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## Overview

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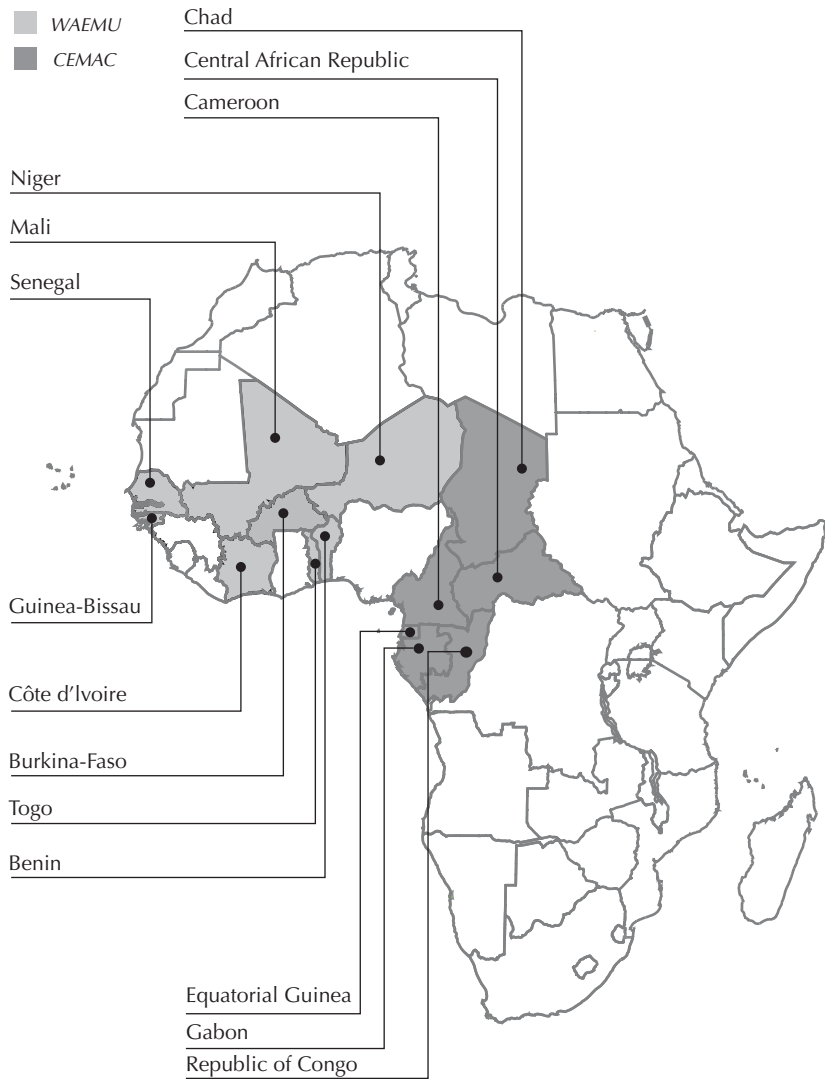
Most independent states have their own national currencies. Worldwide, only four groups of countries issue a common currency and conduct joint monetary policy.<sup>1</sup> With so few countries belonging to a monetary union, conducting monetary and related macroeconomic policies in a common currency area does pose “uncommon” challenges. Two of the four monetary unions are in Africa: the Central African Economic and Monetary Community (CEMAC) and the West African Economic and Monetary Union (WAEMU) (Figure 1.1). While CEMAC and WAEMU each have their own distinct currency, they are closely linked: both unions peg their currencies to the euro at the same level, they share certain institutional features, and they are commonly referred to as the CFA franc zone.<sup>2</sup>

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<sup>1</sup>Monetary unions are characterized by a common central bank, which issues a regional currency. The four monetary unions are CEMAC, WAEMU, the euro area, and the Eastern Caribbean Currency Union (ECCU). “Dollarization” is a related but different monetary arrangement in which a country adopts the currency of another country. In that case, however, monetary policy is conducted solely by the issuing country, and there are no common monetary institutions (examples are Panama, Ecuador, and Honduras, which use the U.S. dollar). Finally in the rand monetary area in Southern Africa several countries peg their currencies to the South African rand and also accept it within their borders as legal tender. But there is no common central bank and no common monetary policy.

<sup>2</sup>In addition to France, WAEMU, and CEMAC, the “franc zone” also includes the Comoros. In 1979, the government of the Comoros signed a monetary cooperation agreement with France, making the Comoros part of the *franc zone* but not part of the *CFA franc zone*. The exchange rate of the Comorian franc to the French franc (now euro) has also since 1994 differed from that for the CFA franc. The Comoros are therefore not part of the discussions in this book.

**Figure 1.1. The Central and West African Monetary Unions**



This book examines the CFA franc zone's unique features and experiences and assesses the policy challenges it currently faces. One of the more notable characteristics of the zone is the longevity of the fixed exchange rate regime, which has been among the most stable of such arrangements worldwide. Even abstracting from the related precursors, the current system

has been in place for nearly 60 years.<sup>3</sup> A related feature has been the stability in the level of the peg, which was changed only once, in January 1994.

The exchange rate system and the common monetary institutions have been credited with helping the zone for many years—especially in the 1970s and 1980s and again after the exchange rate adjustment of 1994—to achieve lower inflation and more macroeconomic stability than other countries in sub-Saharan Africa. The CFA arrangement has also been linked to stronger institutions and more policy transparency. Yet, some analysts have also suggested that the arrangement has important drawbacks, given sharp shifts in the terms of trade in the regions.

With increasing financial globalization, volatile oil and raw materials prices, and some difficult regional security problems, the CFA franc arrangement now confronts deep challenges. Among them are, for example, the prolonged real appreciation of the currency brought about by the movement of the euro against the U.S. dollar, and significant changes in export prices for the two unions. All but one of CEMAC's members are oil exporters, with production and price increases reflected in sizable oil booms in some countries; in contrast, there have been sharp declines in world prices for cotton, the main export of some WAEMU countries. Both unions also face the costs and disruptions of regional conflict and the related political and socioeconomic instability in some of their members.

