

Policy Brief

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Overview

The 14-member Franc Zone in West and Central Africa represents the largest monetary union in the southern hemisphere, predating the European Monetary Union by decades. With monetary unions planned for other parts of Africa in the near future, *Macroeconomic Policy in the Franc Zone* focuses on some of the key challenges facing the Franc Zone today:

- how does a single currency area meet the needs of such a wide range of countries facing very different economic conditions? How close is the Franc Zone to being an 'Optimum Currency Area'?
- how well do the institutions of the Franc Zone manage monetary policy in the area? Have they been able to adapt the 'best practice' of OECD central banks to African conditions?
- how do the policies of the Franc Zone impact on the poorest and most disadvantaged communities in the region?

Policy Brief written by David Fielding

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What can the European Central Bank learn from Africa?

THE CREATION OF THE EUROPEAN MONETARY UNION has stimulated a great deal of discussion about the costs and benefits experienced by countries sharing a single currency. The debate has encompassed Africa, where plans for monetary unions have been mooted in Southern Africa (among the existing members of the SADC), in Eastern Africa (resurrecting the East African Currency Board) and West Africa (among the English speaking members of ECOWAS). Now more than ever before, it is important to assess the ways in which membership of a monetary union might help or hinder social and economic development. One key source of evidence is the CFA Franc Zone, the world's oldest and most robust multinational single currency area. *Macroeconomic Policy in the Franc Zone* presents evidence on recent economic performance in this area.

What is the Franc Zone?

The Franc Zone is a monetary system based on the institutions of the French empire, and encompasses most of France's former colonies. The cornerstone of the Franc Zone has been the use of currencies that the French Treasury has guaranteed to exchange for French Francs – and now Euros – at a fixed rate. In continental Africa, member states are grouped into two regions, each with a single currency issued by a single central bank: the Banque des Etats de l'Afrique Centrale (BEAC), operating in the Communauté Économique et Monétaire de l'Afrique Centrale (CEMAC), and the Banque Centrale des Etats de l'Afrique de l'Ouest (BCEAO), operating in the Union Economique et Monétaire Ouest Africaine (UEMOA). Both of these currencies bear the name 'CFA Franc', and both are convertible with the Euro at a fixed rate. (CFA originally stood for *Colonies Françaises d'Afrique*, but after the African countries gained independence this interpretation was changed to *Communauté Financière Africaine* in the UEMOA and *Coopération Financière en Afrique Centrale* in the CEMAC.)

The Franc Zone evolved from the monetary institutions of the last phase of French colonial Africa, and the two central banks date from 1955. After political independence (1960-62), the banks retained their function and their currencies,

and the French Treasury continued to guarantee convertibility at a rate of 50 CFA Francs to 1 French Franc. All of the newly independent Central African states, Cameroon, the Central African Republic, the Congo Republic, Gabon and Chad, continued to adhere to a monetary union under the auspices of the BEAC. These were joined in 1985 by the former Spanish colony of Equatorial Guinea. In West Africa, all of the former French colonies except Guinea-Conakry and Mauritania form another monetary union under the auspices of the BCEAO: Côte d'Ivoire, Benin, Burkina Faso, Mali, Niger, Senegal and Togo. The former

means that the rate is now defined in terms of Euros, but the current Euro rate is equivalent to 100:1 against the French Franc. The fixed exchange rate has meant that average inflation rates within the Franc Zone have not been significantly higher than those in France. (iii) *Free transferability*. The CEMAC constitution states that 'transfers of funds between member states and France will be unrestricted'. Similarly, the UEMOA constitution prescribes the 'freedom of financial relations between France and members of the Union'. This obligation on the part of the African states is not without qualification, and the practice of member states has

Central bank monetary policy is still not very proactive

About the Editor



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Portuguese colony of Guinea-Bissau joined this union in 1997.

The Franc Zone in Africa comprises two completely separate and independent monetary unions with two different currencies, although the two unions share many common features. The two monetary unions are founded on an array of contractual obligations on the part of the African states and France, designed to ensure the following conditions.

(i) *Guaranteed convertibility between the Euro and each CFA currency*. The French Treasury will exchange CFA Francs for Euros on demand. It also agrees to provide the Franc Zone central banks with as many Euros as are needed to ensure the smooth running of the zone's financial system.

(ii) *A fixed exchange rate*. From 1948 to 1994 there was a fixed rate of 50 CFA Francs to one French Franc. The rate has been changed only once, to 100:1, in January 1994. The entry of France into the European Monetary Union

not always been in harmony with the principle. Nevertheless, there is usually a reasonable degree of capital mobility across the frontiers of each of the two monetary unions.

