

CRISIS IN THE FRANC ZONE

The thirteen sub-Saharan Africa countries of the franc zone have conventionally been associated with economic stability attributed to a fixed exchange rate with France and guaranteed convertibility of their currency, the CFA franc. But the franc zone economies have experienced economic decline in recent years and most countries have had to adopt economic austerity programmes. Farmers have protested against lowered crop purchase prices while public sector workers have been antagonised by wage cuts and freezes. Most of the thirteen countries enter the 1990s both politically and economically unstable.

This Briefing Paper examines the challenges facing the African members of the franc zone. It discusses whether the deterioration in economic performance can be reversed under existing exchange rate arrangements and if not, what changes are likely. It considers the role of France in supporting the franc zone and the options for the future.

Aspects of the Crisis

Box 1 summarises the essential features of the franc zone and its member states. Until 1986 real GDP growth in the franc zone was maintained at reasonable but not outstanding rates. In comparison to the rest of sub-Saharan Africa, which grew slowly, the franc zone performance appears quite good (see Figure 2) and when compared with many of their West African neighbours such as Ghana and Nigeria it was difficult not to see benefits in franc zone membership. However, in 1987 and again in 1988 real output fell by 2% and estimates for 1989 are for less than 2% growth (ie less than population growth) at a time when growth has picked up elsewhere in Africa.

The decline in output and economic activity is the result both of the adverse international environment and the accumulated effects of poor domestic economic management. Here we consider three factors contributing to the worsening situation: commodity prices, debt and economic mismanagement.

Commodity prices

Heavy dependence on a narrow range of raw material exports with weak and highly fluctuating prices has been a problem for franc zone economies. Five commodities are important sources of export revenue: cocoa (Côte d'Ivoire, Eq. Guinea) petroleum (Congo, Gabon, Cameroon) cotton (Chad, Burkina, Mali) phosphate (Togo) and coffee.

Between 1984 and 1989 the commodity dollar prices show some evidence of a trend decline. Cocoa and petroleum in 1989 for example were less than 60% of their 1984 nominal dollar prices (and cocoa reached a fourteen year low), although there was some recovery in 1990. However, franc zone economies' experience of commodity price changes in the 1980s was quite different from that of most other African economies, which faced broadly similar changes in international prices, because of the fixed exchange rate with the French franc. The variation of the dollar-French franc exchange rate has introduced greater volatility in the level of CFA franc prices. These increased to 1985, and fell sharply during 1986 and 1987. In these last two years the franc zone economies were dealt a double blow: first, a loss of income

Box 1: What is the Franc Zone?

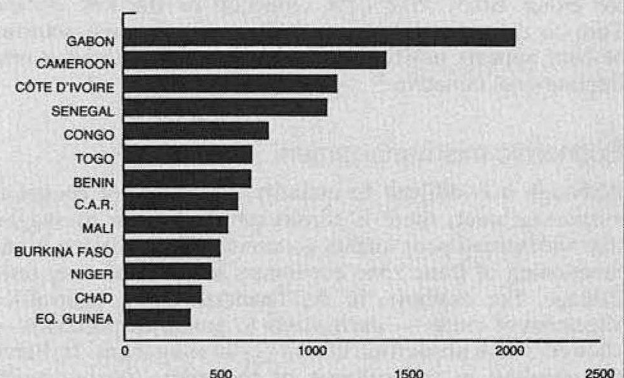
★ African franc zone members have a fixed exchange rate with France of 50 CFA francs to the French franc (since 1948).

★ Two regional central banks, the Banque Centrale des Etats de l'Afrique de l'Ouest (West Africa) and the Banque des Etats de l'Afrique Centrale, set money and credit targets by agreement between member states and France.

★ The French Government guarantees convertibility of the CFA franc into French francs through an 'operations account', or *compte d'opérations*. This automatically finances franc zone countries' foreign exchange deficits whilst two thirds of surpluses are required to be deposited in the operations account. The overall deficit on the operations account has moved from \$15m end-1986 to \$928m end-1988 and deteriorated further in 1989-90.

Figure 1:
Franc Zone per capita GDP

1987 International Dollars



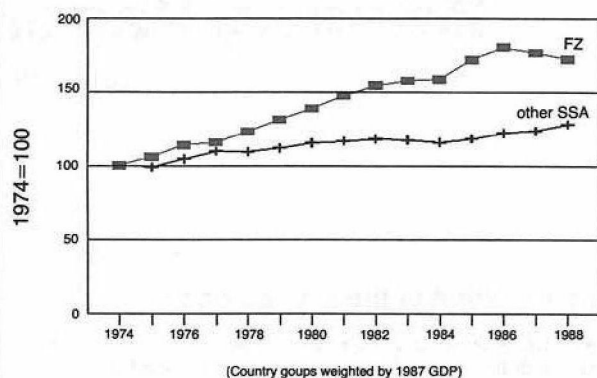
Source: UNDP, *Human Development Report 1990*

In all three respects (fixed exchange rate, monetary policy and guaranteed convertibility) franc zone countries differ substantially from other African states and most other developing countries.

