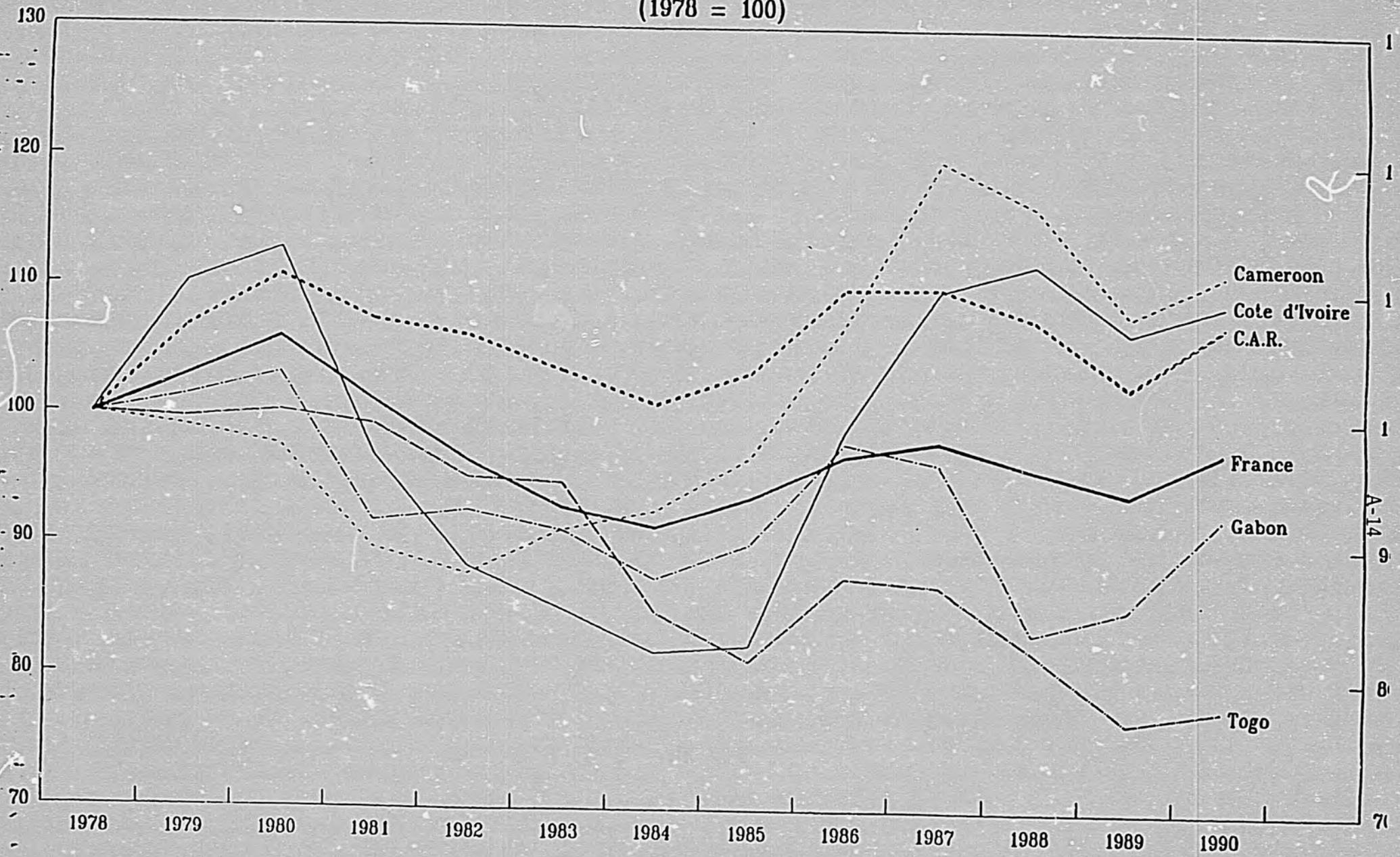
Source: Berg, E; Langan, T and Hunter, G, "The Social Costs of Adjustment: Evidence from Latin America and Africa. DAI 1993.