Against this background, the studies in this volume examine how policies need to be conducted to retain the stability benefits CFA franc countries have enjoyed in the past but also to afford sufficient flexibility for growth-oriented strategies that respond to domestic, regional, and global developments. A common theme in the essays is competitiveness, specifically, whether the gains of the 1994 devaluation have been preserved and how competitiveness can be ensured in the future. The debate touches on macroeconomic and structural determinants of competitiveness, and, where appropriate, on institutional settings that are needed to ensure appropriate adjustment.

There is considerable consistency among the findings of the authors, which is also supported by the conclusions of the IMF's surveillance work for both regions: the consensus seems to be that the arrangement has benefited the area in the past, but a number of reforms and more consistency between regional and national policies are needed to retain or regain and strengthen these benefits.

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<sup>3</sup>First under the French Union that regrouped France's former colonies after the World War II and, since the late 1950s/early 1960s, as the monetary system of the newly independent member countries.

The discussion in this book may also offer lessons that go beyond the narrow confines of the CFA franc countries. There is now significant interest in the formation of new monetary unions, in Africa and elsewhere, as well as discussion of the pros and cons of new members joining existing groupings.<sup>4</sup> For these ventures the experiences and challenges of the CFA franc zone can serve both as a model and as a reminder of the policy requirements and the importance of flexibility in goods and factor markets if full benefits are to be drawn from a common currency.

## The CFA Franc Setting

This section explains important features of the—sometimes complex—institutional arrangements of the CFA franc zone, describes the main economic issues, and discusses common policies in the region and the policy experience related to the operation of the exchange rate arrangement.

### Institutional Background

The CFA franc zone arrangements are umbrella agreements between France and two monetary unions in Africa, CEMAC and WAEMU. The origins of the arrangement date back to colonial monetary systems (Box 1.1) but have since evolved and include also two members that were not former French colonies. Each zone has a separate treaty with France and its own currency and regional institutions, anchored by each zone's central bank. There are biannual meetings of the CFA franc zone between CEMAC and WAEMU on the one side and France on the other. These meetings review economic performance in both zones and decide on major institutional designs to be implemented in both groups. But each union decides on the exact implementation rules it will adopt, and fine-tunes operating principles to suit its economic circumstances.

The main institutional characteristics that apply to both unions are (1) a fixed peg to the euro, (2) a convertibility guarantee by the French

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<sup>4</sup>Current examples are the relatively advanced preparations for a monetary union among the members of the West African Monetary Zone (WAMZ), and the planned monetary union among members of the East African Community (EAC), which includes Kenya, Tanzania, Uganda, Burundi, and Rwanda. There are also discussions about a possible common currency for members of the Common Market for Eastern and Southern Africa (COMESA) and African Union–led efforts for an Africa-wide common currency by 2020. Outside of sub-Saharan Africa, the Gulf Cooperation Council has been planning a monetary union, though this venture may now have been put on hold.

Treasury, and (3) a set of legal, institutional, and policy requirements designed to ensure the sustainability of the arrangement. In practice, there has been a high degree of parallelism in other institutional and operational features—such as the design of supervisory arrangements within the two unions, as well as the conduct of regional monetary and financial policies.

After the 1994 devaluation, both unions acknowledged the need to strengthen real and financial integration among their member countries (Box 1.2). Reform efforts for both monetary unions started immediately after the devaluation with a view to supporting their long-term sustainability through laws and institutions modeled on those of the European Union (EU). Key elements were (1) an agreement on macroeconomic convergence criteria designed to help coordinate macroeconomic policies, and (2) phased abolition of trade restrictions within each union and the creation of regional common markets. To facilitate integration, both unions also supplemented their central banks with new institutions supporting real integration: an economic commission (WAEMU) and an economic secretariat (CEMAC).<sup>5</sup>

Experience with the post-1994 reforms has, at best, been mixed. In both unions there are still many physical obstacles to integration, among them too few transportation links between countries and, in spite of the free trade zones, too many nontrade barriers. Common institutions other than the central banks have often failed to make their mark because of insufficient financing.<sup>6</sup>

Accordingly, both unions have given renewed impetus over the past two years to integration efforts. With financial support from donors both zones have drawn up regional economic plans. The substantial resources (amounting to more than 10 percent of GDP) that have been committed by the members of the zones themselves, bilateral donors, the EU, and the World Bank should allow for stepped-up efforts to address infrastructural and institutional requirements for integration. The priorities in both unions are regional transportation and power projects and the reinforcement of regional institutions.

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<sup>5</sup>Other common institutions, such as a regional court of law and a parliament, and common policies, for example, competition policies, also exist or are planned. In practice, however, these institutions and policies have not yet assumed a major role in the unions or member countries.

<sup>6</sup>Common institutions other than the central banks and supervisory agencies are mostly financed through surcharges on external tariffs, but many countries failed to collect or to make the funds available to the regional institutions.

### **Box 1.1. The CFA Franc Zone: Historical Origins and Current Institutional Setting**

The CFA franc zone arrangement defines the monetary relations between CEMAC, WAEMU, and France.

#### **History**

The predecessors of the CFA franc arrangement date back to colonial times when it was decided to issue currency in the dependent territories to avoid the need to transport cash. At the end of World War II, two “issuance houses” were in charge of remitting currency for the French colonies in Africa. In the run-up to independence, these institutions were renamed Banque Centrale des Etats de l’Afrique de l’Ouest (BCEAO) and Banque Centrale des Etats de l’Afrique Centrale et du Cameroun (BCEAC). Even after independence the BCEAO and BCEAC remained in place, led by France and with their headquarters in Paris. For those newly independent countries that opted to stay within the franc zone, the main aspects of their monetary affairs thus remained with the former colonial power. Conventions concluded in 1962 and updated in 1973 (with the BCEAO) and in 1972 (with the BCEAC) created formal central banks, reduced the role of France, and created African leadership in the institutions. In this context, the BCEAC was also renamed Banque des Etats de l’Afrique Centrale (BEAC). Only in the late 1970s the headquarters of the central banks were relocated from Paris to Africa: for the BCEAO to Dakar, Senegal, and for the BEAC to Yaoundé, Cameroon.