The administrative structures of the Franc Zone are built around the BEAC and the BCEAO, which are the only institutions in the region granted with the power to issue CFA currency.

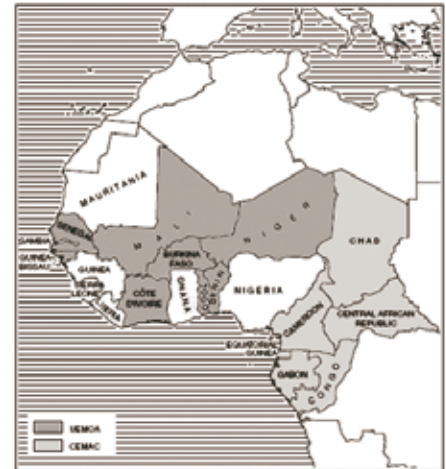
They also implement monetary policy, and finance and regulate government and private banking activity. Overall control of monetary creation is sought through monitoring and regulation of the different components of the money stock.

Following the 1994 devaluation, which was prompted by persistent Balance of Payments deficits in a number of the larger members of the Franc Zone, there was a substantial overhaul of the regulation of macroeconomic policy in both the CEMAC and the UEMOA. The rules governing central bank credit to governments were tightened

considerably, member states agreed to aim to meet economic convergence criteria similar to those used at the creation of the European Monetary Union, and the BEAC and BCEAO sought to base monetary policy on a rationale similar to that now common among OECD central banks. Ten years on from the start of the reforms, it is timely to review economic progress in Franc Zone, and the macroeconomic challenges still facing its members. *Macroeconomic Policy in the Franc Zone* addresses three key areas of concern: how close are the two monetary unions to being 'optimum currency areas', how well do the central banks manage monetary policy, and how do the policies and institutions of the Franc Zone impact on the poorest households?

and whether asymmetries are being eroded over time. If the asymmetries are large and persistent, then there is a serious worry that a single monetary authority will be able to meet the needs of all member states, and it is worth re-thinking the current groupings of the Franc Zone states.

The existing literature on the macroeconomics of monetary union – as applied, for example, to the European Monetary Union – makes a distinction between 'real' and 'nominal' convergence, and the book deals with both concepts as they relate to the Franc Zone. Nominal convergence relates to broad macroeconomic aggregates that are, to a greater or lesser extent, under the control of the monetary and fiscal authorities. Such aggregates include the size of the government's budget deficit, the level of foreign debt and



From 1948 to 1994 there was a fixed rate of 50 CFA Francs to one French Franc

The Franc Zone Today: Convergence

Part 1 of the book looks at the degree of economic convergence among the members of each monetary union. The Franc Zone is largely the result of historical accident, grouping together places that just happen to have been colonized by France rather than Britain (along with two non-Anglophone neighbours). The division between the CEMAC and UEMOA countries reflects a colonial administrative distinction; there was no underlying economic rationale to the formation of these two monetary unions. It is therefore important to establish exactly how much macroeconomic similarity there is between the member countries,

average tax rates. Large and persistent differences in these are likely to make it impossible for a single central bank to conduct monetary policy in a way that meets the needs of all member states simultaneously, and in recent years Franc Zone governments have been committed (at least in principle) to bringing them into line.

Real convergence relates to the underlying macroeconomic structure of the different countries. There is a great deal of variation in the composition of economic production across the members of the Franc Zone: some countries are oil exporters, others export cash crops such as coffee, cotton and cocoa. Some countries are among the poorest in the world: Guinea-Bissau,



Mali and Niger still have an annual per capita GDP below \$1,000; others are much richer: Gabon, for example, has an annual per capita GDP over \$6,000. These differences might create asymmetries in the degree of wage and price flexibility, the way in which countries respond to changes in

the case of nominal convergence criteria. The results regarding nominal convergence in the Franc Zone are mixed. For example, econometric analysis of the macroeconomic variables explicitly listed in the UEMOA 'convergence pact' instituted after the 1994 devaluation, and monitored by

... it is important to be clear about whose inflation we are talking about

monetary policy, and the impact on the economy of external shocks such as oil price rises. The extent to which policy makers can promote cross-country convergence of such characteristics is likely to be much more limited than in

the BCEAO, shows that there has been some convergence in variables over which the central monetary authorities have some influences, such as inflation. However, a striking result of the analysis is that there is markedly less convergence in those factors, such as budget deficits, relating to the policies of individual governments. There is still some way to go in ensuring that the policies of individual governments are consistent with the effective implementation of a common monetary policy.

