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THE CFA ZONE: THE PROSPECTS FOR SUCCESSFUL MONETARY INTEGRATION

Ljubljana, April 2003 **CLAUDE NOMSI**

I, Claude Nomsi Mpirat, hereby declare that I am the author of this Master's thesis that was written under mentorship of Mr. Ivan Ribnikar and in compliance with the Act on Copyright and Related Rights – Para. 1, Article 21. I herewith agree to this thesis being published on the website of the Faculty of Economics.

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TABLE OF CONTENTS

LIST OF TABLES

TABLE OF FIGURES

1 INTRODUCTION

The various kinds of monetary integration schemes can be classified into two groups: full fledged monetary union and incomplete monetary unions. The best-known incomplete monetary union today is undoubtedly the European Monetary System (EMS), which was instituted in 1979 by the members of the European Community (EC). On January 1st 1999 the European Union entered the last phase of monetary union – which was completed by the year 2002. Monetary unions have occurred in Africa since the beginning of the 1950s, beginning with the creation of the Franc Zone. This monetary agreement between France and its former African colonial territories was first intended to be a means to ensure a common exchange rate. It regrouped three monetary zones:

- The West African Monetary Union (WAEMU/UEMOA), which comprises eight members under the monetary control of the Banque des Etats de l'Afrique de l'Ouest (BCEAO): Benin, Burkina Faso, Cote d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, and Togo.
- The Central African Monetary Union (CEMAC), which regroups 6 countries under the control of the Banque des Etats de l'Afrique Centrale (BEAC). These members are: Cameroon, the Central African Republic, Congo, Equatorial Guinea, Gabon, and Chad.
- The Comoros

The first two monetary unions (UEMOA and CEMAC), also known as the CFA Zone, will be the subjects of our analysis. The CFA Zone is believed to be an instrument of solidarity and development between France, and the EU since 1999, and its former African colonies, which comprise the members of these monetary unions.

The aim of this work is to analyze and assess the functioning of the Franc Zone and to examine the evolution of monetary unions in West Africa and Central Africa. An emphasis will, of course, be placed on the monetary integration schemes of West and Central Africa. For this purpose a range of literature and sources will be used.

The aim is also to propose solutions, if necessary, with regard to improving the results obtained so far in the assessment of the results of monetary integration in Western and Central Africa in order to determine the reasons for success and/or failure. With the recent admission of Guinea Bissau as a new member of the West African Monetary Union and the intention to extend monetary union to the non-CFA countries, which are also members of the ECOWAS[1], the CFA zone is loosing its "colonial" aspects and is being more and more considered as a stable monetary area providing prosperity. This monetary union was to be achieved by January 2003, while a wider monetary integration with all the ECOWAS countries is planned for 2004. In this regard, some questions have been raise concerning

[1] ECOWAS stands for the Economic Community of West African States and includes 15 countries Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, The Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone, and Togo.

the soundness of the CFA monetary system. This “diversification” also makes an analysis of CFA monetary integration interesting. We should bear in mind that the CFA Zone (or the Franc Zone) was, previously, established for colonial purposes and for Francophone countries in order to serve French economic interests.

The first step of the assignment will be to outline the theoretical background in the process of economic and monetary integration.

An overview of the Franc Zone will be a part of the second step, taking into account its history and its monetary mechanisms. The two monetary unions of the CFA Zone will be included in order to analyze the economic and financial situation of those two sub-regions (West and Central Africa). And finally, an assessment of the evolution of the monetary policies and monetary aggregates of both sub-regions will also be included in the analysis.

2 MONETARY INTEGRATION

2.1 THE CONCEPT OF MONETARY INTEGRATION

The process of monetary integration manifests itself in the intensified efforts of countries in particular regions to create, by means of treaties, an economic and monetary union as the highest form of monetary integration. But the causes for closer economic relations between states can also be found in the process of globalization.

Monetary integration entails voluntarily transferring national monetary sovereignty in favor of a single currency, a single central bank, and common monetary and exchange rate policies. Such relinquishing of monetary sovereignty is required only in the case of a monetary union, as the highest form of monetary integration. Lower forms, also called incomplete monetary unions, allow a certain level of monetary "freedom" or sovereignty enjoyed by the members of the union. They can have their own currency and their own central bank with limited powers – limited monetary and exchange rate independence.

2.1.1 FORMS OF MONETARY UNIONS

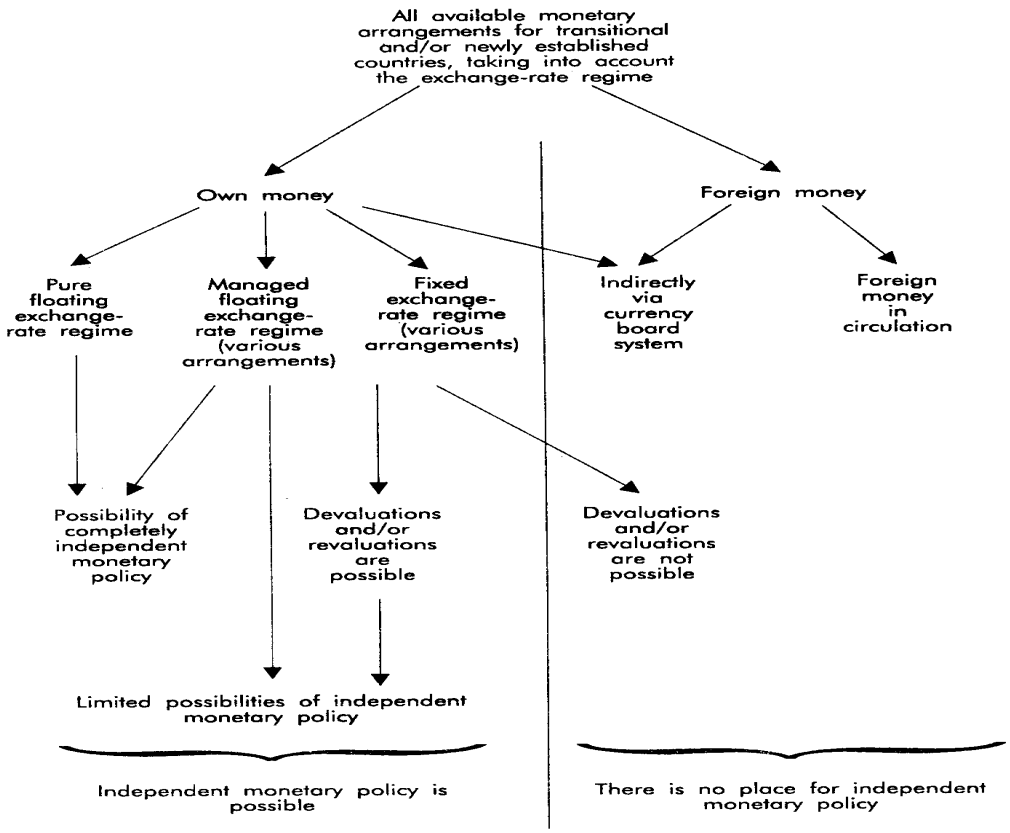
Support for monetary unions stems from two facts or two goals: freedom of capital movement and fixed exchange rates. The achievement of these goals, according to Padoa-Schioppa, requires a single currency area and a single monetary authority.

Monetary unions are regions with no payment restrictions. Within monetary unions, exchange rates among the different existing currencies, if there are more than one, are permanently fixed. There are different kinds of monetary unions. There are unilateral monetary unions, where no contract or agreement between the members has been signed in constituting such. These kinds of monetary union are defined as de facto or informal. The opposite are formal monetary unions that have been established under contracts or agreements.

Ribnikar (1995 and 1998) identifies two kinds of monetary unions: non-formal and formal. An informal monetary union is characterized by the fact that a country chooses, as a goal of its monetary policy, to maintain an unchanging exchange rate (irrevocably fixed) between a foreign currency and the domestic one, and directs its policy to achieve this objective. Two principal problems can be noticed. First of all, changes can be made concerning the exchange rate. So it will never be irrevocably fixed. Secondly, in such monetary unions, small countries, due to their limited monetary/financial strength, will usually open up to larger ones. So that "inflation import" is always possible. In informal

monetary unions domestic and/or foreign currencies are the legal means for making payments.

Figure 1: Monetary integration



Source: Ribnikar

In formal monetary unions, countries agree, on the basis of a treaty or arrangement, to a monetary union with fixed exchange rates between the national currencies of the members. Here also domestic and/or foreign currencies can be used as a legal means for making payments. Formal monetary unions are the most popular in the world. Additionally, there are formal monetary unions where there is only a single currency functioning as the legal means for making payments, or those where besides domestic currencies there is a common currency that constitutes the only legal means for making transnational payments within the zone. The difference between a single and common currency resides in two opposing terms: centralization and competition.

A full-fledged monetary union is the way towards policy coordination and economic convergence, which is directly implemented by replacing a number of monetary authorities with a single central authority. In reality, full monetary unions are rare. Instead, there are many monetary arrangements somewhat removed from full monetary union. These

alternative arrangements also entail rules and constraints for the participants. Dyson (1994) talks about two alternative types of evolutionary models: “currency competition” or “free inter-circulation” union and “parallel currency” union.

In both models, states are able to retain their currencies. In a competing currency union the currencies of the member states would freely circulate throughout the union and irregular, problematic or “weak” currencies would be driven out of circulation. This latter fact functions as an incentive and, therefore, reinforces ideas about monetary policy convergence, that is, common rates of interest and inflation and fixed exchange rates. For the parallel model, besides the existence of national currencies, a parallel currency is created and circulates alongside the national currencies. And, additionally, a monetary authority responsible for issuing the parallel currency is also created. Thus each member state’s currency is in competition with the parallel currency.

Forming monetary unions necessitates choosing the right model and requires the existence of certain conditions. A well functioning monetary union should contribute to stabilizing income and prices and facilitating payment adjustments among participating countries. Capital and labor mobility are considered to be preconditions for a successful monetary union. According to Mundell and De Grauwe (1997), regions or countries, which boast high factor mobility should join into a single or multi-currency area with fixed exchange rates – an optimum currency area (OCA). Countries, which do not fulfill this condition, should adopt flexible exchange rates. This point of view has been criticized. It has been determined that other factors can affect the choice of a monetary union. Dyson (1994) and Masson and Taylor (1993) identify six necessary criteria in the assessment of the potential for a monetary union. These criteria are: factor mobility, country openness, trade integration, international financial integration, wage and price flexibility, and fiscal policy. Each of these factors works in favor of monetary union.

But the nature of a monetary union strongly suggests that the regions or countries involved must have some common political interests and/or a willingness to adopt fiscal and monetary policies consistent with those of the other countries in the union. This, of course, requires close similarity of political and/or economic interests. Sometimes political and/or economic competition – in the case of France and Germany - can be a decisive factor in the formation of a monetary union. Generally speaking, similarity and/or affinity in sociopolitical and economic spheres may be the deciding factor contributing to the success of a monetary union.

2.2 COSTS AND BENEFITS OF MONETARY UNIONS

The divergent trends among countries and regions and the relations among them, as well as the technological changes that are linking economies ever more tightly through an increased flow of trade finance, are imparting new urgencies to international economic policy-making and co-ordination. Monetary integration can be defined as the process that abolishes restrictions on trade between different countries, reduces confrontation between their policies, and encourages coordination and homogenization of their economies. The formation of a monetary union is an example of international monetary cooperation in which participating countries experience advantages and disadvantages specific to them.

2.2.1 COSTS

The costs of forming a monetary union can be addressed through the macroeconomic management of the economy. According to Barrell (1992), the cost of setting up a monetary union depends upon the speed and size of any adjustment that is required – under the convergence policy. The closer the countries are to achieving these requirements the lower the cost will be and vice versa.

The main cost of moving towards a monetary union is the loss of an instrument of national demand management, i.e. domestic policy, and of the associated ability to adjust exchange rates. Such costs are borne by the country relinquishing its national currency, in effect the one giving up an instrument of economic policy. Monetary policy can be used to control interest rates, or exchange rates, key prices within any economy, or to adjust the quantity of the national currency in circulation (De Grauwe, 1997; Dyson, 1994). The costs associated with the loss of this policy instrument depend on: the effects of asymmetric shocks in the participating countries; the speed and flexibility of the adjustment process; and the extent to which fiscal policy can and should serve as an alternative to the use of monetary policy to foster adjustments.

Under the Optimum Currency Area (OCA) theory, the economic differences between the participating countries in many areas will also be the source of some of the costs when forming a monetary union because those differences will still remain (De Grauwe, 1997). Only the country's ability to adopt its own monetary policy, such as being able to adjust exchange rates, can be considered a powerful instrument that can help eliminate macroeconomic disequilibria – i.e. demand shocks, the inflation rate, the unemployment rate and an inadequate fiscal system (De Grauwe, 1997; Dyson, 1994; Padoa-Schioppa, 1994; Barrell, 1992; Gros, 1993).

2.2.2 BENEFITS

Eliminating a national currency when moving towards a monetary union can be expected to produce some gains in the form of increased microeconomic efficiency. There are two reasons for this. First, and most visibly, a common currency system will eliminate transaction costs in the exchange of money. This will also reduce the scope for price discrimination between national markets. Second, this system will eliminate the risk that accompanies uncertain future fluctuations in exchange rates.

According to De Grauwe (1997), monetary union, by reducing transaction costs directly and indirectly, allows the redeployment to more profitable uses of the resources used in exchange rate transactions, and associated improvements in cross-border payment facilities provide additional savings. Direct gains from the elimination of transaction costs rely on the replacement of the domestic currency by a common currency. Indirect gains can result from a reduction in the scope for price discrimination, which is still possible due to national market segmentation.

As mentioned, monetary union should result in a reduction in or elimination of the risk of realignment and devaluation included in the interest rates of most participating countries. This, of course, will promote general welfare gains. De Grauwe (1997) and Gros (1993) argue that uncertainty over future exchange rate movements generates uncertainty about the future revenue of firms and the future prices of goods and services, and may affect economic growth. So eliminating exchange risk will reduce the source of uncertainty and increase the general welfare. Forming a monetary union will also result in efficiency gains through trade and capital movements. Gains should be obtained from both the reductions in exchange rate uncertainty and greater price transparency. These gains are likely to increase with the degree of openness of an economy. Stable prices and an internationally stronger currency are other gains associated with the formation of a monetary union.

There are two extreme views, which try to explain the costs and benefits of countries joining a monetary union. One of these views is the so-called “monetarist” view, the argument of which is based on the belief that exchange rate changes are ineffective as an instrument for catalyzing and reducing the differences in development (De Grauwe, 1997).

In the monetarist view the use of exchange rate changes makes countries worse off. Therefore, the cost curve is very close to the origin. Countries would gain by abandoning their national currencies and joining a monetary union.

The “Keynesian” is the other extreme approach, which sees the world as full of rigidities (wages and prices) so that the exchange rate becomes a powerful instrument in the elimination of imbalances. The cost curve is far from the origin so relatively few countries should find it beneficial to join a monetary union. Many large countries with one currency

would be better off economically by splitting the country into different monetary zones (De Grauwe, 1997).

2.3 OPTIMUM CURRENCY AREAS (OCA)

The recent proliferation of regional integration arrangements and proposals has fuelled fears about the reduction of the general welfare. The concern is that forming a monetary union will produce both costs and benefits.

There is no general theory on potential gains and costs. Instead each analysis on monetary union tries to emphasize its reasons why countries might find it costly to join a monetary union. This analysis of costs is usually referred to as the theory of Optimum Currency Area (OCA). According to Lavrač (1995), the OCA theory defines certain structural characteristics of the "model" as the criteria for the choice between a fixed and a floating exchange rate regime. If the existence of such characteristics is determined, making exchange rate changes an unnecessary or inefficient instrument of balance of payments adjustment, then a fixed exchange rate regime should be adopted.

2.3.1 TRADITIONAL CRITERIA OF OCA

The traditional OCA is based essentially on the study of costs arising from the loss of the ability to conduct a national monetary policy – the inability to affect its exchange rates, considered to be a strong instrument for ensuring stability in the monetary field. In his work, Mundell (1961), considered to be the pioneer of the theory, identified some criteria under which a monetary union will be successfully attained. According to the theory, regions or countries can be affected by different distortions (symmetric or asymmetric shocks).

For traditional OCA the adjustment mechanism in a monetary union will depend more on factor mobility than on exchange rate flexibility because real exchange rates can change due to divergences in price movements (Beine, 1999; De Grauwe and Vanhaverbeke, 1993). For monetary union with competitive currencies, the adjustment mechanism for asymmetric shocks will emphasize real exchange rate changes more than factor mobility.

The essence of the theory is outlined through demand shifts from one country to another. According to Mundell, because of these asymmetric shocks, both countries are confronted with adjustment problems. The first country faces a decrease in its level of employment and a deficit in its current account. The second country faces an expansion, which can result in upward pressures on its price levels and it accumulates a current account surplus.

As mentioned, for eliminating such macroeconomic disequilibria, the control of exchange rates constitutes a powerful instrument for adjustment. A depreciation of the currency in the first country would eliminate the current balance problems and unemployment, on one hand, and inflationary pressures, on the other hand. In the absence of exchange rate flexibility, the adjustment mechanisms will be supported by variations in wages and unemployment.

The nature of the criteria is diverse. Some of them emphasize adjustment mechanisms, which can substitute for exchange rate flexibility. The degree of diversification within the monetary union can accentuate the existence of asymmetric shocks. These criteria make it possible to limit the extent of a monetary union and/or to determine whether or not an existent monetary union constitutes an OCA (Beine, 1999; Masson and Taylor, 1993; Dyson, 1994; Ascheim and Tavlas, 1995):

- Factors mobility. In the case of demand shifts, labor mobility is a "natural" mechanism that will lead to a new equilibrium. This movement of labor eliminates the need for wage declines. Thereby, unemployment problems and inflationary wage pressures disappear. At the same time, current account disequilibria will also decline;
- Wage flexibility. As is the case with demand shifts, total price and wage flexibility ensure a return towards initial equilibrium. If there is no labor and wage flexibility, the adjustment of the real exchange rate is necessary;
- Country openness. Two opposite views are linked to the criterion of country openness. According to the first view, more openness reduces the cost of a monetary union, as it reduces the probability of the occurrence of asymmetric shocks. The second view is opposed to the first one. The costs of a monetary union increase with the degree of openness of a country. The idea behind the degree of openness is the effectiveness of the exchange rate in dealing with asymmetric shocks.
- Diversification of the production structure. When an economy is well diversified in its production structure, a demand shock will have a small effect. Diversification implies a compensation of international immobility by means of inter-sector mobility (Beine, 1999; De Grauwe, 1997; De Grauwe and Vanhaverbeke, 1993).
- Integration and specialization dynamism. For Masson and Taylor (1993), the impact of a monetary union will depend on intra–community trade, which will condition the degree of asymmetric shocks.

2.4 THE CFA MONETARY UNION[2]

Africa is a region of great diversity in terms of geographical size, population, income per capita, resource endowment, historical background, socio-political fabric, climate and the topology of individual countries. These characteristics make it almost impossible to address issues of economic development for all of Africa without over-generalizing.

However, the CFA (*Communauté Financière Africaine*) links a group of countries that have pegged their currency to the French franc, and since 1999 to the euro. This form of integration has enhanced, at least partly, trade and factors mobility among members and has provided a measure of stability. At the same time, the link to the French franc has worsened the competitiveness of member countries.

Although the CFA monetary union, as Boughton (1993) argued, does not constitute an OCA, it does, however, provide an effective monetary standard for its members. It is one of the most durable monetary unions, the CFA franc zone, and has special characteristics. The zone features two central banks. Thus, in addition to being a monetary standard, it also forms two different regional currency unions.

2.4.1 REASONS FOR THE FORMATION OF THE CFA MONETARY UNIONS

In general, different reasons can make a country decide to enter an integrative scheme (economic and/or monetary). The theory of OCA is to use it as a tool to determine the suitability of countries for the formation of a "successful" integration. With its structural criteria approach and its cost-benefit analysis, it is the theoretical and methodological basis for decisions on monetary integration. However, other more specific reasons, such as political, institutional, and economic, can also be listed.

2.4.1.1 ECONOMIC REASONS FOR MONETARY UNIONS

It is commonly argued that during the 1970's membership in the CFA franc zone brought advantages to the participants in terms of lower inflation, lower debt burden, higher growth rates, currency stability and strong export performance, which was very rare on the continent. However, changes in the 1980's, most notably the debt crisis, the appreciation of the dollar vis-a-vis the European currencies, and the decline of raw material prices, meant that the members of the union needed to adjust their economies through both expenditure-switching and expenditure-reducing policies.

[2] The CFA franc zone is composed of two groups of countries in west and Central Africa. See annex A and B.

In the CFA zone, the mechanisms designed to instill fiscal and monetary prudence – guarding against unbridled public spending and high inflation – among member governments are the major reasons for integrating the Union. Each country is required to deposit, through the regional central bank, at least 65 percent of its foreign currency reserves into a special account with the French Treasury from which that country may borrow or collect interest. The French treasury can also limit the amounts available to the countries. By doing so, it restrains the money supply and thereby, at least theoretically, limits government spending by member countries. In order to meet their budgetary requirements, member countries borrow from their central banks, which in turn borrow from the French Treasury.

The special accounts can show a negative balance. As they receive interest on any credit balances they maintain, they are also charged interest on any overdrafts. These accounts guarantee the member states of the Zone unlimited access to foreign exchange and the possibility of borrowing from the French Treasury and allow these countries to maintain a fixed parity even when facing payment difficulties. Despite the possibility of running negative balances in their operations account, monetary restrictions have guaranteed that this only happens occasionally and hence the cost to the French Treasury has been quite limited.

As Boughton (1993) pointed out, the adherence to an external monetary standard, especially to a hard currency, provides a measure of discipline – reflected in price stability throughout the region and policy credibility - to financial policies that would otherwise be difficult for the authorities of an embattled economy to maintain. Additionally, Nashashibi and Bazzoni (1994) see the benefit of the formation of a monetary union, such as the Franc zone, also in the fact that a fixed exchange rate regime, for small and open economies, provides a convenient nominal anchor around which a consistent set of macroeconomic policies can be formulated.

In the special case of the CFA zone, the members are given the opportunity to access France and the European Union - good trade deals, currency convertibility and open capital movements, important financial support, and substantial official development assistance, mostly from France through the ODA.

2.4.1.2 OTHER REASONS

The need for monetary integration can also be found in the process of globalization, the decline in official development assistance, and attempts to reduce risks resulting in part from the absence of well established institutional and legal infrastructures to support market transactions – including adequate protection of property rights – and in instances of economic and political instability. It has been proved that a stable financial and macroeconomic environment can go a long way toward reducing the degree of uncertainty

investors (domestic and foreign) face. Capital formation has been hindered by the perceptions of high risks. But beyond the macroeconomic fundamentals, legal and institutional changes are necessary to ensure that investors are effectively protected against sudden and arbitrary changes in the economic environment and the rules of the game. To achieve these measures, which need discipline, usually one needs a back up, which is found in integration.

As Hernandez-Cata (1999) put it, the achievement of sustained high growth requires an increase in investment. This requires both the maintenance of a stable macroeconomic environment and, of course, far-reaching improvements in governance to avoid capricious interference in private sphere activity and to develop and maintain a transparent and stable legal and regulatory environment that reduces the risks that currently discourage private domestic and foreign investors. The ending of political/armed conflicts that hamper development and divert resources is also a condition that should be fulfilled. It should also be noted that the introduction of new currencies would increase transaction costs.

2.4.2 MONETARY AUTONOMY

Goodhart (1995) argues that introducing a national currency is more a psychological than economic factor because of its symbolic importance. Introducing a national currency means that the benefits of having one's own currency – seigniorage is collected by the country's national central bank, and the country can conduct its own monetary policy and exchange rate policy – outweigh the costs.

The basic problem of regional economic and monetary integration schemes in Africa has been and remains that the economic costs of participation in such arrangements are immediate, while economic benefits are long-term and uncertain. Political leaders in Africa are unwilling to sustain the immediate costs of integration for uncertain benefits available only in the long run. This explains why governments have mostly failed to implement trade liberalization and other agreements, and why the schemes have failed to achieve their goals.