#### **Membership**

Historically, all French colonies in sub-Saharan Africa were members of the broad franc zone. Once independent, however, former French colonies in northern Africa left the arrangement to introduce their own currencies, as did Guinea (1958), Madagascar (1972), and Mauritania (1973).

Today, the principal members of the CFA franc zone are France and the two African economic and monetary unions that evolved from the country groups served by the two issuance houses—the Central African Economic and Monetary Community (CEMAC, with the BEAC as its central bank) and the West African Economic and Monetary Union (WAEMU, with the BCEAO as the central bank). CEMAC has six members: Cameroon, the Central African Republic, Chad, the Republic of Congo, Equatorial Guinea, and Gabon. (Equatorial Guinea, a former Spanish colony, joined in 1985.) WAEMU has eight members: Benin, Burkina Faso, Côte d’Ivoire, Guinea-Bissau, Mali, Niger, Senegal, and Togo. (Guinea-Bissau, a former Portuguese colony, joined in 1997.)

### Main institutional and operational arrangements

- The CFA franc zone links three currencies: the CFA francs issued separately by each bank, and the euro.<sup>1</sup> Both CFA francs are fixed to the euro (previously to the French franc) at the same rate, 655.957 per euro. However, the CFA francs are issued by two distinct central banks and are independent of each other. Each CFA franc is nominally convertible into the euro, but they are not directly convertible into each other.
- France guarantees the peg of the CFA franc to the euro. It provides an operations account in the French Treasury for each of the two central banks, on which they may draw in case of reserve shortages. While theoretically this amounts to a possibly unlimited overdraft, there are institutional safeguards and restrictions to ensure the viability of the arrangement. The most important are that (1) at least 20 percent of sight liabilities of each central bank must be covered by foreign exchange reserves, (2) at least 50 percent of foreign exchange reserves must be held in the operations account;<sup>2</sup> and (3) increasing interest rate penalties apply if there is an overdraft. France is also represented on the board of both institutions.
- Within the limits of the fixed exchange rate arrangement, the BEAC and BCEAO are responsible for the conduct of monetary policy in their respective regions. Both central banks are also charged with implementing banking supervision at the regional level. Differences in the speed of policy and policy instrument reform between the two banks have led to differences in financial depth and in the array of tools available to the two central banks and to the autonomy of each central bank.
- After the 1994 devaluation the unions initiated efforts to speed up economic and financial integration within the subregions. These were largely inspired by the institutional and legal arrangements of the EU and are intended to coordinate macroeconomic policies and create a common market. The current “second generation reforms” include the creation of regional infrastructure and strengthening of regional institutions.

<sup>1</sup>The BCEAO issues the Franc de la Communauté Financière de l’Afrique (CFA); the BEAC issues the Franc de la Coopération Financière Africaine (CFA).

<sup>2</sup>Previously the required level was 65 percent. In the case of CEMAC, the new level will be phased in through 2008.

### Box 1.2. The CFA Franc Devaluation

Effective January 12, 1994, the CFA francs of CEMAC and WAEMU were both devalued by 50 percent. As the sole adjustment, and a very large one, in almost 60 years, the event still marks a watershed in the operation of the regime.

**Economic pressures.** From the mid-1980s, members of the CFA franc zone became aware that they were losing competitiveness. Internal and external adjustment problems began to build up. In particular, a prolonged deterioration in the terms of trade and a substantial appreciation of the French franc against the currencies of major trading partners (especially during 1984–90) had made both zones less competitive. The impact of these shocks on growth, exports, and government finances was reinforced

#### CFA Franc Zone Developments: 1990–93 Versus 2001–06

	CEMAC				WAEMU			
	1990–93	1993	2001–06	2006	1990–93	1993	2001–06	2006
Terms of trade (average annual change, in percent)	-0.7	3.1	6.2	16.0	-2.1	4.8	0.6	1.3
Real effective exchange rate (average annual change, in percent)	-4.9 <sup>1</sup>	-5.2	3.2	3.5	-1.1	-2.1	2.0	-0.6
Real GDP growth (average, in percent)	-0.9	-0.6	5.2	2.2	1.3	0.3	3.4	3.4
Domestic fiscal revenue (average, in percent of GDP)	15.4	14.9	23.2	29.0	15.1	13.1	15.8	16.5
Overall fiscal balance (average, in percent of GDP) <sup>2</sup>	-6.4	-6.6	5.7	18.9	-5.9	-6.0	-0.5	8.4
External current account (average, in percent of GDP) <sup>2</sup>	-1.6	-3.6	-2.6	6.2	-7.9	-7.5	-5.5	-6.8
Reserves (months of imports)	3.3	0.9	4.2	9.4	6.7	4.5	6.9	7.3
External debt (average, in percent of GDP)	63.9	78.4	57.7	24.8	65.4	71.4	61.5	36.0

Source: IMF, World Economic Outlook database.

<sup>1</sup>Excluding 1990.

<sup>2</sup>Including grants.



by such structural rigidities and fragilities as high wages and poorly managed banking systems. The eroding tax base and increased demands for fiscal transfers worsened government deficits, and accumulation of arrears then crowded out the private sector and weakened banking systems further.

**Preparation and implementation.** The IMF and the World Bank began to analyze the overvaluation of the CFA francs as early as the late 1980s. At the same time the African monetary union members, France, and the IMF began to discuss the possibility of an exchange rate adjustment. This required complex coordination and secrecy. The decision was finally made only in early 1994 during a meeting officially held to discuss the airline jointly operated at the time by franc zone member countries. Immediately after the devaluation, most of the countries affected agreed on IMF- and World Bank-supported programs to help them implement far-reaching policy reforms. Once the devaluation was accomplished, the region also put in place a plan to enhance economic convergence and create common markets.

