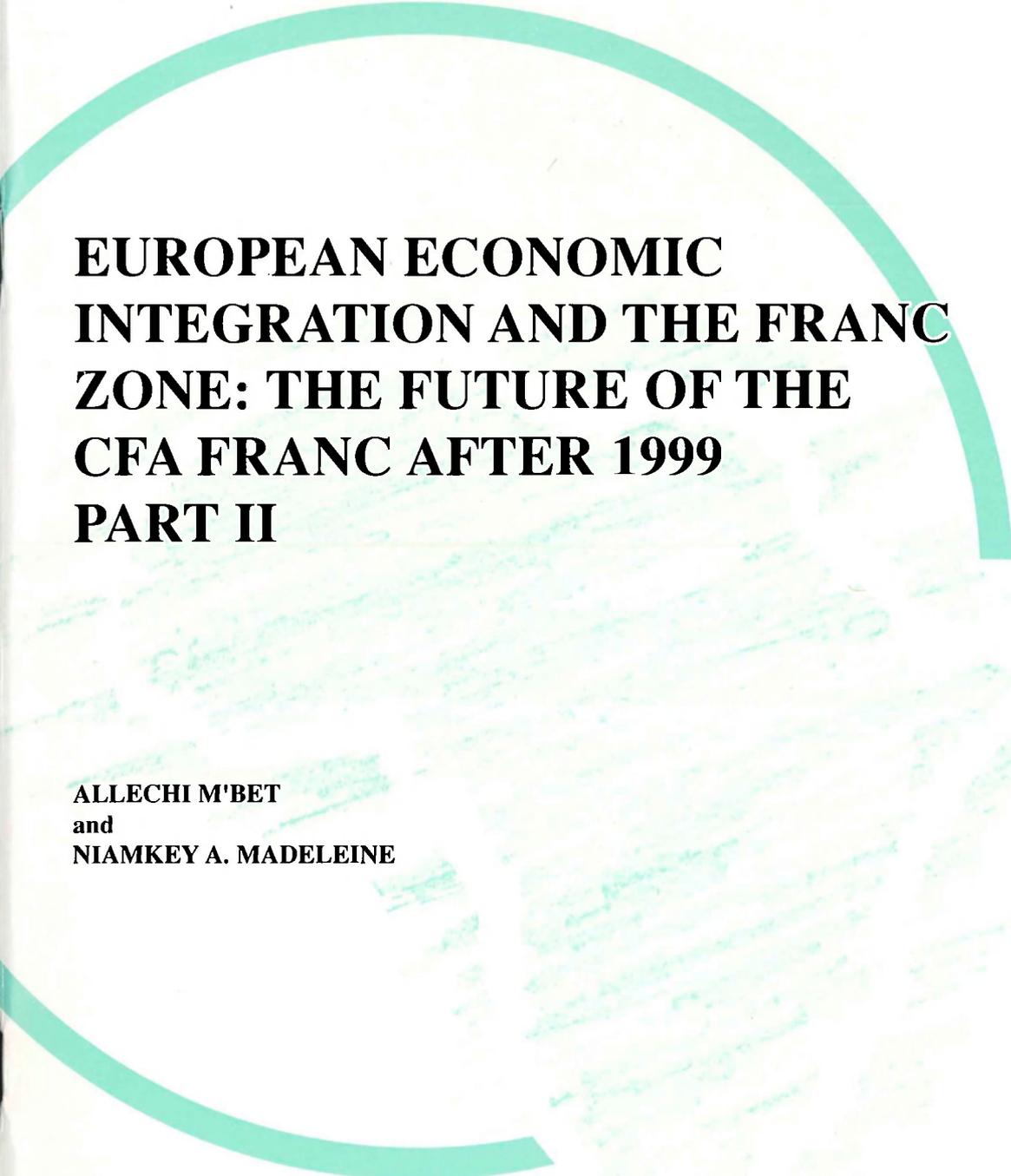


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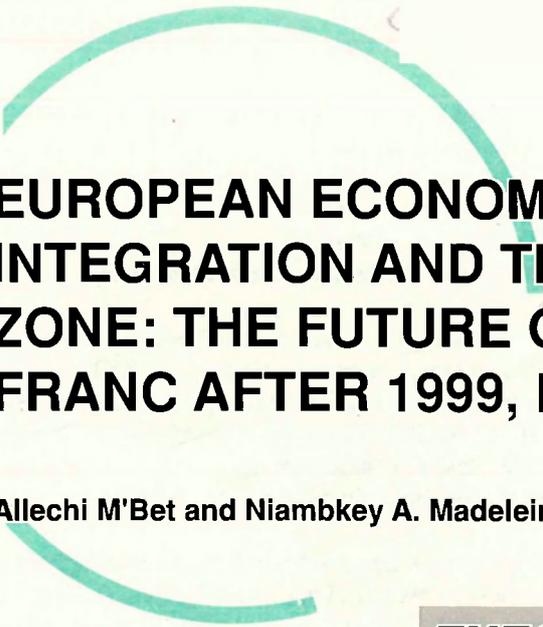
**EUROPEAN ECONOMIC
INTEGRATION AND THE FRANC
ZONE: THE FUTURE OF THE
CFA FRANC AFTER 1999
PART II**

**ALLECHI M'BET
and
NIAMKEY A. MADELEINE**



AFRICAN ECONOMIC RESEARCH CONSORTIUM

CONSORTIUM POUR LA RECHERCHE ECONOMIQUE EN AFRIQUE



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EUROPEAN ECONOMIC INTEGRATION AND THE FRANC ZONE: THE FUTURE OF THE CFA FRANC AFTER 1999, PART II

Allechi M'Bet and Niambkey A. Madeleine

EXECUTIVE SUMMARY

Context

It is well known that the exchange rate plays a central role in an open economy. For most African countries, the role has been amplified by structural adjustment in which achieving a realistic exchange rate has been a key objective. For the CFA franc zone countries, the issue is complicated even more because they have institutionally pegged their common currency to the French franc. This paper addresses exchange rate options for the CFA franc in the light of European monetary integration by the year 1999, when a single European currency is likely to emerge.

What is the problem?

The CFA franc has been pegged to the French franc for nearly 50 years. The Maastricht accord of December 1991, which calls for a single European currency (the "euro") by 1999, means that in a few years time the French franc will effectively cease to exist. This gives rise to the question, *What is the fate of the CFA franc in relation to the single European currency?*

Reassurances that the CFA franc would be pegged to the euro raised even more questions, because they were made without either consultation with African partners in the Franc Zone or consideration of the impact of singling out the CFA franc over the currencies of other develop-



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ing countries. Nor did they address questions of the basis on which such a peg would be implemented. This study explores some of the options open to CFA countries.

Exchange rate concepts and alternatives

Developing countries currently have three options for their exchange rate regimes:

- Fixed exchange rate
- Independent floating rate
- Intermediate regime, i.e., adjustable peg or crawling peg

Criteria for choosing one or the other are uncertain and differ from country to country. The fixed rate is supposed to favour low inflation, but it will vary with the value of the pegged currency. Independent flotation gives greater flexibility as it is primarily market determined, but it can be unstable. Intermediate regimes have flexibility, but reserve the right to correct for disequilibrium.

The Franc Zone countries not only have fixed exchange rates, but their rates are fixed to a single currency, the French franc. This should have both advantages and disadvantages. On the plus side, pegging to a single currency should reduce the fluctuations in the exchange rate between a developing and a developed country, which should facilitate trade and capital flows. Moreover, when a developing country pegs to an external anchor, it broadly aligns its policies with those of the pegged country; this may stimulate investment. Finally, a fixed regime may be regarded as more disciplined and resulting in greater stability.

The CFAF countries have not realized the benefits of the single currency peg. The low inflation that they have experienced has been offset by declining productivity, low investment volume and disadvantages when trading with partners other than France.

Exchange rate options for the CFA franc after 1999

With the likelihood that the French franc will not exist as a national currency after 1999, it is time to consider the future of the CFA franc. The authors see five possible scenarios:

1. Pegging to the euro - The euro seems to be the natural anchor, given that the CFAF is already linked to it through the French franc. Because of the strict requirements of the Maastricht accord, the euro can be expected to exhibit low inflation and will be strong enough to ensure that no single African currency would influence the direction in which other countries will want to go. There are then two options for pegging to the euro, separately as the BEAC franc and the BCEAO franc, or combined into a single unit. Each option has advantages and disadvantages, including guarantee of convertibility, exchange rate, etc., and these must be sorted out. What would be the mechanisms for convertibility, and indeed, why should the CFAF have guaranteed convertibility when other developing countries' currencies do not?

2. Multi-currency pegging - The CFA countries trade with the EEC more than with any single country in the world. However, most of their imports are denominated in US dollars, as are most grants and loans from the major financial institutions. And more and more transactions are denominated in the Japanese yen. It may therefore be desirable to peg the CFAF to a composite basket of the euro, dollar and yen. But all the CFA countries should have the same basket to avoid problems of cross rates and the rigidities of a single currency peg.
3. ECOWAS-wide single currency - One of the biggest impediments to intra-community trade in ECOWAS is the diversity of currencies and currency regulations in the countries of the bloc. Currency convertibility is a major issue, and the CFAF is convertible by only 7 of the 16 ECOWAS countries. A single currency within the region has been mooted as a way to solve the convertibility problems. How would the CFAF in its new relationship to the euro relate to an ECOWAS currency?
4. Breakdown of the Franc Zone and creation of separate currencies - The CFA countries are not really a homogenous group. There are wide differences, not only between the two components of the Franc Zone, but within each one, in levels of income, movements of capital, factors of production costs, growth rates and other indicators. Therefore, the possibility of disagreement among the countries on issues like exchange rate alignment is very real, and could threaten the integrity of the Franc Zone. Such a result goes against all the trends toward economic union and would further balkanize the monetary system in Africa.
5. Institutionalizing an African monetary fund - Some pan-Africanists think that a continent-wide monetary union would be the answer to all the troubles of the continent. The economic summit in Lagos in 1980 called for economic integration of Africa by 1985. The deadline is long past, a testimony to lack of political will. How can such a proposal be taken seriously?