Also, the relative absence of what neo-functional theorists call favorable background conditions for integration, that is, conditions existing before the integration effort starts, the weak institutional structures of regional organizations owing to their limited authority, bickering among member states over the unequal sharing of economic gains, nationalism, which predisposes states to a considerable reluctance to sacrifice perceived national interests on the altar of regionalism, are factors that drive countries away from integration.

The introduction of a national currency, regarding the mentioned reasons, should be the right decision for African countries. For them it entails an important symbol of their independence. It is, therefore, a political decision. However, a national currency can also

be justified on purely economic grounds. But, as Abrams and Cortés-Douglas (1995) put it, the introduction of new national currency requires some preparations.

To emphasize it again, according to the theory of OCA, the main advantage of having a national currency is that the exchange rate can be a useful adjustment instrument in the case of nationally differentiated shocks. However, this advantage has to be weighted against the gains from the formation of a monetary union. The possibility of conducting independent monetary and exchange rate policies is the main benefit of introducing a new currency. Introducing a national currency leads governments to try to control its production and supply. Controlling the creation of money provides the government with an additional source of revenue, seigniorage, whose value is small to a stable country with low inflation.

So why do these African countries not choose to have their own national currency instead? The same question can be asked in a different way: Does national monetary sovereignty for small African countries – small in terms of their economic output – matter? Generally speaking, it has been argued that it is better for a country to have the possibility of conducting independent monetary and exchange rate policies so that it can achieve internal and external balances. However, monetary sovereignty also has its price. Ribnikar (1995), argued that a small country may introduce a currency board system or permanently fix its exchange rate and force prices, wages, and interest rates to adjust to a permanently fixed exchange rate as an anchor. But the price for such a policy would also be high.

Additionally, the much desired freedom to pursue an independent monetary and exchange rate policy, according to Ribnikar (1995), can be misleading – by conducting an unadjusted policy - and will therefore lead to other costs. The central bank may pursue the wrong monetary policy and stay with it long-term if the exchange rate adapts to it. Or the central bank may provoke a balance of payments crisis if it does not allow the exchange rate to adapt to domestic monetary policy (Ribnikar, 1995: 232). The main reasons for joining a monetary union can be found, in addition to the cost-benefit analysis, in: (1) the structure of those African economies which are essentially exported oriented and which are deeply dependent on commodity price movements; (2) political and economic risks; (3) the absence of a well developed capital market that allows producers to finance an initial period of "learning by doing" and to finance investment in capital; and (4) technology necessary to keep up with international competition.

Various circumstances, both internal and external, have often prevented these efforts from being sustained for an adequate period of time and policy reversals have therefore taken place. The introduction of separate currencies would create a barrier for inter-trade because of higher transaction costs. And also the introduction of new currencies depends on the intensity of trade and the efficiency of the payment and transaction system provided by, for example, the CFA franc.

3 ECONOMIC AND FINANCIAL DEVELOPMENTS IN THE FRANC ZONE

3.1 THE FRANC ZONE

3.1.1 HISTORY OF THE FRANC ZONE: A BRIEF OVERVIEW

The franc zone is composed of two different monetary arrangement areas: the West and Central African Monetary Unions, the so-called CFA franc zone, and French overseas territories regrouped under the CFP. The Franc zone is a legacy of the French colonial empire – with a few exceptions, Equatorial Guinea and Guinea-Bissau. France was deeply involved in the management of the franc zone's institutions. France managed these institutions until 1972-1973, when new monetary co-operation agreements were signed between the different parties involved. The central organs of these institutions, namely the central banks, were previously located in France before being transferred to Africa (the BCEAO headquarters was transferred to Dakar, Senegal, while the BEAC[3] was transferred to Yaounde, Cameroon) and French overseas territories and French representation in the board of directors of these institutions was reduced, giving more credit to African natives. This entailed the beginning of the loosening of French control. However, French policy was still aimed at preserving its influence in the region, resulting in significant political support for African rulers instead of much-needed economic reforms, which would have jeopardized political stability and thereby French legitimacy.

In the first step, France, as a sign of its sovereignty, imposed the use of the franc as the only legal money (currency). During the 1930s and 1940s, France established in each of its colonies currencies that were pegged to the French franc. After the Second World War those currencies were consolidated into "*le franc des Colonies Françaises d'Afrique*" or the CFA franc and "*le franc des Colonies Françaises du Pacifique*" or the CFP franc. Its parity was set in October 1948 at 0.5 CFA franc per French franc and at 0.18 CFP franc per French franc. These parities remained unchanged until January 1994. The CFA franc was issued initially by the central bank for France's overseas territories (*Caisse Centrale de la France d'outre mer*) before being shifted, after the independence of its former African colonies to two regional central banks. These banks, originally dominated by France until the early 1970s, eventually secured responsibility for issuing currency and overseeing the functioning of the zone.

[3] BEAC stands for Banque des États de l'Afrique Centrale. It replaced the BCEAEC on November 23rd 1972.

After World War I, new rules were adopted and more severe obligations were imposed on currency issuing organs. At the same time new mechanisms, such as account operations for the exchange of banknotes among these different issuing organs under the same parity as those printed by the Banque of France were established. By the Second World War the cohesion between France and its colonies was complete. Before the independence of its members, the Franc Zone appeared to be a very centralized entity characterized by common exchange rules, common reserves and free convertibility, at fixed parity. After that, the parity remained unchanged until January 11th 1994 when the CFA franc and the CFP franc were devalued by 50 percent of their value compared to the French franc (1 CFA franc = 0.010 FRF).

With independence between 1954 and 1962, the newly independent states agreed to maintain their relationship with the former colonial power, France, and to remain in the zone. This consequently constituted a more homogeneous ensemble in a new institutional cadre. The monetary system established in that period allowed the franc zone to stay a stable monetary entity integrated with France and its currency. New agreements were also signed for the period 1959-1962. In April 1959, six newly independent West African countries – Côte d'Ivoire, Dahomey (current Benin), Haute-Volta (current Burkina Faso), Mauritania (which withdrew from the Zone in 1973), Niger, and Senegal – established "*l'Union Monétaire Ouest Africain*" (UMOA), now known as the WAMU (West African Monetary Union), whose disposition was essentially based on rules and guidelines regarding the issuance of currency, the centralization of exchange reserves, the free circulation of currency symbols and the freedom of transfers within the Union, and additionally created the "*Banque Centrale des États de l'Afrique de l'Ouest*" (BCEAO) in order to manage the common currency, the CFA franc[4]. The BCEAO was created to replace the AOF. Togo joined the BCEAO in 1963.

In Central Africa a similar process was also occurring. In 1959, five countries – Cameroon, the Central African Republic, Congo, Gabon, and Chad – founded the "*Banque Centrale des États de l'Afrique Équatoriale et du Cameroun*" or the Central Bank for African Equatorial States and Cameroon (BCEAEC) to replace the Equatorial Africa and Cameroon Issuing Institute (*l'Institut d'Émission de l'Afrique Equatoriale et du Cameroun*). The objectives of the new central bank were to manage the issuing process for the CFA[5] franc, whose parity to the French franc was the same as that of the CFA franc in West Africa. Ultimately, both central banks had to open operations accounts in the French Treasury. After gaining independence in 1976, Comoros and its issuing institute maintained its privileges before the newly created central bank took over in 1981.

In 1994 new movements toward integration were signaled in the CFA franc zone with the creation of the "*Union Economique et Monétaire Ouest-Africaine*" (UEMOA), or the West

[4] In west Africa the CFA franc means, franc de la Communauté Financière Africaine.
[5] In Central Africa the CFA franc means, franc de la Coopération Financière en Afrique Centrale.

African Economic and Monetary Union (WAEMU) the treaty of which is complementary to that of the former WAMU, thus making the BCEAO and the BOAD ("*Banque Ouest-Africaine de Dévéloppement*" – the West African Development Bank) two specialized and independent institutions. A similar move has been achieved in Central Africa with a new treaty creating the "*Communauté Economique et Monétaire de l'Afrique Centrale*" (CEMAC) or the Central African Economic and Monetary Area (CAEMA) with the BEAC as the central monetary authority.

3.1.2 MONETARY MECHANISMS OF THE FRANC ZONE

3.1.2.1 THE PRINCIPLES OF MONETARY COOPERATION

The Franc Zone is also regulated by a number of key operating principles expressed in the agreement on monetary cooperation between the member states of the two regional central banks, the BEAC and the BCEAO and France on one side, and between the Comoros central bank (BCC) and France on the other side. The major principles are:

- The guarantee of convertibility by the French Treasury. However, the central banks (BCC, BCEAO and BEAC) must open an operations account with the French Treasury with market related-yields or charges. These accounts can have a positive or negative balance, providing, therefore, an unlimited overdraft facility;
- A fixed parity against the French franc – adjustable if required for economic reasons after consultation with the French government and with the unanimous decision of all member countries within each monetary area. The currencies of the Zone are convertible among themselves with fixed parities without a limit amount;
- Free capital mobility between France and the "French franc" region;
- Foreign exchange reserves pooling for each regional monetary area. However, the principle of free capital mobility has been restrained by a number of administrative regulations such as prudential limits on the net holdings of net foreign assets by commercial banks and high commissions for capital transfers abroad.

Furthermore, these principle are maintained through a number of rules which are stipulated in the statutes of the central banks: 1) to maintain at least 65 percent of its foreign assets in its operations account with the French Treasury; 2) to maintain a foreign exchange cover of at least 20 percent for its sight liabilities; and 3) to limit its credit to each government of member countries to a ceiling representing 20 percent of that country's government revenue in the previous year. These operating rules are to limit potential drawings by the two central banks through their overdraft facility with the French Treasury, thus encouraging financial discipline.

3.1.2.2 ACCOUNTS OF OPERATIONS

The implementation of the above mentioned principles is possible only through the application of a particular mechanism, the accounts of operations, whose method of functioning is defined and formalized under agreements signed between the French Ministry of Economics and Finance and each of the representatives of the issuing Institutes composing the Franc zone. The accounts of operations are the fundamental mechanism linking the French treasury and the different central banks regrouped in the franc zone.

The main characteristic of these accounts of operations is the deposit of at least 65 percent of all foreign assets of the member states of the Franc and/or CFA zone in the French treasury. All import and export operations (public and/or private) realized by these countries, all financial transfers made by economic operators are centralized in these special accounts. This centralization permits the unlimited support of the CFA and CFP franc by France. Through the accounts of operations, the members of the Franc Zone realize the majority of their foreign currency operations.

The accounts of operations generate both cost and revenues. When the account has a positive balance, the owner receives interest. Otherwise, interest is charged. No matter how negative their balance of payments was member states were provided the French francs necessary for their transactions with other foreign countries. However, this system has a safeguard device in order to prevent the abuse of the unlimited cover offered by the French Treasury – which is an exceptional measure. In order to limit long-term deficits in the accounts of operations, some preventive measures were designed:

- When the ratio of gross foreign assets to sight liabilities is below 20 percent for three consecutive months, the board of the central bank concerned will meet in order to take appropriate measures: increase the intervention rate, reduce the amount of refinancing;
- In the statutes of the BCEAO it is written that in the case of a deficit in the account of operations, the bank must supply the account with other foreign currencies obtained, against CFA francs. These foreign currencies are obtained by public and private organizations in the member countries. Additionally, member countries are invited to exercise their special drawing rights at the IMF. Regarding the BEAC, there are some measures that can be applied in the event of a deficit in the account of operations for three consecutive months. The central bank must reduce the amount of refinancing: by 20 percent in the countries which have a negative balance in the account of operations, and by 10 percent in countries that have a positive position for an amount lower than 15 percent of the fiduciary money in circulation reported during this same period.

Accounts of operations are, first of all, a mechanism for the management of monetary solidarity - (1) through the centralization or pooling of foreign exchange assets of both central banks (BCEAO and BEAC) in the French Treasury, and (2) through the process of unlimited resources provided by France (the French treasury) to its African partners.

However, it is only a partial instrument for measuring the evolution of the balance of payments. A better measure for examining the external monetary situation is the net/gross foreign assets. It should also be noted that the two regional central banks act independently of each other. However, two member countries, Côte d'Ivoire and Cameroon as members of, respectively, the BCEAO and the BEAC, have a strong influence on the status of the accounts of operations because of their economic weight in respective monetary unions.

3.1.3 THE INSTITUTIONS

The application of the general principles of the Zone also necessitates a structured institutional organization in each issuing zone. This institutional organization also gives room for flexibility, permitting the conciliation of monetary discipline with respect for political and economic differences.

The organs of the UEMOA comprise the Conference of the Heads of States, the Council Ministers, the Central Bank, and the Bank Commission. The Conference of the Heads of States is the supreme authority in the Union. It decides on matters where the Council of Ministers does not reach a unanimous vote. The Conference decides on the admission of new eventual members, as such are accepted one-to-one following the withdrawal of a member. It also decides on the exclusion of participants. The Conference meets at least once a year and the decisions it takes must be unanimous.

The Council of Ministers determines the monetary and credit policies of the Union. It provides the grounds for the protection of the common currency, ensures the financing and the refinancing of the development and the economic activity of the members. Each member has two representatives, both with the rank of minister, of which one must be the minister of finance.

The Central Bank, BCEAO, is the sole currency issuing institution within its distribution zone. The Board of Directors is composed of 18 designated members, two for each country. The Board also includes two representatives of the French government, in accordance with the dispositions of the different agreements on monetary cooperation. The Board determines the conditions for monetary interventions, however, the Governor, who is appointed by the Council for a six year mandate, does not participate in the voting process. The Board also appoints the Vice-Governor for a five year period. In each member country a national agency has been established within which exists a national committee for credit. Under the supervision of the Board these national committees determine, at the national level, the volume of currency to be printed and the allocation of credits.

The Banking Commission, created in 1991, is in charge of the elaboration of the prudential rules and regulations and their application by credit institutions within the Union. It also has control of the soundness of the banking system.

Monetary policy and cooperation within the CEMAC, in accordance with the Conventions on monetary cooperation signed in 1972 between the Central African states and France, is ensured by different organs: the Monetary Committee, the Mixed Monetary Committee, the BEAC, and the Banking Commission of Central Africa (COBAC), created in 1993.

The Monetary Committee is an organ, which brings together the Ministers of Economics and Finance of the members of the BEAC. Its role is to enforce the provisions included in the convention on monetary cooperation signed between the members. It also makes recommendations to the governments of the member states regarding adjustments, if necessary, to those provisions that stem from the economic evolution of the countries. The Mixed Monetary Committee brings together the Ministers of Finance of the member countries and France. Its role is to supervise the application of the convention on monetary cooperation between the members of the BEAC and France. It also makes recommendations on adapting the convention to the economic development of the member countries signatory of this convention.

The Central Bank, the BEAC, has one agency and other centers in each member country. The Bank has the exclusive privilege to issue currency – banknotes and coins – in the Union. The Board of Directors, with the approval of the member states and France, appoint the Governor and Vice-Governor, unanimously, for a period of five years, which may be renewed. The Bank is led by a Board composed of 13 members appointed for three years, which may be renewed. The composition of the Board is as follows: 4 administrators for Cameroon, 2 for Gabon, and 1 for the other members, while France holds 3 seats for its own representatives.

The Board determines the monetary policy of the Bank. In each member state there is a National Monetary Committee. It elaborates the financial needs of each member and determines the means to achieve these needs. The Minister of Finance, who also has a seat on the Board of the BEAC, directs the National Monetary Committee. It also includes the Governor of the BEAC and two *censors,* of which France appoints one. Additionally, each member has a National Council for Credit comprised of representatives of commercial banks and insurance companies. The Banking Commission (COBAC) was created in January 1993 in order to elaborate the prudential regulations of the banking system in Central Africa and to exercise control over other credit institutions in its area.

3.1.4 THE DEVALUATION OF THE CFA FRANC

3.1.4.1 THE REASONS FOR THE DEVALUATION

At a meeting on January 12th, 1994, the representatives of the African Franc Zone countries decided to halve the value of the CFA franc. Various commentators, economists, and development experts criticized the lack of preparation for the devaluation and predicted that it would not work. Others, especially IMF and World Bank experts, argued that devaluation was a necessary adjustment without which the economies of the Franc Zone countries were headed for bankruptcy. Years later, the results do not seem to support the catastrophic predictions, but the success expected remains subject to a whole range of conditions. Among these, social conditions are critical since wage increases must still be contained and any negative impact of the devaluation on the meager incomes of the poorest social groups must be alleviated.

From the early 1950s to the 1980s, the economic results achieved by the CFA franc countries, compared to that of other sub-Saharan African countries, were characterized by strong real GDP growth and lower inflation. The fixed parity, in existence since 1948 and guaranteed by the Bank of France, was a factor of stability in the face of inflation and an asset for the economies of the zone. However, the fixed parity evidenced some limitations, which were especially noticeable during the period 1986-1993: sharp cumulative deterioration in terms of trade combined with deflationary pro-cyclical fiscal policies. This situation induced, with a substantial depreciation of the equilibrium, a real effective exchange rate in the zone. In the absence of nominal exchange rate flexibility combined with the substantial appreciation of the French franc relative to the US dollar since 1986, the CFA franc as a consequence also appreciated in nominal effective terms. The adjustment measures implemented by most of the CFA franc countries had only a modest impact on the real effective exchange rate of the Zone as a whole. Therefore, the modest depreciation of the real effective exchange rate was not sufficient to offset the impact of the terms of trade loss, thereby leading to competitiveness problems. Exports of member countries became prohibitively expensive, making it almost impossible for local products to compete on the world market. The result is that, without devaluation, CFA governments had to reduce the prices paid to producers, thereby disturbing supply. According to Boughton (1993), the main reason for that was the global weakness in primary commodity prices.

For a number of years France pursued a strong currency policy – aimed at maintaining the franc's parity against the deutsche mark within the European Monetary System. In conjunction with the structural imbalances of African economies, this led to an overvaluation of the CFA franc. As a result of this overvaluation of the CFA franc, import prices plunged, while those of exports soared. Exports from the Franc Zone countries were

40 to 60 percent more expensive than those of their competitors. Local industry was unable to compete with cheap imports. Only with the help of tariffs and other trade barriers, were the remaining industries able to survive. However, these trade barriers distort market signals and constrain economic efficiency. This led to the fact that investment occurred only in protected industries and monopolies.

Table 1: Some macroeconomic indicators of the CFA Franc Zone countries

	1975-1986 (%)	1986-1993 (%)
Variation of GDP	+ 4.6	- 0.6
- Per capita	1.6	-3.6
Budget balance (annual average)	-5	7.6
Current Account Balance (% of GDP)	-6.5	7.4
Indebtedness ($ billion)	25	48.6

Sources: IMF

Further aggravating the problem, a number of neighboring African countries such as Nigeria, Ghana and the former Zaire (now the Democratic Republic of Congo) devalued their currencies and adopted a floating exchange rate system. These devaluations have created a lucrative business for smugglers bringing goods into CFA countries to take advantage of their overvalued currency. The weak enforcement of customs barriers contributed to the development of a flourishing trade in illegal imports, to the detriment of domestic enterprises.

With government revenues drained by the civil service wage bill, social expenditure and investment declined and indebtedness climbed sharply. Since the Franc Zone members hold accounts of operations with the French Treasury through the system of fixed parity, France covered current account deficits, notably by paying the wages of civil servants – in some countries. It decided to put an end to this practice – as a consequence of the Maastricht Treaty and its convergence rules.

With sluggish GNP growth and negative growth in GNP per capita, the virtual bankruptcy of public finances, unsustainable external indebtedness and accelerating capital flight, the magnitude of the imbalances was such that attempts to achieve internal adjustments largely failed. These were based on cuts in public spending – especially through a reduction of the civil service wage bill – the reduction of production costs through lower wages and prices, and the restructuring of state enterprises. In fact, internal adjustments resulted in a reduction of expenditure on infrastructure, health care and education. The operating rules adopted by the Zone to instill fiscal discipline were very limited and even inadequate in such situations. If this policy had continued, it would inevitably have created a deflationary

spiral with disastrous social consequences. Devaluation, with three principal objectives: reestablishing competitiveness and thereby a positive balance of trade, the sharp reduction of deficits and the stimulation of growth, combined with the implementation of restrictive incomes and credit policies accompanied by a number of structural and institutional reforms, seemed to be the only alternative.

3.1.4.2 EXPECTED RESULTS

Devaluation was expected to restore productivity and rapidly generate economic growth rates that would exceed the pace of population growth. Higher import prices – in local currency – coupled with cheaper exports – in foreign currency – should give an advantage to those local producers, especially those in the agricultural sector, who are not heavily dependent on imported raw materials or semi-manufactured products. Resources should flow into the most dynamic sectors and enterprises, while the CFA earnings of export-oriented local producers were expected to increase. Trade in illegal imports should become less attractive financially and thus be limited more effectively than by customs barriers. Lastly, private and foreign investment should recover.

Real growth rates, currently between –6 and +4 percent, were expected to become positive throughout the zone in 1995 and 1996 – between 4 and 7 percent. The proportion of government revenue drained by civil service wage costs – between 40 and 95 percent in 1992-1993 – should have reduced to 20 to 45 percent by 1996 - of course, depending on the economic structure of individual countries and on the containment of inflation and wages and on the effectiveness of accompanying social measures, without which the risk of economic or political setbacks would be high. Lastly, for most countries in the zone, devaluation paved the way for a revival of talks with the IMF, which means access to debt financing and rescheduling arrangements.

3.1.4.3 ECONOMIC AND SOCIAL RISKS

Initially, the adverse effects of devaluation were expected to be: a significant rise in inflation; higher consumer prices and local currency prices for imported foodstuffs; higher production costs for enterprises dependent on imported energy, raw materials or capital goods and higher oil prices, with a commensurate impact on transport costs. These effects could, in turn, give rise to difficulties in obtaining supplies and higher costs that could wipe out the productivity gains achieved by local industrial, agricultural, and handicraft enterprises, regardless of whether their output was intended for the domestic market or for export. One hopes that the devaluation will lead to a shift in the consumption patterns of the urban population away from imported foodstuffs and toward local agricultural produce. However, this presupposes that the price differential is not offset by higher transport costs and wider profit margins for intermediaries.

Another pitfall is that inflation could induce a round of wage demands, which, if met, could place such a heavy burden on both the competitiveness of local industry and the government budget so as to completely offset all the benefits of the devaluation. Alternatively, if such wage demands are not met and the rise in the cost of living becomes unbearable for non-wage earners, the build-up of discontent could lead to serious social unrest that might even destabilize political institutions.

3.1.4.4 THE ASSESSMENT OF THE DEVALUATION

On the whole, the results of the devaluation, concerning inflation and growth, have been very close to the estimations. It should be mentioned that devaluation intervened in a very favorable international climate characterized by growth increases in the major industrialized countries and increases in commodity prices – except for oil. After five years, from 1994 to 1998, it was possible to assess the effects of the CFA franc devaluation. Thus, a few months after the devaluation, the initial results failed to substantiate the most pessimistic predictions. The devaluation combined with restrictive income and credit policies and a number of structural and institutional reforms contributed to boosting growth in real per capital incomes in the Zone at a rate of 0.8 percent from 1994-1996, after annual declines of 2.6 percent for the period 1986-1993. Consequently, inflation was brought down to single-digit levels by 1996 – below 5 percent. However, the predicted rate was to surge, in 1994, between 30 and 40 percent – depending on the country considered. In 1995, inflation was between 5 - 10 percent. Fiscal imbalances were reduced. The overall balance of payments was also contained while most countries of the Zone saw their external debt burden significantly eased through concessional debt relief. By 1997, it was estimated that about half of the gains in external competitiveness, measured by changes in the consumer price-based real effective exchange rates, as a result of the devaluation, had been preserved. However, it cannot be considered a success until the expected benefits of the resulting austerity materialize – economic recovery, greater tax revenue, job creation, and an eventual reduction in poverty.