**Economic impact.** The devaluation of the CFA franc was generally successful, and is widely credited with restoring internal and external balance. It also led to a reflow into the zone of the capital that had left in anticipation of the exchange rate change. Assessments of the equilibrium exchange rate in both zones show that a part of the competitiveness gains from the devaluation persists.<sup>1</sup>

**Current situation.** Movements between the euro and the U.S. dollar, and domestic wage developments have led to a loss in competitiveness in both zones, while the effect of terms of trade developments differed between CEMAC and WAEMU.<sup>2</sup> There are, however, marked differences from 1994, including less severe current account pressures (for the CEMAC significant surpluses), capital inflows, better fiscal performance, and reserve levels well above minimum levels. Addressing the structural obstacles to competitiveness remains key to longer term non-oil growth.

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<sup>1</sup>See Chapter 6 of this volume.

<sup>2</sup>See Chapter 7 of this volume.

In the past years the speed of reform has varied between the two unions in important areas. As a result there are now—in spite of large commonalities in the overall framework—some noticeable differences in key areas of economic policymaking between the zones. WAEMU, for instance, has an economic commission with a more visible role in macroeconomic surveillance; CEMAC, until recently, had only a precursor (an economic secretariat) with fewer resources.<sup>7</sup> With the abolition of the (limited) earlier margin for central bank advances to member governments in 2003 and the introduction of a regional treasury bill market and open market operations, WAEMU also has made more progress toward the use of indirect monetary policy instruments than CEMAC. With the abolition of direct government financing the BCEAO has also achieved a more arms-length relationship to member countries and is thus closer to being an independent central bank. But in spite of differences in the speed of reforms, there is agreement between the two unions on the direction of changes.

Through the common peg, CEMAC and WAEMU essentially share a currency, but as yet there are no special institutions or programs to draw benefit from this wider union and facilitate further integration between the two. Trade between the unions is low and each union imposes its external tariff. Capital flows between the zones are restricted, and the exchange of banknotes is prohibited. While each currency is convertible into the euro, direct convertibility between the two currencies has been suspended since shortly before the devaluation. In both academic and policy debates, it has nevertheless been common practice to discuss the CFA franc zone as if it were unitary. For reasons of comparability with other studies this book will follow this tradition, but it will—where relevant for economic analysis—emphasize the differences between the two unions.

### Economic Characteristics

The 14 African countries in the CFA franc zone account for nearly one-third of all sub-Saharan Africa states. Yet, in terms of population and output the zone is far smaller. The total population of 123 million amounts

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<sup>7</sup>However, during a June 2007 meeting in N'jamena (Chad) member heads of state agreed to institutional reforms in CEMAC, notably the transformation of the CEMAC secretariat into a commission, more balanced representation of members on the board of the central bank, and other changes to strengthen regional policymaking.

to only 17 percent of the population of sub-Saharan Africa and is in fact less than the population of Africa's most populous country, Nigeria. The CFA franc zone accounts for about 15 percent of Africa's GDP and produces 22 percent of its oil (Table 1.1).

A striking feature of the economic landscape of the CFA franc zone is the heterogeneity not only between the two unions but even within each grouping. The production structures and macroeconomic and structural indicators for WAEMU and CEMAC differ significantly. And though WAEMU has more than double the population of CEMAC, its average per capita income in 2006 was less than half the CEMAC level. Measured by the share of exports to GDP, WAEMU is also less open. As a group, it has a combined current account deficit. Meanwhile, the recent oil inflows have generated current account surpluses in CEMAC for several years. Nevertheless, with more varied domestic production, internal trade in WAEMU is far more advanced. And—in part due to the creation of treasury bills—WAEMU also has significantly deeper and more developed financial markets than CEMAC (see IMF, 2006b).

Current differences in income levels and economic performance reflect historically higher average growth in CEMAC since the 1980s (Table 1.2) and, more recently, the changing production structures in the two unions. In recent years, Chad and Equatorial Guinea have emerged as significant petroleum exporters, joining Gabon, Cameroon, and the Republic of Congo—the region's longer-standing producers. By contrast only one WAEMU country (Côte d'Ivoire) produces oil. The main export products of WAEMU are agricultural goods, particularly cotton, which has suffered from sharp price drops in the past few years. The differences in fiscal performance largely reflect the different production structures, because the recent oil booms have allowed CEMAC countries to build up fiscal surpluses.

Notwithstanding some common production structures within each zone, there remain wide differences among member countries. Per capita incomes in CEMAC range from less than \$400 in the Central African Republic to more than \$7,000 in Equatorial Guinea. These differences reflect not only the levels of oil output and population but also the after-effects of conflict. By contrast, differences in per capita income in WAEMU are much narrower. They range from about \$200 in Guinea-Bissau to slightly less than \$1,000 in Côte d'Ivoire. In WAEMU, domestic instability in Côte d'Ivoire—the WAEMU region's largest economy—has eroded its former role as the economic locomotive of the union and the destination country for labor flows and a substantial part of intraregional and transit trade.