Figure 1



- Oil Exporting
- - Non-oil Exporting
- ..... CFA
- . - Non-CFA

Note: 1972-78 extrapolated. Figure for 1990 based on March value. The countries represented in figure are Botswana, Burkina Faso, Burundi, Cameroon, Central African Republic, Congo, Côte D'Ivoire, Ethiopia, Gabon, Gambia, Ghana, Kenya, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Niger, Nigeria, Senegal, Sierra Leone, Somalia, Sudan, Swaziland, Tanzania, Togo, Uganda, Zambia, and Zimbabwe.



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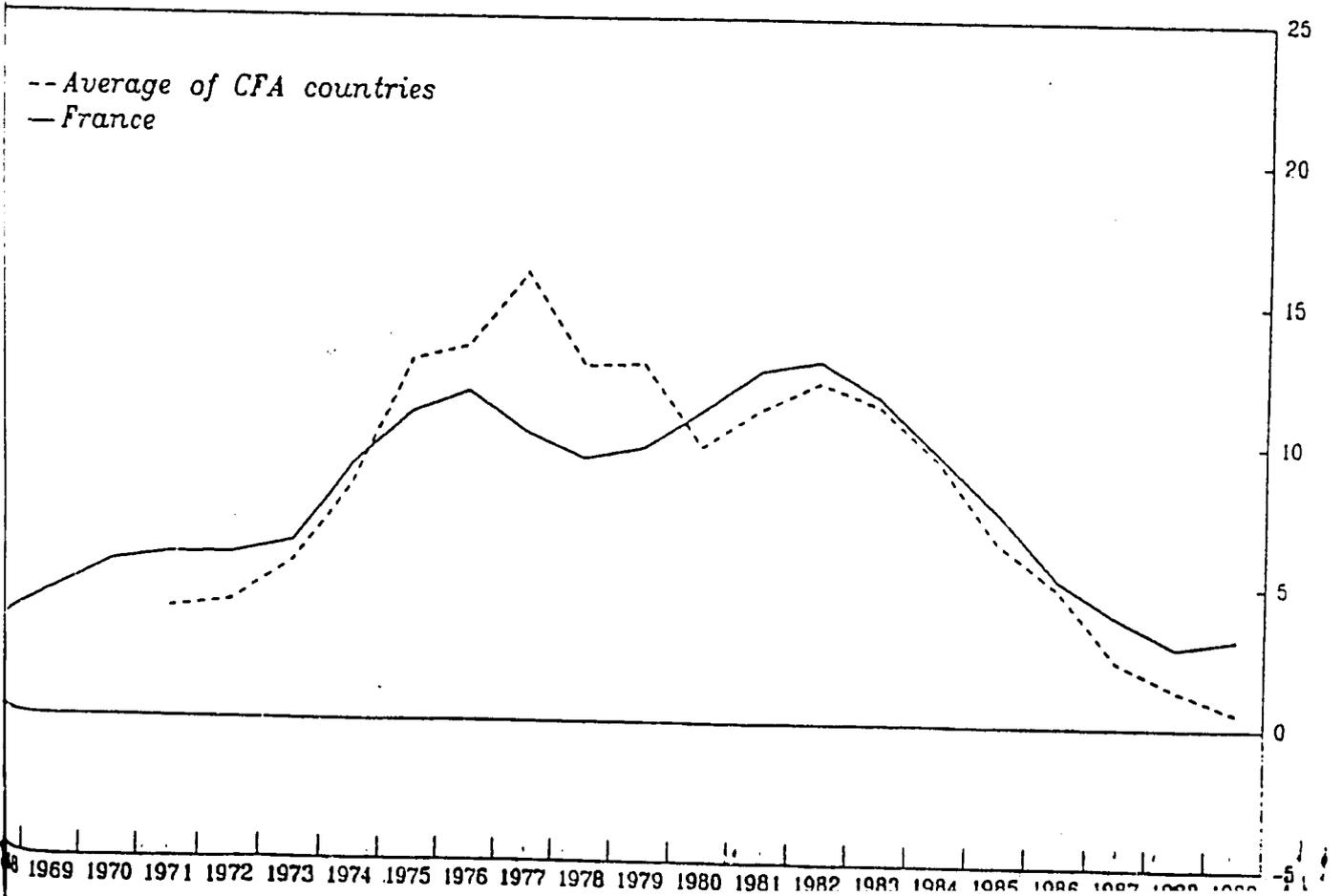
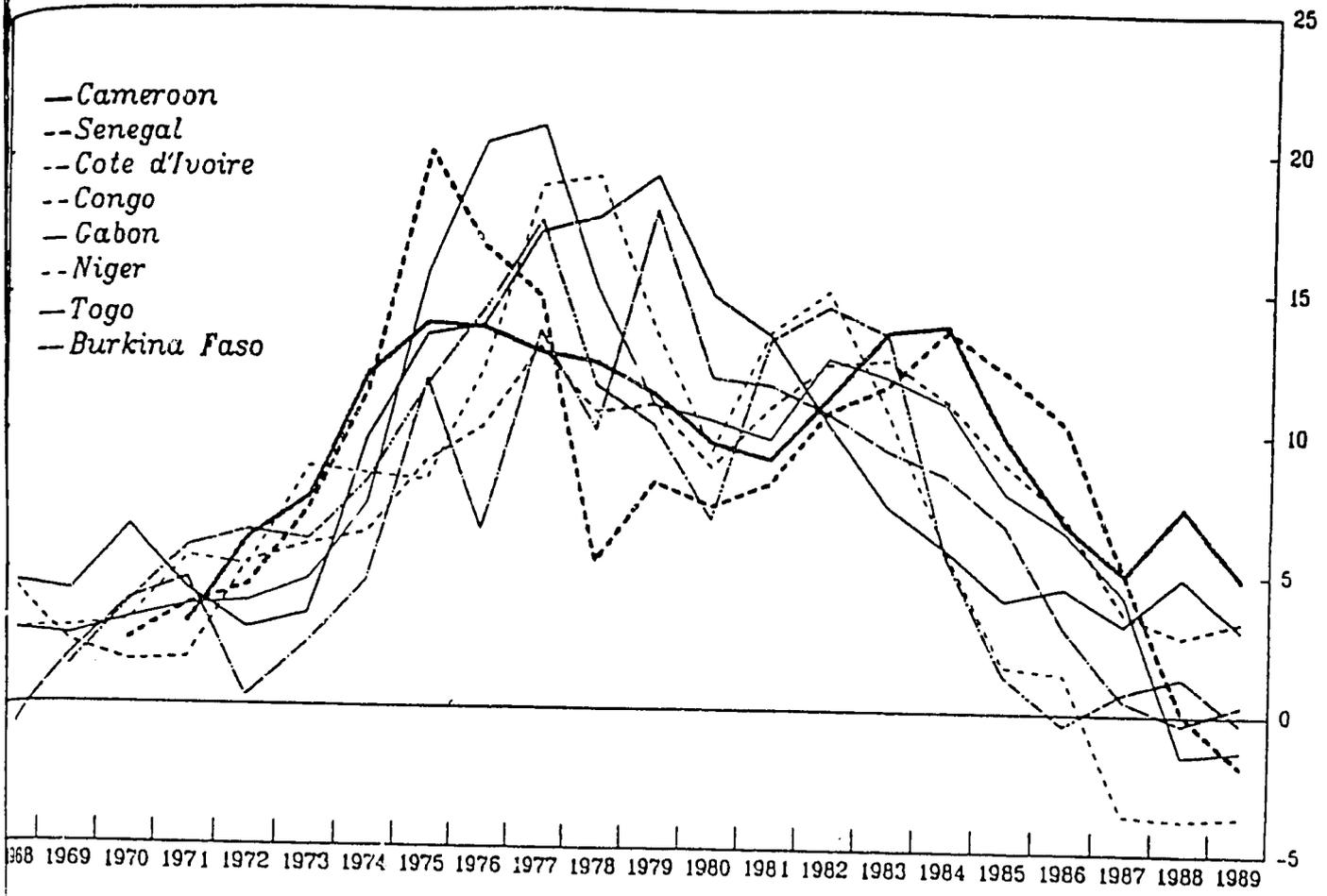
A-14  
9