The real effective exchange rate for the Zone depreciated by 26 percent between 1993 and 1997, while the terms of trade improved slowly. Bolle (1997), Hoffmaister, Roldos, and Wickham (1998) conclude that the effects of devaluation permitted the countries of the CFA Franc Zone to close the gap separating them from most of their neighbors. Public finances also improved. Countries in the Zone had for long been subject to chronic budget deficits. Revenues increased and public spending stabilized as a result of restructuring duties and taxes, the improved administration of tax collection and customs services, increased imports and economic recovery, together with a reduced share of civil service wages in public expenditures. Additionally, investment and social spending have increased, with a concomitant decline in operational spending.

Although economic growth slowed in 1998-99 and the level of output per head declined, the benefits of the 1994 devaluation were mostly reflected in better macroeconomic and structural policies. The thrust of economic policies, however, generally remained positive. However, persistent weaknesses in world commodity prices, including cotton, cocoa, coffee, tea and metals, continued to constrain growth.

We should also note that as an integral part of the adjustment program adopted by the countries of the Zone, the two regional central banks changed their policy concerning intervention. They shifted from direct instruments of monetary control to more subtle indirect market-based instruments. Additionally, they set up inter-bank money markets and created new central bank financial instruments issued through auctions.

4 ECONOMIC AND FINANCIAL DEVELOPMENTS IN THE CFA FRANC ZONE

4.1 OVERVIEW

The CFA franc zone is a currency union linked to the French franc. According to Boughton (1992), if the CFA franc zone is taken alone, it does not appear to represent an OCA but when included in the wider euro zone its benefits become apparent. The CFA franc zone is an outgrowth of the economic and financial arrangements under which France administered its colonies. However, since its formation, there have been some important institutional changes over the years reflecting the political and economic evolution this region had experienced. One of these changes is that the system has become less dependent on France.

Today there are two separate currencies known as the CFA franc. The eight countries in West Africa use the "*franc de la Communauté Financière d'Afrique*". They formed the West African Economic and Monetary Union (WAEMU), and have vested authority to conduct monetary policy in a common central bank, the BCEAO. The six members in Central Africa use the "*franc de la Coopération Financière en Afrique Centrale*". They formed the CEMAC and have their own central bank, the BEAC.

There are three basic mechanisms for controlling monetary growth in the zone. First, interest is charged on overdrafts in the operations accounts – and interest is paid on credit balances. Second, when the operations account balances fall below specified target levels, the central bank concerned must implement policies restricting credit expansion. These restrictions focus on raising the cost of rediscounting paper with the central bank and restricting access to rediscount facilities; this emphasis on rediscounting reflects both the limited development of domestic financial markets and the under-use of bank reserve requirements as an instrument. In order to implement the credit restriction rules, each central bank's operations account balance is notionally allocated among the member countries, with a residual allocated to the bank itself. Third, credit from the central banks to the public sector of each country is limited to a maximum of 20 percent of the previous year's fiscal revenue. These rules do impose a strong measure of financial discipline, while they don't dictate a strict ceiling on total domestic credit growth. For Boughton (1992) the soundness of the system depends on how well it fits the usual criteria for a successful currency union, such as the degree of flexibility of wages and prices, the degree of labor mobility, the effects of external disturbances and the degree of intra-regional trade. But it has been generally recognized that the CFA franc zone does not meet these conventional criteria for the formation of OCA: the benefits associated with participation in a monetary

area - such as lower transaction costs, reduced uncertainty about exchange rate variability and relative price changes – would exceed the costs linked with the loss of monetary sovereignty (government printing power and nominal exchange rate flexibility).

Therefore, the great advantage of the CFA franc zone, according to some economists including Boughton (1992, 1993), Nashashibi, and Bazzoni (1994), is that it combines the use of a common currency by a group of countries with a firm link to an outside anchor currency, with the active cooperation of the anchor country. This feature conveys potential benefits in terms of the strong independence of the central bank, fiscal discipline, and currency convertibility. But after poor economic performance, the CFA franc was devalued. The expected results were: restored productivity, increased competitiveness and economic growth. It would appear that the 1994 devaluation might be deemed an economic success, though its social benefits have been late to materialize, in a general sense. For regional integration, if the positive short-term effects of the devaluation are to be translated into sustainable economic improvement, according to Bolle (1997), then integration must be strengthened.

4.1.1 MONETARY UNION IN WEST AFRICA: THE UEMOA

Since the devaluation of the CFA franc in January 1994, substantial progress has been made toward the closer integration and the coordination of macroeconomic policies among the member countries. Most recently, a common external tariff with a simple average rate of 12 percent was put in place in all countries, and a regional convergence pact was adopted in December 1999. Member countries have also taken important steps to integrate the UEMOA into the larger regional arrangement of the Economic Community of West African States (ECOWAS) with a view to creating a unified regional market and currency between the 15 member states.

The overall economic and financial situation in the UEMOA improved considerably during the period following the devaluation of the CFA franc in 1994. Output, exports and investment increased more rapidly than in other sub-Saharan countries. There has been a sustained growth rate and an increasingly favorable international environment. However, since 1998, the economic performance of the UEMOA as a whole has weakened, mainly because of a slackening of policy resolve and delays in implementing structural reforms in several countries in the context of political uncertainties linked to the election process. This situation has been compounded by the impact of the adverse terms of trade developments caused by a decline in the prices of key export commodities - cotton, cocoa and coffee – and a sharp rise in the import prices of oil products.

Real GDP reached a level of 4 percent in 1999, which is less than in previous years, but higher than the 2.2 percent in the rest of sub-Saharan Africa. Average CPI inflation remained subdued at less than 1 percent, and the real effective exchange rate of the CFA

franc (based on the CPI) remained virtually unchanged in 1999. Relative to 1994, the improvement in the competitive position was estimated at 28 percent at the end of December 1999. As a consequence of the deterioration in the terms of trade, the external current account deficit, including official transfers, widened from 5.4 percent in 1998 to 6.1 percent of GDP.

Reflecting a weakened fiscal stance in several countries, the zone-wide overall fiscal deficit (excluding grants) increased slightly to 5 percent of GDP in 1999. Including official transfers, the fiscal deficit widened from 1.3 percent to 2.5 percent of GDP in 1999. Total government revenue declined by 1 percentage point of GDP to 16.7 percent, reflecting lower export tax revenue owing to the fall in commodity prices, the fiscal impact of the first round of tariff reductions in the context of the common external tariff and weakness in the tax administration. Government expenditure fell slightly by 0.3 percentage point to 21.7 percent of GDP mainly because of a reduction in foreign-financed investment. The conduct of monetary policy was successful during 1998 and 1999 in maintaining a foreign exchange cover ratio in excess of 100 percent. Monetary policy was considerably tightened in mid-1998 in response to speculative capital outflows sparked by the public expectation of a new devaluation in 1999 with the switch of the French franc to the euro as the anchor.

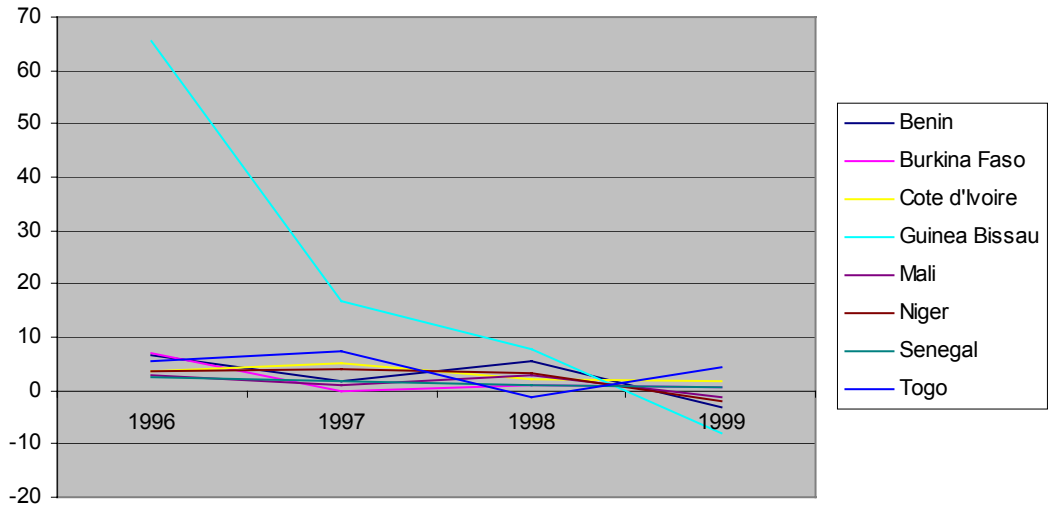
4.1.1.1 CPI AND INFLATION

The evolution of the real effective exchange rate indicates that since the devaluation of the CFA franc in 1994 the competitive position of the zone as a whole has deteriorated only partly. Structural rigidities and other institutional factors as well as the dependence of the zone on the exports of commodities and higher domestic production costs hinder growth and weaken the competitive position of the UEMOA. Price levels were almost unchanged in 1999. The CPI increased by 0.6 percent, which is the lowest increase since 1993. The principal reason for such stability is the decrease in the prices of foodstuffs due to excess supply after two years of good agricultural performance. The prices of other consumer goods, other than foodstuffs, were contained at 2.3 percent while the 1998 level was 2.2 percent. Besides prices, other factors did contribute to the stability of prices. The implementation and the maintenance of a strong monetary policy, stability in deficits, a slight increase in the prices of non-oil products coupled with the implementation of a new external tariff and the partial impact of oil product prices in domestic markets for those products all had a limited impact on the inflation rate. The real exchange rate of the union's currency (based on the CPI) depreciated by 2.7 percent during 2000 as a result of low inflation and the appreciation of the US dollar against the euro. The inflation rate in the Union reached an annual average of 4.1 percent in 2001. This is more than the 3 percent set by the UEMOA as a norm. However, this still confirms that inflation was stabilized at a moderate level. Inflationary pressures persisted, stemming more from rigidities in distribution channels for foodstuffs, instead of money creation. However, there are still great disparities in the consumption price index in the countries of the Union. This

indicates the existence of differences in the evolution of prices within each country. Disparities in price levels in the different countries of the Union are still very important. One of the reasons is the heterogeneity of the price index structures. Pressures on the prices of certain foodstuffs – which are highly weighted – provoke inflationary pressures during the crop period. This pressure is the result of the inefficiency of the system of production and distribution.

In 1999 fiscal discipline and a strong monetary policy worked to control prices despite the fact that only two categories of prices – public services and certain agricultural products – are regulated. But according to the directive adopted by the Commission, the inflation convergence criterion was set at 3 percent. The necessity to converge toward this criterion forces the members to ensure a better supply of foodstuff products, which are still very much dependent on climatic conditions, and on better distribution. It should be noted that shortages are a great source of inflation.

Figure 2: CPI evolution in UEMOA (in %)



Source: INS, BCEAO, Afristat

It is clear that the differences in the inflation rates among the members are still very important and inappropriate in a monetary union with a common monetary policy. The reason for this state of affairs lies in the insufficient supply of agricultural products, mostly depending on climatic conditions. In addition to the proper orientation of macroeconomic policies in the union, the control and convergence of inflation rates will necessitate the enforcement of pertinent policies in the agricultural sector in order to increase supply and thereby to ensure a minimal variation in this domain. Again, members could, when necessary, support, short-term stocking actions for the market. This would create a freeing of prices for these agricultural products, and therefore would contribute to the realization of the common objectives concerning the inflation rate.

4.1.1.2 INDICATORS OF CONVERGENCE

The regional Pact for Convergence, Stability, Growth and Solidarity was adopted to reinforce the framework for fiscal discipline in the zone. However, one question is whether it might also constrain the scope for counter cyclical fiscal policy. In December 1999 the pact came into force. The pact establishes a new dimension in the process of the convergence of the monetary policies of the member states of the Union. It fixes a precise horizon for the convergence by determining that all members should reach the final objective of stability by January 1, 2003. The Pact distinguishes two different phases of convergence: the first from January 1, 2000 to December 31, 2002, in which member states must progressively reach the fixed community norms, and a phase of stability starting from January 1, 2003, in which all the members must satisfy the convergence criteria.

The Pact determines eight criteria divided into two categories: first-order and second-order criteria. First-order criteria are the following: 1) an average annual inflation of no more than 3 percent; 2) a basic fiscal balance (defined as non-grant revenue minus expenditure excluding foreign-financed investment) -to-GDP ratio that is zero or positive; 3) an overall debt-to-GDP ratio of less than 70 percent; and 4) no change or a decrease in domestic and external payment arrears.

These first-order criteria are supplemented by second-order criteria, which are related to the wage bill (to be maintained at less than 35 percent of tax receipts), the ratio of domestically financed investment to tax receipts (which must be over 20 percent), the tax receipts-to-GDP ratio (over 17 percent), and the external current deficit, excluding grants (must be less than 3 percent of GDP). The adoption of new and efficient measures, such as indicators of convergence, to assess the degree of efforts made by countries to reform their economies, is proof of their determination to strengthen their economic performance by implementing reforms undertaken.

The convergence criteria implemented since then emphasize the constraints on the public deficit and public debt sustainability. Unsustainable budget deficits and excessive indebtedness can increase the need for monetary financing and jeopardize the soundness of the common currency. The setting up and implementation of budgetary norms is also predicated on the belief that fiscal consolidation will lead to sustainable growth by freeing up resources for the private sector. Because of the decline in growth and other structural and institutional factors, complying with the convergence criteria by the end of 2000 was difficult.

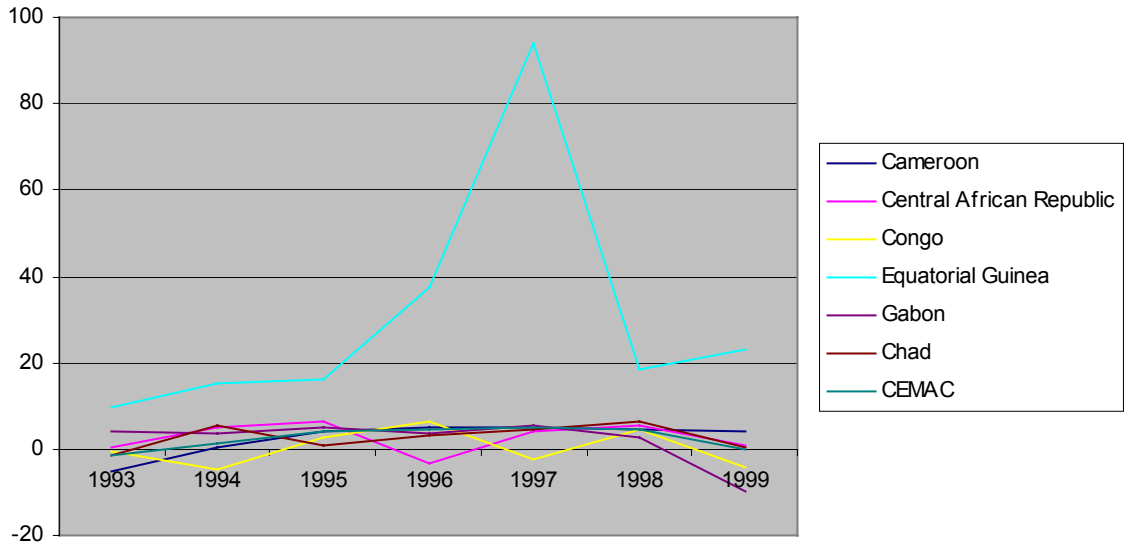
In addition to the adoption of new criteria for convergence through the Pact, the establishment of a customs union represents the principal task for regional integration. By January 1, 2000 the regulations of the Customs Union had been implemented: the

application of a common customs framework and the application of a common external tariff (CET).

4.1.2 MONETARY UNION IN CENTRAL AFRICA: THE CEMAC

The revival of growth and the positive effects resulting from the reform of public finances – planning and budgetary management – were not sufficient to attract more non-oil foreign investments in the sub-region. For the first time following the devaluation of the CFA franc in 1994, the member countries of the CEMAC recorded a recession (-0.2 percent). Furthermore, in 1998, the Zone underwent an important deterioration of the terms of exchange but its recession effects were covered by overwhelming budgetary expenditures in Gabon and Congo as well as good agriculture performances in Chad and in the Central African Republic. In 1999, the partial stabilization of public finances combined with a decrease in oil production and in prices for agricultural products strongly influenced the activity of the CEMAC. But in the second half of 1999, oil prices increased substantially. This had positive effects in the oil production countries of the Zone. In the wake of high iol prices domestic consumption, which contributed 1.3 percent of the growth rate, and investment expanded enhance by external demand and a decrease in imports. Due to budgetary constraints, public expenditures were sharply reduced. Global consumption is the pillar for growth in the CEMAC. However, a lack of productive investment, combined with limited public investment, constitutes one of the most important obstacles to sustained growth in Central Africa. Moreover, considerable efforts have been made in order to stabilize the economies: containing inflationary pressures, the creation of new jobs, salary increases in productive sectors and the administration, and raising revenues from rent.

Figure 3: Growth rate of GDP (in volume)

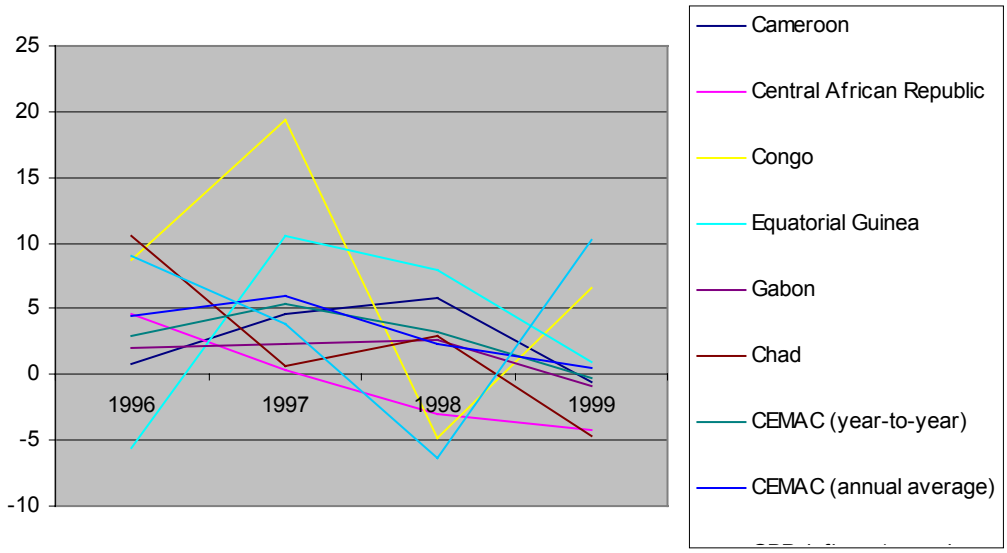


Sources: FMI, BEAC

4.1.2.1 INFLATION

From 1998 to 1999, the reduction of inflationary pressures is explained by the effects of price liberalization, the implementation of prudent stabilization policies aimed at controlling financial management – in the context of adjustment programs. Progress realized in the implementation of the customs reform contributed, evenly, to reducing inflation. All the member countries, except Congo, recorded very encouraging results in their fight against inflation. In other respects, the members of the CEMAC also benefited from a fall in prices, in international markets, of manufactured products. Inflationary pressures will be under relative control due to discipline in budgetary and monetary policies, and also because of a sufficient supply of foodstuffs in urban markets. The consumers of the Community will also benefit from a low increase, 1.6 percent, in international prices for manufactured products from South-East Asia and the EU. But if the price of oil in international markets continues to jump, this can have some impact of the rate of inflation in the Community. However, a sustained increase in oil prices could result in a rise in the price of oil products. The process of the privatization of public services and thus the elimination of a monopoly in these countries brought down prices. Price stability contributed to the better competitiveness of the CEMAC. As a consequence and according to the regional Central Bank (BEAC) the effective real exchange rate depreciated by 3 percent in 1999. On a year-to-year basis the CPI decreased by 0.2 percent while, in terms of annual average, the inflation rate in the CEMAC increased by 0.5 percent in 1999 and reached 3.3 percent against 2.4 percent in 1998.

Figure 4: CPI evolution in CEMAC



Source: BEAC

Member countries of the CEMAC continued a sustained policy of stabilizing public finances through the amelioration of productivity in the fiscal administration and by a control on expenditures. This has been reflected in a reduction in the public deficit. Public expenses have been reduced by 11.2 percent, especially in Gabon. Except wages, all other current expenses were reduced by almost 20 percent. However, capital expenses had a different evolution, according to the country. Public investments increased except in two countries, Chad and Gabon, where the decrease was remarkable and painful. Therefore, the budgetary deficit decreased from 5.5 percent of the GDP in 1998 to 1.2 percent in 1999. Stabilization policies (restrictive budgetary policies, the reform of the fiscal administration, better control of public expenditures) will still remain a priority in the coming years.

4.1.2.2 CONVERGENCE AND MULTILATERAL SURVEILLANCE

In 1991 the members of the BEAC decided to further adopt the formation of an economic union. A system of multilateral surveillance, the objectives of which were to enhance performance by means of the coordination of economic policies and to ensure coherence between national budget policies and the common monetary policy. The aim of the system is to enhance the regional integration process.

The Council of Convergence is authorized to monitor national macroeconomic policies and render them compatible with the stability of the single currency of the Community, the proper implementation of structural adjustment programs supported by the international financial community and to promote sustained economic growth. The council examined the economic and monetary situation of the six members, the development of their public finances and the position of each of the members according to the criteria of surveillance. The system of surveillance is based on four criteria: the external covering rate of money by official foreign assets must be at least 20 percent; the budgetary primary balance must be zero or positive; variations in internal and external arrears must be negative or equal to zero; the growth in public wages must be equal to or less than budget revenue growth.

Although the member countries have made great efforts regarding the stabilization of public finances, the last committee report pointed out the fact that none of the member countries respected all the convergence criteria. Two countries respected three of the four criteria and three countries respect only two criteria. Compared to 1998, there was a net increase. The adoption and implementation of the criteria for multilateral surveillance have enabled progress concerning regionally based planning for national budget policies, and the greater public to be informed of the orientation of the economic policies of the Community.

5 MONETARY POLICY IN THE CFA FRANC ZONE

5.1 MONETARY REGIMES

Many factors properly enter into the choice of regime. These basic factors include (1) economic criteria, such as the weight of trade with partner countries, the symmetry of shocks, and the existence of institutions and markets capable of regulating exchange rate fluctuations; (2) political considerations, such as the desire for regional integration.

In post-independence sub-Saharan Africa, institutional arrangements for monetary policy have taken a variety of forms. However, despite the variety of regimes, many African financial systems have followed a similar pattern – passing from relatively open fixed exchange rate regimes under colonialism, through an era of greater economic regulation and control of banks, to a less regulated, more open financial system. This is not surprising in view of the wide differences among these countries in terms of their economic and financial circumstances. For many developing countries, which have very limited involvement in global financial markets, pegged exchange rates retain important advantages. They can provide a useful and credible nominal anchor for monetary policy and simplify the adoption of an alternative anchor (such as a functional and credible inflation target backed by an operationally independent central bank – generally speaking African policymakers are embracing a more conventional and modern view of central banking with an emphasis on the objectives of monetary policy). However, as these countries have adapted to expanding opportunities arising from deeper involvement in an increasingly integrated global economy and to changes in their own economic situations, there has been a shift toward greater flexibility.

5.2 THE FUNCTIONING UNDER THE DIFFERENT REGIMES

Most African countries inherited a rules-based, fixed exchange rate regime with independence. In most cases the starting point was a formal currency board, which was jeopardized by nationalist aspirations combined with the conviction that national sovereignty requires the creation of a national currency. However, the involvement of France in monetary arrangements in post-independence African countries helped to maintain its influence on the continent. The CFA zone, with the different benefits it provided, namely the overdraft facility, which was offered to these countries, remained stable.

When those countries wanted to abandon the currency board model they had to choose between strongly opposing alternatives: an ideological model accepted by socialist-oriented governments, an economy of rationing and controls; another possibility was to give up any attempt to restrain inflation and to give the printing press free rein; the last option was to follow the more contemporary fashion of increasingly discretionary central banking in an market-oriented economy.