Table 1.1. CFA Franc Zone: Key Economic Characteristics, 2006

	Population 2005 (In millions)	Per Capita GDP (In U.S. dollars)	Exports (In percent of GDP)	Current Account (In percent of GDP)	Government Revenues/GDP (In percent)	Financial Depth (M2/GDP)	Main Export Product
CEMAC							
Cameroon	36.4	1,281.4	57.0	5.1	29.3	14.1	
Central African Republic	16.3	999.2	26.0	-0.7	18.9	17.5	Petroleum
Chad	4.4	356.1	13.9	-3.8	21.2	15.8	Diamonds
Congo, Republic of	9.8	687.6	56.4	-6.3	16.8	11.3	Petroleum
Equatorial Guinea	4.0	2,227.1	87.3	12.8	44.7	16.6	Petroleum
Gabon	0.5	7,319.3	94.5	4.4	45.7	7.1	Petroleum
	1.4	6,835.6	65.9	19.7	31.7	19.6	Petroleum
WAEMU							
Benin	86.7	588.5	32.1	-4.3	17.2	26.9	
Burkina Faso	8.4	623.9	10.8	-6.4	16.8	29.3	Cotton
Côte d'Ivoire	13.2	448.9	11.9	-10.3	12.5	19.6	Cotton
Guinea-Bissau	18.2	951.0	51.3	3.0	18.2	25.0	Cocoa
Mali	1.6	188.5	22.9	-12.2	19.5	34.3	Banana
Niger	13.5	486.9	30.6	-4.9	17.1	28.5	Gold
Senegal	14.0	283.0	15.7	-8.3	13.1	14.9	Uranium
Togo	11.7	820.5	25.8	-10.1	20.0	36.3	Fish
	6.2	350.7	40.5	-6.0	16.9	33.2	Cement
Total CFA franc zone	123.1	793.2	44.7	0.5	23.3	21.1	
Memorandum items:							
Nigeria	131.5	769.7	56.6	12.2	27.1	20.3	
Sub-Saharan Africa	703.9	932.4	40.4	0.6	26.4	46.9	
East African Community <sup>1</sup>	116.3	407.6	21.6	-4.8	17.0	31.0	
Southern African Development Community	239.3	1,563.4	37.2	-1.7	28.1	61.9	
Common Market for Eastern and Southern Africa	255.1	468.5	44.5	5.1	28.0	29.5	

Sources: IMF, *International Financial Statistics* and *World Economic Outlook*; and UN COMTRADE.<sup>1</sup>Includes Rwanda and Burundi, which joined in 2007.

**Table 1.2. CEMAC and WAEMU: Long-Term Economic Trends***(Average, in percent a year)*

	Inflation	Real GDP Growth	Government Balance	Current Account	Export Growth
CEMAC					
1970–79	10.8	2.9	–3.2	7.6	0.9
1980–89	8.3	3.8	–3.1	–6.4	13.9
1990–99	5.7	6.8	–5.5	–10.7	4.1
2000–06	3.1	7.5	4.6	–6.5	17.0
WAEMU					
1970–79	10.2	3.3	–4.6	–8.0	6.7
1980–89	12.0	2.1	–5.2	–8.6	2.9
1990–99	9.5	3.5	–4.4	–7.0	9.6
2000–06	2.4	3.3	–2.5	–7.0	5.5
Memorandum items:					
WAMZ <sup>1</sup>					
1970–79	14.6	3.4	–4.8	–1.9	1.6
1980–89	30.5	1.7	–4.9	–4.5	2.0
1990–99	18.7	1.4	–3.7	–4.5	6.9
2000–06	10.2	4.9	–2.6	–3.5	5.1

Sources: IMF, *International Financial Statistics* and staff estimates.<sup>1</sup>The West African Monetary Zone includes The Gambia, Ghana, Guinea, Nigeria, and Sierra Leone.

## Policy Experience

Academics and policymakers generally see the experience with the operation of the CFA franc system as positive, noting the benefits of the arrangement for macroeconomic stability, in particular low and stable inflation, and the way it has stimulated institutional development. Still, there is continuing debate about the potential costs of rigidities associated with a fixed exchange rate system, given that most member countries are susceptible to major shocks, such as the current fall in cotton prices. In spite of widespread official support, national authorities in member countries have more often than not failed to fully put in place the macroeconomic policies and market-oriented reforms agreed at the regional level.

Although there have been few direct empirical studies of the benefits and costs of the CFA franc arrangement, a more general strand of literature looks at the real effects of nominal exchange rate arrangements to see whether there is a systematic difference in economic performance between peggers and floaters. The consensus seems to be that fixed exchange rates lead to lower inflation and more fiscal discipline; the direct effects of the nominal exchange rate regime on growth differs among studies and is

mostly not statistically significant.<sup>8</sup> For the CFA franc zone specifically, the benefits for lower inflation are confirmed by Masson and Pattillo (2004). There may well be second-round benefits; there is agreement in the literature that lower inflation in itself can provide important additional advantages for the stability of the economic environment, and longer-term benefits for financial development.<sup>9</sup>

When the CFA franc zone was created, most, if not all, African countries—like the rest of the world—were operating fixed exchange rate systems. Following the breakdown of the Bretton Woods agreements in 1973, a debate emerged on the costs and benefits of different exchange rate regimes, including also for low-income countries. By 2004 about three-quarters of non-CFA franc zone African countries had switched to money anchors and more flexible exchange rates, mostly, it was hoped, to facilitate adjustment to real shocks. In practical terms, though, not all the advantages materialized. Most African countries have significant “fear of floating” and often lean back on managed floating.

The difficulties in implementing floating exchange rates in Africa reflect, in part, a lack of the necessary monetary and financial infrastructure to support a flexible rate system. At the same time, ongoing efforts to create or expand monetary unions in Africa, also emphasize more vigorously the perceived credibility advantages of fixed exchange rates.

In light of the official commitment of CFA franc countries to the current system, what little debate there has been on an optimal exchange rate regime for the zone has taken place largely outside of official channels. In this debate a smaller group of researchers has questioned whether the fixed rate regime itself continues to be appropriate given the unprecedented economic shocks of the past years and the global trend to more flexible exchange rate regimes in developing countries.<sup>10</sup> Others, along with policy-makers in the region and in Europe, stress both the actual and potential credibility benefits, in particular if policy reforms can ensure smoother function of the systems.<sup>11</sup>

A related debate is about the quality of institutions and governance. On this score the CFA franc zone has the benefit of comparatively strong institutions, especially the well-recognized central banks. Despite some weaknesses, official assessments (such as Financial Sector Assessment Programs

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<sup>8</sup>For an overview see Ghosh, Gulde, and Wolf (2002).

<sup>9</sup>See, for example, Chapter 11 of this volume.

<sup>10</sup>See, for example, Sissoko and Dibooglu (2006) and Michailof (2007).