All the African franc zone countries are small; none has a population above 12m inhabitants; and most are poor, particularly the Sahel countries of Chad, Mali, Niger and Burkina Faso. The highest income countries are heavily reliant upon oil (Gabon, Congo and Cameroon) and most of the others upon exports of agricultural commodities (Côte d'Ivoire, Senegal, Togo).

and purchasing power for exporters (as with other African economies) and, second, the appreciating exchange rate made imports cheaper, which lowered demand for producers of goods for the home market. However, urban workers, particularly in the public sector, profited from cheaper imports while their wages stayed firm.

Figure 2
Real GDP Indices: Franc Zone Africa and other Sub-Saharan Africa



Source: World Bank, *World Tables 1989/90*

Debt

Debt problems in the African franc zone countries do not appear to have been worsened substantially by guaranteed convertibility with a fixed exchange rate. Although per capita debt in the franc zone is nearly double that in other sub-Saharan African countries, so is the per capita GNP.

However, economic stagnation has now left the franc zone in a 'debt distressed' state, with eight out of thirteen countries in substantial payments arrears and 'severely indebted' according to the new World Bank classification scheme. Of the remaining countries, three are 'moderately indebted' (Cameroon, Gabon, Central African Republic) and two have had low access to foreign credit (Burkina Faso and Chad). Although debt reduction is a necessary precondition for sustained economic recovery, the indebted middle income countries (Côte d'Ivoire, Congo and Gabon) do not qualify for either Brady Plan debt reduction or the low income Toronto debt initiative so that comprehensive restructuring of debt appears unlikely in the near future without a new international initiative.¹

Economic mismanagement

Although it is difficult to quantify the effects of economic mismanagement, there is considerable evidence to suggest that widespread poor quality government intervention in the functioning of franc zone economies has created long term damage. For example, in the financial sector, centralised allocation of credit — particularly to public corporations — allowed a high proportion of non-performing loans. In Benin this resulted in the collapse of the entire (state-owned) banking system. In Côte d'Ivoire all the development banks have been placed in liquidation or have had their deposits frozen. Extensive bank restructuring is already being undertaken in Senegal and Cameroon. Commercial banks have also been affected: in June 1990 the Banque Internationale de l'Afrique de l'Ouest (BIAO), a major regional chain, was put into liquidation after years of mounting losses primarily caused by politically influenced lending.

Has the Franc Zone made a difference to economic performance?

Relative economic performance can be assessed by grouping sub-Saharan African countries into franc zone and non-franc zone categories and examining output and price indicators.

1. see ODI Briefing Paper *Recent Initiatives On Developing Country Debt*, April 1990. President Mitterrand made such an initiative, as regards debt owed to France, at the Franco-African summit of 19-21 June 1990.

Growth

Statistical studies which allow for differences in the external environment and commodity export composition have generally concluded that up to 1986 there has been a significant difference in economic performance attributable to the conduct of economic policy, of which the franc zone monetary and exchange rate arrangements are assumed to be a major positive component. The differences are greater when measured against other sub-Saharan countries than against other non-African groups of developing countries. The fall in output from 1986 (Figure 2) now challenges this analysis and brings into question the need for adaptation of the franc zone arrangements as a part of a long-term development strategy.

Inflation

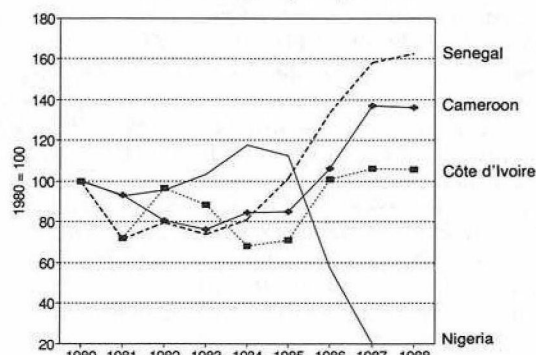
The most notable performance difference is the much stronger control over the rate of inflation in franc zone countries sustained over long periods. By 1986-88 franc zone inflation was negative at -1% per annum whilst in other sub-Saharan Africa the rate averaged 31% per annum. Low inflation has been achieved by imposing restrictions on money growth agreed upon at an inter-state level with the regional central banks. Although loopholes exist through which credit can be rapidly expanded, for example to agricultural marketing boards, the requirement to monitor and report back to the regional central bank has served to restrict long run monetary expansions which have pushed up inflation rates in the rest of Africa. However, inflation has also been suppressed by the accumulation of public sector arrears to the private sector (ie concealed taxation) which amount to several percentage points of GDP in Côte d'Ivoire, Benin, Chad and Senegal.

Has the fixed exchange rate helped?