Analysis of variables relating to real convergence criteria also produces mixed results. When we look at the extent to which Franc Zone countries differ in the external shocks they face, and in the ways in which production and inflation respond to these shocks, we see some common patterns among the members of the UEMOA, and also among the members of the CEMAC. This is partly because – serendipitously – all of the oil exporters are located in the CEMAC region, with none in the UEMOA region. However, if one were to group countries together in terms of these real convergence criteria, the groups would not be identical to the existing UEMOA-CEMAC grouping. We also widen the geographical horizon by making a comparison of the macroeconomic

Franc Zone Human Development Index Components (2002)

	Life expectancy (years)	Adult literacy rate (%)	Per capita GDP (US\$)
Equatorial Guinea	49.1	84.2	30,130
Gabon	56.6	71.0	6,590
Cameroon	46.8	67.9	2,000
Senegal	52.7	39.3	1,580
Côte d'Ivoire	41.2	49.7	1,520
Togo	49.9	59.6	1,480
Central African Republic	39.8	48.6	1,170
Burkina Faso	45.8	12.8	1,100
Benin	50.7	39.8	1,070
Chad	44.7	45.8	1,020
Congo	48.3	82.8	980
Mali	48.5	19.0	930
Niger	46.0	17.1	800
Guinea-Bissau	45.2	39.6	710

the Franc Zone comprises two completely separate and independent monetary unions with two different currencies, although the two unions share many common features

characteristics of the CFA countries with those of their neighbours. Does the 'hard' fixed peg of the Franc Zone mean that macroeconomic shocks there have a different explanation from shocks in countries with more flexible exchange rate regimes? Some differences do appear: for example, a typical shock to demand appears to have less impact on inflation in the Franc Zone less than it does on inflation in neighbouring countries. Nevertheless, there is also some similarity between the oil exporters in the region as a whole (including both Franc Zone countries and Nigeria) and between the oil importers in the region as a whole, particularly in terms of the immediate impact of monetary shocks on inflation.

The Franc Zone Today: Monetary Policy

Since the interesting times surrounding the 1994 devaluation, the CFA Franc Zone has enjoyed a period of relative monetary tranquillity. The external balances of the most indebted CFA members have improved somewhat, and there has been no discussion of any second devaluation, or of a de-linking of the CFA currencies from the Euro. The two central banks have re-orientated monetary policy, motivated by a desire to emulate what is seen as best practice in the OECD. The interest rate – alongside the reserve assets ratio and some credit controls – is considered as the prime monetary policy instrument. Central bank communiqués inform the public about monthly decisions on the value of the policy instruments,

providing some rationale for the decisions. In this context, Part 2 of the book assesses the conduct of monetary and exchange rate policy in the Franc Zone.

If the BCEAO and BEAC are indeed operating in the fashion of an OECD central bank, then it ought to be possible to analyse their policies in the way that OECD central bank policies are analysed. With the exception of South Africa, Africa has received very little attention in the literature on monetary policy rules. So the book analyses the use of BCEAO monetary policy instruments over the last decade, with a particular emphasis on the reserve assets ratio and the interest rate.

We ask questions about the degree of consistency and transparency in the conduct of monetary policy. For example, can interest rate setting in the UEMOA be described in terms of a Taylor Rule? Do changes in reserve asset requirements (which vary across member states) systematically reflect country-specific macroeconomic fluctuations, and do they promote or hinder nominal convergence? The evidence suggests that the central bank does sometimes use the interest rate as a macroeconomic stabilization device; however, its interventions are relatively small and tentative. Moreover, there is no evidence for the systematic use of the reserve assets ratio as a stabilization device. It remains to be seen whether policymakers will use the tools at their disposal in a more ambitious way in the future.





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The Franc Zone Today: Poverty

The final part of the book is designed to fill a gap in the existing literature, by analysing the impact of monetary policy and institutions on the incidence of poverty in the CFA. The analysis of the relevant macro-micro linkages has received very little attention to date.

We address three specific questions. First, over the long run, on average and controlling for other social and economic characteristics, do Franc Zone countries experience less income inequality than other developing countries? Second, what was the impact on poverty of the 100 per cent devaluation of the CFA Franc in 1994? Third, what is the impact on poverty of monetary expansions or contractions initiated by the central bank?

The analysis of long-run trends suggests that Franc Zone countries are not atypical of the developing world as a whole. Cross-country variations in long-run levels of income inequality, and in the rate of growth of the income of the poor, can be explained by factors such as average income levels, fertility rates and the degree of ethnic diversity within a country. These factors do not vary significantly between Franc Zone countries and their African neighbours; moreover, controlling for these characteristics, income inequality is no greater and no less in the Franc Zone than it is in the rest of Africa. However else the Franc Zone affects social and economic development, it appears to have had no impact on long-run income inequality on average, either for better or for worse.