Policy implications

From the examination of all the possible exchange rate arrangements, the study indicates that an adjustable peg to the euro at an early stage would be the best arrangement, with a convertibility guarantee at the European Central Bank. But which CFAF to be pegged—the BCEAO/UEMOA CFAF or the BEAC/CEMAC CFAF? Can nations with a single currency and a common central bank that is accountable not to the nation states but to a common body (UEMOA or CEMAC) be truly independent? (An issue with which some EU members are still not fully comfortable.) Can the policy of convergence under UEMOA and CEMAC offset national self-interest and specific budget constraints?

The option of a multi-currency pegging to the euro, US dollar and Japanese yen does not appear feasible for the very near future, as a learning process to manage the adjustable peg is necessary. Nor does the option of an ECOWAS-wide single currency appeal, though it is

desirable; time is needed for ECOWAS to become better organized and its institutions operational.

The least attractive option is separate currencies for the individual CFA countries, which goes against the trends of building trading blocs and would further fragment African economies. Finally, there is the possibility of an African monetary fund that will clear the way for a continent-wide currency. We feel that this option is premature and the effort should be put into implementing one of the first three scenarios.

The next research task is to study the underlying economic adjustment in CFA economies under a flexible CFAF pegging regime. This will give insights into the performance of the CFAF in the new world currency order.

Other related AERC publications

European Economic Integration and the Franc Zone: the Future of the CFA Franc after 1996, Part I, by Allechi M'Bet and M. Niamkey, AERC RP 19, July 1993.

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Part II**

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I. Introduction

It is well-known that the exchange rate plays a central role in an open economy. Indeed, economists have written a lot about exchange rates, especially during the last 20 years.

According to Aghevli, Khan and Montiel (1991):

The exchange rate performs a dual role in small open economies. Its movements can achieve and maintain international competitiveness and so ensure a viable balance of payments. At the same time, a stable exchange rate can anchor domestic prices. A debate has emerged, however, in both policymaking and academic circles on the relative weight that should be assigned to each of these objectives in formulating exchange rate policy.

Fundamentally, and put differently, exchange rate changes have important pervasive effects, with consequences on prices, wages, interest rates, production levels and employment opportunities, and hence direct or indirect implications for the well-being of economic agents.

The emergence of the role of the exchange rate stemmed from the collapse of the post-war international monetary system after 15 August 1971. Under the Bretton Woods Accord, member countries of the IMF kept their currencies at a fixed exchange rate or at best at fixed rates within narrow ranges with occasional adjustments. The official IMF classification made three broad categories: fixed or pegged exchange rate; flexible exchange rate; and an in-between exchange rate arrangement known as crawling peg.

For most African countries, the role of the exchange rate has been amplified by structural adjustment programmes in which achieving a realistic exchange rate has been a key objective. For the CFA franc zone countries, the issue is complicated even more because they have institutionally pegged their common currency to the French franc so that an independent exchange rate adjustment was ruled out for over 45 years – until 12 January 1994 when the very first collective exchange rate devaluation occurred, in the amount of 50%.

It is against this background that this paper addresses the issue of the likely exchange rate arrangement options for the CFA franc in the wake of European monetary integration by the year 1999 when, according to the last stage of the Delors Report, a single currency will emerge.

The paper proceeds as follows. Section I reviews the exchange rate policies that developing countries have been implementing since the Bretton Woods accord. That includes a recall of the exchange rate concept followed by the main characteristics of

developing country economic structures and the various exchange rate regimes that have been attempted over the years; Section II lays out the exchange rate options for the CFA franc after 1999. Section III makes some concluding remarks.

Review of exchange rate policy in developing countries

As a preliminary to the CFA alternative exchange rate options after 1999, it is appropriate to review the exchange rate policies that prevailed over the years in developing countries in general. Therefore, we first recall the concepts and objectives of exchange rate policies. But since the exchange rate regime depends on the degree of the development of the economies, we examine next the characteristics of developing countries such as those of the CFA zone. Finally, we present the most recent evolution of exchange rate regimes in developing countries, thereby clearing the way to the different options available to the CFA countries.

The concepts of exchange rate and objectives of exchange rate policy

The concepts of exchange rate

Several authors give different definitions of the exchange rate. In most basic international economics textbooks, the exchange rate is defined as the price of one nation's currency relative to that of another nation's currency. An exchange rate shows the number of units of one currency that are needed to buy a unit of the other currency. Among previous works on the exchange rate matter, the most recent one is attributable to Collier and Joshi (1989) who defined the exchange rate as "relevant relative price indicating the competitiveness of tradeables". The nominal exchange rate (NER) simply indicates the number of units of foreign currency per unit of domestic currency. The NER can have some influence on the competitiveness of tradeables if it can affect the real exchange rate, the latter being the domestic price of tradeables relative to the foreign price of tradeables measured in a common currency.

RER	=	NER*(Pf/Pd)
RER	=	real exchange rate
NER	=	nominal exchange rate
Pf	=	foreign price; usually the wholesale price of major trading partners is used. In CFA countries, the French wholesale price Index (WPI) is usually used as foreign price.
Pd	=	domestic price proxied by the consumer price index

As Krumm (1987) put it: "Though it is difficult to know with precision the level of competitiveness that is required for growth consistent with the healthy external sector,

the RER acts as an important signal to economic agents and to those formulating macroeconomic policies”.

In other words, the RER is broadly defined as a relative price that summarizes the degree of competitiveness of the external sector of a country. Although a country can usually alter its currency rate vis-à-vis other currencies by devaluation, it is still possible to adjust the rate through the foreign/domestic price ratio.

This is particularly valid when speaking about CFA countries where devaluation on a country basis is ruled out by institutional agreement. Since countries trade with each other in an interdependent world, policy makers are concerned not merely with the bilateral real exchange rate, but with the real effective exchange rate (REER). The REER is the trade-weight adjusted real exchange rate.

$$\begin{aligned} \text{REER}_i &= \text{RER}_i * W_i \\ \text{REER}_i &= \text{NER}_i * (P_j/P_i) * W_j \\ i &= \text{country } i \\ n &= \text{trading partners} \\ W &= \text{weighting term} \end{aligned}$$

Thus defined, an increase in the REER implies a real appreciation, according to the well-known purchasing power parity (PPP) definition.

It should be noted that the nominal exchange rate does not constitute a satisfactory indicator for use in economic policy (Ngirabatwaré, 1986). In fact, in open economies, countries trade with different currencies that fluctuate regularly according to the evolution of economic fundamentals. This induces a variability of the real exchange rate as defined earlier. Hence to take into account the uncertainties associated with hard fluctuations of currencies' such as the French franc, the real effective exchange rate represents the best exchange rate tool. Several methods have been used to measure the REER by different authors (Arthus and Rhomberg 1973; Rhomberg, 1975; Bautista, 1989; Edwards, 1989, 1990).

We should remember that all these different concepts are compared with the ideal exchange rate or the equilibrium exchange rate, which will bring internal and external current account and payments balance.

No matter which concept is used, various characteristics of developing countries have an important bearing upon the costs of alternative exchange rate regimes.

Objectives of the exchange rate policy

The choice of an exchange rate regime must take into consideration the structural characteristics of each given economy, the sources of external and domestic shocks, and the goals to be achieved. According to policy makers the objectives of the exchange rate regime are twofold. First, a realistic exchange rate allows the economy to achieve and to maintain competitiveness and thereby to ensure a viable balance of payments. Second, a realistic exchange rate will also lead to some stability of the effective real exchange rate

that will in turn stabilize domestic prices at low levels in developing countries. According to Ngirabatwaré (1986), an adequate exchange rate regime, by increasing economic wealth, must raise the standard of living of the population.

These goals are at times conflicting and neither the fixed nor the flexible exchange rate can reach both low stable prices and increase the standard of living of the population. According to Aghevli, Khan and Montiel (1991), one issue that must be addressed concerns the criterion of optimality. For these authors, "modern analysis... has focused on the relatively narrow criterion of macroeconomic stability defined in terms of minimizing the variance of real output, the price level or real consumption in the face of random transitory shocks".

Since the structure of an economy influences its functioning, we turn now to the most salient characteristics of the developing countries, such as those of the CFA zone.

Characteristics of developing countries and their exchange rate regimes

Despite their common label, developing countries constitute a rather heterogeneous group, even within a sub-group like CFA countries. Indeed, some CFA countries are oil exporters, others are oil importers; yet others are landlocked and Sahelian, while others are coastal and covered in rain forest and so suitable for tree crops. All these various characteristics affecting the production of tradeables, also affect the exchange rate regimes for the CFA countries.

Accordingly, in this part of the study, we indicate what these characteristics are and what impact they may have on the exchange rate adjustment process.

In general, the main differentiating characteristics of developing countries relevant to this research relate to their inability to affect export or import prices in foreign currency through their own exchange rate policies; the inelastic nature of their demand for imports and, in the short run, the inelastic supply of exports; the rather rudimentary nature of their financial sector; and the fact that capital flows are not determined by conventional yield considerations, in which case we have capital movements, but rather by political considerations, implying capital flight.

Overall, the main characteristics of developing countries can be grouped into five points, which set them apart from developed countries, following Collier and Joshi (1989) and Crockett and Nsouli (1977):

- They tend to have large non-tradeable sectors. Indeed, the manufacturing sector, which constitutes the most tradeable part of production, is not highly developed. Many developing countries have more than a trivial volume of manufactured goods, with the share of industrial products in GDP only about 12% on average. This contrasts sharply with more developed economies where a large diversity of industrial goods is produced and traded and represents at least 23% of GDP.
- Developing countries have the majority of their labour force in the primary sector.