5.2.1 RULES-BASED SYSTEMS

No African country has ever applied the pure currency board system, whose main characteristics are a fixed exchange rate and the exclusion of lending to the government. However, currency boards were instituted by the colonial power, which were aimed at economizing on the use of the currency of the colonial power. The pure currency board had limited powers. Its role was essentially based on the issuance of local currency in exchange for claims on the colonial government, while other standard functions performed by a central bank were excluded. A pure currency board can be interpreted as preventing the exercise of discretion in central bank activities and thereby it produces a system with considerable resistance to policy errors. Despite its ability to avoid the policy traps of more complex regimes, the lack of flexibility of a currency board makes it ineffective concerning exogenous shocks - it has no ability, no role in financing a payments deficit, which would drain the economy of liquidity, induce an increase in domestic interest rates and put downward pressure on domestic prices, wages and economic activity and potentially threaten the solvency of banks. In a county using such a system, the central bank cannot be qualified as the “lender of last resort” in a banking crisis because this system does not allow lending and/or prudential supervision of banks. A currency board was instituted in Liberia and by two countries in the rand zone (Lesotho and Swaziland) but was abandoned in favor of more flexible systems. Additionally, an imperfect analogy with the CFA zone was made, especially regarding the statutory limitations on both central banks assistance to the government. But it is clear that central banks in the CFA zone do make commercial loans and do regulate bank credit (Honohan and O’Connell, 1997).

5.2.2 THE “PRINTING PRESS”

According to Honohan and O’Connell, the aim of this system, to deal with shocks, internal or external, with a passive monetary accommodation – do not rely on heavy rationing in the foreign exchange market and domestic goods markets, or those in which such interventions as exist are highly ineffective. The main features of such a system are the lack of a nominal anchor and the virtually automatic response of prices and the exchange rate to shocks. However, the system has limitations related to the inverse relationship between money demand and expected inflation. In this regard, the fiscal gap, which is closed through an inflation tax, cannot be met by means of the printing press. This system

has been experienced by a number of African countries, especially the Democratic Republic of Congo (the former Zaire) despite hyper – or near-hyper – inflation.

5.2.3 THE CONTROLLED ECONOMY

In a controlled economy prices or quantities are not allowed to adjust in order to clear markets. The result is the rationing of goods and foreign exchange. The stronger shocks are, the more severe rationing is. This policy was an important feature in many African countries between the late 1960s and the mid-1980s. Such a policy was also to encourage parallel markets. However, countries such as Angola, Ghana, Guinea, and Tanzania, which were characterized by this kind of regime, abandoned the "controlled economy" system (Honohan and O'Connell, 1997).

5.2.4 CREDIT CEILING

During the 1980s a growing number of African countries adopted this regime, in which commercial banks face ceilings on credit expansion. The IMF also pushed this system as part of its stabilization programs. Credit ceilings, which can be associated with interest rate controls, are believed to induce macroeconomic responses to shocks that are quite different from those that emerge when credit is market-determined.

5.2.5 PURE MARKET-CLEARING

The pure market-clearing or market-oriented central bank is a mid-point between rule-based systems and the "printing press" regime. Its characteristic features are lending to governments and to banks in order to meet anticipated and unanticipated needs and active monetary accommodation as a normal response to shocks. However, it prevents heavy government reliance on monetary expansion. In order to meet the needs they face, monetary authorities may choose among a variety of instruments including the nominal exchange rate, interest rates, central bank lending, foreign borrowing by the government, and others. This is also called discretion, without reliance on administrative control policies. Although this type of regime, in which market-determined prices play a central role, is a common practice in industrial countries, it is only now becoming the norm to an increasing number of African countries. Pure market-clearing seems to have become the monetary regime of the future although the rules-based systems, essentially the CFA zone in Africa, still have strong roots (Honohan and O'Connell, 1997).

5.3 MONETARY AGGREGATES

Monetary aggregates are alternative measures of the money supply in terms of degree of liquidity. Changes in the monetary aggregates indicate the thrust of monetary policy as well as the outlook for economic activity and inflationary pressures. Therefore, three potential roles for monetary aggregates can be identified: first, the aggregates may be used as information variables to provide a guide for the conduct of monetary policy; second, the aggregates may be used to signal the intentions of the central bank regarding its policy and goals; and the aggregates – through the monetary base – may be used to target nominal income growth.

The monetary aggregates, known individually as M1, M2, and M3, used to be all the rage a few years ago because the data revealed the central bank's (tight or loose) hold on credit conditions in the economy. The central bank issues target ranges for money supply growth and if growth moved outside such ranges an adjustment of interest rate by the central bank was then expected. A rational first definition of money is: currency (banknotes and coins, held by households, firms, and governments) plus sight deposits (bank accounts that are payable on demand). This is a generally accepted definition of money. This monetary aggregate is denominated as M1 and is generally accepted as a means of payment.

M1 = currency in circulation + sight deposits

A broader definition of money has been accepted because of the characteristics of sight deposits and the existence of new monetary instruments. This aspect gives rise to M2, which, because of each country's financial system, offers a different palette of such assets. Generally, however, we can define

M2 = M1 + time (or savings) deposits at banks with unrestricted access

An even broader measure includes instruments such as large certificates of deposit, or longer-term time deposits (depending on local rules and regulations) and possibly restricted access, foreign currency deposits, and deposits with non-bank institutions. These instruments are less liquid – more costly or difficult to convert into cash or checking accounts. This is called M3:

M3 = M2 + larger, fixed-term deposits + accounts at non-bank institutions

Beyond currency and M1, all definitions are inevitably arbitrary and vary from country to country. This is why monetary aggregates are not directly comparable across countries. Still, all the aggregates measure the "liquid wealth" of the non-banking sector. Differences

across countries reflect the stage of development of banking services as well as national regulations.

5.3.1 MONETARY AGGREGATES AND INFLATION

After years of high inflation, price stability is becoming the norm in both developed and developing countries. Inflation reduction has become a main target in central bank monetary policy. By moving toward announcing the future course of key nominal variables, as a way to influence inflationary expectations, central banks have helped spread this view. As a consequence, during the last decade, a growing number of countries have granted institutional independence to central banks and statutorily committed them to aim monetary policy at achieving price stability. This trend is also related to the fact that since the 1980s, the traditional relationship between money and a policy target has deteriorated in many developing economies. As a result, money growth targets have lost their importance in the conduct of monetary policy. Up to the mid-1990s, the central banks in the CFA zone focused on quantitative controls to influence money and credit growth. Money and credit aggregates were used as intermediate targets for monetary policy. Since the devaluation of the CFA franc in 1994, the central banks adopted an indirect means for influencing its monetary policy.

For intermediate targeting, a pre-announced exchange rule or targets for a specific monetary aggregate is a prerequisite. Under the exchange rate rule, monetary policy is very limited. It is, therefore, only aimed at the exchange rate, restricting the ability of the central bank to respond to domestic and/or external shocks. In flexible exchange rate arrangements monetary aggregates become the intermediate target for monetary policy – *monetary targeting*. The central bank adjusts its instruments – such as the interest rate – to control monetary aggregates, considered to be the main factors of inflation in the long run. Thus, controlling monetary aggregates would be equivalent to stabilizing inflation. The effectiveness of monetary aggregates as intermediate targets depends on their empirical relationship to the goal variable – here inflation – and on their relationship to the instruments of the monetary policy.

Although lowering and then stabilizing inflation is the ultimate objective in targeting monetary aggregates, it also allows the application of much greater control over monetary aggregates such as M1. However, in order to be effective, monetary targets require that a stable or predictable relationship exist between the aggregate and the rate of inflation. If this is not the case, meeting the target for monetary aggregates will miss the – implicit - inflation target. Therefore, although there is a gain in credibility, the goal of lowering and stabilizing the inflation rate will not be achieved. Instability of money demand is particularly common to developing countries undergoing processes of financial liberalization. The progress of financial development cannot be easily assessed by looking at some of the usual indicators, such as the ratio of narrow to broad money (M1 to M2), the

ratio of M2 to GDP, the share of private sector credit in total credit, and the ratio of private sector credit to GDP. Judging from the M1-to-M2 ratio, there has been a steady process of development over time.

5.3.2 THE DEMAND FOR MONEY

On independence, most sub-Saharan African countries opted for the prevalence of rules-based fixed exchange rates. In the post-independence period the main monetary policy instruments consisted of direct credit ceilings, interest controls, and limits on central bank refinancing. Little or no efforts were made towards the promotion of domestic savings and the preservation of each monetary union's net foreign assets position. In the mid-1980s many countries embarked on a reform agenda that included liberalizing interest rates, eliminating credit controls, adopting indirect instruments of monetary policy and developing financial markets. However, for the CFA zone the 1990s remain a turning point. Both central banks of the zone shifted from direct to indirect instruments of monetary policy; interest rates were liberalized and credit control lifted and the common currency was devalued. Currently, the BCEAO and the BEAC rely primarily on market operations, and reserve requirements. With the currency pegged to the euro, allowing free capital mobility with the EU, the interest rates in the CFA zone are tied more than ever to those in the French money market in particular and to those of the ECB in general. However, having initiated these processes of change, both central banks now face the question of how to adjust their monetary policy without destabilizing the existing fixed exchange rate system with the euro - the common currency, the CFA franc, issued by the central banks, is pegged to the euro although the French Treasury guarantees the convertibility of the currency; both central banks have to keep net foreign assets at a sustainable level in order to maintain their ability to repurchase CFA francs at the given parity at any time. In this regard, the maintaining of a sufficient level of net foreign assets determines the central banks' approach to monetary policy based on the relationship between net foreign assets, net domestic assets and the volume of money.

To target net foreign assets the central banks have to predict or control possible changes in the demand for broad money and the volume of domestic credit. In the CFA zone, where free capital movement with the EU exists, interest changes directly affect net capital flows, resulting in changes in the demand for domestic money but leaving domestic credit unchanged. This may in fact allow the demand for money to become unstable in the short term. With the switch to indirect instruments, the central banks in the CFA zone increased the uncertainty concerning the credit volume as well as the demand for money – through an uncertain relationship between various variables such as the interest rates on the money market and on the credit market as well as the link between the credit market and the volume of credit. If the central banks are able to control the money market by using indirect instruments, the volume of credit in the economy as well as the equilibrium interest rate is determined by inflation expectations.

Additionally, a substantial excess of liquidity in the banking system, as has been noticed in both the BCEAO and the BEAC, worsen the use of indirect instruments. Excess liquidity may cover the relationship between the market for central banks money and the commercial banks' activities in the retail market as long as commercial banks can always take recourse in their liquid resources to finance additional credit. Therefore, this excess liquidity must be absorbed so that the central banks' instruments can be fully efficient on the money market.

Additionally, new financial instruments, as a result of liberalization, may widen the array of financial assets at the agents' disposal – agents will be able to substitute money holdings for other financial assets and vice versa in response to changes in the economic environment in such a way that the decision to hold money depends increasingly on relative prices. In this regard, the stability of the demand for money will depend crucially on the public's confidence in the soundness of the financial sector. Then, the change in real broad money demand is a positive function of both real income growth and changes in deposit rates – interest rates. However, the acceleration of both currency depreciation and inflationary expectations do reduce real money balances. With both inflation and interest rates imported from France in particular and the EU in general, the targeted level of CFA zone international reserves can be achieved by appropriately controlling central banks' domestic credit.

5.3.3 MONETARY AGGREGATES AND EXCHANGE RATES

Although more countries decide to adopt more flexible exchange rate arrangements, 14 (since 1997 the number has increased to 15 because Guinea Bissau joined the zone) sub-Saharan countries of the CFA zone have continued to maintain a pegged exchange rate. The CFA franc has been pegged to the French franc (since 1999 to the euro) since 1948. A fixed rate was maintained until 1994, when the CFA franc was devalued. The CFA franc is fully convertible into euros and, with a few exchange restrictions, into other currencies. The exchange rate peg to the French franc, since 1999 to the euro, is therefore the main nominal anchor for the conduct of macroeconomics and financial policies. The impossibility of using the exchange rate as a policy instrument and the constraint, for convertibility purposes, imposed on monetary policy by the need to maintain a net foreign assets position at a sustainable level, have two major policy consequences: fiscal as well as credit policies remain the main adjustment tools and these tools have been used largely with an aim to promoting economic growth and development. The main monetary objectives of both central banks in the CFA zone is to maintain the peg to the euro and to achieve a substantial level of net foreign assets position in line with the peg. As mentioned above, with the pegged currency and free mobility of capital, with France essentially, interest rates in the CFA zone and those in the French money market and/or EU money market are linked.

A fixed exchange rate has clearly been effective in establishing and maintaining low inflation in the CFA zone. However, the choice of a fixed exchange rate has to be based on a certain number of considerations and not only on its merits as a nominal anchor. There must exist structural characteristics of the economy that must be supportive of the fixed regime (the degree of price rigidity, political support). Otherwise, the peg will face considerable pressure, which may push the monetary authorities away from their original objective of stabilizing inflation. A nominal anchor limits the use of monetary instruments: it reduces the discretion of the authorities to respond to short-term shocks. Additionally, with a peg to a single currency, fluctuations in the anchor currency will automatically induce fluctuations in the effective (trade-weighted) exchange rate of the concerned economy.

The use of the exchange rate as a nominal anchor is related to two aspects: the instability of the demand for money, which tends to increase in such crisis situations, and the belief that an anchor may enhance the credibility of the program. In such a case, the monetary policy has to be subordinated to the requirements of the peg. Consequently, the ability of the monetary authorities to finance fiscal deficits through seigniorage is limited. Therefore, the most commonly used nominal anchors are a fixed exchange rate and a money aggregate (reserve money or broad money, M1). Under a fixed exchange rate regime, whenever the market rate threatens to move from the predetermined rate, the monetary authorities intervene through open market operations – by buying and selling foreign exchange for the domestic currency – to ensure that the exchange rate remains fixed. Under a monetary anchor the policy used is quit similar. Monetary authorities predetermine a path for a monetary aggregate, and tighten or loosen the monetary stance when the aggregate shows signs of moving from that path. Thus, the monetary authorities in the CFA zone give up control of the money supply. Similarly, authorities, under a monetary anchor, cannot pursue an exchange rate target.

5.4 MONETARY POLICY IN THE UEMOA

5.4.1 THE OBJECTIVES OF MONETARY POLICY

The conduct of monetary policy in the UEMOA has been assigned to its Central Bank, the BCEAO. Members are obliged to centralize their external monetary assets in the BCEAO. The Bank, through the Board of Directors, defines and determines the monetary and credit policies. This main objective of the monetary policy is to ensure price stability and maintain an appropriate level of foreign reserves. As it has been already mentioned it is required to keep a minimum level of foreign exchange with the BCEAO equivalent to 20 percent of its short-term liabilities, that is foreign reserve ratio. In 1997 the Council and, to

a lesser extent, the Board, gave to the monetary and credit policy three major orientations: the control of the money supply (liquidity); the promotion of internal savings and foreign capital; and the strengthening of exchange reserves.

These objectives have been in total cohesion with the global economic policy fixed by the Council for the Union: (1) the pursuit of a moderate revenue policy; (2) the stabilization of budget deficits; (3) the acceleration of structural reforms in order to eliminate rigidities in supply, affecting prices; (4) the establishment of a legal, stable, and transparent environment for the conduct of economic and financial activities; (5) the diversification of exports; and (6) the implementation of the convergence policy.

The orientations stated for the conduct of monetary policy were essentially the reduction of the inflation rate, appropriate financing of economic activity and a consolidation of foreign exchanges. These objectives are in line with the convergence norms through the establishment of a procedure for "Multilateral Surveillance". However, the BCEAO, as well as the BEAC in Central Africa, in order to prevent excessive recourse to central bank financing of budget deficits, integrated in its agreement the rule that its gross foreign assets must be maintained above 20 percent of sight liabilities – including notes and coins, sight deposits of all financial institutions and the treasury, and foreign currency liabilities.

5.4.2 INSTRUMENTS

The BCEAO uses three different types of instruments: statutory advance ceilings to governments and financial establishments; required reserves; and key interest rates. Concerning credit to governments, the 1962 statutes of the BCEAO contained a strict limitation on Bank credit to the governments of member countries. It limits statutory advances to treasuries to 20 percent of the previous year's tax revenue. Its aim is to finance current account deficits and Treasury bonds and notes. Initially, the maximum credit was fixed at 10 percent of fiscal revenues for the previous year, but then it was progressively increased, to 15 percent in December 1968 and 20 percent in November 1978. However, the idea was to gradually bring the stock of advances down to zero by the end of 2001. The worsening of the public finance of the member countries compelled the BCEAO to maintain such instrument to the year 2001. The rules for establishing these statutory advances distinguish between two levels for decision-making: the Central Bank Board of Directors and the Council of Ministers – which grants its approval.

These statutes circumscribed the member governments as well as the BCEAO. The former were limited in their recourse to bank financing even though their "needs" may have been high. Since these advances were basically short term, at least in theory, the monetary arrangements appeared to have established the philosophy of the need for a balanced budget. The statutes also constrained the BCEAO in its operations vis-à-vis the governments. It had no right to refuse credit to a treasury as long as the statutory ceilings

were not exceeded. Thus, even when other considerations would have justified restricting credit, loans to governments could not in general be refused if their drawings happened, at that juncture, to be below the statutory minimum.

The system of obligatory reserves was put in place in 1993 with the objective of strengthening the efficiency of the interest rates policy – through differentiated coefficients applied according to the country. Initially sight deposits and short-term loans – excluding loans to peasants - constituted these reserves. A reform in 2000 included loans to peasants and the gross external assets of banks. The rate was fixed at 1.5 percent. For other financial institutions, the rate for required reserves is 5 percent of a clients' demand less liability from other financial institutions. Required reserves are not interest bearing assets.

Reforms adopted in October 1993 and July 1996 (repo tender procedures for both liquidity injections and withdrawals) aimed at a central role for interest rates as an instrument in monetary regulation. To achieve this goal, the monetary market, especially interbank markets, must be developed in order to serve as a transmission channel for the Central bank signals in terms of interest rates. The BCEAO has four key interest rates: the discount rate, the repurchasing (repo) rate, the tender rate and the BCEAO Treasury bills rate.

The discount and repo rates are subject to discretionary policy from the Central Bank while the tender rate and BCEAO bond rates are fixed by the BCEAO through auctions with variable rate "Dutch" auctions. The manipulation of both rates is first of all used for bidding effects. The BCEAO has the right, according to the existing circumstances, to regulate these operations – hitherto limited to fixed-rate tenders.

5.4.3 IMPLEMENTATION OF THE MONETARY POLICY

Monetary conditions remained stable throughout 2000. However, 2001 was characterized by a slight increase in central bank assistance to governments. Credits to the private sector contracted marginally, firstly because of a slow rise in ordinary credit demand and secondly, a decline in crop credits. This contraction of private credits was equivalent to 0.5 of 1 percent of the beginning-of-period broad money. Additionally, there was a strengthening of the net foreign positions of the banking system, up to 5 percent of the beginning-of-period money, to about $3 billion, or 104 percent of base money, at the end of December 1999. However, on June 2000, the BCEAO raised its key interest rates by 75 basis points, in accordance with developments in European financial markets.

From 1994 to 1996, the BCEAO considerably reduced its credit to the governments of the member countries. This was to reduce the liquidity surplus, which occurred after the restructuring of the banking sector and the devaluation of the CFA franc in January 1994. But in 1997 and 1998 the situation was reversed. The Central Bank increased its loans to different economic agents. However, in 1999, a decrease in BCEAO global assistance (-7.4

percent) as a result of the reduction by one-third of its assistance to the banking sector and of a growth of 5.4 percent in its support to countries. In 2001, the central bank reduced its assistance to banks by approximately 48 percent. The banks' refinancing went through repo agreements on public or private securities, which has been the case since 1998. Advances to governments increased by 16 percent, mostly overdraft facilities.

In 1995 the securitization[6] process contributed to the re-use of the withdrawn liquidity. In July 1994, the Central Bank proposed that the commercial banks buy public securities it guaranteed at a rate of 5 percent and tax-free in order to reinvest their excess liquidity. These Treasury bills had an effective interest rate of 7 percent, close to that of the tender rate in September 1994. However, the banks did not have any problem with that due to two different effects: the pursuit of capital repatriation and the payment of member countries' arrears in order to reduce the internal debt. In 1996, the BCEAO, because of persistence in liquidity excess, was forced to lower its indicative ceilings for bank refinancing. Despite this, the level of bank refinancing reached the level, which prevailed in 1995. Ceilings were again raised in 1997. But because of an increasing need for capital, in some member countries, limits were once again exceeded.

Following the liquidation process, on the 31st of December 1997 the refinancing structure appeared as followed: refinancing had increased through rediscounts, the increase in credits given through open market operations. But it is necessary to note the decrease in BCEAO activity on the monetary market for the whole of 1997. The outstanding amount of credits allocated to commercial banks fell by 42 percent, while raising funds through the issuance of Treasury bills by the BCEAO declined by 10 percent. The assistance granted by the BCEAO to national treasuries (excluding securitization), according to article 16 of the BCEAO statutes, include loans and the refinancing of Treasury bills and other securities representing member countries' indebtedness. But this excluded loans from the IMF to national treasuries. Globally, the use of statutory financing increased from 84 percent to 85 percent. The refinancing by the BCEAO of member countries through the issuance of Treasury bills decreased. However, this method of financing public treasuries was frozen at its 1998 level. Additionally, the member states of the union agreed to eliminate central bank statutory advances to governments by 2002. The rate of utilization of these statutory advances reached 104 percent in 2000 and decreased to 71 percent by the end of 2001.

5.4.3.1 RESERVES REQUIREMENTS

In 1997 the BCEAO did not see any reason to modify the rate or the basis for required reserves. However, in 1998, monetary authorities had to raise the coefficients of required reserves. The reasons for such an action stemmed from the increase in credit to the private

[6] The subscription of credit institutions to investment securities.

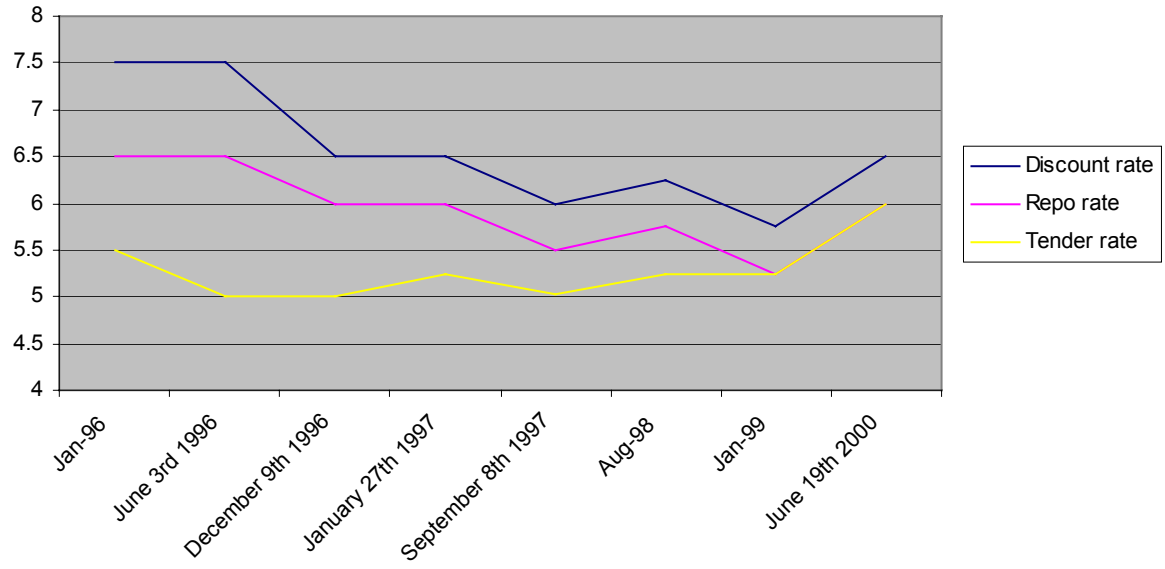
sector and the contraction of net external assets. This measure contributed to the loosening of internal price pressures, to a reduction in credits for governments, and to the amelioration of the banks' external position.