8

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100

(3-Year Moving Averages)  
A-15



**ANNEX B**  
**THE FRANC ZONE**  
**INSTITUTIONS AND OPERATIONS**

## THE FRANC ZONE INSTITUTIONS AND OPERATIONS

Given the complexity of the structure, operations, and problems of the Franc Zone, it is essential in thinking about monetary policy in the region to have some understanding of what it is and how it works.

Although the CFA Franc Zone is normally referred to as a single entity, this is not altogether the case, despite the fact that all member countries employ a single currency with a uniform exchange rate, fixed against the French franc. The CFA zone in fact consists of two separate unions, each with its own central bank, operating rules, and separate CFA franc, both having the common exchange rate of CFAF 50 to the French franc. Although the essential features of the two unions are very similar, the currency of each is separately supported and underwritten by the French treasury via the so-called operations account (compte d'opérations). All exchanges among the two Franc Zone currencies and the French franc are carried out commission free.

The two monetary unions are, respectively, the West African Monetary Union (UMOA) and the countries of the (central) Bank of the Central African States (BEAC), generally known as the BEAC zone. The members of UMOA are Benin, Burkina Faso, Côte d'Ivoire, Mali, Niger, Senegal, and Togo; those of the BEAC zone are Cameroon, Chad, the Central African Republic, Congo, Equatorial Guinea, and Gabon.

The CFA zone is a carryover of the tightly knit system that regulated the financial relationships between France and its African colonies until their independence. Some original members (Mauritania, Guinea) opted out at independence, and Mali withdrew at independence, only to rejoin the Franc Zone in 1967 and UMOA in 1984; Madagascar stayed with the French franc until 1973, and Equatorial Guinea, a former Spanish colony, joined in 1985. Otherwise the zone's membership, whose total population is roughly 70 million, has not substantially changed since the early 1960s.

The French franc/CFA parity has remained unchanged at 1 to 50 since 1948 despite substantial differences in the evolution in the economies of the zone since then. This includes major shifts in the terms of trade of primary producers, particularly of the two major oil exporters, Cameroon and Gabon, whose fluctuating oil revenues have heavily influenced the global results of the BEAC zone. But terms of trade and overall export markets have evolved quite differently in the non-oil-producing countries as well.

Countries of relatively high incomes as well as some of the poorest countries in the world are members of the two monetary unions. Thus the BEAC zone, for example, includes both Chad and Gabon, whose per capita GDP is 15 times that of Chad. Like Chad, the poorest countries of both zones are landlocked countries of the Sahel, whereas the coastal countries are, for the most part, much better off. Unfortunately, the relative financial integration characterizing the CFA zones (less than their institutional structures might imply) does not work to transmit wealth among countries, whose ties for the most part are stronger with France than with one another. Financial savings, however, tend to flow from the poorest countries of the Sahelian periphery to the better-off coastal countries.

Both unions of the CFA zone incorporate features essential for monetary integration. First is the freely convertible common currency (both for current account and capital account transactions). The convertibility of the CFA franc against the French franc at the fixed rate is supported by the operations account. This is basically an overdraft facility that absorbs any excess supply of CFA francs on foreign exchange markets at the existing exchange rate, thereby guaranteeing its convertibility. Next come a number of operating rules designed to ensure that credit creation and aggregate demand within each monetary union are maintained at levels consistent with exchange rate stability and minimum net use of the operations account facility.

To keep the operations account position within acceptable limits, the level of net foreign assets (for each zone) is taken as the principal policy target of the operations of each central bank. The net foreign asset position is essentially controlled through strict limits on rediscounts of private sector borrowing and advances to governments.

If credit creation through these channels results in a level of money supply in excess of domestic requirements as determined by expected nominal growth in GDP<sup>1/</sup>, the unneeded liquidity spills into the balance of payments and leads to a reduction in net foreign assets (or a greater level of indebtedness on the operations account). On the other hand, if credit creation is less than the liquidity required to sustain domestic growth, money flows in and the net foreign asset position improves.

This model follows the typical evolution of a country's exchanges in a situation of fixed exchange rates and free convertibility: the central bank has no independent control over the money supply. This is shown by the relationship:

Total credit creation + increase in net foreign assets = growth in the money supply.

A major feature of the CFA zone is that the net foreign asset position is zealously guarded through statutory procedures, even if growth suffers as a result.