And since primary products are fairly homogeneous and the volume of exports share is small and has no effect on the international market, most of these countries are “price takers”. Even Côte d’Ivoire, which is the world’s largest cocoa producer, has no control over cocoa prices.

- Reflecting the highly specialized production structure of developing countries, their foreign sector differs in nature and importance from that of more developed economies. Because of this, they are more prone to external shocks and need all the “tools in the box” to resist these shocks. However, they have tended to respond to the balance of payments problem by altering trade restrictions. Distorting policy can create allocative inefficiency and lead to substantial changes in income.
- Economic growth in developing countries, as contrasted with that in industrial countries, depends heavily on the foreign sector for two major reasons. First, due to inadequate domestic savings availability, private foreign capital inflows play a greater role to supplement domestic savings, but not at a sufficient level to attain the desired targets. Secondly, dependence on imported manufactured equipment from developed countries creates foreign reserves constraint problems.
- The financial markets in most developing countries are rudimentary, although improving gradually over time. The process of financial intermediation is still at a developing stage. This limited extent of domestic financial assets calls for more direct links between the budget deficit and the money supply, and between money supply and the price level. Accordingly, a monetary approach to the balance of payments may be more applicable to developing countries than to developed countries.

Given these characteristics, the question arises as to what exchange rate regime may be suitable for developing countries.

Exchange rate arrangements

According to the IMF’s classification, as reported by Collier and Joshi (1989.) and Aghevli, Khan and Montiel (1991), developing countries currently have three options for their exchange rate regimes:

- Fixed exchange rate
- Independent floating rate
- Intermediate regime, i.e., an adjustable peg or a crawling peg

According to these authors, the criteria of the choice of a given exchange rate regime are rather uncertain and vary from country to country. Developing countries must not neglect any of the criteria that have major influence on the effective real exchange rate. The identification of these criteria is particularly difficult. These difficulties stemmed

from the reasons for external and domestic shocks as well as temporary and permanent shocks. Another source of difficulty is the structural characteristics of developing economies. Given these difficulties, developing countries attempt to implement exchange rate regimes that can correct for the balance of payments imbalances, that is exchange rate regimes that are less “harmful” (Ngirabatwaré 1986)

Table 1 below presents this classification of exchange rate regimes in 1987 as it figures in the *IMF Annual Report*, and as reported by Collier and Joshi. Furthermore, Table 2 summarizes the quantitative importance of the various exchange rate regimes in developing countries.

Table 1: Exchange rate arrangements as of 30 June 1987

Pegged					Flexibility limited vis-a-vis a single currency or group of currencies			More flexible		
Single currency			Currency composite		Single currency ²	Cooperative arrangement ³	Adjusted according to a set of indicators	Managed floating	Independently floating	
US dollar	French franc	Other	SDR	Other						
Afghanistan ⁴	Suriname	Benin	Bhutan	Burma	Algeria	Bahrain ⁵	Belgium ⁴	Brazil	Argentina	Australia
Antigua and Barbuda	Syrian Arab Republic ⁴	Burkina Faso	(Indian rupee)	Burundi	Austria	Qatar ⁵	Denmark	Chile ⁴	China	Bolivia
Bahamas ⁴	Trinidad and Tobago	Cameroon	Kiribati	Iran, Islamic Republic of	Bangladesh ⁴	Saudi Arabia ⁵	France	Colombia	Costa Rica ⁴	Canada
Barbados	Uganda	Central African Republic	(Australian dollar)	Jordan	Botswana	United Arab Emirates ⁵	Germany, Federal Republic of	Madagascar	Dominican Republic	The Gambia
Belize	Venezuela ⁴	Chad	Lesotho ⁴	Kenya	Cape Verde		Ireland	Portugal	Ecuador	Ghana
Djibouti	Vietnam ⁴	Comoros	(S. African rand)	Libya ⁷	Cyprus		Italy		Egypt ⁴	Guinea
Dominica	Yemen, Arab Republic	Côte d'Ivoire	Tonga	Rwanda	Fiji		Luxembourg ⁴		Greece	Lebanon
El Salvador	Yemen, Republic	Equatorial Guinea	(Australian dollar)	Sao Tome and Principe	Finland ⁴		Netherlands		Guinea-Bissau	Maldives
Ethiopia	Yemen, People's Democratic Republic of	Gabon		Seychelles	Hungary				Iceland	New Zealand
Grenada	Zambia	Mali		Vanuatu	Israel				India ⁸	Nigeria ⁴
Guatemala ⁴		Niger			Kuwait				Indonesia	Philippines
Guyana ⁴		Senegal			Malawi				Jamaica	Sierra Leone
Haiti		Togo			Malaysia ⁶				Korea	Somalia ⁴
Honduras					Malta				Mauritania	South Africa ⁴
Iraq					Mauritius				Mexico ^{4,9}	
Lao, People's Democratic Republic					Nepal				Norway	United Kingdom
Liberia					Papua New Guinea				Morocco	United States
Mozambique					Poland				Pakistan	Uruguay
Nicaragua ⁴					Romania				Peru ¹⁰	Zaire
Oman					Singapore				Spain	
Panama					Solomon Islands				Sri Lanka	
Paraguay ⁴					Sudan ⁴				Tunisia	
St. Kitts and Nevis					Sweden ⁴				Turkey ¹¹	
St. Lucia					Tanzania				Western Samoa	
St. Vincent					Thailand				Yugoslavia	
					Zimbabwe					

Notes to Table 1:

- 1 No currency information is available relating to Democratic Kampuchea.
- 2 In all cases listed in this column, the US dollar was the currency against which exchange rates showed limited flexibility.
- 3 This category consists of countries participating in the exchange rate mechanism of the European Monetary System. In each case, the exchange rate is maintained within a margin of 2.25% around the bilateral central rates against other participating currencies, with the exception of Italy, whose exchange rate is maintained within a margin of 6%.
- 4 Member maintains dual exchange markets involving multiple exchange arrangements. The arrangement shown is that maintained in the major market.
- 5 Exchange rates are determined on the basis of a fixed relationship to the SDR, within margins of up to $\pm 7.25\%$.
- 6 The exchange rate is maintained within margins of $\pm 2.25\%$.
- 7 The exchange rate is maintained within margins of $\pm 7.5\%$.
- 8 The exchange rate is maintained within margins of $\pm 5\%$ on either side of a weighted composite of the currencies of the main trading partners.
- 9 After 30 June 1987, the spread between the two exchange rates was less than 1%.
- 10 Member maintains a system of advance announcement of exchange rates.
- 11 The central bank establishes its selling rate daily and the buying rate is set at 0.5% below the selling rate. Commercial banks must use the central bank's selling rate, but are free to set their own buying rate.
- 12 The exchange rate is maintained within margins of $\pm 1.5\%$.

Table 2: Developing countries: exchange rate regimes in selected years (Number of countries)

	1973	1976	1982	1987
<i>Pegged to a single currency</i>	86	67	56	53
of which:				
US dollar	54	46	38	34
French franc	17	13	13	14
Pound sterling	11	3	1	-
Other	4	5	4	5
<i>Pegged to a composite</i>	-	25	34	37
of which:				
SDR	-	11	15	10
Other	-	14	19	27
<i>Flexible arrangements</i>	11	15	35	42
of which:				
Limited flexibility against single currency	-	2	10	4
Adjusted according to a set of indicators	8	6	4	4
Managed floating	-	4	16	22
Independent floating	3	3	5	12
Total	97	107	125	132

Source: Annual Reports of the IMF.

Table 3 : Developing countries exchange rate arrangements, 1976-1989. (in percent of total number of countries)

Classification	1976	1979	1983	1989
Pegged to a single currency	62.6	52.1	43.5	38.2
U.S. Dollar	43.0	35.0	29.0	23.7
Other currency	4.7	2.5	3.2	3.9
(pound sterling)	(2.8)	(2.6)	(0.8)	(-)
Pegged to composite	23.4	23.1	28.2	28.2
SDR	10.3	11.1	11.3	5.3
Other (currency basket)	13.1	12.0	16.9	22.9
Flexible arrangements	14.0	24.0	28.3	33.6
Adjusting to indicators	5.6	3.4	4.0	3.8
Other ¹	8.4	21.4	24.3	29.8
Total	100.0	100.0	100.0	100.0

Source: IMF Annual Report (1982) IMF Report on Exchange Arrangements and Exchange Restrictions and IMF International Financial Statistics April 1990.

Notes: Based on mid-year classifications, except for 1989, which is based on end-year classification. Excludes democratic Kampuchea, for which no information is available. ¹Includes the following categories: "flexibility limited vis-à-vis single currency, "managed floating" and "independently floating"

These tables indicate in different ways how many countries have used a particular exchange rate regime since major countries started floating their currencies in 1973, following the USA's decision of 15 August 1971 to stop the convertibility of the US dollar into gold.

Historically, most major currencies were pegged to the US dollar, which became a de facto international reserve after World War II. Such a peg was an adjustable one before August 1971.

In developing countries, apart from being pegged to the US dollar, currencies of most ex-colonies of France and Britain were pegged to the French franc and the pound sterling respectively, themselves pegged to the US dollar. The particular case of the ex-French colonies, which is our main concern here, drew considerable attention because their fixed peg has not changed since 1948. Such fixity may come to an end sometime after 1999 and our goal is to seek alternative pegging or just alternative exchange rate regimes, to which we will come back later in detail.

As Table 2 shows, since the general flotation in 1973, some changes occurred as many countries reacted to the costs of single-currency pegging. Mainly, there has been a switch from single currency pegging to multi-currency pegging. Moreover, some developing countries even made the move to float their currency vis-à-vis the major ones. Table 3 shows the evolution of the different exchange rate regimes in percent of the number of countries. It indicates that the proportion of developing countries that have pegged their currency to a single currency has declined drastically, from 63% in 1976 to 38% in 1989. The proportion of countries that have pegged their currency to the US

dollar went from 43% to 24%. The proportion of currencies pegged to the British pound fell considerably, from 2.8% in 1976 to 0.8% in 1983. In 1989 no currency was pegged to the British pound. The proportion of currencies pegged to the IMF SDR also declined from 10.3% to 5.3%. The pegging to the French franc constitutes an exceptional case. Indeed the majority of francophone countries have maintained their fixed parity with the French franc.