After a period of stabilization of credits and of speculative inflationary pressures, the central bank, two times in 1998, decided to lower the coefficient for required reserves. Coefficients of reserve requirements, which had been fixed between 1.5 percent and 9 percent, according to the country, were brought back to levels between 1.5 percent and 3 percent, in 1998. From 1999 to 2001, the coefficients remained unchanged because banks had excess liquidity, which was equivalent to seven times the amount of required reserves.

5.4.3.2 KEY INTEREST RATES

After the devaluation, the BCEAO sharply increased interest rates. But since June 1994 the situation has been the reverse. The Central Bank has pursued a constant policy of progressive reduction of interest rates, justified as a method to control inflation and lower short-term interest rates in France.

Figure 5: BCEAO key intervention rates



Source: BCEAO

The discount rate, which had been reduced from 14.5 percent in June 1994 to 6.5 percent in October 1996, was cut again to 6.25 percent in February 1997 and 6 percent in October 1997. The repo rate was brought down from 12.5 percent in June 1994 to 6 percent in August 1996, fell to 5.75 percent in February 1997 and then 5.5 percent in October. However, the tender average rate, fell from 9.25 percent in January 1994 to 5.04 percent at

the end of 1996, stayed around 5 percent in 1997 before falling to 4.5 percent at the end of December. Finally, the marginal rate of BCEAO Treasury bills declined from 5 percent at the beginning of August 1996, when they were first issued, to 4 percent fifteen days later, and 3.8 percent in October 1997, before rising again to 4 percent at the end of 1997.

By August 1998, the BCEAO adopted new measures to reverse the negative trends observed in the Union. These measures included: raising the required reserves coefficient; the reduction of bank liquidity through tenders and BCEAO one-month Treasury bills at a fixed rate of 5.25 percent; a rise in repo and discount rates. However, at the end of 1998, because of the relaxing of interest rates in foreign markets, and in order to stimulate growth in the Union, the Central bank reduced, by 0.5 percentage point, its key rates and lowered coefficients applicable to banks' required reserve basis. Since January 4th 1999 new applicable rates were fixed as followed: the discount rate: 5.75 percent; the repo rate: 5.25 percent. Because of the increase in key interest rates in Europe and in the USA, the BCEAO has also adjusted its rates since June 19th 2000. Interest rates were increased by 75 basis points. In 2001, the central bank did not change its key interest rates, which were maintained at 6.5 percent for the discount rate and 6.0 percent for the repo rate in order to control credit to the national economies and thereby to attenuate inflation pressures.

Interest rates, in the inter-bank market, ranged from 3.80 percent to 9.50 percent in 1998 and 3.30 percent to 8.25 percent in 1997. On average, the basic banking rate in the Union was stable at 9.71 percent. Compared to 1997, the monetary situation in 1998 was characterized by a deterioration of net foreign assets, an increase in internal credit and an expansion of the money supply.

5.5 MONETARY POLICY IN THE CEMAC

5.5.1 THE OBJECTIVES

According to its statutes and to the convention governing the Central African Monetary Union (CAMU-UMAC[7]), the BEAC has the exclusive authority to print currency and the necessary powers to mould the monetary policy of the region in consultation with national credit committees.

The Board of Directors of the BEAC fixes, for each member country, the objectives as regards net external assets, credit growth in the economy and the money supply (M2). Moreover, since the creation of the money market in July 1st 1994, it is responsible for determining the objectives of bank refinancing in accordance with macroeconomic targets

[7] UMAC stands for l"Union Monétaire de l"Afrique Centrale.

(the growth rate and internal and external balances). Additionally, it also monitors the growth of net internal credit. In accordance with the statutes of the BEAC (article 18), it can assist the member countries only to an amount up to 20 percent of the previous year's budgetary revenues - excluding extraordinary budgetary revenues. But since July 2001, the Board has decided to freeze the central bank's assistance to national treasuries at the level recorded on December 31, 2002, and to reduce it by one-tenth each year from January 1st 2003. Therefore, advances to governments will be progressively replaced by T-bills and T-bonds issued by national treasuries with the temporary guarantee of the central bank, the BEAC. This mechanism will be adjusted every three years. However, this central bank guarantee will be in accordance with available resources through a sub-ceiling for guaranteed public securities. Thereby, this sub-ceiling will be equivalent to a cumulative reduction of the ceiling for national treasury advances. In case the guarantee is used, exceptional advances will be subject to a penalty rate by the Treasury. Thus, this is a two-fold mechanism because it maintains credit ceilings (direct or indirect) at the level recorded at the end of 2002 – as a guarantee - and combines the obligation of reducing regularly direct access to credit with the possibility of benefiting, on a competitive basis, from the Central bank guarantee.

Under the Convention for monetary cooperation between the member countries of the BEAC and France, the French government guarantees the convertibility of the currency issued by the BEAC and provides the Central Bank with unlimited drawing rights for an operations account opened at the French treasury. However, this account should not have a negative balance for more than three successive months. The statutes also specify one intermediary goal of monetary policy. Article 11 determines that the gross foreign assets of the Central Bank must be maintained above 20 percent of sight liabilities. Otherwise, the Board of the Directors must take appropriate measures: banks' refinancing ceilings must be reduced by 20 percent in member countries showing negative balances in their operations account within the BEAC, and 10 percent otherwise. From 1997 to 1999 monetary policy was motivated by the intention of the central bank to: (1) maintain competitive gains by consolidating dis-inflation; (2) sustain economic growth; and (3) continue adjustment programs.

5.5.1.1 INTERMEDIATE OBJECTIVES

As they carry out their responsibilities, central banks often define their goals by specifying some targets. Because macroeconomic policy often aims at conflicting objectives – a low rate of inflation, rapid growth, a low unemployment rate, and balance of payments equilibrium –choosing a target is not easy. Therefore, the difficulty resides in the choice of the proper targets to be used. These intermediate targets are usually variables through which the monetary authority can control the efficiency of its policies and therefore provide a means for economic agents to understand and anticipate developments in the economy. Two categories of variables can constitute intermediate targets in the case of the

BEAC: the price of money (interest rates and/or exchange rates) and the quantity of money or credit (monetary aggregate). However, these intermediate targets (quantitative or qualitative) are not always explicitly expressed. From its creation in 1972 up to 1991 the BEAC did not exercise an explicit policy of monetary objectives. Only since 1991 has a monetary program been adopted. The aim was to determine quantitative targets such as the monetary base (maximum refinancing), internal credit and the money supply (M2) in order to restore the external balance necessary for the stabilization of the economies of the zone. In this context, in 1992 the BEAC began to define quantitative monetary targets as follows:

Instruments	**operative objective**	**intermediate target**	**goal**
	maximum refinancing	internal credit	economic growth

The choice of the intermediary variables is also determined by the ability of the monetary authorities to control the selected targets. It has been argued that it will be difficult for the BEAC to support its targets, in terms of monetary aggregates, and it will be impossible for the central bank to implement a real protective monetary policy (internal and external to its currency). This argumentation is based on the fact that: (1) the central bank has a limited range for its actions, the countries under its supervision are relatively small and the currency used is pegged to a foreign one and capital mobility within the zone is almost nonexistent; (2) the attractive force is established in the main country within the system, France, which alone can determine both the rhythm of inflation and the exchange rate in the BEAC zone.

5.5.2 INSTRUMENTS

The BEAC has two different types of instruments: advance ceilings for banks (a refinancing mechanism), interest rates and required reserves. In the BEAC, bank refinancing is possible through two mechanisms:

- "*Guichet*" A, which includes two instruments: a 7-day tender rate initiated by the central bank (also used for liquidity drawings), and 2-7 day repo rate, initiated by commercial banks;
- "*Guichet*" B, through which old irrevocable medium-term loans are refinanced, as well as new productive investment loans accepted by the BEAC.

When the foreign exchange cover for the entire zone exceeds the statutorily fixed level of 20 percent, the refinancing ceilings can be increased, especially in the case of direct and prompt interventions by the BEAC. In the opposite case, assistance and advances to member countries must be limited or even suspended in order to reestablish external balances.

The BEAC uses four key rates:

- The interest rate on tender rate (TIAO)[8] for "positive" tenders, which is the refinancing rate on which commercial banks can bid;
- The interest rate for repo (TIPP)[9], which is equal to the TIAO increased by 150 to 200 basis points;
- The interest rates for banks' investments (TISP)[10] applied in the framework of "negative" tenders. This rate varies according to maturity (7, 28, and 84 days) and were established in January 1996;
- The penalty rate for banks (TPB)[11]. This rate is applied to banks' overdraft facilities with the BEAC and is equal to two times the TIAO;

Additionally, the BEAC also fixes the rate for statutory advances to national treasuries, which corresponds to its key-refinancing rate for credit institutions. Besides these rates, BEAC also determines two additional banking rates: the minimum lending rate (TCM)[12], applied only on savings for amounts less than FCFA 5 million (EUR 7.633), and the maximum borrowing rate (TDM)[13], which is equal to TPB plus 7 percent.

In November 2000, the Board of the BEAC approved the modalities for establishing required reserves by adopting uniform coefficients for the entire banking system and by giving to the Governor the power to adjust these coefficients according to the evolution of the monetary situation. Therefore, in August 22, 2001, the Governor decided to propose to banks the establishment of required reserves by September 1, 2001. The decision was motivated by the necessity to attenuate inflationary pressures linked to the significant excess of liquidity of the banks. At the same time, the establishment of required reserves will strengthen the efficiency of interest rates policy. For this objective, banks – only those entitled to make deposits and have a current account with the BEAC - are obliged to keep a portion of their clients' deposits in accounts with the central bank. These accounts are interest bearing – at a level up to the TISP, reduced by some margin.

Required reserves coefficients are determined and modified by the Governor, under the same conditions as apply for the central bank's intervention rates, according to the national and international economic climate. These coefficients have been fixed as following: 1) coefficients applied for sight deposits were increased from 1 to 2.5 percent on December 31, 2001; 2) coefficients applied for time deposits and savings were increased from 0.5 to 1.5 percent on December 31, 2001. In July 2002 the Board of the BEAC decided to adopt a required reserves coefficient differentiation principle according to the country and regarding the degree of liquidity excess observed.

[8] TIAO stands for taux d'intérêt des appels d'offres.
[9] TIPP stands for taux d'intérêt des prises en pension which is equal to TIAO increased of 150 to 200 basis points.
[10] TISP stands for taux d'intérêt sur placement.
[11] TPB stands for taux de pénalité aux banques.
[12] TCM stands for taux créditeur minimum.
[13] TDM stands for taux débiteur maximum.

5.5.3 MONETARY POLICY SITUATION

The monetary situation in 1999 was characterized by a deep decline in the net position of foreign exchange from $423 million in 1998 to $133 million in 1999. This is more proof of the close dependence of Central African economies to international commodity markets prices, and therefore of the limited working margin of economic policies and their inflexibility. The balance of payments dis-equilibrium in Gabon, Congo, Equatorial Guinea, and the deterioration of foreign exchange position of Chad and the Central African Republic could not be influenced by the good results achieved by Cameroon. While in 2000 the situation was reverse. Due to a more favorable economic environment, reflected in an amelioration of the external position of the member countries, by contained inflation and limited credit assistance to national economies, the BEAC relaxed its monetary policy for the first time.

5.5.3.1 NET EXTERNAL ASSETS

The negative trend in net foreign assets first observed within the BEAC at the beginning of 1999 still continues. This results from the persistence of external imbalances – due to the collapse of exports. Despite moderate imports and the postponement in debt payments, net foreign reserves have been falling in all member countries except for Cameroon, where the balance is in deficit all the time. Official reserves continued their retreat from $1.003 billion in March 1998 to $642 million a year later or a fall of 34.1 percent, which is less than in 1998 when official reserves fell by 36.7 percent. This relatively better result is due to improvements in international commodity market prices in the expectations of the euro impact and its influence on CFA franc zone economic policies.

The total official foreign liabilities of the Community has decreased by 2.3 percent and were determined to be $620 million at the end of March 1999, which has slightly increased since December 1998, when they were at a level of $548 million due to: a reduction in BEAC foreign liabilities (-16.9 percent), and an increase in IMF assistance to BEAC members (12.3 percent).

The net official foreign assets were reduced to an insignificant amount of $22.7 million compared to the $134 million in 1998 or $368 million the previous year. External imbalances in Gabon, $200 million, and in Congo, $62.5 million, in that year, led to a sharp reduction in foreign reserve assets. Again, the main reason for such was the poor performances of commodity market prices.

Table 2: BEAC net foreign assets (in millions of $)

	1997	1998	1999
ASSETS	December	December	December
Gold	67	65	67
Foreign exch. assets (a)	1,088	690	650
Reserves with the IMF	2	2	2
Holdings of SDR	0.14	0.33	8
Total	1,157	758	727
LIABILITIES			
IMF loans	364	391	413
External liabilities (b)	268	217	134
Total	632	608	547
Balance	**525**	**150**	**180**
(a) Including the net credit balance of the operation account			
(b) Including the net debit balance of the operation account			

Source: BEAC

Banks' foreign assets balance rose to $110 million or an increase of 57.5 percent in the year following a period of weakening in 1998. This is explained by a normal process of export revenues repatriation, which slightly shifted banks' assets up by $47 million from March 1998 to March 1999. Most of the growth was produced by banks in Cameroon followed, to a lesser extent, by banks from Equatorial Guinea and Chad, while banks from Congo and Gabon preferred to use their assets deposited in foreign countries to handle their need for additional resources. Their foreign partners assisted banks in the Central African Republic.

5.5.3.2 BEAC ASSISTANCE TO THE ECONOMY

The refinancing objectives for banks were significantly strengthened to offset the effects of a liquidity reduction. In 1997, financial assistance to banks amounted to $84 million. Furthermore, the entire banking system, except for Congo, remained below their refinancing ceilings in the first quarter of 1997. However, in the second half of 1999, the ceilings were brought back to their normal level due to the favorable results recorded in the oil sector. Except in Gabon, the central bank advances to the banking system remained below the ceiling at the end of 1999. The increase in assistance for Gabonese banks stemmed from the significant demand for short-term credits related to the government's domestic debt. The average amount of liquidity injections greatly increased in 1999, by 71 percent. This phenomenon is related to the financing by banks in Chad of crops (cotton

essentially). However, on a yearly basis, the average amount of liquidity drawings decreased by more than half, by 53 percent.

Despite the fact that the 7-day repo tender rate remained the major instrument for banks' refinancing, the need for advances compelled banks to also use other instruments, such as the 2-7 days repo – but this trend was reversed in 2001 because banks reduced their need for refinancing. After a peak in 1999, drawings through *guichet B* reached a very low historic level, the lowest since the creation of the money market in 1994. Liquidity drawings, which drastically increased in 2000, continued this progression until September 2001 and reached 29 percent as compared to 22.9 percent in 2000, while total BEAC advances reached 42.3 percent in 1999 against 49.7 percent in 1998. The excess of liquidity in the banking system, which drastically decreased in 1998 and in the first half of 1999, increased again in the second half of 1999 due to the amelioration of oil revenues. As a result of the banking sector liquidity excess, which was still important in 2001 mainly because of oil revenues, the central bank continued its policy of reducing credit to banks. Thus, the banking system of the BEAC remained globally under the statutory ceilings. Consequently, the covering ratio of loans-to-deposits was 97.7 percent on December 31, 2001 or a decrease of 4.1 points compared to 2000.

Domestic credit rose by 10.3 percent to settle at $3.268 billion in March 1999, as compared to 13.9 percent and $3.047 billion for the previous year. This relative moderation is the result of the slowing of credit growth in the private sector, 8 percent in March 1999, as the result of higher demand for medium-term loans, as compared to 12.9 percent in 1998, because claims on countries rose by 13.3 percent in March 1999, while in December 1998 they increased by 15.4 percent. Domestic credit was expanded in an unfavorable global economic state of affairs worsened by internal and external imbalances. However, there was a slight fall in credit line distributions, whose total amount was $1.817 billion in 1999, while in 1998 the amount was $1.890 billion. This indicates a return to a normal situation after the speculation, which occurred in 1998, especially concerning the euro.

Short-term credits amounted to $1.277 billion after an annual increase of 5.9 percent. This slow growth was provoked by a weak demand in Cameroon and Gabon, which together account for almost 70 percent of all credits. Medium-term credit, essentially for housing, rose to $477 million at the end of March 1999, from $425 million in March 1998, an increase of 15.5 percent, which was half the previous year's growth (30.6 percent). Credit evolution in Cameroon and Gabon, which together account for 95 percent of the total supply, explain the situation. However, Cameroon, with its diversified economy, can more easily absorb shocks stemming from international commodity market fluctuations. Because of this, demand for medium-term credit is still higher. In real terms, investment credits in the other member countries remain structurally marginalized. Long-term credit is given principally in Cameroon and Gabon, both with more developed bank offers and banking

systems. However, these credits rose very slowly and by the end of March 1999 they represented an amount equal to $64 million.

Ceilings for statutory advances were raised in 1997 because of the encouraging results registered for all the countries in the Community, except for the Central African Republic. These ceilings were still being respected in the zone at the end of 2001, except for in the Central African Republic.

Interest rates

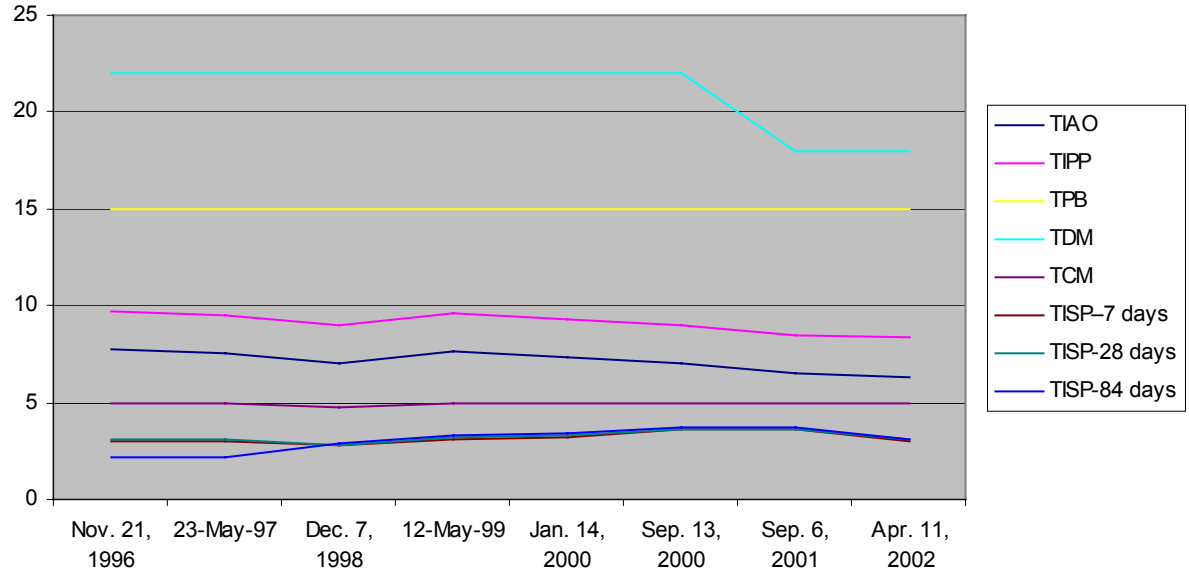
Traducing the negative trend in economic activity, the monetary situation first deteriorated in few months before it stabilized again. Exchange assets in the operations account fell by 29.3 percent in three months. As has been mentioned, domestic credit increased, reflecting the important pooling of cash from national treasuries (20.9 percent) and the acceleration in bank credit (11 percent).

In the money market, the average level of direct financing, from the central bank to commercial banks, doubled in one year from $43.5 million in 1998 to $86 million in 1999. At the same time, the monthly average of outstanding deposits in banks is very insignificant. It fell from $68 million in April 1998 to $5.7 million a year later. In order to deal with the existing unfavorable economic and monetary situation, the Governor of the central bank decided to raise its intervention rates and reduce its refinancing rates. Rates were increased as follows: TIAO from 7 percent to 7.60 percent; TIPP from 9 percent to 9.60 percent; 7-day TISP from 2.8125 percent to 3.15 percent; 28-day TISP from 2.8125 percent to 3.2125 percent; 84-day TISP from 2.8750 percent to 3.2750 percent; the penalty rate to 15 percent; TCM to 4.75 percent; and TDM to 22 percent. Rates applied for advances to national treasuries were also increased from 7.00 percent to 7.60 percent for advances within statutory ceilings, the penalty rate (advances beyond statutory ceilings) to 10.50 percent and interest rates on special deposits (public sector deposits) from 2.75 percent to 3.15 percent. The reduction in refinancing objectives was up to 10 percent for the Central African Republic and Chad (which had a positive balance in their operations account) and up to 20 percent for Cameroon, Congo, Equatorial Guinea, and Gabon (which had a deficit in their operations account) as required by the statutes of the BEAC. These measures aimed at the preservation of competitive gains acquired since the devaluation of the CFA franc, and the creation of an appropriate climate for the execution of structural adjustment programs. Through these measures three main objectives were targeted: the protection of the external value of the currency; the maintenance of a satisfactory level of foreign exchange reserves; and the promotion of a satisfactory growth rate for credits and economic activity.

In 1999, the BEAC increased its key interest rates by 60 basis points for the TIPP and the TIAO, respectively to 9.60 percent and 7.60 percent, and by 40 basis points for the TISP,

to 3.15 percent. In parallel, the TCM was increased from 4.75 percent to 5 percent. These measures of the adjustment program were implemented in order to reduce internal and external imbalances in 1998. From 2000 to April 2002, the BEAC again decreased its key rates. TIPP and the TIAO were reduced respectively to 8.35 percent and 6.35 percent in order to induce investment and growth, while the TISP was first increased to prevent capital outflows but then reduced to 3 percent in April 2002. This policy was in line with the objective of the central bank to maintain a foreign exchange cover, thereby contributing to the credibility of the currency.

Figure 6: Intervention rates of the BEAC (in %)



Source: BEAC

5.5.4 THE UEMOA AND MONETARY AGGREGATES

5.5.4.1 COMPONENTS OF THE MONEY SUPPLY

In 1997, the money supply increased by 11.1[14] percent while in 2001, it increased by 11.4 percent, which was a more rapid increase than nominal GDP (6.6 percent). Therefore, the money velocity decreased. The different components of the money supply also increased at almost the same rhythm even if the portion of notes rose more rapidly than deposits – term deposits only accounted for less than 30 percent in 2001 while sight deposits increased to +9.3 percent. Money supply grew by 3.2 percent as a result of an increase of 6.9 percent in

[14] The money supply increase excludes Guinea Bissau and liquidated commercial banks. Official monetary data include Guinea Bissau only from January 1st 1997.

the fiduciary money circulation, which reached $2.006 billion as compared to $1.932 billion in 1997. Bank deposits settled at $3.863 billion. The exclusion, in the monetary data, of the liquidated banks had two effects on available data: the lowering by one percentage point of the money supply/GDP ratio: this ratio was 24.8 percent in 1997; an increase of one percentage point in fiduciary money: its share was 33.2 percent in 1997.

The available monetary data, concerning member countries, shows disparities in the rate of growth in the money supply. Growth in the money supply accelerated quickly in Benin, Guinea Bissau, and Burkina Faso to a lesser extent. But it should be noted that the substitution of the peso by the CFA franc in Guinea Bissau, biased the monetary statistics. But in Niger, the money supply contracted. Since July 31st 1997 the Guinea Bissau peso entered the CFA franc. It was the first time that a non-francophone country entered the CFA zone – and signaled the growing importance of the CFA franc in Western and Central Africa. Then, after a couple of false starts, the transition began in May when France injected FRF 2 million for civil servants' salaries, which the government had been unable to pay all year. Fresh money from France, and partly from the EU, funded the cost of the changeover.