<sup>11</sup>See, for example, Guillaume and Stasavage (2000) and Noyers (October 16, 2007, as quoted by Reuters, 2007).

and Reports on the Observance of Standards and Codes) acknowledge that the two central banks are not only relatively transparent and efficient, but also compare favorably with other institutions in sub-Saharan Africa. Similarly, the regional surveillance and review process by the two regional commissions, which publish their reports, has the potential to increase the transparency of policymaking in the region.

Policymakers in the region in general support the CFA franc arrangement, but few countries have emerged as champions for deepening regional integration and fostering policy coordination. In day-to-day national policymaking there has therefore been less emphasis on regional requirements than on pressing domestic issues. This is reflected, for example, in the history of noncompliance with regional convergence criteria. Similarly, although there is a recognized need for institutional reforms in both unions, reform efforts have been stalled for years by the inability of policymakers to reconcile national and regional goals.<sup>12</sup> Finally, member governments have at times circumvented regional requirements, or even legal obligations, especially those relating to trade and the pooling of reserves.

## Main Challenges

The CFA franc zone may now be at a crossroads. In CEMAC, oil is rapidly coming to dominate the economic structure.<sup>13</sup> In WAEMU five countries (Benin, Burkina Faso, Mali, Niger, and Senegal) have reached the completion point under the Heavily Indebted Poor Countries Initiative and have benefited from the Multilateral Debt Relief Initiative, which has granted them additional fiscal space to address developmental issues. In both unions domestic or border tensions—in Côte d'Ivoire, the Central African Republic, and Chad—have been disrupting economic activities, but there are recent signs that the conflicts may be subsiding. Internally, both unions are embracing deeper regional integration and have committed to renewed efforts to put in place the foundations of an economic union—meaning an end to barriers to intraregional trade and financial flows and improvements to labor mobility.

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<sup>12</sup>Recently, CEMAC has started refocusing on institutional reforms; in June 2007 its members agreed on the principles of an agenda, but considering the differing national priorities, implementation will be challenging.

<sup>13</sup>Although high oil prices have helped increase incomes, output from known sources is stagnating or declining in three CEMAC producers. The question of sources of growth outside the oil sector is becoming increasingly acute.

Against the background of a long and varied history and rapidly changing external and internal environments, the chapters in this book try to examine how the CFA franc arrangement can retain credibility, achieve its financial stability objectives, and help member countries raise potential and actual output to levels that would allow them to meet the Millennium Development Goals.

The challenges in these efforts for member countries and the unions appear to fall into three distinct groups: (1) how to maintain fiscal and monetary policies that avoid pressures on the peg and keep debt sustainable; (2) how to build capacity to adjust to inevitably changing external conditions, with economic systems that are flexible enough to absorb shocks and avoid the renewed buildup of one-sided imbalances; and (3) how to speed up integration and raise growth potential by exploring how the regions can derive more benefit from regional trade and financial integration and agree on a common roadmap for structural reforms. These three challenges are the organizing principle for this book.

### **Sustainability of Macroeconomic Policies**

The first set of papers looks at the macroeconomic environment in the CFA franc zone. These four chapters ask whether the current CFA franc arrangement is an appropriate basis for common policies. They also seek to address the question of whether there is sufficient impetus for coordinating national and regional macroeconomic policies, a necessary condition for maintaining a common peg. Looking forward, they attempt to assess the sustainability of the policy stance. The general findings, including differences between WAEMU and CEMAC and between the countries of each region point to an important institutional reform agenda, and the need for more efficient policy coordination.

Among macroeconomic policies in a currency union, monetary policy is most clearly linked to the region. However, since the CFA franc is fixed to the euro, is there need or in fact room for independent monetary policy? In Chapter 2, Deléchat, Ramirez, and Veyrune examine this issue for CEMAC. Recognizing the persistence of significant and growing excess liquidity in the banking system, they argue that there is both scope and role for a more active monetary policy. Empirically, money growth is found to be one of the determinants of inflation, along with exchange rates and significant pass-through of foreign prices. The scope for monetary policy stems from limited capital mobility between the zone and France and—even more so—the rest of the world. The authors argue that the present policy environment in CEMAC, which is characterized by large liquidity



increases from oil inflows, calls for structural improvements and more direct monetary responses. Structural improvements, in particular in government cash management, could be a first response to limit the buildup of liquidity. However, beyond that, more active sterilization may also be needed to control money growth and keep inflation in check.

The contribution of money growth to inflation in WAEMU is examined in Chapter 3. Diop, Dufrénot, and Sanon argue that regional policymaking and appropriate responses to competitiveness challenges in the region will depend on a fuller understanding of the economic processes that drive inflation. Using an empirical model to investigate the long-run determinants of inflation, the authors find that while in WAEMU countries money supply does contribute to price changes, it is not the sole long-run determinant of inflation. Instead, reflecting the many structural obstacles to market activity in the region, supply constraints in the agricultural sector and the pass-through effects of changes of the CFA franc exchange rate (along with the euro) against third-country currencies are also significant.

Fiscal policies in a currency union with an exchange rate fixed to an anchor currency pose unique challenges. The complexities arise because fiscal policy is set at the national level and there are no provisions for inter-country fiscal transfers. The sum of members' national fiscal decisions need to be consistent with a regional monetary stance that is in line with the preservation of the peg. In Chapter 4, Adedeji and Williams turn to these issues, examining fiscal reaction functions for the CFA franc zone from 1989 through 2006. Predictably, they find that fiscal policy has to a large extent been determined by national considerations, and fiscal efforts have been significantly influenced by the stock of outstanding debt and country-specific economic circumstances and performance, such as growth, per capita GDP, terms of trade, and openness. Furthermore, past fiscal performance has a strong influence, suggesting a possible bias toward procyclical fiscal policy. The authors argue that, in these circumstances, the regional convergence criteria may not be sufficient to ensure the necessary policy coordination. Instead, they see a need for supplementary fiscal-related criteria, more squarely geared to the actual determinants of fiscal outcomes.