However, one could note from Tables 2 and 3 that the exchange rate regime evolution is in favour of pegging to a basket of currencies. In fact, in 1976, the number of countries that pegged their currency to a basket was 14. In 1987 that number had increased to 27. Proportionally, the number of countries that pegged their currencies to a basket increased from 13.1% in 1976 to 22.9% in 1989. According to Aghevli, Khan and Montiel (1991):

The decision by an increasing number of developing countries to switch their pegging arrangement from a single currency to a composite basket of currencies has been prompted partly by the desire to minimize the adverse effects on their economies of fluctuations in the exchange rates of major currencies that have taken place since the advent of generalized floating in 1973, and particularly in 1980s.

However, the most important evolution is in favour of flotation. The proportion of countries that adopted a flexible exchange rate regime increased from 14.6% in 1976 to 33.6% in 1989. Aghevli *et al.* (1991, p.3) attributed the change to

the high level of domestic rates of inflation in many developing countries during the 1980s; the uncertainty associated with the fluctuations in the exchange rates of the major currencies.... Such an arrangement enables the authorities to take advantage of the fluctuations in major currencies to camouflage an effective depreciation of their exchange rate, thus avoiding the political repercussions of an announced devaluation.

Any choice between fixed pegging, independent flotation and an intermediate adjustable peg carries with it some advantages and some inconveniences. In examining these points, it is worth noting that the choice between exchange rate regimes concerns essentially the fixity or variability of the nominal exchange rate. Indeed, any exchange rate regime, fixed or variable, is capable in principle of correcting for balance of payments disequilibrium by altering the real exchange rate in the same way that a floating regime will.

Fixed exchange rate

Conceptually, the fixed exchange rate is supposed to favour low inflation. Unfortunately, if wages and prices are downwardly rigid, the process of achieving external and internal

balance in the event of unfavourable external shocks, such as the oil price or the fall in commodity prices, can be non-converging. In such a case, these shocks can cause large losses in output and employment.

How did the fixed CFA exchange rate operate in the recent economic crisis years? The strict monetary discipline has verified the case for low inflation stemming from a fixed CFA exchange rate. Indeed, the average inflation rate for CFA countries has been about 10% in recent years, whereas other African countries reach up to 20% inflation rate (Oladeji, 1988).

The pressing question remains as to whether low inflation constitutes an economic goal per se. In fact, at what price did CFA countries achieve low inflation? Recent studies (Devarajan and Rodrik, 1991) on the fixity of the CFA rate showed that low inflation was achieved at a high cost of output and employment. More on this issue will follow.

For the time being, it is useful to know that there are two forms of the exchange rate that have a fixed parity: the single currency peg and the multi-currency peg.

Let us examine each peg in turn.

The single currency peg

According to Crockett and Nsouli (1977), pegging to a single major currency seemed to have been the option most favoured by developing countries. From a practical viewpoint, it is the simplest. It involves no more than continuing the exchange rate policy that prevailed before the end of the system established since Bretton Woods. Table 1 above indicates that although many countries have switched away from single-currency pegging, this arrangement is still practiced in some 20 countries, as Collier and Joshi reported (1989, p. 101). Among these 20 countries are the 13 ex-French colonies grouped in the CFA zone, and some small Central American countries such as Panama that pegged their currency to the US dollar.

Various advantages as well as disadvantages may be attributed in theory to pegging the value of a developing country's currency to that of its major trading partner.

Advantages of single-currency peg: There are four known advantages attached to a single-currency peg. First, pegging to a particular currency, like the French franc for CFA countries, may reduce, relative to other alternatives, the fluctuations of the exchange rate between the developing and the developed country. Other things being equal, this facilitates trade between the two countries by reducing the uncertainties associated with changes in the exchange rate. Similarly, capital flows for investment purposes may increase.

Concerning the CFA case, one can consider two periods: 1962-1980, and thereafter till now. From 1962 to 1980, and especially during the coffee and cocoa boom in the 1970s, trade between France and CFA countries stood at about 50%-60% per cent of total trade. Capital flows were high. The balance of the operations account was positive. But after world commodity prices started falling sharply in the 1980s, export earnings were reduced and subsequently the balance of the operations account became negative

for countries such as Côte d'Ivoire and Senegal; trade and capital flow dropped dramatically. This casts doubt on the ability of the single-currency pegging mechanism to adjust to unforeseen external shocks. Despite single-currency pegging coupled with low inflation, investment volume dropped and many French firms closed shop, profitability being reduced by the weak demand caused by low real income.

The second advantage of single-currency pegging relates to the relative stability of the industrial nations vis-à-vis the rest of the world. Here again, after 1971, several swings in the major currency (US dollar) occurred to which the FF reacted. In addition, recession in industrial countries offset monetary stability, so much so that trade was not stimulated, but rather hampered by protective barriers, related tariffs or non-tariff barriers, despite the ongoing Uruguay round. The protective economic environment overwhelmed any stability provided by single-currency pegging. Countries like Côte d'Ivoire could not increase trade despite monetary stability, since market access became extremely difficult.

Third, a developing country that pegs its currency to an external anchor, such as the French franc, intends to align its policies broadly to those of the partner country; this might increase confidence in the CFA franc.

This may, in turn, stimulate investment. But because of the difference in the level of productivity, and the policies adopted by industrial countries such as France to remain competitive vis-à-vis other EEC countries, single rate fixity may not be regarded as adequate to promote long term stability. We have shown that CFA countries have more and more diversified trading partners. In such a case, "if the peg-currency floats against major currencies, the developing country's normal and real effective exchange rate also floats but without any reference to its own needs" (Collier and Joshi, 1989, pp. 101-102). This has been the case for the CFA countries. Their imports still come largely from France, although they are more diversified than before. But the CFA countries' export destinations are geographically diversified. Thus converting major currencies, say the dollar or yen, into FF at the operations account leads to exchange rate costs, as we have computed.

Changes in the dollar-franc exchange rate have had substantial undesirable effects on CFA economies.

Finally, the disciplinary aspects of pegging can sometimes be viewed as an advantage if a fixed rate acts as "a fulcrum for domestic stability" according to the 1970 *Report of the Fund's Executive Directors*. This report argues as follows:

... the need to defend a fixed exchange rate against depreciations may promote political willingness to impose unpopular domestic restraints; and where the attempt to defend the parity is ultimately unsuccessful, the psychological shock of a devaluation may promote broad support for the necessary associated measures to curtail domestic demand. For CFA countries, on the criteria of external and internal balance, a major benefit that analysts mentioned arises from the anti-inflationary discipline provided by the peg. Indeed, the CFA zone is best regarded not as an exchange rate policy but as a budgetary policy. Members are not able to finance budget deficits by printing money beyond limits set by a non-national monetary authority.

The question that arises is: can an independent monetary authority, set by itself and for itself, pursue some domestic monetary growth rate in accordance with its macroeconomic policy? Whatever the case, low inflation has brought other heavy disturbances in CFA countries. Let Devarajan and Rodrik (1991) tell the story:

For most of the CFA members, the benefits of lower inflation do not appear to have been large enough to offset the costs of reduced output (high unemployment). Under "reasonable" output-inflation trade-off, these countries would have been better off having the flexibility to adjust to external shocks through exchange rate adjustment.

Disadvantages of a single-currency peg: In addition to the difficulty of realizing the benefits of a single-currency peg in CFA countries, there are four genuine disadvantages for such peg. Indeed, a single currency peg in a world of major floating currencies does not have the same consequences as adopting a fixed exchange rate in a world of stable parities. Hence, there exist potential drawbacks to a system in which all countries adhere to par values.

The first drawback is the need for increased foreign reserves. Indeed exchange rate fluctuations in the pegged currency will not reflect actual developments in the balance of payments of the pegged-currency country; rather they will reflect the development in the balance of payments of the industrial country to which the developing country is pegged.

The amount of reserves needed will depend on the nature of the relationship between the equilibrium exchange rate of the two countries. If the relationship is close and positive, induced changes in the developing countries exchange rate vis-à-vis the rest of the world will usually be in the right direction. However, if, as is perhaps more likely, the factors affecting the equilibrium exchange rate of the two countries are not closely related, the need for reserves may be greater than under an adjustable regime.

For the Franc zone, to our knowledge, there has been no study dealing systematically with equilibrium exchange between CFA and FF. However, it is well known that the CFA is over-valued by at least 30%-50% depending on the methodology used for the computation. No matter the degree of over-valuation, this has economic consequences with regard to microeconomic allocative efficiency. Exchange rate disequilibrium leads to wasteful movements of resources, by increased imports and less incentive for export activities. That is the reason a devaluation has been so often called for in recent years for CFA countries.

A second drawback is that a single-currency peg may interfere with the pursuit of internal policy objectives, especially in the presence of exogenous and independent fluctuations in the exchange rate. One may consider for example the case of developing countries, such as CFA countries, trying to stimulate national production and employment to move out of their continuing economic crisis. An exogenous fluctuation that increases the value of the intervention currency, the French franc for our purposes, will lower the local price of imports and exports, thus stimulating imports and curbing the incentives to export. The overall effect may be a reduction in local production and employment, as the

Côte d'Ivoire has been experiencing. Resulting from the uncertainties associated with the production and consumption of tradeables, there may be a diversion of activity towards non-traded sectors.

A third disadvantage with single-currency pegging in a world floating system, is that exchange rates between developing countries' currencies will be volatile since different countries peg to different major currencies, such as the US dollar or the French franc. This is particularly pernicious when, in a sub-region like West Africa, many countries of small size are trying to attain some market advantages by promoting intra-regional trade.