The Central Bank's interventions, in terms of money injections, grew by 13.2 percent in 1998 and by 4.8 percent the previous year. Injections stood at $933 million. This evolution was induced by increases in the Central Bank's assistance to national treasuries with liquidity difficulties. In 1999, the money supply increased by 5.6 percent, at the same level as GDP in value. Thereby the volume of money in circulation was stabilized. The structure of the money supply was not modified. The share of time deposits (quasi money) remained below 30 percent, despite a more rapid increase in the volume of such deposits (6.7 percent). For sight deposits, there was a contraction of such deposits from the public sector and an increase of 9 percent in sight deposits from the private sector. For 2001, there was a slight increase (+9.3 percent) in sight deposits as there was an increase in deposits from the public and private sectors.

However, for some countries the growth in the money supply is biased by at least two factors: the growth rate in the considered countries and the selection and redistribution of bank-notes – each bank-note has a mark, by which the central bank can identify the issuing country.

5.5.4.2 COUNTERPARTS OF THE MONEY SUPPLY

In 1996, the progression of net foreign assets was the principal factor of money supply growth. The following year loans granted to governments were the essential reason for growth in money supply. In 1998, the monetary situation was characterized by a deterioration in net foreign assets, an increase in internal credit, and an expansion in the money supply. In 1999, the increase in the money supply stemmed from the reconstitution

of official external assets, reduced in 1998 and from moderate growth in domestic credit (2.5 percent). In 2001, the increase in the monetary supply was mainly attributable to the strengthening of net foreign assets (+42 percent), to moderate assistance provided to economic operators (+6.5 percent) and to governments' internal debt reduction (-11.6 percent).

Net external assets

From 1993 to 1997 the external assets of the Union increased. The principal causes of these changes were increases in exports revenues, the pursuit of net capital repatriation, the mobilization of foreign resources as a support for structural adjustment programs and debt rescheduling and cancellation.

Table 3: Evolution of the key composites of the money supply (in millions of $)

	Benin	Burkina	Cote d'Ivoire	Guinea B.	Mali	Niger	Senegal	Togo	Central services	**TOTAL**
Fiduciary money										
1996	135	271	929	12	236	113	279	117	-12	**2,080**
1997	138	291	977	35	221	71	244	102	0	**2,079**
1998	124	291	1,178	34	239	43	280	115	0	**2,304**
1999	247	220	949	37	190	53	277	123	0	**2,096**
Scriptural money										
1996	237	222	969	21	236	65	396	120	166	**2,432**
1997	193	202	869	28	217	55	342	108	172	**2,186**
1998	202	208	1,003	27	234	62	421	117	162	**2,436**
1999	173	213	898	27	220	54	402	101	172	**2,260**
Quasi money										
1996	178	152	1,022	1	152	67	425	130	39	**2,166**
1997	170	143	904	2	152	43	406	126	33	**1,979**
1998	174	167	861	2	163	36	412	115	0	**1,930**
1999	170	167	742	2	152	37	422	106	0	**1,798**
Total										
1996	550	645	2,920	34	624	245	1,100	367	193	**6,678**
1997	501	636	2,750	65	590	169	992	336	205	**6,244**
1998	500	666	3,042	63	636	141	1,113	347	162	**6,670**
1999	590	600	2,589	66	562	144	1,101	330	172	**6,154**
Growth rate										
1996	13.1	9.6	4	n/a	24.8	-6.6	11.7	-6.3		**7.40**
1997	17.4	14.7	10.7	n/a	8.7	-4.1	5.4	8		**13.00**
1998	-3.6	1.4	7	-6.5	4.3	-19.1	8.6	0.3		**3.40**
1999	35.3	3.1	-2.5	14.1	1.2	15.5	13.2	8.4		**5.60**

Source: BCEAO

In 1998, the net external position of monetary institutions contracted from $1.726 billion in 1997 to $1.584 billion in 1998, for a change of $114 million. This situation is related to discrepancies in exports revenue collection, difficulties regarding the selling of some goods, and debt payments. BCEAO net external assets diminished from $1.526 billion in 1997 to $1.377 billion in 1998. Official exchange reserves in 1998 increased from $2.998 billion to $3 billion or from 6 to 7 months imports coverage. The covering rate for monetary transactions was reduced from 105.9 percent, at the end of December 1997, to 98.3 percent in 1998 due to a strong increase in the circulation of fiduciary money and deposits in national treasuries. In 1999, net official assets increased by $219 million and reached an historic peak. This resulted from two factors: an augmentation of exchange reserves by $259 million to reach $3.257 billion or the equivalent of 6-months imports coverage at the end of 1999 as compared to 4.5 months in 1997, 4.1 in 1996 and les than a month in 1993; and a relatively low level of liabilities. This was emphasized by the good performances of the dollar and by the higher price of gold. However, the augmentation of foreign exchange reserves in 2001 is explained as a benefit deriving from the French Treasury exchange rate guarantee and by the accumulation of French franc in the BCEAO due to the implementation of the euro as the unique currency in the EU.

The interpretation of official assets in each country must be prudential because of a bias in bank notes stock evolution, which are sorted according to the issuing country. All the member countries, except Mali and Niger, have registered increases in net official assets. These discrepancies were significantly reduced in 1997. The same kind of bias is also observed in gross foreign exchange reserves. In Mali, for example, they represented 6.1 months of imports coverage, 5.8 in Burkina Faso, and only 1.5 months in Niger and 2.2 months in Côte d'Ivoire.

Commercial banks' net foreign position expanded as the result of credit lines granted to member countries of the Union to finance their gain in imports. Import increases in Burkina Faso, Côte d'Ivoire, and Mali were in part financed by commercial banks through their foreign partners. But in 1998, there was another contraction in net foreign assets resulting in increases in countries' liabilities. In 1999, the net external position of the banking sector was stabilized at a lower level (with a rise of only $15 million) in a context of a higher increase in assets (by 49.5 percent) and commitments (by 60 percent). Deposits as collateral in foreign banks stayed at a stable level so that in 1999 this represented only 27 percent of the banks' gross external assets against 34 percent in 1998.

Governments' debts toward the banking sector increased by $117 million between 1998 and 1999. The slight reduction (-$6 million) in the governments commitments stemmed from a decrease in governments' loans contracted with local banks. Liquidity problems faced by both the public sector and the governments were reflected by a reduction in the level of deposits with banks and with the central bank, respectively, $88 million and $35 million – this situation was the reverse in 2001 where the governments' net position

improved, which thereby increased the level of deposits of public treasuries in the central bank. However, governments did increase the use of direct financing from the central bank, which put in jeopardy the elimination of this method of financing at the end of 2001. According to the analysis performed, it is possible to notice that all the governments of the member countries, except for Benin and Togo, faced a net degradation of their position.

Internal credit lines

Internal credits settled to $5.542 billion in December 1998, or a change of 7 percent compared to 1997. This evolution reflects the decline of loans granted to governments while credits to banks and enterprises increased. The net debtor position of governments was at $1.700 billion in 1998. It increased by $99 million, compared to 1997. The increase in Central Bank's assistance to national treasuries and the use of IMF loans contributed to the strengthening of the debtor position. However, the impact of these two factors was moderated by the progression in public deposits and the decline in commercial banks' assistance. In 1999, advances to the economy stayed at almost the same level. From December 1998 to December 1999 credits increased by only 0.5 percent.

The Central Bank's assistance to the economy, essentially to enterprises, was strengthened by an increase of $270 million or an increase in 7.6 percent. This infusion resulted in higher ordinary credits being augmented by $370 million to stabilize at $3.486 billion as a result of imports reviving – due to shortages in some agricultural products – and the energy crisis, which prevailed in some countries. Ordinary credits rose by 5.5 percent compared to December 1998. Crop credits contracted to $355 million due essentially to delays in commercialization campaigns for agricultural products for 1998/1999. In 1999, the amount of crop credits decreased by 60 percent compared to the 1998 level but increased by 68 percent in 2001 compared to 2000. At the same time, the share of credits in abeyance, compared to total assistance to the economy, increased from 7.3 percent, in December 1997, to 8.4 percent in December 1998. The issuance of securities by the private sector increased from $78 million to $127 million. Although this represents only 3.7 percent of commitments in 1999 and 2.8 percent in 2001, the amount of securities issued is increasingly becoming an important aspect in the demand for credit.

5.5.5 MONETARY AGGREGATES IN THE BEAC

In 1997, the (M2) money supply improved (by 13.9 percent) largely ahead of real GDP (9 percent) while in 2001 it increased by 7.1 percent for a GDP growth of 4 percent. After a continuous decline between 1990 and 1996, the ratio of M2 to GDP increased slightly from 13.7 percent, in 1996, to 14.4 percent in 1997. The amelioration of the trade balance induced a shift in net foreign assets, which contributed to a large extend in money supply growth. But in 2001, there was a decline in foreign assets (-23 percent) compared to 2000. Domestic credit continued its increase throughout 2001 (+17 percent) essentially as the

result of an increase in loans to economic operators (16.3 percent in 1999 and 7.2 percent in 2001), although credits to states also rose (6 percent for 1999 and 38 percent in 2001). In 1999 the money supply was in a decreasing phase, which started at the end of 1998. It was estimated at $2.463 billion in March 1999 against $2.596 billion a year before. Persistent weakening of the Community's overall external position and the contraction of economic activity resulted in the reduction of the money stock despite growth in domestic credits.

During the course of 1999, M2 improved by 9 percent on a year-to-year basis as compared to 0.5 percent in the previous year and is higher than the estimated non-oil GDP growth rate (2.2 percent) but in line with total GDP (10.1 percent). After a long period of increase, the amount of currency in circulation was stabilized.

The improvement in external assets (by $89 million) contributed to the augmentation of the money supply by 40 percent while in 1998 the external counterpart (- $387 million) had a negative impact. However, the increase in internal credit (4.1 percent) was less than in the previous year (15.1 percent).

5.5.5.1 THE STRUCTURE OF THE MONEY SUPPLY

At the end of 1999, the portion of fiduciary money in the money supply contracted by 0.5 percent compared to the previous year, while the share of sight deposits and quasi money improved. The stability and relative soundness of the banking sector gave confidence to other economic agents, which stimulated deposits. In 2001, there was a slight increase in the fiduciary money (+33 percent) and quasi-money (+32 percent) and a decrease in scriptural money (-8 percent) compared to 2000.

5.5.5.1.1 THE FIDUCIARY MONEY

The stock of notes and coins in circulation in the BEAC contracted by –1.4 percent to settle at $834 million at the end of March 1999. This contraction was observed despite a strong increase in fiduciary money in Cameroon (24.6 percent in 1999 against 33.7 percent the year before) that could not offset the decline of this aggregate in the other member countries. It should be noted that the economic structure of these countries – overly dependent on fluctuations in commodity market prices - does not permit them to easily absorb adverse shocks, as does Cameroon's diversified economy. Thereby Cameroon strengthened its influence on fiduciary money circulation, which grew from 23.5 percent in March 1997 to 36.4 percent in March 1999, through to 28.8 percent in March 1998. However, it should be noted that the increase in fiduciary money, and thereby in the money supply, is biased by the fluctuations related to the relocation of banknotes. Each currency note has an identification mark by which the central bank can determine the issuer and then put it back in circulation into that country. Before they are identified, the notes are included in the fiduciary money of the country, which sent them to the central bank.

Therefore, variations in the stock of currency not redistributed and the rapid increase in fiduciary flux provoke important corrections and this in turn can affect the exactness of national historical data for the money supply.

Table 4: Money supply structure

	Cameroon	CAR	Congo	Gabon	Eq. Guinea	Chad	**TOTAL**
Fiduciary money							
1996	187	204	172	218	17	174	**972**
1997	307	159	134	207	11	134	**952**
1998	363	133	140	220	10	130	**996**
1999	366	125	158	162	19	105	**935**
Scriptural money							
1996	405	248	129	287	11	49	**1,129**
1997	415	24	137	296	12	51	**935**
1998	497	22	113	280	21	51	**984**
1999	463	27	126	254	25	46	**941**
Quasi money							
1996	497	19	61	277	4	10	**868**
1997	455	152	62	291	7	11	**978**
1998	456	18	52	305	9	11	**851**
1999	472	15	41	274	10	10	**822**
Total							
1996	1,089	471	362	782	32	233	**2,969**
1997	1,177	335	333	794	30	196	**2,865**
1998	1,316	173	305	805	40	192	**2,831**
1999	1,301	167	325	690	54	161	**2,698**
Percentage share in1999							
Fiduciary money	28.1	74.9	48.5	23.5	34.3	64.5	**34.6**
Scriptural money	35.6	16.2	38.7	36.8	46.6	28.5	**34.9**
Quasi money	36.2	8.9	12.7	39.7	19.1	6.1	**30.5**

Source: BEAC

In 2001, after the important increase recorded in 2000 (+34.4 percent), the stock of coins and bank notes progressed by 10.5 percent. This growth, which was stimulated by a favorable economic situation, was noticed in the entire zone excluding the Central African Republic, in which fiduciary money declined by 6.8 percent.

5.5.5.1.2 SCRIPTURAL MONEY

Sight deposits fell by 1.3 percent and were fixed at $859 million at the end of March 1999 compared to $895 million at the end of March 1998. However, at the end of 1999,

scriptural money (composed essentially of sight deposits) improved considerably to reach a growth rate of 9 percent for the entire year. This contrast with the first half of 1999, when economic recession and uncertainty compelled a reduction, at least in the short term, of savings movements in Cameroon and incited decline and stagnation in the other countries with the exception of Equatorial Guinea where a stabilization process in the banking system reinforces credibility and stimulates deposits. After the significant increase in 2000, up to 34.4 percent, sight deposits recorded a decrease of 2.9 percent in 2001.

5.5.5.1.3 QUASI-MONEY

Time deposits and savings accounts registered a significant decrease of 4.7 percent to $770 million at the end of March 1999. This development, beginning in November 1998, was intensified by economic difficulties in some countries, particularly in Congo and Gabon. However, quasi-money continued to improve in Cameroon, and to less of an extent, in Equatorial Guinea. The modest level of savings in the Central African Republic and Chad contracted again. At the end of 1999, time deposits and savings increased by 10.5 percent for the whole year. More important increases were noticed in Cameroon (18.3 percent), Equatorial Guinea (14.5 percent) and Chad (10.7 percent). After three years of consecutive decrease, the increase in time deposits would reduce the risk of banks' transformation, thereby constraining long-term credit development. In 2001, time deposits and savings recorded an increase of 16.2 percent for the whole year. All the countries of the zone, except Congo (with a decrease of 19.3 percent), contributed to this increase.

5.5.5.2 COUNTERPARTS OF THE MONEY SUPPLY

Net foreign assets

After an important contraction in 1998 and at the beginning of 1999, net external assets sensibly increased and reached $291 million at the end of 1999. These improvements stem from the appreciation of the dollar, from oil and wood prices, and from, above all, the implementation of restrictive budgetary measures and from more regular inflows of revenues from exports. However, the historical levels of 1996 and 1997 were reached only during the year 2000. Moreover, the increase in net external assets resulted in the accumulation of external arrears in Gabon and Congo. After the important increase in 2000, foreign assets declined in 2001 mainly due to the fall in the price of oil. This situation was more obvious for oil exporting countries such as Gabon and Congo, whose economies are heavily dependent on the international commodity market.

Banks reached a net creditor position of $122 million by the end of 1999, which represented an increase of $40 million compared to the previous year. This is in fact the consequence of an important increase in net external assets of banks in Cameroon, Equatorial Guinea and Chad in the context of a growth in claims and commitments. The

banking systems in Gabon and Congo had had a moderate deficit position since 1999 although it they had traditionally been positive. Banks also saw their foreign assets diminished at the end of 2001.

In 1999, net foreign assets improved, essentially in oil exporting countries, by $49 million after an important contraction in 1998. This amelioration is related to an increase in foreign exchange assets ($47 million) and gold assets, through the reevaluation of the French franc to CFA exchange rate. However, it should be noted that the member countries of the CEMAC feature important divergences regarding net foreign assets and exchange reserves. Despite an important amelioration from 1994 to 1998, the net external assets of Cameroon have always been negative. In Gabon the opposite situation existed during that same period but since 1998 the trend has been negative (0.2 months of imports in 2001). On the other hand, those of the Central African Republic became positive and the exchange reserves represent more than seven months of imports against less than two days in Cameroon.

Credits to the economy

Internal credits improved by only 6 percent in 1999, compared with the 13.9 percent of the previous year and by 7.2 percent in 2001. This is the result of a moderate demand for short-terms credits while the demand for long-term loans decreased. This situation was conditioned by stagnation in the zone and by anticipated effects related to the fear of a parity adjustment of the French franc to the CFA franc rate with the introduction of the euro.

The share of medium and long-term credits in 1999, for the total credit line, reached the level of 1996, that is 26 percent, following 28 percent in 1997 and 29 percent in 1998. Medium and long-term loans are concentrated in Gabon and Cameroon, at more that 95 percent, and are marginalized in the other countries of the zone. In 2001, medium-term loans followed a progressive trend and increased by 8.5 percent as a result of investment programs implemented by governments. Long-term loans, essentially housing loans, contracted by 6.2 percent. Short-term loans again increased in Cameroon (10.3 percent) but the slowing down observed compared with the previous year's growth rate (17.9 percent) hide the improvement of short-term loans for treasury purposes in the last quarter of 1999. In 2001, short term loans increased by 7.4 percent. Those loans were approved for oil distribution companies and other industrial companies. All the member countries of the BEAC, except Chad, recorded increases in short-term credits. After an increase of 22.7 percent a year ago, medium-term credits decreased by 5.7 in 1999. This is the result of the decline and the decrease in private investments in Gabon and Cameroon.

Loans to national treasuries increased by 38 percent in 2001. This was due to the reoccurrence of financial difficulties faced by the governments. However, 56 percent of the

increase was supported by the central bank, the BEAC, which was the main source of government refinancing.

5.5.5.3 MONEY MARKET INTERVENTIONS

Central bank advances increased. The average amount of central bank interventions in favor of the banking system increased to $86 million per month in the final three months of the year as compared to $55 million for the period October 1998-January 1999. In the meantime, liquidity withdrawals through negative repo tender rates stabilized. They varied between $5.4 million and $5.7 million for the period from February 1999 to April 1999. The relative steadiness in credit institutions' refinancing from the central bank, and banks' deposits within the BEAC reflect the stability of bank liquidity and the soundness of the banking system. Inter-bank exchanges slightly increased to $92 million, for the period from February 1999 to April 1999, as compared to $86 million during the period from October 1998 to January 1999. Additionally, the Governor of the BEAC proceeded with the revamping of its key intervention rates in order to support adjustment efforts.

5.5.5.3.1 GENERAL PRINCIPLES

In the functioning of the money market, BEAC measures sterilized the money (a double role consisting of simultaneously injecting and withdrawing liquidity), according to the objectives of the monetary policy drawn up by the Board.

Since the money market came into effect, on July 1st 1994, the central bank interventions have had to take into account the refinancing objectives (*Objectif de Refinancement*) of each member country as determined by the monetary authorities each year. However, the stated objectives for the coming year can be revised on a half-year basis. The "*Objectif de Refinancement*" determines the liquidity potential for the central bank's assistance to member countries without jeopardizing macroeconomic stability. However, the assistance level can exceed advance ceilings only when the country's ratio of its gross foreign assets to sight liabilities is higher than 20 percent or when judged acceptable, and also when there are available advances from eligible credit institutions. In this last case, there exists a mechanism for prompt interventions (*mécanisme d'interventions ponctuelles*). The "*Objectif de Refinancement*" becomes a rigid quantitative ceiling, which a country is not allowed to exceed, when a member country is in an IMF adjustment program.

If the BEAC can, at anytime, decide to inject money into the system, it can also determine when to withdraw it by letting credit institutions purchase or make advances on public securities and/or central bank bonds, in the framework of negative repo tender rates.

5.5.5.3.2 LIQUIDITY INJECTIONS

During the period under investigation, central bank interventions in the money market were stable at $85 million. The average level of central bank participation, in *guichet A*, slightly varied, between $73 and $75 million.

Positive repo tender rates

This is one of the instruments of central bank intervention through which it can inject liquidity into the banking system. For the period from February 1st 1999 to April 30th, eligible credit institutions carried out 13 acquisitions through tender procedures, amounting to $836 million. Much more important financial assistance has been needed by banks, especially in Chad at 58.9 percent of the overall assistance. In other member countries the central bank assistance was limited.

Interventions through repos

The average amount of interventions, in favor of the banking system, through repurchase agreements, more than doubled, from $6.3 million in February 1999 to $13.4 million in April of the same year. Banks in Gabon and Central African Republic induced this development, with a preference for very short (2-3 day) repurchase transactions instead of longer term (7 day). In April 30th 1999, interventions were allocated as following: 63.9 percent for banks located in the Central African Republic, 22.6 percent for banks in Gabon, 12.2 percent in Congo, 1.3 percent in Chad, and 0.1 percent for banks located in Cameroon. Regarding the fact that the "*Objectifs de Refinancement*" were all respected, the BEAC had no need to use its "prompt interventions" instrument. Furthermore, no exceptional advance, with certificates of deposit (CDs) used as collateral, was made during that same period. Only an advance on a penalty rate was granted, between February and April 1999, to a bank located in Gabon, for an amount of $1.087 million for a 3-day period.

5.5.5.3.3 LIQUIDITY MOP UP

The daily average of BEAC interventions in favor of banks, as irrevocable medium-term credits (excluding special assistance), contracted to $5.246 million in April 1999, as compared to $7.098 million in February 1999. This decline is due to a slight decrease in the use of those credit facilities by banks in both Cameroon and Gabon – for the latter no transfers were made from commercial banks to the central bank.

Negative repo tender rates

Between February and April 1999, average outstanding deposits through negative repos were estimated at $6.5 million against $10 million for the period between October 1998 and January 1999. The severe fall in bank deposits occurred in a period characterized by a reduction in foreign exchange reserves. Only commercial banks from Cameroon and Congo used negative repos to deposit their assets in the BEAC.

5.6 ASSESSMENT OF MONETARY POLICY

5.6.1 THE RESULTS OF MONETARY POLICY IN THE UEMOA

5.6.1.1 THE CURRENCY COVER RATIO

The covering ratio of gross foreign assets to the sight liabilities of the central bank fell in 1993 to 17 percent, which was below the required rate of 20 percent as specified in article 51 of the statutes of the BCEAO. After the devaluation, the rate climbed to 81.4 percent in December 1994. Subsequently, it rose, to 98.5 percent at the end of 1995, 100.4 percent in 1996, and 102.4 percent in 1997, which was much higher than the objective. The objective was to maintain this level for 1998. However, the ratio fell by 4.1 points to stabilize at 98.3 percent at the end of the year as a result of the slow increase in the central bank's external assets (only $97 million against $472 million in 1997) and of the increase in sight liabilities.

However, in 1999, the ratio improved by 6.6 points and reached 104.9 percent especially because of the small increase in the circulation of fiduciary money and the increase in the BCEAO gross foreign assets (by $259 million). Despite this performance, the covering ratio for money issuing stayed slightly below the initial objective. Since 1999, the covering ratio of gross foreign assets to sight liabilities has remained largely above 100 percent although it declined in 2001 as a result of a more rapid progression of fiduciary money and sight liabilities compared to gross foreign assets.

5.6.1.2 MONETARY AGGREGATES

The liquidity of the economy could not be stabilized in accordance with the initial objective, but its increase was only limited, resulting in a less than 3 percent variation between monetary supply growth and GDP, in absolute terms. The objectives set for gross foreign assets as well as for governments' net position were not achieved. The increase in credits attributed to the economy was not anticipated. Overall, the increase in the money

supply stayed in line with the projections of 1998. The liquidity ratio (M2/GDP) was stable and above the expected level because of the weaker than expected increase in GDP in terms of value. Overall, for the year 2001 the money supply increased by 11.4 percent and was higher than expected by the monetary authorities. Therefore, the liquidity ratio was above the expected limit. Gross foreign assets also were above the initial objective. Although assistances to governments and to other economic operators decreased, they were still below the established objective.