Although Franc Zone membership has not impacted on income inequality and the incidence of poverty on

average over the long run, it is still possible for substantial changes in monetary and exchange rate policy to have a substantial impact on the poor. Analysis of poverty following the 1994 devaluation, focussing on the cases of Côte d'Ivoire and Niger, reveals some surprising results. Existing wisdom suggested that the devaluation would alleviate poverty, because it would generate a real exchange rate depreciation (an increase in the relative price of internationally traded goods), and most of the poor were small farmers engaged in the production of traded goods. However, it turns out that the picture is much more complex than this. Many of the urban middle classes in service sector employment, who lost most from the devaluation, used their income to finance informal sector activities employing workers from very poor households. The devaluation was associated with a contraction of this sector, which hurt the poor.

The 1994 devaluation was a one-off event: a devaluation of similar magnitude in the near future is unlikely. However, day-to-day monetary policy interventions by the Franc Zone central banks can still impact on the poor, so the book also includes an analysis of the monetary transmission mechanism from a pro-poor perspective. In the short term, changes in monetary policy instruments can have an asymmetric impact on the prices of different commodities, not all of which adjust at the same rate. Within a monetary union, it can also have a geographically asymmetric impact on prices. So, in general, the brunt of monetary policy changes could be borne by the rich or by the poor, depending on

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whose consumption basket experiences the most price volatility in the wake of a monetary policy intervention. It turns out that the groups most likely to bear the brunt of such changes are the poor in a subset of Franc Zone countries. If the Franc Zone central banks are to adopt OECD-style monetary policy based on the objective minimizing volatility in inflation rates, it is important to be clear about whose inflation we are talking about. It is important to be aware of the potential burden imposed on the poor of a policy to minimize variation in growth of average prices.

The Future

While the Franc Zone remains a haven of financial stability, it also faces a number of serious challenges. As it deals with these challenges, the heterogeneity of its member states is likely to become a key issue. Central bank monetary policy is still not very proactive, and the defining policy intervention remains the 1994 devaluation. But if it does become more proactive, then policymakers ought to be sensitive to the asymmetries in the consequences of their actions: asymmetries between different countries, and between the rich and the poor in each country.

What may appear as purely macroeconomic analysis actually goes on to show the impact of monetary policy in the West and Central Africa Franc zone on rich and poor households. This book proposes measures to cushion the poorest of the poor – who bear the brunt of the monetary adjustments reviewed here.

—Mamadou Kani Konaté, Center for Research and Training Support (CAREF), Bamako, Mali

This book not only examines macroeconomic shocks and (monetary) policies in the context of the Franc Zone countries and their neighbours, but also draws policy implications for growth and poverty reduction from the studies in an analytical rigorous manner. The book is an invaluable resource for policymakers and researchers in West and Central Africa as well as those engaged in other regional economic groupings in the rest of Africa, where issues of convergence and monetary union would be a central policy question.

—Alemayehu Geda, Associate Professor, Head, Department of Economics, Addis Ababa University, and African Economic Research Consortium

This volume featuring contributions by some of the leading scholars in Development Macroeconomics provides theoretically informed, empirically grounded and factual evidence on macroeconomic developments in the CFA Franc zone in West and Central Africa. The combination of historical developments and methodological depth renders it the ideal, unique and comprehensive guide for all those interested in monetary union in Africa. Moreover, it extends the frontier of knowledge on the impact of monetary union on poverty, a seemingly evolving area in the literature.

—Afeikhen Jerome, Department of Economics, University of Ibadan, Nigeria

The findings of the book are a good start for a critical examination of the theoretical and empirical underpinnings of monetary policies in the Franc Zone and areas of their complementarities with fiscal policies. The rigorous scrutiny of UEMOA's and BCEAO's policymaking is a healthy endeavour that should concern more local academicians and professional economists.

—Jacques Pégatiénan Hiey, Consultant, PH International, and Direction Générale de l'Economie, Ministère d'Etat, Ministère de l'Economie et des Finances, Côte d'Ivoire



The World Institute for Development Economics Research (WIDER) was established by the United Nations University (UNU) as its first research and training centre and started work in Helsinki, Finland in 1985. The Institute undertakes applied research and policy analysis on structural changes affecting the developing and transitional economies, provides a forum for the advocacy of policies leading to robust, equitable, and environmentally sustainable growth, and promotes capacity strengthening and training in the field of economic and social policy making. Work is carried out by staff researchers and visiting scholars in Helsinki and through networks of collaborating scholars and institutions around the world.

INSIDE: Policy Brief

“What can the European Central Bank learn from Africa?”

The UNU-WIDER project on ‘Macroeconomic Policy in the Franc Zone’ analyses the recent economic experiences of the African Franc Zone’s member states and of its economic institutions.

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