Pegging to a single-currency in the context of generalized flotation is, therefore, not a continuation of the exchange rate policy under adjustable par values since the world conditions changed in August 1971. The single peg does reveal some clear-cut identifiable disadvantages, which we have indicated. In an attempt to limit these problems, some developing countries decided to peg their currency to a weighted basket of currencies that takes into consideration the trade share relationship.

The multi-currency peg

According to Collier and Joshi (1989, p. 102) "the object of the multi-currency peg is to eliminate the effect of third currency fluctuations by pegging the nominal effective exchange rate, or in other words, by pegging the home currency to a suitable average of foreign exchange rate". Multi-currency pegging is an attempt to mimic a fixed exchange rate in a world of floating currencies. This alternative peg tries to retain the advantages of pegging while minimizing the disadvantages. But to advocate a stable effective exchange rate implies the choice of weights. The appropriate weights depend on the policy variables policy makers wish to stabilize. For small countries such as those in the CFA zone, this clearly points to the internal and external balance; accordingly, this comes to stabilizing the price of tradeables relative to non-tradeables. This requires the use of bilateral shares of partner countries as the appropriate weights. For large countries, this requires the use of elasticity-base weights.

In any case, the most comprehensive measure of a country's effective exchange rate would include its trade and payment structure, the price effects generated by exchange rate changes, the price elasticities for different products, the competitive relationships of a country's exports, the pattern of bilateral trade, and the effects on capital flows. Such a comprehensive and sophisticated index has yet to be constructed. The best approximation so far has been the IMF's multilateral exchange rate model (Rhomberg, 1975). The volume of data required to construct such an index prohibits small developing countries without a decent data base from attempting to do so.

Three indexes based on the pattern of merchandise trade are usually constructed:

- the export-weighted index
- the import-weighted index
- the bilateral trade index

The *export-weighted index* of a country's currency is the arithmetic average of its exchange rate against other currencies relative to a base period, weighted by the share of each trading partner in the export of the country concerned. Similarly, the *import-weighted index* is the arithmetic average of its exchange rate against other currencies, relative to a base period, weighted by the share of each country in the imports of the country concerned.

The *bilateral trade index* is the arithmetic average of the export-weighted index and the import-weighted index, weighted by the shares of exports and imports, respectively, in the sum total of imports and exports.

All three indexes permit in some way the pattern of bilateral trade. However, they do not take into account repercussions on prices, substitution effects, changes in competitiveness and effects on capital accounts.

For developing countries, because of the relative homogeneity of primary commodities, the import-weighted index provides the closest approximation to the effective exchange rate index. Indeed, prices of primary commodities are set in world markets independently of the precise geographical pattern of trade. Hence, for a given volume of exports, foreign exchange earnings will not be affected by changes in the prices of the exchange rate of the countries to which they export. Industrial countries, on the contrary, export products are not homogeneous; consequently, no uniform international price prevails and changes in the exchange rates will affect the price paid by the importing countries. The import price index denominated in local currency will be affected by changes in the sources of supply of its imports or by changes in exchange rates among supplying countries. Thus, the purchasing power of the foreign exchange earned will vary according to the geographical distribution of imports.

The import-weighted basket peg has the advantage of reducing the price instability generated by foreign exchange rate changes. Multi-currency pegging retains some disadvantages. Specifically, there is the problem that, due to each developing country using different basket, there would be varying cross rates between all developing countries using such baskets. Under the single-currency peg, there is at least stability amongst currencies using the same peg. This implies that CFAF countries would be better off pegging to a common basket, should the opportunity arise. Furthermore, the use of an unfamiliar peg for each country's currency, such as the CFAF, may render the countries less attractive as outlets for foreign investments.

In order to overcome these intangible drawbacks associated with the construction of separate baskets for each country, some countries have pegged to a common numeraire with an already existing international status, the Special Drawing Rights (SDR). As of 1987, ten countries had pegged their currency to the SDR. The case for such pegging to a numeraire is that it will reduce cross-rates variability and may stimulate intra-regional trade. Moreover, pegging to the SDR has the convenience of published daily data on the basis of the exchange rates in major financial markets and is based on the trade share of 16 major industrial countries.

The case against pegging to the SDR stems from the fact that it does not reflect movements in the effective exchange rate quite as closely as an import-weighted basket. Some interesting salient features emerge from Table 4. First, for most countries the SDR peg deviates very little from the import-weighted basket peg. In most cases, the standard deviation does not exceed 3%. In some other rare cases, the SDR index coincides almost

exactly with the import-weighted index, such as in Ghana.

Second, the SDR basket peg shows a smaller standard percentage deviation than a single currency peg. For countries pegging to the US dollar, the differences are quite dramatic. For countries pegged to the UK pound, the results are mixed. In some cases, the standard percentage deviation is less than that of an SDR peg.

With regard to the French franc peg, the table shows that it is significantly better than the SDR peg. For instance, the standard percentage deviation of the SDR peg as compared with the French franc is two times more for Cameroon, four times more for the Central African Republic, five times more for Chad, and four times more for Congo and Gabon. From the pattern of trade of these nations, we can conclude that, in general, "the more diversified the import structure of a country, the closer will be the movement of the SDR basket index to the import-weighted index" (Crockett and Nsouli, 1977).

Given the fact that the percentage deviation point for the French franc is better than any other peg, pegging with a reference to some disciplinary restrictions for stability would be better for the CFAF. Hence, we would opt for pegging to the future European single currency, the European currency unit (ECU) now called euro, which will require strict discipline, rather than the SDR.

Independent flotation

To overcome the disadvantages of fixed exchange rates, either single currency peg or multi-currency peg, one may advise developing countries to consider greater flexibility in their exchange rates. This may necessitate abandoning pegs in order to achieve continuous adjustment to external shocks. Indeed, a floating exchange rate regime is one in which the exchange rate is predominantly market-determined. Here, too, a trade-off operates between the benefits of pegging against the advantages of a more continuous adjustment of the external position. It should be noted that flexible rates for developing countries have different implications compared with industrial countries, mainly because of their different institutional setting.

We will centre our discussion around the costs and benefits involved in flotation with particular emphasis on the issues of exchange rate stability, the use of the exchange rate as a policy instrument and the freedom of internal policy making.

As mentioned earlier, relatively stable exchange rates have several advantages: the greater the stability of the exchange rate, the greater the level of trade, the greater the production of export goods, the greater the capital inflows from developed countries and the greater the level of capital formation, other things being equal. Accordingly, if flotation were to lead to unstable exchange rates, this arrangement would be undesirable. For flexible exchange rates to be stable without government intervention, a well functioning foreign exchange market with Walrasian auctioneers is needed.

In any case, the classical case for a floating exchange rate is the achievement of external balance without undue interference with the pursuit of domestic objectives, while policy-makers retain monetary autonomy. By enabling the control of the money supply to secure the appropriate mix of employment and inflation, a floating exchange rate can reduce anti-inflationary discipline. In addition, since many LDCs like CFA countries, are price-takers, exchange rate devaluations generate higher inflation.

Table 4: Standard percentage of the SDR, US dollar, UK pound and the French franc from the import-weighted basket peg

	SDR peg	US \$ peg	UK £ peg	FF peg	Current exchange rate policy
Algeria	03.8	11.9		01.3	Basket peg
Benin	05.6	13.6		01.9	FF peg
Burkina Faso	05.1	13.0		00.9	US \$ peg
Burundi	05.9	14.0		13.5	US \$ peg
Cameroon	0.34	11.5		01.5	FF peg
Central Afr. Rep.	04.5	12.7		00.9	FF peg
Chad	04.9	12.9		01.0	FF peg
Congo	04.2	12.3		01.0	FF peg
Côte d'Ivoire	03.5	11.7		01.5	FF peg
Equat. Guinea	02.0	10.3			Sp pta peg
Ethiopia	02.5	10.8			US \$ peg
Gabon	04.1	12.2	01.1		FF peg
Gambia	02.0	10.0	09.5		UK £ peg
Ghana	00.7	09.0	08.7		UK £ peg
Guinea	01.4	09.0			US \$ peg
Kenya	01.3	08.5	08.0		US \$ peg
Liberia	06.7	14.6			US \$ peg
Libya	02.1	07.3	07.0		US \$ peg
Malagasy Rep.	04.6	12.7		01.0	FF peg
Malawi	02.2	07.6	07.0		SDR peg
Mali	02.2	09.3		04.3	FF peg
Mauritania	02.3	10.4		02.7	FF peg
Mauritius	01.2	09.5	09.0		UK £ peg
Morocco	03.8	12.0		01.5	Basket peg
Niger	05.5	13.4		01.5	FF peg
Nigeria	00.8	08.8	08.4		Basket peg
Rwanda	07.6	15.5			US \$ peg
Senegal	04.4	12.4		01.0	FF peg
Sierra Leone	01.4	08.3			UK £ peg
Somalia	02.2	09.8			US \$ peg
South Africa	01.3	09.9	09.6		US \$ peg
Sudan	01.0	09.4	09.1		US \$ peg
Tanzania	01.9	10.8	09.9		US \$ peg
Togo	04.6	12.8		01.8	FF peg
Tunisia	03.6	11.8		01.4	Basket peg
Uganda	01.5	09.7	09.2		US \$ peg
Zaire	04.0	12.4			US \$ peg
Zambia	01.2	08.5			US \$ peg

Source: Crockett and Nsouli (1977, pp. 653-4).

It has been recognized that no developing country has so far successfully floated on a sustained basis. Lebanon's longstanding, unique example has just collapsed, despite a well developed banking system. Most of the examples in Africa, such as Zambia, Ghana and Nigeria, are countries that have introduced foreign exchange auctions within the

context of International Monetary Fund (IMF) stabilization programme, but which are still controlling capital movements and the subsequent flourishing parallel markets. Foreign exchange auctions collapsed in Zambia and Uganda following a deep fall in the exchange rate level. In Ghana and Nigeria, the auction regime still exists and shows some positive features.