5.6.1.3 INTEREST RATES IN THE MONEY MARKET

According to the strategy adopted by the Council, the central bank implemented a policy of flexible interest rates and pursued the reform of the monetary market in order to increase the efficiency of its policies. The central bank wished to determine the bounds (lower and upper) of interest rates in the inter-bank markets, to see if they would fluctuate within the determined bounds according to tender and repurchasing rates. However, liquidity crises in the inter-bank market have sometimes compelled interest rates, and therefore transactions, to vary outside their boundaries. Moreover, liquidity excess in the banking system forced the BCEAO to issue and sell bonds in the second quarter of 1997. The minimum rates in the inter-bank market then drove closer to the BCEAO bond rates.

Measured by the excess of reserves constituted through required reserves (including government T-bonds for consolidated debts), liquidity in the banking sector increased after 1994. The excess of liquidity constituted in required reserves represented 17 percent of total deposits or $766 million. However, from 1997 to 1998, liquidity excess was reduced because of the decision of the central bank to control the liquidity by increasing, first of all, the coefficients for required reserves and by, secondly, allowing withdrawals through the issuance of central bank T-bonds. Thus, at the end of 1998, excess liquidity was reduced to $459 million. In 1999, after the central bank reviewed its coefficients of required reserves, the liquidity excess had grown to $669 million in June. In December of the same year it stood at $463 million. The reduction of the central bank intervention stimulated the inter-bank market despite the excess of liquidity in that market. Therefore, for the year 1999, the amount of transactions progressed by 31 percent compared to 1998 and by 89 percent when compared to 1997. In 2000, the central bank worked on reducing the excess of liquidity by adjusting the basis and coefficients of required reserves. In 2001, the BCEAO accelerated the process by intervening into the monetary market by issuing T-bonds.

However, the development of the inter-bank market is hampered by high risks in transactions because of the absence of an efficient judicial framework, the absence of support in transactions (most of the operations are carried out without effective exchange of securities, bonds or borrowings) and difficulties in the evaluation of counterpart risk and because of the non-existence of information networks which can support demand and supply in the capital market.

5.6.1.4 THE REGIONAL STOCK EXCHANGE MARKET

In 1998 the UEMOA realized its financial autonomy. The Union is now financed by its own resources supplied by revenues levied on imports from third countries. This revenue is the "*Prélèvement Communautaire de Solidarité"* (PCS) rate, which is 0.5 percent of imports coming from non-members of the UEMOA. Besides this, two major events characterized the financial market: the establishment of the regional stock exchange market and the improvement of the rules in the money and capital market (BRVM[15]).

In September 16th 1998, the stock exchange market officially began operating. Market activity is estimated through two indexes: the $BRVM_{10}$ and the $BRVM_{composite}$. The $BRVM_{10}$ represents the 10 most active securities on the market. It is revised on a three-month basis in order to provide investors with permanent liquidity for securities in the index. The $BRVM_{composite}$ is a larger index comprising all the securities actually listed in the market. The main characteristics of the BRVM index are: 3 sessions a week with a fixing quotation; centralized transactions; transactions guaranteed by brokering companies, under the constitution of a special fund; dematerialized securities stocked at the central trustee's office, which processes the payment of transactions.

For that September both indexes were positive. But from October to November the stock exchange indexes were negative, at –9.19 percent for the $BRVM_{10}$ and –6.77 percent for the $BRVM_{composite}$. But in December, both were again positive. In capital terms, the $BRVM_{10}$ strengthened from $798 million to $1.042 billion, while the $BRVM_{composite}$ cruised from $1.327 billion to $1.616 billion, for the period between September 16 to December 31, 1998. In percentage terms, that is a respective gain of 30.6 percent and 21.8 percent. In 1999, the annual volume of issued securities and bonds doubled compared to 1997, to reach $217 million due to the extraordinary improvements in the issuance of bonds. The West African Bank for Development and the Ivory Coast Treasury issued bonds. The rate for bonds issued was between 6.9 percent and 10 percent while the rate for securities issued was between 6.25 percent and 8 percent. At the end of 1999, the capitalization of the BRVM was at $1.527 billion and ranked fourth among the other existing sub-Saharan stock exchange markets. The volume of transaction in the secondary market is still limited. The weekly average amount for securities in 1999 was $1.234 billion. For bonds, the amount is quite small. In the first half of 2000 the volume of transactions again declined.

During the year 1999, the highest point of the composite index was 100.8 and the lowest 87.3. For the first half of 2000, the trend was downward, such that the composite index reached its lowest historical level at 86.1 or a decrease of 23 percent compared to the highest level of 1998.

[15] BRVM stands for Bourse Régionale des Valeurs Mobilières.

Table 5: Total annual volume of issued securities (in millions of $)

	1996	1997	1998	1999
Negotiable debts	69	138	86	83
Public debt securitization	3	61	-	7
Bonds	-	-	30	127
Total	**72**	**199**	**116**	**217**

Source: BCEAO

5.6.2 THE RESULTS OF MONETARY POLICY IN THE BEAC

5.6.2.1 CURRENCY COVER RATIO

The covering ratio (gross foreign assets to sight liabilities) of the central bank, in December 1997, stood at 60.0 percent, against 50.9 percent in December 1996, and 36.9 percent in December 1995. However, this rate was below expectations. In 1999 the ratio improved and reached 46.94 percent, up by 7 points compared to 1998 and close to the projected 47.90 percent. In 2001, the ratio climbed to 64.1 percent, which is five points less than in the previous year.

5.6.2.2 MONEY MARKET AND INTER-BANK INTEREST RATES

The amount of transactions in the banking sector was estimated at $6 million as a monthly average. This is a severe decrease if compared to the previous year's $20 million. In 1999 – from February to April – transactions outstanding rose to $30.5 million. At the end of 1999, transactions improved by 9 percent to reach a monthly average of $33 million, which is less than 2 percent of deposits. The development of the inter-bank market was hampered by banks' liquidity excess and higher risks for market operations due to the non-existence of a judicial framework and support. One example is that the banks do not accept CDs issued by the central bank and used in the procedure of negative repos as collateral as they are not liquid or tradable, and there is no agreement on their use in repos. And the market is also segmented: there are no financial operations between financial institutions of different countries.

During the last three months of the period, the activity in the money market was characterized by stability in BEAC credit lines for commercial banks with a quasi stagnation of deposits in the central bank, and a slight improvement in inter-bank transactions because of a higher return. But this shortage of liquidity combined with a higher demand for loans, from households and other economic operators, will compel

banks to require more financial assistance from the central bank. The interest rates applied in the inter-bank market were very tight in 1999. The inter-bank weighted average rate (TIMP[16]) stayed ahead of the TIAO for almost the entire year. In 2001, the situation was the reverse. TIMP stayed below TIAO, reflecting the excess of liquidity in the banking system.

5.6.2.3 MONETARY AGGREGATES AND INFLATION

Developments in monetary aggregates were consistent with objectives in 1997, except for loans to the private sector in Gabon, whose higher growth rate was not anticipated. A more rapid rise in monetary aggregates than real GDP stimulated economic growth without accentuating inflationary pressures. Net external assets and internal credits were the two factors that had an important impact on the money supply. The M2 growth rate and internal credits lines were slightly higher than expected by the BEAC. In 2001, money supply growth was lower than the objectives fixed by the monetary authorities.

The year-on-year price changes were 3.8 percent in 1996, 5.1 percent in 1997, 3.1 percent in 1998, and 2.3 percent in 1999. Inflationary pressures were induced by civil war in Congo and network difficulties in the distribution of foodstuffs, in the other countries of the Community. The yearly average for price increases in 1999 was 0.5 percent as compared to 2.4 percent in 1998 and was largely below the expected average of 2.3 percent. In all the countries of the zone, except in Congo, a decline in prices was observed. During 2001, inflationary pressures present since 2000 were confirmed. Inflation reached a rate of 4.2 percent on an annual basis as compared to the 3.5 percent expected and 1.3 percent in 2000.

5.7 THE BANKING SYSTEM

5.7.1 THE UEMOA BANKING SYSTEM

The banking system in the UEMOA has since 1989 been undergoing a restructuring process centered upon: (1) the liquidation of institutions whose financial situation was unsolvable, and (2) the stabilization of those with a viable balance. The process is more or less completed. Like the consolidation of the economic recovery that has been observed in the UEMOA since 1994, banking activity continued to expand in 1998. That proves that the soundness of the banking system depends largely on the orientation of economic activity and the environment.

[16] TIMP is le taux interbancaire moyen pondéré.

The banking system is diversified and widening. At the end of December 1997, the UEMOA comprised 85 formally authorized credit institutions, 58 banks and 28 other financial organizations. In comparison with the previous year, the banking system expanded with five new banks and two additional financial institutions. The 78[17] credit institutions in operation as of December 1997, and whose balance-sheet as a whole stood at $6.508 billions, can be divided as follows: 10 non-specialized banks, which account for a little more than 50 percent of the balance-sheet, assets and resources in the Union, as of 1997; 32 medium and small-sized non-specialized banks, which hold 30 percent of the entire assets and resources in the Union; 12 specialized banks with 14 to 16 percent of the overall balance-sheet, assets and resources; 24 financial institutions with more than 3 percent of the overall balance-sheet and assets. In 1999, the banking system was composed of 91 credit institutions of which 88 were active. The credit institutions were composed of 63 banks and 28 financial institutions. In 2001, the banking system was composed of 90 financial institutions, including 64 banks. The banking sector is characterized by an oligopoly structure dominated by seven international groups controlling 70 percent of the market.

5.7.1.1 RESOURCES

The increase in the resources provided by customers decreased from 10.6 percent in 1996 to 8.2 percent in 1997. However, between September 1994 and December 1997, these resources were close to $4.762 billion. An important volume of additional resources is provided by equity capital, which increased by $57 million in 1997. During the last four years, the rise in nominal capital reached almost $284 million, or 104 percent.

5.7.1.2 ASSETS

Assets are mainly composed of credits to customers. These credits rose sharply during the last four years from $2.2 billion in September 1994 to a little more than $3.968 billion at the end of 1997. In 1996, short-term credits remained relatively stable, but in 1997, they increased again by $476 million. Thus, their share in the overall portfolio of bank credits rose from 51 percent in September 1994 to 59 percent in December 1997. The net amount reported by banks accounts for 6.5 percent to 7 percent of the total volume of the credits granted to customers during the last three years, as compared to a percentage of 10.6 percent in 1994. In 2001, loans to customers increased by 6 percent, at a rate lower than customers' resources (+7.8 percent).

[17] The seven new financial institutions, mostly from Guinea Bissau, which joined the Union in 1997, are not included in the analysis.

5.7.1.3 CASH POSITION

Between September 1994 and December 1997, taking into account the fact that the increase in assets (almost $2.063 billion) was more important than the rise in resources (almost $1.587 billion), the important excess of banks' liquidity observed after the devaluation of the CFA franc could not but shrink. However, this strain is due to a large extent to the subscription of credit institutions to investment securities in 1995, representing consolidated credits in an amount of more than $476 million.

Between 1993/1994 and 1997, the interest margin of the banking system more than doubled, and represented gains amounting to $174 million, as a result of the increase in profits stemming from the return from lending capital and the reduction of borrowing costs. In 2001, the gross margin rate and the coefficient of profitability improved. The increase in net banking income was moderate (3 percent).

Drawing profit from this up-trend, the banking system reduced in the period under review its overheads, increased its depreciation charges and its appropriations to provisions covering liabilities. The net positive result was maintained with an average return on equity capital of 21.9 percent or $127 million.

5.7.1.4 SUPERVISION

Throughout 1997, the supervision of credit institutions in the Union was carried out in accordance with the new rules deriving from the compulsory implementation of the Banking Accounting Plan from January 1st 1996.

The difficulties encountered at the beginning, stemming from conception problems, adaptation and interpretation, were considerably lessened in 1997, as the supervisory authorities could have access in due time to crucial and more reliable data. There are two kinds of control: off-site inspection and on-site inspection. Off-site inspections are conducted on the monthly, quarterly, half-yearly, and yearly basis of statements established according to the Banking Accounting Plan and the requirements of the banking regulations in force. Concerning on-site inspections, the Secretariat General of the Banking Commission conducted about fifty large-scale and specific inspections during the year 1997. The scope of this control was notably extended to the inspection of the financial services of a postal administration, of a holding company owning an inter-bank group, and of banks operating in Guinea Bissau.

On the whole, prudential rules have been satisfactorily respected with few exceptions. The actions of the Banking Commission were aimed at enhancing rigor and transparency in the interventions of the banking system, so as to increase security, competitiveness, and profitability. The financial structure of these credit institutions was restored. The quality of

portfolios continued to improve and restructuring measures and efforts to collect debts were pursued.

5.7.2 THE BEAC BANKING SYSTEM

In the BEAC zone 32 credit institutions were registered at the end of 2001 but only 27 of them were listed by the COBAC. Only 16 of those credit institutions were declared strong and stable, 9 are fragile, and 2 might be in a critical situation. For 1997, the entire Community registered substantial increases in credit outstanding (12.1 percent), which affected the credits-deposits covering ratio (from 88.6 percent in 1996 to 86.3 percent in 1997 and 135 percent in 2001). In order to face this new situation, banks reduced their deposits with the central bank. But overall, the banking system had liquidity excess; banks net position in December 1997 was $248 million or 40.0 percent of their own capital. Foreign exchange assets were reduced at the same rate as the reduction of foreign liabilities. At the end of March 1999, except for Gabon and Congo, financial institutions in other countries raised their credit lines in favor of households and other economic agents. In Cameroon this development went along with increases in deposits, while elsewhere governments used banks' deposits to finance the public deficit. For this reason, the Central Bank advances grew from $22 million in December 1997 to $77.8 million by the end of March 1999.

Banking activity is under the strict control of the COBAC, which defines and determines plans and accounting procedures and prudential norms for the management of financial institutions. The COBAC organizes and exercises off-site and on-site surveillance. It also has the authority to issue sanctions according to the seriousness of the transgression. The prudential norms of the COBAC were elaborated according to the BEAC member countries' economic characteristics. Therefore, five solvency and two liquidity norms were established.

Solvency norms: (1) the risk covering ratio: credit institutions must continually demonstrate that their net normative capital covers at least 5.0 percent of their total assistance – including financial assistance to member states; (2) the risk division ratio: banks and other credit institutions are not allowed to assist only one client for an amount equivalent to more than 75.0 percent of their net normative capital. This limit will be lowered to 45.0 percent; (3) the fixed assets covering ratio: credit institutions must finance at 100 percent their fixed assets with their permanent resources; (4) a financial institution can invest into the capital of any enterprise only up to 15 percent of its own net capital. Overall participation must not exceed 75 percent; and (5) assistance to shareholders, managers, employees, and partners of a credit institution is limited to 15 percent of its own net capital. The liquidity norms include: (1) the liquidity ratio: credit institutions must show and justify available and immediate resources capable of covering the integrality of their debt which will fall due in the next month; and (2) the L/T transformation ratio of

credit institutions must be at least 50 percent of loans and liabilities (with a term of more than five years).

At the end of 1999, the banking activity of the zone recorded rapid growth. The total balance sheet improved by $449 million. Good results were recorded in all the countries of the zone with sustained increases in Cameroon, Equatorial Guinea and Gabon. Doubtful debts also increased as a result of the economic recession. However, their covering ratio also improved from 71.3 percent to 76 percent. Deposits and credits increased as well.

Three key reforms are underway in the BEAC zone that will help to improve the effectiveness of monetary policy. These reforms concern: 1) the introduction of non-zero reserve requirements aimed at mopping up banks' excess liquidity; 2) the planned elimination of central bank financing of government deficits; and 3) the reform of the payment systems.

Table 6: Simplified status of the banking system in the CEMAC (in millions of $)

ASSETS	1998	1999	LIABILITIES	1998	1999
Treasury and other assets	415	497	Treasury and other assets	823	790
Lending to government	464	433	Government deposits	430	416
Lending to the economy	1,683	1,692	Private sector deposits	1,630	1,641
Doubtful claims	118	154	Capital	325	404
Fixed assets	528	475			
TOTAL	3,208	3,251	TOTAL	3,208	3,251
			Net margin rate (%)	25.0	22.6
			Coefficient of rentability	22.4	13.7

Source: BEAC

6 THE EURO AND THE CFA FRANC

France, a core member of the EU, is among the initial members that joined the new euro zone. It ensures the convertibility of the CFA franc. It is believed that this will have some implications for the CFA franc. The advent of the euro meant that adjustments needed to be made. A fixed rate of 656 FCFA for1 Euro was set at the beginning of 1999. The switch to the euro has prompted many to question the desirability of prevailing CFA franc monetary architecture.

6.1 AN OVERVIEW OF THE FUNCTIONING OF THE CFA FRANC SYSTEM

The CFA franc system includes fourteen African economies of different size and structure. The system involves two distinct regional groups, each with its own Central Bank, which set monetary policy with the assistance of the French, the French Treasury and national monetary committee representatives. In West Africa there is the UEMOA and the monetary authority lies with the BCEAO. In Central Africa there is the CEMAC with the BEAC, which exercises monetary authority. Each Central Bank prints its own banknotes, although they share the same currency. Banknotes are exchangeable one-to-one with each other. The French Treasury, through an operations account, has guaranteed the convertibility of the currency against the French franc – and since January 1999 against the euro. Each regional central bank has an operations account. The French Treasury's guarantee is expressed through potentially unlimited overdrafts on these accounts. In return, both central banks aim at "defending the peg to the euro, while providing financing for economic activity and development in the African countries of the CFA franc zone".

Within each region, the foreign exchange reserves of member countries are pooled at the central bank level (the BCEAO and the BEAC), and at least 65 percent of foreign assets have to be maintained in its operations account with the French Treasury. Moreover, each central bank is required to maintain a foreign exchange cover of at least 20 percent for its sight liabilities. Extraordinary measures need to be taken to restrict monetary expansion, if this threshold is breached or whenever operations accounts go into deficit. Furthermore, central bank direct financing of governments has been limited to 20 percent of the previous year's budgetary revenues, so as to avoid monetary financing of budget deficits. However, this rule was bypassed in the 1980s and early 1990s: several governments in both regions used to raise credits from private commercial banks and development banks, which could easily refinance those credits from the central banks. This resulted in excessive lending to governments, despite respecting the ceiling on central bank direct financing. The UEMOA

(WAEMU) decided to eliminate central bank direct lending to governments from early 2002 on.

The CFA franc zone's mechanism is considered to be a budgetary agreement between the French Treasury and the African countries of the franc zone. The Bank of France is not committed. As a result, France and its African partners have sole liability for the management of this mechanism and have the possibility of modifying the parity between the euro and the CFA franc. However, a decision by the Council of the EU is required if a new state joins the agreement or if the principle of the guarantee of external convertibility at a fixed exchange rate against euro is called into question. Therefore, the answer to balancing the obvious costs and benefits of the CFA franc system appears to lie in greater flexibility, with this mostly to be achieved through some form of inflation-weighted crawling peg mechanism. The success of such a scheme lies in the continued backing of French, or possibly even EU, treasury funds.

6.2 COSTS AND BENEFITS OF THE CFA FRANC ZONE

6.2.1 COSTS

The CFA franc system was developed in the post-colonial environment as a mechanism to ensure monetary stability for these countries. Some see this loss of fiscal and monetary autonomy as a substantial cost. In particular, it is argued that the tight fiscal and monetary stance prevailing in the EU is unsustainable for these African economies over the long-term. The argument continues that the extreme differences in economic circumstances (with less developed countries prone to higher inflation due to structural constraints) will lead to sub-optimal GDP growth and uncompetitive exchange rates. For Siddiqi (1998), an excessively stronger European currency against the dollar and yen will undermine the export competitiveness of the CFA franc zone. The export structure of the members of the CFA franc zone is essentially composed of primary commodities whose prices are denominated in US dollars.

This means if commodity prices are not at a satisfactory level and the euro appreciates steeply, then CFA countries will endure significant deterioration in their terms of trade. Furthermore, the major markets for primary commodities are located outside the European Union, so CFA zone products will loose their competitiveness because of an appreciation in the real effective exchange rate. They would then face growing competition from low-cost imports from other neighboring Anglophone countries, such as Nigeria and Ghana, with more competitive exchange rates. Therefore, the EU is not an appropriate means to boost intra-regional trade in the CFA zone. In addition to a decrease in competitiveness, a

strong euro would reduce the burden of the dollar-denominated debts of CFA countries and vice versa.

6.2.2 BENEFITS

The majority of economists – including Siddiqi (1998 and 1999), Boughton (1993) and Moors de Giorgio (1999) see the benefits of the euro for the CFA zone in three main areas. Firstly, enhanced access to EU capital markets: existing free capital flows between France and the CFA zone will be extended to all EU members. Therefore, it will be feasible for CFA franc zone members to control offshore funds and encourage inward foreign investments from European companies. Secondly, attaching the CFA franc to a hard euro will enhance its exchange rate stability, thereby containing imported inflation. Thirdly, there will be positive output effects. There are historical and commercial links between Africa and Western Europe. The EU is the most dominant trading bloc for Africa, as well as one of the principal sources of bilateral and multilateral aid. Furthermore, diversification into the euro would enable CFA zone exporters to benefit from more stable European prices.

So far, the most tangible benefits for the CFA zone are lower transaction costs – commercial and currency – for their trade with the EU. More gains can be realized only if the euro leads to an economic upswing in the EU. Then the CFA zone in particular would reap significant economic benefits such as higher exports and more inbound FDI.

On the balance, the euro will offer CFA countries continued exchange rate stability, and support the franc zone's integration into the globalized economic system. In the meantime, these countries must accelerate their structural reforms and achieve greater diversification of their economic structure if they would like to take full advantage of this particular favorable change in the global monetary system.

6.3 THE CFA QUESTION

Should member countries of the CFA zone worry about the peg with the euro? According to Moors de Giorgio (1999,) there is no need as long as France is prepared to guarantee the free convertibility of the CFA franc to the euro.

In reality things can turn out differently when influenced by some factors. But the fact that the CFA franc zone African countries do not have any effective control over their own currency can be a decisive factor in present and future decisions concerning the currency.

Conventions on monetary cooperation and budgetary arrangements signed between France and the CFA zone countries, and also between the French treasury and the central banks – BCEAO and BEAC – of the CFA zone will not be in effect indefinitely. Any unforeseen pressure on the CFA may prompt calls for a new devaluation of the currency. Some voices, such as the IMF and World Bank, may even go so far as to propose the termination of the agreement. However, both institutions continue to dance a silent minuet around the subject, mentioning aloud only the need for the CFA countries to become competitive.

Additionally, European Union – the Maastricht Treaty – regulations do not give the French government the flexibility to stretch its budget. It has to work along side European authorities. Moreover, why should France alone carry the burden of the CFA if the region is no longer its "pré-carré"? The admission of Guinea Bissau, a former Portuguese colony, confirms this fact. Up to the present, the zone's minuscule economy has not been a burdensome matter for France to back. The CFA zone's money supply is less than two percent of the French supply, while its GDP amounts to only about five percent.

Despite the long-established regime, onlookers have pondered possible changes to the CFA franc. There has been talk of the two entities parting company, as the Western zone (BCEAO) is considered stronger than its Central counterpart (BEAC). The entrance of Guinea Bissau and the possible admission of other western African countries such as Ghana, Guinea, and even Nigeria confirm this. However, the political will is lacking, and any changes to the single currency must be made on a unanimous basis with the approval of France and the EU. The number of countries prepared to enter the CFA zone is increasing, at least in the western part. Any such admission will also depend on the success of the euro in challenging the dollar's hegemony as the international currency of reference – the leading reserve and trade unit. This must be put along side the ambition of these countries to establish a larger West African currency zone, with a possible peg to the Nigerian naira, which would not be a good idea in the near future due to the existence of the serious risks – economic, political, and social – associated with Nigeria, or with a possible peg to a foreign hard currency, the euro. Another point to consider is the possibility of the CFA zone playing a central role in future monetary integration in Sub-Saharan Africa. It could serve as a key building block in a regional stock exchange in both West and Central Africa. It can serve as a model, as is the case for the EU, promoting monetary integration in Africa.