In line with its statutory procedures, each central bank sets global credit ceilings that are consistent with the forecasts of nominal GDP growth rates for the individual countries. Forecast requirements are translated into annual ceilings for central bank rediscounting of private sector credit for each member country. <sup>1/</sup>

Before shares in country rediscount ceilings are apportioned to the individual commercial banks in each country, provision is made for the statutorily agreed central bank lending to member country treasuries. Each year, each member country is permitted to borrow up to 20 percent of the previous year's fiscal revenues from the central bank. This will generate an increase in central bank advances to member governments that is equal to the increase in fiscal revenues in good times. However, if government revenues should fall — say as a result of a decline in GDP — the government will be obliged to reduce its indebtedness to the central bank by the amount in excess of the

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<sup>1/</sup> Central bank rediscounts of private sector credit are identical in their impact on the money supply to central bank purchases of government bonds (or in the case of the Franc zone, advances to the governments, which rarely issue debt securities). High-powered money is created in both circumstances, and produces, through the multiplier effect, an increase in the money supply of several multiples of the original central bank liability created on its books through the rediscount or advance.

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statutory limits. Because this means that government expenditures will have to fall even more than the fall in revenues, this feature of the system can have uncomfortable countercyclical effects.

Until 1980 (in UMOA) the central banks controlled the evolution of bank credit solely through rediscount operations. Banks were assigned rediscount limits roughly in proportion to their size and perceived needs for liquidity. <sup>2/</sup> Such rediscount operations — assuming they were properly planned and carried out — should have sufficed to achieve the net foreign asset target, assuming no slippages elsewhere. However, in 1990, largely at the insistence of the IMF, lending ceilings were introduced on an individual bank-by-bank basis to make doubly sure that balance of payments and foreign asset targets were achieved. Ceilings cause the monetary programming system to be overdetermined, add administrative complications (and restrict the activities of the commercial banks), and needlessly limit competition. Restrictions relative to bank lending ceilings, however, apply with far greater force in UMOA than in the BEAC zone. Although such bank ceilings are used in the latter zone with much less regularity than in UMOA, restrictions on assets that can be presented to the central bank for rediscounting are far more constraining in the BEAC zone than in UMOA.

Once annual global credit ceilings are established in each of the two unions, there is no mechanism to adjust them or to reallocate them among member countries to meet external shocks. The same lack of flexibility applies to rediscount ceilings. Therefore, under the present system it is virtually impossible to offset unexpected fluctuations in the terms of trade or other external shocks such as droughts. This fact must be seen as a drawback to the Franc Zone system.

The UMOA zone has a high degree of uniformity in its operating rules across member countries — the BEAC countries somewhat less so — but this has not ensured true integration within the zones (and still less between them). This is the case for the most part because the financial systems consist almost entirely of commercial banks whose major financial transactions outside of deposit taking and lending are with home offices, the majority in Paris. Although there is a zone-wide money market (marché monétaire) in UMOA — none exists in the BEAC zone — it is essentially a facility intermediated by the central bank of UMOA (BCEAO: Central Bank of the West African States), which guarantees its operations. It is not, however, a true money market in that reserves are not bought and sold through transactions between individual banks, but are pooled and redistributed according to BCEAO's rediscount and credit ceilings, which are not market driven.

There is an interbank market, but it is regulated in a way that makes it relatively uninteresting, even for trade between healthy banks. No direct transactions are permitted between branches of the same parent banks across country lines.

Although there are thus fairly considerable constraints to true financial integration, particularly as found in a developed currency union such as the United States, capital does, ironically, tend to flow from the poorer, landlocked countries of the zone to the richer countries of the coast. Particularly for UMOA, interest-rate structures in the formal financial sectors are identical, guaranteed by a common rediscount rate, largely common deposit and lending rates, and common margins. Thus little competition is found, and rate setting is such that lending from deposit resources

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<sup>2/</sup> This terminology has been applied by the central banks. What it means in practical terms is that banks having less luck in competing for deposits often were provided with greater rediscount facilities. The level of rediscounts banks could expect, however, was not communicated to them.

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is little more attractive than lending from central bank-sourced funds. Although some variations are permitted among final lending rates in the BEAC zone, these variations tend to be relatively unimportant.

For many years each zone maintained lower lending rates to privileged sectors such as housing, agriculture, and small-scale industry. These rates were supported by preferential rediscount rates from the central banks. As in other countries, these lending rates tended not to work very well, and were finally abolished in a general set of liberalizing reforms in the UMOA in late 1989. The lending rates were, however, maintained in the BEAC zone.