In summary, the advantages of flotation for a developing country include the reserve holding it permits, a reduction in distortions that may occur as a result of artificially high or low exchange rates, and some additional freedom in the pursuit of internal policy objectives. On the cost side, there are institutional costs of developing a well functioning foreign exchange market and renouncing the use of the exchange rate as a policy instrument.

For CFA countries, given the reluctance to move away from the French franc peg, the possibility of independent flotation seems remote, as Lane (1989) concluded. In fact, reorganizing the Franc Zone would constitute a tremendous undertaking, and a step-by-step approach would be the wise path to follow. Moving from 40 years of fixed exchange rates to an independent flotation without any prior experience of exchange rate culture and exchange rate manipulation would be too hard a step to take at once, assuming that France, the ultimate guarantor of the system, agreed to such a reorganization.

Intermediate exchange rate arrangements

Between the extreme cases of a permanently fixed rate and independent flotation there are various intermediate exchange rate arrangements, including the *adjustable peg* system and the *crawling peg*.

Under the adjustable peg system, a country defends the peg but reserves the right to alter the exchange rate to correct for disequilibrium. A large number of developing countries listed by the IMF as having pegged currencies in fact pursue an adjustable peg. We must note the difference between a single-currency adjustable peg and a multi-currency adjustable peg. Multi-currency pegging scores over single-currency from a macroeconomic adjustment viewpoint. Moreover, the possible microeconomic efficiency superiority of single- over multi-currency pegging disappears if the peg is adjustable, since the exchange rate is no longer stable against the peg currency.

Several African countries, such as Tanzania, Uganda, Zambia and Ghana, that followed the adjustable peg regime ended up in crisis. Kenya, Malawi and Mauritius, on the other hand, avoided such problems by frequent adjustment in the exchange rate.

Under the crawling peg system, the country defends the peg in small steps in accordance with some pre-announced rule. The crawling peg, like the adjustable peg, could be a single-currency or multi-currency peg, with the presumption that a multi-currency crawling peg is better than a single-currency one. Only four developing countries are listed by the IMF as rule-based crawling peggers: Brazil, Chile, Colombia and Madagascar. Experience with this system has proved to be reasonably satisfactory for maintaining competitiveness.

After such an extensive review of possible theoretical exchange rate arrangements,

we proceed to the practical CFA exchange rate options. Below, we lay down the different scenarios in the advent of a unique European currency emerging from the Maastricht summit and becoming legal tender in the EU by 1999.

II. Exchange rate options for the CFA franc after 1999

The issue of a single European currency beyond 1999 emerges. If this single currency were to come about, as prescribed by the Delors Report, it is highly likely that European countries would sacrifice their national currencies. With the likelihood that the French franc would no longer exist as a national currency, it is timely to contemplate the future of the CFA franc. Some of the comments that have been made include:

If there should be a move toward monetary union among EEC states, the question of how to handle UMOA (and all CFA zones) will inevitably arise. It is generally recognized that the CFA franc is currently overvalued, encouraging imports (and smuggling), and probably costly to CFA countries' export markets at a time when most of them need increased exports and reduced imports. The overvaluation of the CFA and the weakness of the banking and financial systems generally in CFA countries also represent a cost to the French Treasury. Would a combination of financial problems plus a move towards monetary union in the EEC, force a reorganization or possibly an elimination of the CFA area? (Lancaster, 1989).

Carol Lancaster in "Completing the European Market: Implications for West Africa" (p. 11) from the conference on "The Impact of European Market Implication for West Africa", Africa leadership forum, Brussels, Belgium, 21-23 September 1989.

One can hardly imagine France maintaining an operations account or opening an advance account which would have an upper ceiling but which would be used to guarantee a currency whose quantity and value would be unknown to her (Lelart, 1989).

Michel Lelart in "The future of the Franc Zone in the context of the construction of Europe" from *Revue d'Economie Financière* (1989), No. 8/9, p. 201.

Now that the CFA will be pegged to the ECU as the French government has already announced, their parity will definitely, therefore, be difficult for France, subjected like other countries of the EEC to severe budgetary constraints necessary for the economic convergence on which the success of the economic and monetary union is dependent, to continue to support

for a long time, an imaginary parity with its budget ... It is, therefore, in order to say that the European Monetary System challenges, perhaps totally or partially, the Franc Zone (Owoundi, 1992).

Fouda Owoundi, "Financial Europe and the African Bank (Banque Afrique)", paper presented at the International Symposium of the Technical Institute of Banking of Africa, the Magrehb and France, Ouagadougou, 25-27 February 1992.

While a lot has been written or said on this matter, no study has yet seriously considered possible scenarios for the CFA franc. In what follows, we try to search for avenues for the survival of the CFA as the common currency.

Following the Maastricht accord of 14-15 December 1991, monetary integration in Europe is inevitable and the ECU (European Currency Unit), now the euro, will become a single currency by 1999. In the huge Maastricht document, there is no single sentence regarding ACP countries, not alone CFA zone concerns. But immediately, the late Pierre Bèregovoy, then French Finance Minister, announced that the CFA would be pegged to the euro by 1999. Reassuring as this may be for political circles, it does not constitute analytically an adequate response to the complex issue of the future of the CFA. More importantly, such a crucial announcement was made without any consultation with the African partners of the Franc Zone, as rightly observed by Owoundi (1992).

The quotations above give a rather gloomy perspective concerning the status of the Franc Zone as it exists today. Hence, the time has come to set forth our alternative scenarios for the CFAF. But before embarking on such a delicate endeavour, let us recall that from our own computation, we reached the conclusion that the net gains of CFA membership are not all beneficial to CFA countries. Our study concerns the period 1975-1988 where data on the *compte d'opérations* have been available. The net gains include the recognized advantages of stability and low inflation, from which we deducted the cost associated with the interest rate and the exchange risks.

In support of our conclusion, many studies have revealed that CFA countries did not have the capacity to adjust to external shocks despite stability advantages. Hence, the views of Devarajan and de Melo were reversed between their 1987 work on the evaluation of the CFA zone and their 1990 CFA assessment. In the latter, they wrote...

After 1981, changes in the world environment and persistent current account deficits meant that CFA countries needed to adjust their economies along with other developing countries. Their growth performance was disappointing. Under every estimate, CFA zone members' GDP growth rates fell behind those of their counterparts, including the other African states... The burden of adjustment appears to have fallen disproportionately on expenditure-reduction in general, and on investment-reduction in particular. It is possible that the very institutional arrangement that enabled these countries to enjoy faster and more stable growth in the 1980s is *preventing* them from adjusting to the internal and external shocks of the 1980s (pp. 23-24).

In the same vein, Devarajan and Rodrik (1991) wrote:

For most of the CFA members, the benefits of lower inflation does not appear to have been large enough to offset the costs of reduced output. Under “reasonable” output–inflation trade-offs, these countries would have been better-off having the *flexibility* to adjust to external shocks through exchange rate adjustment.

In their study on the “Response of firms to relative price changes in the Côte d’Ivoire: the implications for export subsidies and devaluations”, Newman, Lavy and de Vreyer (1990) of the World Bank concluded:

Firms producing in the tradable goods sector suffer from an overvalued exchange rate not only because they would receive a lower price for their exports, but also because they must compete against lower priced imports. Our estimates indicate that the introduction of an export subsidy alone would be insufficient to the tradable goods sector. The combination of an export subsidy with an import tariff, which comes closer to mimicking the effects of devaluation, would serve to counteract some of the short-run adverse output effects of an overvalued exchange rate.

This over-valuation issue of the CFA was recognized by Patrick and Sylviane Guillaumont (1989b) who observed that the new linkage to the ECU would pose a risk of over-valuation for CFAF. Past experience has shown that this can be a real threat. During the 1970s, many of the Franc Zone countries experienced inflation rates more acute than in France (p. 143).

Finally, Elbadawi and Majd (1992) of the World Bank cautiously noted in their recent study:

These results cast doubt on the merits of a CFA zone-type monetary union during a turbulent period such as the one experienced by the zone members in the post 1984 period. These (CFA) rules, while offering some hope for low inflation, appeared not to have been sufficiently forthcoming in bringing the necessary adjustment to the CFA economies at times of severe exogenous shocks, especially when competing neighbouring SSA countries and LIDCs (Low Income Developing Countries) have achieved considerable real depreciation through changing their nominal exchange rates.

The authors then concluded:

If the latter part of the 1980’s is conceived to be a typical turbulent period, then the present paper has shown clearly that a prompt response to unforeseen internal and external shocks would become synonymous – for the CFA members – with adhering to a series of more flexible rules of absorption, let alone alignment of the nominal currency.

We quote at length these studies to emphasize the problems of the CFA zone, despite the apparent stability. The European monetary integration after 1999 may offer a solution to a profound reorganization of the CFA zone. The question inevitably arises as to how the CFA countries would offer alternative exchange rate arrangements. This is even more compelling in the aftermath of the first devaluation experienced within the zone. The 50% devaluation of 12 January 1994 expressed the need for a more realistic exchange rate policy that will make the CFA economies more competitive than previously. Already different assessments of the devaluation impact reveal some overall improvement in foreign trade and balance-of-payments deficit reduction. It is therefore timely to formulate a CFA franc exchange rate policy that will lead to a prompt adjustment.

We contemplate five different scenarios (Figure 1). Each of these scenarios should preserve one of the most important advantages of the CFA zone, which is the experience with co-existence and use of a common currency with low inflation despite economic divergences. This aspect of economic integration associated with the CFA zone should be kept in mind all the time when conceiving the new exchange rate arrangements. The five scenarios are:

- Scenario 1: Pegging to the euro - The much talked-about arrangement that comes to mind when speculating about the future CFA exchange arrangement is to *peg the CFA to the euro after 1999*.