The sustainability of a fixed exchange rate regime is also predicated in large measure on the level of foreign exchange reserves a central bank has. Reserves not only ensure that external payments can be made on time, they also have a signaling function and contribute to economic stability by increasing the confidence of the public in the durability of the system. Measuring reserve adequacy in the CFA franc zone however is not easy, in part because the French convertibility guarantee could be seen as limit-

ing the need to hold sizable amounts of foreign currency at the regional level. Yet, in Chapter 5, Deléchat and Martjin argue that because both unions have shown a strong preference for avoiding the need to activate the French guarantee, reserve adequacy for the CFA franc zone should be measured against traditional indicators.<sup>14</sup> Analyzing sensitivity to balance of payments shocks and comparing reserve levels with those held by other monetary unions, the authors find that at present reserves are adequate in both CEMAC and WAEMU. Looking forward though, they argue that any changes to the arrangements—including more intensive use of funds for future generations in CEMAC to save part of the oil inflows—will need to be consistent with keeping reserves adequate.

### Capacity to Adjust to External Conditions

The three chapters in the second section deal with the capacity of the zone to adjust to external conditions. Given the fixed exchange rate regime, it is central to economic performance and the preservation of growth that the unions are able to adjust to shocks and changing external conditions without any adjustment of the nominal exchange rate either within the region or between the region and the anchor currency area. These chapters look at specific issues related to the flexibility of WAEMU and CEMAC economies and areas where policy reform can help to preserve or improve external sustainability. They analyze how changes in fundamentals may have resulted in movements in equilibrium exchange rates, the determinants and measurement of competitiveness, and country homogeneities, and evaluate the adequacy of current and proposed monetary unions in West Africa.

In Chapter 6, Abdih and Tsangarides investigate the behavior of CEMAC and WEAMU real effective exchange rates in terms of their long-run equilibrium paths during 1970–2005. They apply the fundamentals equilibrium exchange rate (FEER) approach and the Johansen cointegration methodology to derive equilibrium paths and the associated misalignments for the two monetary unions. Their results suggest that for both CEMAC and WAEMU fundamentals have driven most of the movements in time-varying equilibrium exchange rates: increases in the terms of trade, government consumption, and productivity improvements are found to have put pressure on the exchange rate to appreciate, while

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<sup>14</sup>There are also penalties for possible overdrafts from the operations account; and the conventions call for a minimum foreign exchange cover ratio. In practice, the ratio has not been binding.

increases in investment and openness had the opposite effect. Comparing actual and FEER-based equilibrium exchange rates, the authors conclude that at the end of 2005 in both CEMAC and WAEMU real effective exchange rates were broadly in line with their long-run equilibrium values. As an interesting additional finding, the analysis shows a significant difference in the marginal impact of the fundamentals and speed of reversion to equilibrium following a shock between WAEMU and CEMAC.

Given the significant growth and development needs of CFA franc countries, maintaining or improving their competitive position in the context of a fixed exchange rate regime is often seen as the principal challenge. In Chapter 7, Ramirez and Tsangarides examine a range of issues related to competitiveness. They argue that the real exchange rate alone is not a sufficient indicator. Instead, they propose the use of a broader framework that examines competitiveness based on “environment” and “policy” criteria. Determinants include indicators of productivity and labor market conditions, prices and costs, macroeconomic performance, the business environment, governance, and technology and infrastructure. Their findings suggest that, despite some recent improvements—particularly in CEMAC—when compared to peer countries in both regions competitiveness challenges are mainly structural. With this constellation of conditions, an adjustment in relative prices—for example, a devaluation—would not have a lasting impact on the unions’ competitiveness. The authors therefore argue that the most appropriate response to competitiveness challenges is to undertake structural reforms to improve productivity, reduce factor costs, and create a supportive business, legal, and political environment to attract and diversify economic activity.

Monetary and economic integration efforts in Central and West Africa remain in flux. New constellations—complementing or replacing some of the current regional arrangements—are possible in the context of the West African Monetary Zone (WAMZ) or the Economic Community of West African States (ECOWAS), the possible entrance of a new member country to CEMAC, or the regional effects of the planned Economic Partnership Agreements (EPAs) with the EU. Against this background, in Chapter 8 Qureshi and Tsangarides reconsider the optimal composition of country groupings in the region. To examine country homogeneities they apply techniques of clustering analysis to a set of variables suggested by the convergence criteria and the theory of optimal currency areas. Their findings raise some questions about the geographical boundaries of several current and proposed monetary unions. They also confirm significant heterogeneities within the CFA franc zone as it now exists. The authors find that the WAMZ countries do not form a cluster with the WAEMU countries, but (interestingly) there

are similarities between CEMAC and WAMZ countries. However, within the WAMZ, there is a significant lack of homogeneity.

### **Integration and Growth**

The final set of papers is concerned with long-term prospects for countries in the region. The papers document the level of integration that has been achieved and examine the extent to which institutional and structural conditions in the CFA franc zone allow for deeper integration and higher growth. This subsection deals first with the financial sector, where despite progress on the institutional side and the common currency, measured financial integration still lags behind in key areas. Next, growth and convergence in the region are examined, together with the extent to which integration strategies may have helped support higher and more coordinated output patterns. Finally, with free trade a core feature of the regions, the last paper in this section examines the status of trade integration and the challenges member countries now face in deepening intraregional trade in the context of global trade integration.

A common monetary area with free capital mobility holds the potential for larger and more efficient financial markets. In Chapter 9, Sy assesses the degree of actual financial integration in WAEMU. He finds that the structure of the financial sector and its institutional arrangements indicate that financial integration is in some respects well advanced. For example, common and foreign ownership of banks is very high and for the past few years cross-border transactions in government securities have become more frequent. Furthermore, common regulations and a regional supervisor help achieve a high degree of similarity in rules and their application. Nevertheless, Sy argues, financial sector integration falls short in important areas: for example, there are persistent deviations from the law of one price and few cross-border bank transactions, and the central bank continues to differentiate in how it applies certain monetary policy instruments, such as legal reserve ratios, to member countries. Sy argues that WAEMU does not yet benefit from the full economies of scale and scope of a truly integrated financial market and that policy measures might therefore be needed to achieve greater financial convergence and the related growth benefits.