As indicated above, rigorous monetary programming, backed up by rediscount and lending ceilings, was applied as a means of protecting the net foreign asset (operating account) positions of the zones. These rules and procedures were, however, not altogether successful in maintaining the degree of monetary restraint that was mandated by the UMOA and BEAC zone statutes.

Two major areas of slippage were (1) financing of crop credits and (2) the virtually automatic rediscounting of (government-guaranteed) loans to public enterprises regardless of their financial health, which was usually precarious. With respect to crop credits, loans granted by the commercial and development banks — ordinarily under considerable pressure from the governments — to finance the marketing operations of export crops such as groundnuts, coffee, and cocoa — often had disastrous consequences for the banks. This was the case for two reasons, one of which has directly to do with the overvaluation of the CFA franc. <sup>3/</sup>

Since about 1985 the domestic production of these crops has been uneconomic, given weak world prices reflecting a roughly 40 percent decline in terms of trade (for Côte d'Ivoire) and the sharp appreciation of the CFA franc against the dollar. However, zone financial institutions were nevertheless obliged to lend to provide crop marketing credits where the underlying unit price levels were far higher than export prices, so that at the end of the marketing cycle the loans could not be entirely paid off. Thus the banks were in effect obliged to subsidize these export crops. These marketing credits — government guaranteed — which were ordinarily expected to be unwound at the end of the marketing season, were not counted against credit or rediscount ceilings for the year in which they were granted. This situation initially led to a great deal of monetary slippage, despite the fact that unwound credits were carried over and counted against credit ceilings for the following year. The slippages continued because, with continually appreciating exchange rates, the amounts of unwound credits continued to grow.

A second aspect of the problem was that because of the preferential interest rates applied to the financing of export crop marketing credits, demand for these credits was in excess of requirements for crop collection, because the processing and marketing organizations found them cheap enough to on-lend to other investors outside the crop marketing circuit. Despite these kinds of leakages, these credits were guaranteed by the governments as socially desirable. However, they were rarely entirely unwound, with the unpaid amounts remaining on the books of commercial and development banks at uneconomic interest rates, because governments could rarely afford to repay them. This caused great financial distress (and frequently bankruptcy) of the financial institutions and was one of the main reasons for the virtual collapse of several banking systems in the CFA zone.

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<sup>3/</sup> These credits were not production credits, but simply financed the activities of collection and processing entities.

The reforms of 1989 sharply curtailed this source of slippage in the UMOA countries, but no such reforms were undertaken in the BEAC countries. The UMOA reforms are nonetheless illustrative of the management of the CFA zone in a situation of overvaluation: the subsidies to the marketing sector and to the producers of primary crops (which would have been largely unnecessary had the exchange rate been at a correct parity) were largely absorbed under the credit ceilings, but this meant that making such subsidy payments — whose source lay in the overvaluation of the CFA franc — led to increased credit restraints (and reduced GDP growth) for the rest of the economies. However, the agricultural sector was no better off than it would have been with the right exchange rate.

State enterprise borrowing, which has been classically guaranteed by CFA zone governments and granted favorable rediscount facilities from the central banks, provides another illustration of the way in which the CFA zone operates. These guaranteed credits, which come under the bank credit ceilings, preempted other forms of non-guaranteed credit and were generally unproductive for reasons that are widely understood and need no explanation here. But with their special status, these credits replaced productive ones ordinarily associated with economic growth. Where there was a mandated need to apply sharply restrictive ceilings on credit to maintain net foreign asset positions, this necessarily exacerbated constraints on economic growth. Some attempt at reversing this tendency to favor public enterprise credits was made in the UMOA during the 1989 reforms, but success has been mixed.

Flexibility in monetary programming is increased from another direction. Because the system targets net foreign assets, expected net inflows from foreign assistance, direct investment, or commercial bank borrowing allow for some relaxation in the programming; credit expansion (including government spending) can be freely financed out of these resources under central bank statutes. Such resources were freely available until the mid-1980s, when they began to dry up. Unfortunately, there were major problems associated with these borrowings: they allowed real CFA rates to appreciate without much pain; and they financed an average zone-wide growth rate of about 2.5 percent, at average interest rates considerably in excess of that figure. Although wide differences are hidden in these aggregates, net debt repayments combined with overvaluation will eventually force very sharp restraints in domestic credit, and ultimately in growth.