In fact the French Minister of Finance hurried to state after the Maastricht accord that the CFA would be linked to the euro. CFA African leaders applauded. But the real issue is: On what basis will such a peg be implemented and under what conditions? What are the practical modalities of such a peg? More clearly, at what parity will the CFA be pegged to the euro? Is this going to be a fixed or adjustable peg? Which CFA will be pegged? CFA of UMOA or CFA of BEAC? Separately or together? We will examine these questions later.

- Scenario 2: Multi-currency pegging - A second scenario would be to peg the CFA not to the euro alone but to a basket. We suggest first pegging the CFA to the euro, the US dollar and the Japanese yen, the three major reference currencies of the world.
- Scenario 3: ECOWAS-wide single currency - There are attempts within the Economic Community of West African States (ECOWAS) to create a unique currency in the zone in the future. But looking at the difficulties of the West African Clearing House and the poor functioning of ECOWAS in general, one should wonder how realistic this proposal is.
- Scenario 4: The breakdown of the CFA zone and creation of separate national currencies - The fourth scenario, which is possible but which everybody studiously avoids talking about, is the breakdown of the system as each country, for national sovereignty's sake, would be willing to manage its own currency. At a time of bloc building, this scenario is highly undesirable, but still possible as there do exist important divergences among CFA countries that France refuses to face. If French cover were to be removed, how would individual countries react?
- Scenario 5: Institutionalizing an African monetary fund - An additional scenario concerns the institution of an African Monetary Fund. Advocates see the African Monetary Fund as a means of attaining monetary independence. On a continent where

there have been so many still-born treaties, how realistic is this grandiose proposal?

Let us examine these scenarios one by one in some detail.

Scenario 1: Pegging the CFA to the euro

Beyond all political considerations, the euro seems to be the "natural anchor" to which CFA countries could peg their currencies. Indeed, the CFA was already pegged to the euro via the French franc. The French franc is part of the EMS, which fluctuates within a margin of plus or minus 2.25%. With the euro as the single currency, the margin reduces to zero and pegging to the ECU directly will require a much stricter, but bearable, discipline. In addition, "the euro is likely to be close to the optimal peg for most if not all African countries, whose trade with Europe (of about 60 per cent) is much higher than their trade with the USA or Japan", as rightly pointed out by Cobham and Robson (1992). With the independence of the European Central Bank and its price stability mandate now explicitly written into the Maastricht agreement, the euro can be expected to exhibit low inflation under Germany's rigorous disciplined leadership. Pegging to the euro would avoid the problems of asymmetries and imbalances. This will happen because the euro will be strong enough to ensure that no single African country would influence the direction in which other countries will want to go. Pegging to the euro provides the ground for more monetary integration.

This being so, there are two options for the 13 countries of the Franc Zone to peg to the euro.

Option 1: Let's assume that the seven countries of BCEAO (Banque Centrale des Etats de l'Afrique de l'Ouest) and the six countries of BEAC will pull together and form some sort of a supranational central bank despite differences between the two zones. Let's call it the Union des Banques Centrales d'Afrique CFA (UBCA-CFA) with a chair of the Board of Governors. Beneath this body will be the already existing regional CFA central banks, BCEAO and BEAC, very much like the actual structure with regional governors. Each central bank will be represented by the national branch in each member country. The structure will be as presented in Figure 1.

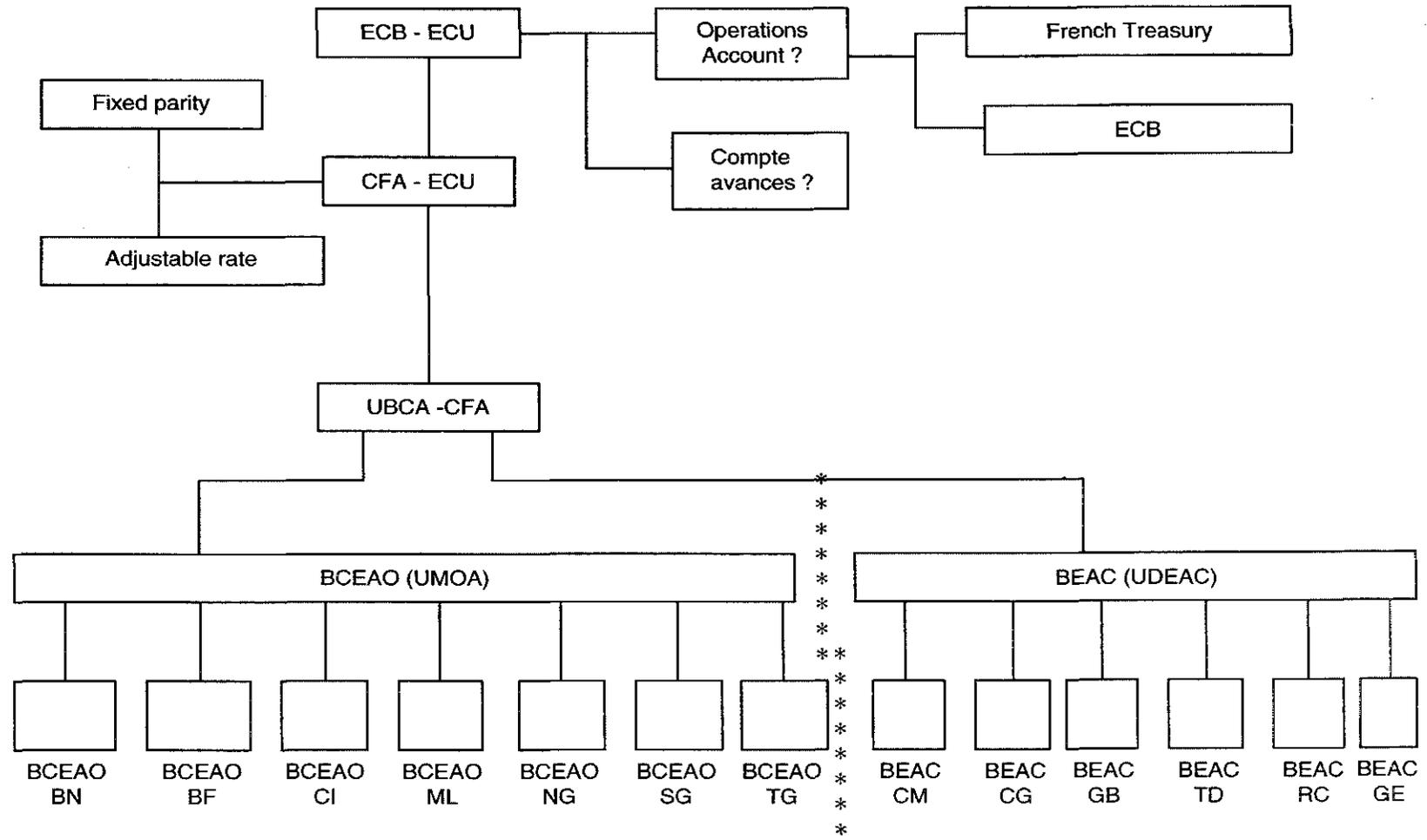
Option 2: The second option would be to have each zone as a separate unit, UMOA and BEAC zone. Each separate unit will then issue a CFA pegged to euro, but with the same parity between the two zones. This possibility arises because in West Africa monetary union prevails, while in Central Africa there is a custom union with the same currency.

In addition, the level of solidarity, as well as the seigniorage sharing between the two zones, is quite different. For instance, in UMOA seigniorage is equally distributed but in BEAC it is proportionate to the importance of each country in the zone.

Here some lessons from the Belgium-Luxembourg monetary cooperation system should be useful. In that scheme, Belgium is the dominant country but the two countries agreed to a common exchange rate policy for their currency. Any exchange rate variation can occur only after agreement by the monetary authorities of both countries.

Hence, in each zone of CFA countries, a proportional representation at the central bank, with a veto right, will prevail in order to avoid outright dominance. The political

Figure 1: Scenarios for future CFA pegging to ECU



commitment to a coordinated monetary policy should be clearly stated.

Furthermore, we assume that divergences among countries of each zone are not important enough to hinder harmonization of economic policy. Under such circumstances, two more questions come to mind: if there should be a convertibility guarantee as it exists in the current institutional arrangement, then one should be concerned with the operations account: where it will be located and how it will function.

Perhaps the most crucial question is to know at what exchange rate the CFA will be pegged to the euro; would it be a permanently fixed rate or an adjustable rate?

Given our previous analysis, based on the work by Collier and Joshi (1989) and Crockett and Nsouli (1977), and also given the historical tendency of moving from fixed to flexible exchange rate, and in addition, given the conclusions reached by Devarajan and de Melo (1990), Devarajan and Rodrik (1991), and Elbadawi and Majd (1992), *we would opt for an adjustable exchange rate parity*. Such flexible pegging will take care of the taboo issue of CFA devaluation, which will inevitably occur with the fixed exchange rate in the long run.

Concerning the guarantee of convertibility, it would be wise at this early stage to opt for the maintenance of a sort of operations account. But as Lelart (1989) so rightly remarked, “we can’t see France maintaining an operations account or a *compte d’avances* to guarantee a currency whose money supply and value are beyond her control”.

The *compte d’avances* allows Maghreb countries, which are also former French colonies, to have independent currencies such as the Moroccan dirham or the Algerian dinar, and yet to benefit from advances from the French government. These countries use the Paris Exchange market for most of their exchange transactions without having to keep their foreign reserves in Paris, as do the CFA countries. One wonders why this cannot constitute a possible alternative for the CFA countries if a profound reorganization of the CFA zone occurs, as it prevails for Maghrebean countries? Moreover, as Owoundi (1992) clearly stated, “as soon as the CFAF would be pegged to the euro, as announced by the French Government, it is clear that the parity will vary regularly depending upon the actual strength of the economy”.

It would be difficult then to maintain the operations account at the French treasury. If France were able to convince her partners, in order to reserve the right to make her own spending and lending decisions, then the operations account would still be kept at the French treasury.