7 THE FUTURE OF THE CFA FRANC

This analysis, in making a case for the CFA franc zone, shows that the Franc zone is far from an optimum currency area, due to the very small degree of intra-trade, some inflexibility in prices and wages, and a wide diversity in the incidence of shifts in the terms of trade – its trade structure is heavily based on primary commodity exports, the prices of which are subject to sharp fluctuations in international markets.

The unavailability of the exchange rate as an instrument of external adjustment does not ease the situation. However, they have gained a measure of stability, budgetary discipline and credibility, and have strengthened their trade and financial links with Europe. Whether this macroeconomic policy choice will reap some benefit in the long run, will very much depend on the ability of these countries to perform successful structural adjustment reforms and improve intra-trade in both sub-zones. But adjustment policies alone, even if fully implemented, are not enough to put the African economies, in general, and the CFA franc zone, in particular, back on the rails of sustained, poverty-reducing growth. Development requires more than just good policies. It also requires sustained investment in human capital and infrastructure, strong institutions and good governance.

For the moment, the monetary arrangements that in the past delivered a stable currency and low prices, and enabled the zone to grow faster than other parts of Africa (until the mid-1980s, when falling commodity prices and a rising franc significantly damaged its terms of trade) remain in place. The CFA zone provides some benefits as well as costs to its members: they are bound to the union, with fiscal discipline, stability, a strong independent central bank, maintenance of currency convertibility, and the loss of the exchange rate as a monetary instrument for adjustment. But whether or not the combination of the use of a common currency with a firm peg against an outside anchor, first the French franc and since January 1999 with the euro, together with the active assistance of the anchor country, will continue to benefit the CFA zone countries will greatly depend on their ability to stabilize economic activity by improving their budget and financial management through structural adjustment programs.

Achieving fiscal reforms and financial management in CFA zone countries has been a difficult task not only because of inadequate institutional capacities in most governments, but also because the extremely fragile nature of public financial systems, and declines in terms of trade and falling per capita income have left the political climate in most countries in disgrace and surrounded any adjustment strategy with substantial risks. Seen from this perspective, improvements in the fiscal performance of these CFA zone countries, and African countries in general, are particularly noteworthy.

Nevertheless, some continuing constraints still impede the smooth development of these economies. These constraints are: (1) a lack of accountability. Despite the fact that financial rules and regulations exist on paper in all countries on the preparation and approval of the budget by the legislature and which reject extra-budgetary expenditures, policymakers have very little incentive to consider these rules, and there is no effective control due to a lack of penalties for non-compliance. Some other weaknesses in this regard include ineffective, deficient or non-existent internal financial control systems. However, great efforts have been made toward improving accountability and transparency in government financial transactions which are likely to enhance governance and help foster political consensus; (2) The weakness of the revenue base. One of the significant factors for the continuing fragility of fiscal balance is the weak effort made by the governments to improve tax and non-tax revenues. The revenue base is very weak particularly where the tax structure depends heavily on levying taxes on international trade – imports and import substitutes. Protecting the competitiveness of the traded goods sector is essential for the preservation of tax revenue; (3) A lack of expenditure control. CFA zone governments have found it extremely difficult to control the rate of growth of public expenditures even under very restrictive fiscal conditions, which is a serious structural constraint in the budget systems. For the authorities, adherence to macro-level expenditure targets is more important than bringing about fundamental changes in the allocation of resources or the control of expenditures.

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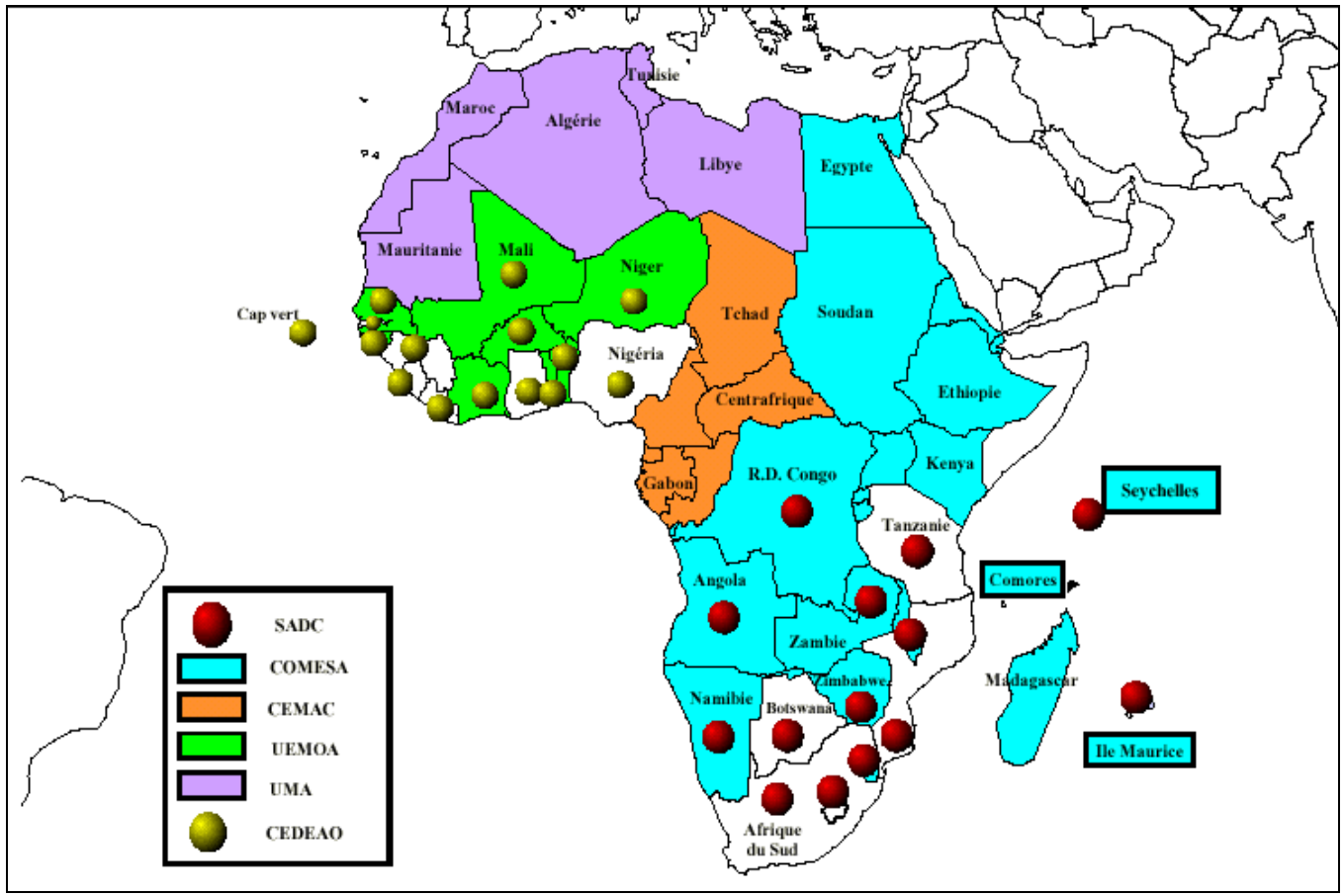
ANNEX

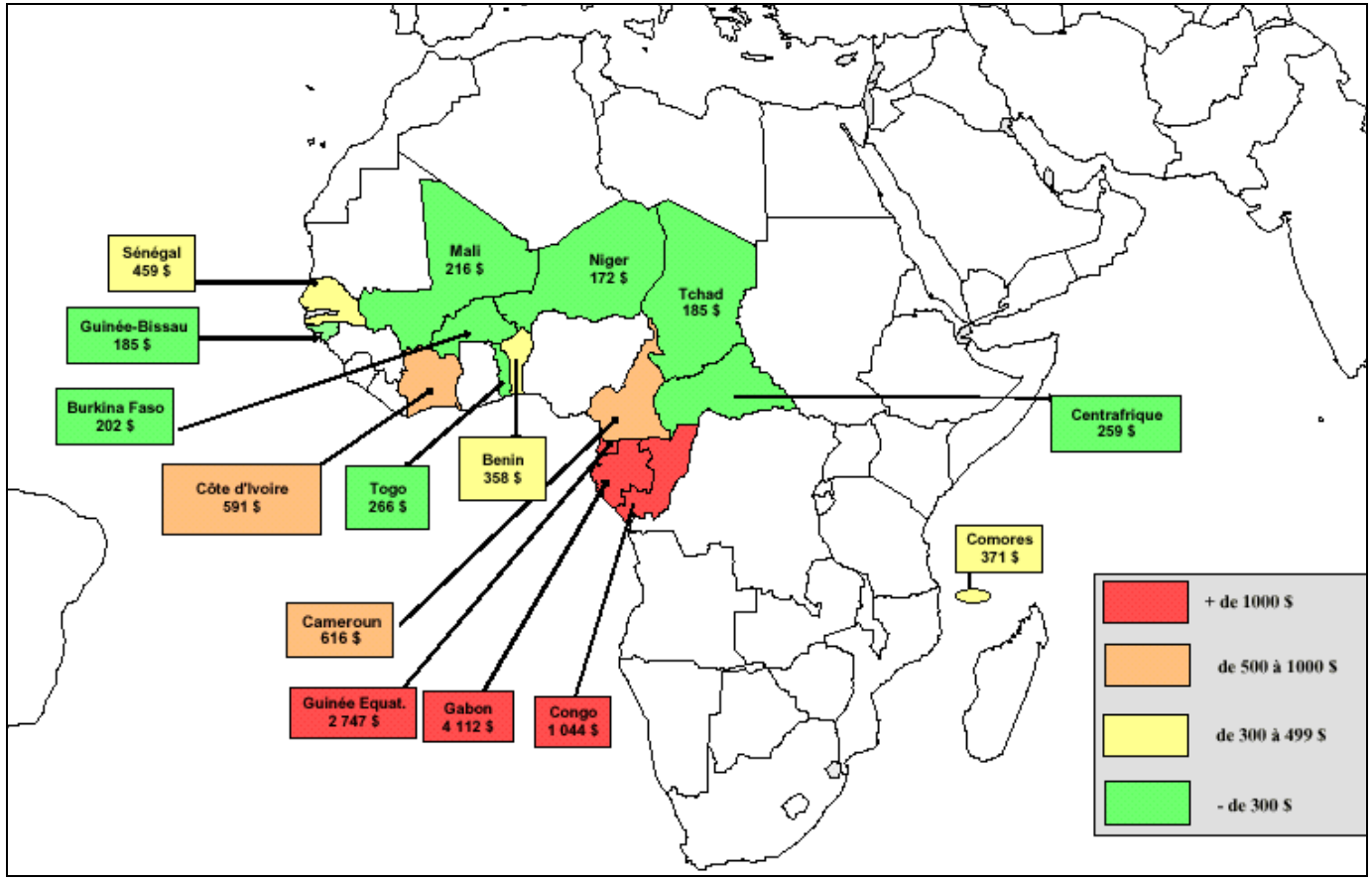
ANNEX A

ECONOMIC ZONES IN AFRICA



Source: Banque de France

GDP PER CAPITA – 2000 - IN USD



Source: Banque de France

ANNEX B

BENIN

Geographic characteristics

- Area: 115, 762 square km.
- Population: 6.1 million inhabitants. Official language: French. Urban population: 15%; Population density: 50 inhabitants/square km; population growth rate: 2.6% from 1998 to 2015.
- Major cities: Porto-Novo (capital city: 200.000 inhabitants), Cotonou (750.000 inhabitants), Djougou (132.000), Parakou (120.000).

Economic indicators

- GDP per capita: USD 368 (2001)
- Composition by sector of activity

	Primary	Secondary	Tertiary
GDP (2001)	35.6%	14.4%	50.0%
Labor force (1996)	54.0%	10.0%	36.0%

Social indicators

Life expectancy (years):	53.8
Infant mortality rate:	9.8%
Adult literacy rate:	37.4%
Enrolment rate in secondary school:	28.2%
Female enrolment rate in secondary school:	18.3%
Population below the poverty line (2000):	N/A
Social development indicator – ranking:	158/173

BURKINA FASO

Geographic characteristics

- Area: 274,122 square km.
- Population (1999): 11 million inhabitants. Official language: French. Urban population: 23%; density: 40.5 inhabitants/square km; population growth rate: 2.8% from 1998 to 2015.
- Major cities: Ouagadougou (capital city: 750,000 inhabitants), Bobo-Dioulasso (350,000 inhabitants), Koudougou (115,000).

Economic indicators

- GDP per capita: USD 196 (2001)
- Composition by sector of activity

	Primary	Secondary	Tertiary
GDP (2000)	37.6%	19.9%	42.5%
Labor force	84.1%	5.3%	10.6%

Social indicators

Life expectancy (years):	46.7
Infant mortality rate:	10.5%
Adult literacy rate:	23.9%
Enrolment rate in secondary school:	12.8%
Female enrolment rate in secondary school:	9.4%
Population below the poverty line (2000):	61.2% (less than 1 USD per day)
Social development indicator – ranking:	169/173

CAMEROON

Geographic characteristics

- Area: 475,442 square km.
- Population (1999): 14.6 million inhabitants. Official language: French. Urban population: 40% (1997); density: 31 inhabitants/square km; population growth rate: 2.4% from 1998 to 2015.
- Major cities: Douala (1,500,000 inhabitants), Yaounde (capital city: 1,000,000 inhabitants).

Economic indicators

- GDP per capita: USD 644 (2001)
- Composition by sector of activity

	Primary	Secondary	Tertiary
GDP (2001/2002)	27.0%	30.0%*	43.0%
Labor force	49.0%	15.0%	36.0%

* of which oil contributes: 5.7%

Social indicators

Life expectancy (years):	50.0
Infant mortality rate:	9.5%
Adult literacy rate:	75.8%
Enrolment rate in secondary school:	39.8%
Female enrolment rate in secondary school:	34.7%
Population below the poverty line (2000):	33.4% (less than 1 USD per day)
Social development indicator – ranking:	135/173

CENTRAL AFRICAN REPUBLIC

Geographic characteristics

- Area: 622,984 square km.
- Population (1999): 3.6 million inhabitants. Official language: French. Urban population: 45% (1991); density: 5.4 inhabitants/square km; population growth rate: 1.9% from 1998 to 2015.
- Major cities: Bangui (capital city: 524,000 inhabitants).

Economic indicators

- GDP per capita: USD 247 (2001)
- Composition by sector of activity

	Primary	Secondary	Tertiary
GDP (2000)	56.0%	16.1%	27.9%
Labor force	56.0%	12.0%	32.0%

Social indicators

Life expectancy (years):	44.3
Infant mortality rate:	11.5%
Adult literacy rate:	46.7%
Enrolment rate in secondary school:	19.0%
Female enrolment rate in secondary school:	12.7%
Population below the poverty line (2000):	66.6% (less than 1 USD per day)
Social development indicator – ranking:	165/173

CHAD

Geographic characteristics

- Area: 1,284,000 square km.
- Population (1999): 7.5 million inhabitants; density: 5.6 inhabitants/square km; population growth rate: 2.6% from 1998 to 2015.
- Major cities (1992): N'Djamena (capital city: 687,000 inhabitants), Sarh (129,600), Moundou (117,500).

Economic indicators

- GDP per capita: USD 183 (2001)
- Composition by sector of activity

	Primary	Secondary	Tertiary
GDP (2000)	37.0%	16.0%	47.0%
Labor force	72.0%	7.0%	21.0%

Social indicators

Life expectancy (years):	45.7
Infant mortality rate:	11.8%
Adult literacy rate:	42.6%
Enrolment rate in secondary school:	17.9%
Female enrolment rate in secondary school:	9.6%
Population below poverty line (2000):	N/A
Social development indicator – ranking:	166/173

CONGO

Geographic characteristics

- Area: 342,000 square km.
- Population (1999): 2.9 million inhabitants. Official language: French. Urban population: 60%; density: 8.4 inhabitants/square km; population growth rate: 2.7% from 1998 to 2015.
- Major cities: Brazzaville (capital city: 950,000 inhabitants), Pointe-Noire (500,000 inhabitants).

Economic indicators

- GDP per capita: USD 911 (2001)
- Composition by sector of activity

	Primary	Secondary	Tertiary
GDP (2001)	6.3%	68.5%*	25.2%
Labor force (1996)	58.0%	13.0%	29.0%

* from which oil: 60.0%

Social indicators

Life expectancy (years):	51.3
Infant mortality rate:	8.1%
Adult literacy rate:	80.7%
Enrolment rate in secondary school:	84.1%
Female enrolment rate in secondary school:	74.3%
Population below the poverty level (2000):	N/A
Social development indicator – ranking:	136/173

EQUATORIAL GUINEA

Geographic characteristics

- Area: 28.051 square km.
- Population (1999): 0.4 million inhabitants. Official language: Spanish; density: 14.9 inhabitants/square km; population growth rate: 2.4% from 1998 to 2015.
- Major cities: Bata (60,000 inhabitants), Malabo (capital city: 45,000).

Economic indicators

- GDP per capita: USD 1,754 (2001)
- Composition by sector of activity

	Primary	Secondary	Tertiary
GDP (2001)	5.4%	91.2%*	3.4%
Labor force (1996)	50.0%	20.0%	30.0%

* from which oil: 68%

Social indicators

Life expectancy (years):	51.0
Infant mortality rate:	10.3%
Adult literacy rate:	83.2%
Enrolment rate in secondary school:	68.5%
Female enrolment rate in secondary school:	64.8%
Population below poverty line (2000):	N/A
Social development indicator – ranking:	111/173

GABON

Geographic characteristics

- Area: 267,667 square km.
- Population (1999): 1.2 million inhabitants. Official language: French. Urban population: 73%; density: 4.3 inhabitants/square km; population growth rate: 2.1% from 1998 to 2015.
- Major cities: Libreville (capital city: 420,000 inhabitants in 1988), Port-Gentil (88,000 in 1988).

Economic indicators

- GDP per capita: USD 3,611 (2001)
- Composition by sector of activity

	Primary	Secondary	Tertiary
GDP (2001)	7.8%	55.6%*	36.6%
Labor force	68.9%	13.4%	17.7%

* of which oil contributes: 41.5%

Social indicators

Life expectancy (years):	52.7
Infant mortality rate:	6.0%
Adult literacy rate:	71.0%
Population below poverty line (2000):	N/A
Social development indicator – ranking:	117/173

GUINEA-BISSAU

Geographic characteristics

- Area: 36,125 square km.
- Population (1999): 1.2 million inhabitants. Rural population: 80%; density: 30 inhabitants/square km; population growth rate: 2% from 1998 to 2015.
- Major cities: Bissau (capital city: 250,000 inhabitants).

Economic indicators

- GDP per capita: USD 162 (2001)
- Composition by sector of activity

	Primary	Secondary	Tertiary
GDP (2001)	62.0%	14.0%	24.0%
Labor force	79.2%	4.8%	16.0%

Social indicators

Life expectancy (years):	44.8
Infant mortality rate:	13.2%
Adult literacy rate:	38.5%
Enrolment rate in secondary school:	24.1%
Female enrolment rate in secondary school:	16.4%
Population below poverty line (2000):	N/A
Social development indicator – ranking:	167/173

IVORY COAST

Geographic characteristics

- Area: 322,463 square km.
- Population (1999): 14.8 million inhabitants. Official language: French. Urban population: 45%; density: 51 inhabitants/square km; population growth rate: 2% from 1998 to 2015.
- Major cities: Abidjan (2,500,000 inhabitants in 1996), Bouake (330,000 in 1995), Daloa (123,000 in 1995), Yamoussoukro (capital city: 110,000 in 1995).

Economic indicators

- GDP per capita: USD 563 (est. 2001)
- Composition by sector of activity

	Primary	Secondary	Tertiary
GDP	30.0%	21.0%	49.0%
Labor force	49.0%	14.0%	37.0%

Social indicators

Life expectancy (years):	47.8
Infant mortality rate:	10.2%
Adult literacy rate:	46.8%
Enrolment rate in secondary school:	34.1%
Female enrolment rate in secondary school:	23.6%
Population below poverty level (2000):	12.3% (less than 1 USD per day)
Social development indicator – ranking:	156/173

MALI

Geographic characteristics

- Area: 1,240,192 square km.
- Population (1999): 10.9 million inhabitants. Official language: French; urban population: 19.2%; density: 8.3 inhabitants/square km; population growth rate: 2.6% from 1998 to 2015.
- Major cities (1995): Bamako (capital city: 1,016 million inhabitants), Segou (88,000), Mopti (75,000), Sikasso (74,000), Gao (55,000).

Economic indicators

- GDP per capita: USD 242 (2001)
- Composition by sector of activity

	Primary	Secondary	Tertiary
GDP	46.1%	20.1%	33.8%
Labor force	79.8%	2.9%	17.3%

Social indicators

Life expectancy (years):	51.5
Infant mortality rate:	14.2%
Adult literacy rate:	41.5%
Enrolment rate in secondary school:	17.9%
Female enrolment rate in secondary school:	12.9%
Population below poverty line (2000):	72.8% (less than 1 USD per day)
Social development indicator – ranking:	164/173

NIGER

Geographic characteristics

- Area: 1,267,000 square km.
- Population (1999): 10.4 million inhabitants. Official language: French; urban population: 17%; density: 7 inhabitants/square km; population growth rate: 3% from 1998 to 2015.
- Major cities (1994): Niamey (capital city: 420,000 inhabitants), Zinder (100,000), Maradi (80,000), Tahoua (60,000).

Economic indicators

- GDP per capita: USD 170 (2001)
- Composition by sector of activity

	Primary	Secondary	Tertiary
GDP	37.6%	15.5%	46.9%
Labor force	85.9%	2.4%	11.7%

Social indicators

Life expectancy (years):	45.2
Infant mortality rate:	15.9%
Adult literacy rate:	15.9%
Enrolment rate in secondary school:	9.4%
Female enrolment rate in secondary school:	6.5%
Population below poverty line (2000):	61.4% (less than 1 USD per day)
Social development indicator – ranking:	172/173

SENEGAL

Geographic characteristics

- Area: 197,161 square km.
- Population (1999): 9.2 million inhabitants. Official language: French; urban population: 42%; density: 46.7 inhabitants/square km; population growth rate: 2.5% from 1998 to 2015.
- Major cities (1995): Dakar (capital city: 1,500,000 inhabitants), Thies (319,000), Kaolack (181,000), Saint-Louis (179,000).

Economic indicators

- GDP per capita: USD 477 (2001)
- Composition by sector of activity

	Primary	Secondary	Tertiary
GDP	21.4%	22.5%	56.1%
Labor force	77.2%	7.3%	15.5%

Social indicators

Life expectancy (years):	53.3
Infant mortality rate:	8.0%
Adult literacy rate:	37.3%
Enrolment rate in secondary school:	19.8%
Female enrolment rate in secondary school:	15.5%
Population below poverty line (2000):	26.3% (less than 1 USD per day)
Social development indicator – ranking:	154/173

TOGO

Geographic characteristics

- Area: 56,785 square km.
- Population (1999): 4.6 million inhabitants; urban population: 31%; density: 76.5 inhabitants/square km; population growth rate: 2.6% from 1998 to 2015.
- Major cities: Lome (capital city: 600,000 inhabitants), Sokode (51,000).

Economic indicators

- GDP per capita: USD 266 (2001)
- Composition by sector of activity

	Primary	Secondary	Tertiary
GDP (2001)	41.4%	22.6%	36.0%
Labor force	67.4%	11.6%	21.0%

Social indicators

Life expectancy (years):	51.8
Infant mortality rate:	8.0%
Adult literacy rate:	57.1%
Enrolment rate in secondary school:	58.3%
Female enrolment rate in secondary school:	40.0%
Population below poverty line (2000):	N/A
Social development indicator – ranking:	141/173