Staying with the subject of financial market integration, Saab and Vacher in Chapter 10 examine the extent of retail banking integration in CEMAC and whether cross-country integration affects banking competition. Using both quantitative and qualitative indicators, the authors find some evidence of price convergence in average interest rate spreads, but they find no increase in actual cross-border flows for retail loans and deposits. They infer

that price convergence may be a symptom of excess liquidity in the region rather than a reaction to regional competition. Empirical tests make it clear that bank competition within CEMAC is very limited. The authors propose specific policies to facilitate regional integration and address shortfalls in legal and regulatory frameworks, infrastructure, and markets.

Pattillo, Tsangarides, and van den Boogaerde in Chapter 11 investigate growth and convergence in the CFA franc zone. They use quantitative measures of convergence and, based on recent growth robustness exercises, compare the experience of WAEMU and CEMAC not only with sub-Saharan Africa as a whole but also with other subregional arrangements within sub-Saharan Africa. Their results suggest that neither WAEMU, CEMAC, nor the CFA zone as a whole is growing faster than the whole of sub-Saharan Africa or the other subregions. However, the authors find that low inflation in the two monetary unions has had a greater positive impact on growth than it has for sub-Saharan Africa as a whole. On the other hand, improvements in investment and policy variables that emerge as robust growth determinants from these recent robustness exercises do not appear to have contributed as much to improvements in growth in WAEMU or CEMAC as in the fastest growing countries in sub-Saharan Africa. The findings have important policy implications and underscore the need to deepen regional integration further and reduce domestic constraints on investment, diversification, and growth.

Since the devaluation, efforts have been under way to facilitate regional trade, which is seen as the cornerstone of regional integration. In Chapter 12, Martjin and Tsangarides provide an update on the main elements of the CEMAC trade reform agenda and make a preliminary quantitative assessment of how certain options would affect tariff revenues and trade patterns. They argue that eliminating nontariff barriers and other obstacles to intraregional trade that are in violation of the regional agreements adopted since the devaluation will require renewed political commitment to regional integration. They also find that problems in applying the customs union and the need for major improvements in the regional transportation infrastructure will have to be addressed before the region can fully benefit from the arrangement. Martjin and Tsangarides also see a solid case for reducing tariffs against the rest of the world, with or without an EPA with the EU. They argue that trade liberalization would help boost economic growth and alleviate poverty and would limit the risks of possible trade diversion from an EPA. However, given the continued heavy reliance of CEMAC members, especially the landlocked countries, on trade-related taxes, tariff reform would need to be complemented by mobilization of more domestic revenue.

In Chapter 13, Goretti and Weisfeld undertake a similar analysis of the WAEMU trade regime. They, too, find that achieving the region's full trade potential is hampered by poor transportation infrastructure and incomplete implementation of the agreed trade regime, owing in part to the concerns of national authorities about competitiveness. The reform agenda includes plans to extend the WAEMU customs union to ECOWAS and to conclude an EPA with the EU. The tariff reduction associated with these initiatives is likely to have important trade creation effects, although it will need to be complemented by improvements in domestic revenue mobilization. Further trade liberalization on a most-favored-nation basis would also contribute to economic growth and poverty alleviation while limiting the risks of trade diversion from an ECOWAS customs union and an EPA.

## Findings and Outlook

The CFA franc arrangement enjoys strong political and popular support. But the requirements for continued successful operation of the regime are stringent, given member countries' vulnerabilities to shocks. Requirements include both considerable macroeconomic discipline and a high degree of market flexibility. At present not all the prerequisites are in place; there are some shortcomings in the design of common institutions and policies, and—more important—common policies are often not implemented with sufficient vigor and consistency.

Policymakers are aware of the need for reform to overcome emerging pressures and allow the region ultimately to draw more economic benefits from monetary and economic union. The papers collected in this volume intend to encourage these reform efforts; common trends and weaknesses highlighted in several papers point to priority areas for change.

The themes and priorities that emerge from the articles in this book may be summarized as follows:

- **More depth before further widening.** A variety of efforts are under way to widen regional groupings. Yet the trade and financial links among their current members lack depth, and efforts to design structural policies that could deepen these links have not been sufficient. Administrative and other bottlenecks are likely to become more severe with premature expansion, and immediate positive returns would be few. Notwithstanding the eventual benefits of an even larger economic space, a proper sequencing of reform efforts should therefore best begin with creating the economic, political, and structural preconditions for deepening current economic links.

- **More and better markets.** In a monetary union, imbalances should resolve themselves through flows of goods, capital, and labor. Internal trade and capital flows in both subzones continue to be subject to informal restrictions, and labor mobility in particular suffers from too many limitations. For more integration within the current setting, attention in both WAEMU and CEMAC should focus first on eliminating the many obstacles to the unfettered play of regional goods and factor markets. Once removed, the effects of shocks will be less severe and the region will draw stability benefits from the common economic space.
- **Greater consistency between national and regional policies.** Obstacles to integration often arise from national policies that are inconsistent with both the spirit and the letter of regional policies. That applies to both active policies (for example, in relation to trade taxes) and a lack of national reform efforts (for example, in relation to tax harmonization or domestic revenue mobilization) that make it impossible to create a firm foundation for further integration.
- **More balanced development in the CFA franc zone as a whole.** Through the common peg to the euro CEMAC and WAEMU essentially share a currency. Yet economic structures and developments in the two unions are increasingly diverging. To preserve the benefits of a common currency, more attention to achieving balanced developments in the two unions will be needed. Such efforts could be helped by reducing the barriers between WAEMU and CEMAC (for example, through improved trade, or capital and labor mobility in the larger zone). In addition, underlying economic structures will need to become sufficiently flexible to ensure that the regime is sustainable even when economic conditions and shocks differ.

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