Beyond such an unlikely event, we foresee that the adjustable pegging to the euro should be guaranteed by the European Central Bank, and consequently, an operations account should be opened at that European Central Bank. As Patrick and Sylviane Guillaumont (1989b) put it

The establishment of a European monetary unit would have no major juridical implications for the Franc Zone. Furthermore, the cash flows implied by the negative balances in the operations account can be considered as the type of balance of payment assistance that many industrialized countries accord to developing economies... It is known that the negative balance of operations account that appeared first in 1987 is a very small

part of France's official public aid. It is only about 0.2 per cent of France's foreign exchange reserves".

Consequently, this share will be even smaller for the EEC as a whole, should the political will exist.

Such political will sparks other questions. As a sub-group of the ACP, why should the CFA countries benefit from special treatment at a time when all of these countries are knocking at EEC doors? How will the former British colonies react to such CFA treatment?

More important, although the operations account is held at the French treasury, most of the work on the CFA is conducted at the Banque de France, the treasury being simply the bookkeeper. Most of the exchange rate transactions take place at the Banque de France where the secretariat of the Franc Zone is located.

The question naturally arises: Will the future European Central Bank be willing to take over this role of the Banque de France? As stated earlier, the Franc Zone is an economico-political scheme concerned with more than mere monetary cooperation. If the political will prevails, then pegging the CFA to euro is a plausible alternative.

Scenario 2: Multi-currency pegging

We demonstrated earlier that the CFA countries, and in fact most African countries, trade more with the EEC than with any single country in the world. However, most of the imports of oil are denominated in US dollars. Most grants and loans of the major financial institutions, the World Bank and the IMF, are also in dollars. Furthermore, given the economic weight of Japan, more and more transactions are denominated in the Japanese yen. A multi-currency pegging is therefore called for.

Accordingly, it is conceivable that the CFA be pegged to a composite basket of euro, dollar and yen. But all CFA countries should have the same basket in order to avoid cross-rate multi-peg variability as well as the rigidities of the single currency pegging. This would take care of the drawbacks associated with a single ECU pegging.

At this early stage, if the issue of convertibility is resolved by lodging the operations account at the French treasury or at the ECB, then such guaranteed convertibility would be better than pegging to a basket where the convertibility is not guaranteed.

Scenario 3: An ECOWAS single currency

The time is ripe for economic bloc-building, from the EEC to the North American trade agreement to Pacific rim economic cooperation centred around Japan.

One of the principal goals of the efforts to integrate the economies of the 16 ECOWAS countries is to expand intra-community trade. Several studies have identified the impediments to the development of trade expansion. One of them is the widespread controls and restrictions on exchange transactions throughout the community that make most of the 11 currencies of the member states inconvertible. Currency convertibility is,

therefore, an important issue. Among the 11 currencies is the CFAF, a convertible currency among 7 of the 16 countries that compose the community. Unfortunately, the experience of the community through the West African Clearing House reveals some real difficulties. In fact, as Frimpong-Ansah (1987, pp. 22-23) reported, "After 10 years of existence, the West African Clearing House (WACH) system remains rather ineffective in terms of most of the primary objectives... It has not been able to promote the greater use of national currencies, or bring about increasing economies in the use of foreign reserves, or liberalize intra-regional trade".

There have been large and persistent late settlements. This has created transaction imbalances with domestic and international ramifications. Hence, given the convertibility of the CFAF, BCEAO has held all along a creditor position. Nigeria, on the other hand, by not channelling her oil sales through WACH, has held average monthly debtor positions.

This clearly shows that the convertible nature of CFA F matters in the regional trade. Hence, any move towards a single currency in ECOWAS should proceed in a gradual fashion, moving from CFA to incorporate other currencies progressively.

Scenario 4: The breakdown of the CFA zone - Possible but undesirable

Our previous analysis of the gains from pooling reserves has shown that differences do exist among countries even within each zone. Some countries have positive balances and continue to contribute to the pool. Other indicators of convergence clearly show that CFA countries are rather heterogeneous. Growth levels, current account deficit levels factors of production costs and per capita income show great variability. However, one of the conditions to be met for a successful economic integration is that participating countries should have roughly the same income level. In case of wider divergences, large movement of capital, labour and net transfers would be necessary to maintain the union. Even shares of the monetary aggregates should not be too far apart. On the basis of the above, in UMOA, Senegal and Côte d'Ivoire are fairly close, whereas the Sahelian countries of Niger, Mali and Burkina Faso lag behind. In the BEAC zone, Cameroon and Gabon dominate, while Chad and the Central African Republic lag behind. If these considerations were taken into account, then the CFA countries should regroup to form more harmonious blocs. A former BEAC governor once recognized (1989) that even within our zone, all countries do not have the same economic conditions. One country may need a devaluation and not the next one. One of the strengths of the existence of our organization is the solidarity that prevails between all member countries.

This indicates that the possibility of disagreement among countries on issues like exchange rate alignment is real, if France were to remove her "paternal" guarantee. In fact, in 1982, the then Minister of Cooperation, Jean-Pierre Cot, hit headlines when he suggested that more monetary sovereignty should be granted within the Franc zone. Specifically, a national currency should be created that will be pegged to the common international CFA currency at a specific rate and administered by a central authority. If

this were to happen, the CFA zone would break down.

To avoid such a breakdown, which would yield more balkanization of the monetary system in Africa, as happened with anglophone Africa, a common exchange control should be in place, and guarantees granted by a central pool that convertibility should exist with a common administration. This would reduce the incentives to convert and to keep a given country's reserves in other international reserves.

At a time of economic bloc-building, this scenario should be disregarded.

Scenario 5: The institution of an African monetary fund - myth or reality?

Some pan-Africanists have suggested that the solution to all the troubles of the continent would be a continent-wide monetary union with a supranational governing body in the Organisation of African Unity (OAU) framework. In this spirit, African leaders, during the economic summit held in Lagos, Nigeria, in April 1980, decided to create an African monetary fund no later than 1985. Its foremost objective would be "to establish the basis of economic integration in Africa. Monetary cooperation between African countries is a pre-condition and the AMF would serve as an engine to start that cooperation without which it would be practically impossible to accomplish its mission". In such a system, according to its advocates, no guarantee from France or the EEC would be necessary.

The deadline of 1985 is long since gone, a testimony to the lack of political will. How then can we seriously consider such a proposal?

Given the difficulties encountered in the working of limited organizations such as ECOWAS, we would rather opt for a gradual process. The African Centre for Monetary Studies, the African Development Bank and the existing monetary systems should establish a think-tank to meticulously assess the possibility of such a mechanism. In the meantime, existing regional monetary cooperation organizations (UMOA, BEAC and the Preferential Trade Area – PTA) should gradually establish some compensatory links as a starting point. We do not share this grandiose view of a continent-wide monetary scheme. The emphasis should be put on the sub-regional and more manageable organizations.

III. Concluding remarks

In the wake of European economic integration, following the stages of the Delors committee, the CFA zone is highly likely to be reorganized. But the bedrock of the Franc Zone is the convertibility guarantee granted by France to her former 13 colonies in sub-Saharan Africa.

The Maastricht accord of December 1991 clearly indicated that the ECU will serve as a full-fledged single currency by the year 1999. This implies that European currencies will no longer exist as national entities. The French franc guarantee of the CFA then becomes questionable.

This research contemplates the likely scenarios that may be available to the CFA countries after 1999. Five different scenarios have been analysed.

First is pegging the CFA to the euro by the two CFA zones or separately. This is the most talked about scenario, and it is also the one obviously favoured by the French government. *Indeed, since the CFA countries are trading mostly with the EEC, pegging to the euro might be the optimal peg.*

But questions remain under the rug. At what parity, fixed or flexible, should the CFA be pegged to the ECU? How will the convertibility guarantee, which constitutes the most attractive CFA characteristic, be secured.

From the examination of all the possible exchange rate arrangements, fixed peg (single or multi-currency), independent flotation and intermediate regimes (adjustable and crawling peg), *our study indicates that an adjustable peg to the euro at an early stage would be the best arrangement*, with a convertibility guarantee at the European Central Bank. But questions remain: Which CFA franc will be pegged to the euro – the BCEAO or UEMOA CFA or the BEAC or CEMAC CFA franc? Money always has political consequences. Can nations with a single currency and a common central bank that is accountable not to the nation states, but to a common body–UEMOA in West Africa and CEMAC in Central Africa – be truly independent? Can the policy of convergence under UEMOA and CEMAC offset national self-interest and specific budget constraints? Some fact finding research to the Caribbean islands will be necessary to understand the use of the East Caribbean dollar.

The second option concerns a multi-currency pegging to the euro, US dollar and Japanese yen. This option is not for the very near future as some learning process to manage the adjustable peg to the euro is necessary. This seems the case for countries like Kenya and Zimbabwe.

The third option is an ECOWAS-wide single currency. This choice, although desirable, needs more time to allow ECOWAS itself to become better organized, and existing

institutions such as the West African Clearing House, now the West African Monetary Agency, to become operational. This would constitute a test of how serious and committed the countries' leaderships are to economic integration.

The fourth possible scenario, which is very undesirable, would be the creation of individual country currencies as a result of divergences among CFA countries. At a time of economic bloc-building, all necessary safeguards should be taken to overcome such a possibility.

Finally, there has been talk about an African monetary fund that will clear the way for the creation of a continent-wide currency. We honestly believe this option is premature and the effort should be put into implementing one of the first three scenarios.

Now that our best scenario has been identified, the next task will be to undertake a study on the underlying economic adjustment in CFA economies under a flexible CFA pegging regime in the presence of external shocks. This will constitute the subject of future research.

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Africa Analysis

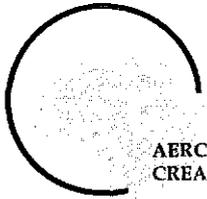
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