With a fixed exchange rate and low inflation the franc zone could have been expected to remain competitive in international markets. But during the 1980s the exchange rate became increasingly overvalued for most franc zone countries. Two factors have been at work. First, the introduction of floating exchange rate regimes in neighbouring or competing African countries (Nigeria, Ghana, Sierra Leone, Gambia, Uganda, Zaire and Zambia) has allowed a very significant depreciation from what had been grossly overvalued rates. The Thill Report for the French Ministry of Cooperation highlighted the difficulties of the franc zone competing with neighbouring Ghana and Nigeria: smuggling into the franc zone is an increasing problem. Cameroon, for example, is considering ways to stem substantial imports of petroleum and consumer goods from Nigeria which are dodging protective tariffs. Purchasing

Figure 3
Real Manufacturing Prices

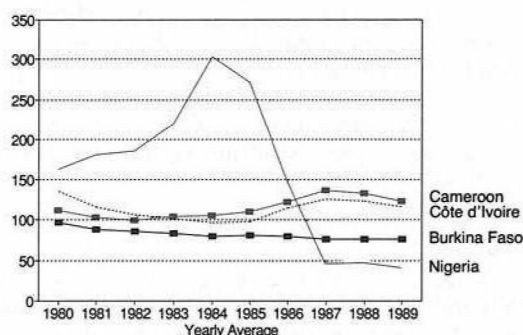
Deflated by import prices



Source: World Bank, *World Tables 1989/90*

Figure 4
Real Effective Exchange Rates

1970-72 = 100



Source: IMF, *International Financial Statistics*

smuggled imports in CFA francs has a direct recessionary effect by reducing demand for home goods. As a respected critic commented recently 'The franc zone . . . has become a tool for an urban elite to promote and profit from cheap imports'.²

As an indication of the shift in competitiveness, Figure 3 shows the changes in real manufacturing costs in Nigeria compared to three major franc zone economies. Similar effects can be shown for manufacturing wages and industrial prices. Not surprisingly, direct foreign investment is now shunning the high cost franc zone despite the assurance of fixed exchange rates. Foreign firms are utilising the guaranteed convertibility of the CFA franc to remove their investments from franc zone economies.

The second impulse to exchange rate appreciation has been the pegging to a relatively strong currency, the French franc. In the 1960s and 1970s the franc was relatively weak and was periodically devalued against the dollar. During the 1980s, French participation in the European Exchange Rate Mechanism has meant that inflation rates must be lower than in the past to remain competitive in the franc zone. Real exchange rates (the trade weighted basket of exchange rates adjusted for changes in prices) have also diverged as a result of changing patterns of trade, as some countries diversified their external trade away from almost total dependence on the French market.

The larger economies in the franc zone such as Côte d'Ivoire and Cameroon which dominate the process of credit distribution have the most inflationary monetary policies and therefore the most over-valued exchange rates (Figure 4). Smaller and poorer Sahel economies have less influence in regional central banks, a more restrictive monetary policy and lower inflation rates. However, their real exchange rates remain considerably higher than neighbouring countries with floating exchange rates when a comparable base year is used (Figure 4). On the operations account the four Sahel economies had accumulated surpluses of US\$ 500m at end-1988 which partly financed the deficit of US\$ 1500m for Côte d'Ivoire, Senegal and Cameroon. Most of the difference was supplied by France.

These disparities highlight the weakness of a single nominal fixed exchange rate: if the mechanics of the franc zone cannot ensure reasonably tight domestic macroeconomic policies and at least approximate uniformity across member countries, then the arguments for a single fixed rate fall away.

Mounting pressures to change

So far the IMF has not required any commitment to exchange rate devaluation, arguing that the franc zone is a special case in Africa. Michael Camdessus, the IMF's Managing Director, asserted 'The problem of the franc's parity does not arise' in Côte d'Ivoire at the end of 1989.

But as the IMF's own exposure to franc zone economies increases, (all but two of the African franc zone countries have IMF programmes in 1990) the pressures from the most influential IMF members such as the US and Japan are mounting for concrete evidence that exchange rate change is not required. Within the franc zone, detailed studies are being undertaken to examine the questions of competitiveness, costs and parity in major franc zone economies.

Publicly, France and franc zone Africa too have rejected the idea of devaluation. In November 1989, Jacques Pelletier, France's Minister of Cooperation, spoke strongly in favour of the franc zone remaining in its present state until after 1992. Senegal's Minister of Finance announced 'In the West African CFA franc zone, we don't even think the word devaluation should be pronounced'. However, a run on the banks in Senegal during a recent meeting of West African finance ministers was indicative of the current nervousness over the future of the franc zone.

To sustain the franc zone, liquidity must be supplied to keep the CFA franc convertible. Lending via the operations account at the French Treasury increased by an estimated \$900m during 1987 and 1988 and France also supplies direct balance of payments support. The cost to France of financing franc zone economies has raised critical voices: the Hessel Report for the French government in 1989 recommended that aid to the developing world should be spread more widely and with less reference to ex-colonial ties. So far, such a modernisation of French aid has not occurred; it would erode the rationale for maintaining the fixed exchange rate for a narrow range of former African colonies. French relations with Côte d'Ivoire are perhaps the key to understanding future developments (see box 2).

Côte d'Ivoire is something of a test case because its size and political importance (its president and France's were fellow cabinet ministers in a Fourth Republic government in the 1950s). Its problems of indebtedness, slow growth, economic mismanagement and high costs exemplify those of the franc zone more generally.

Impending Franc Zone reforms

Discussions will have to be held later in 1990 on the sort of revisions to be made to franc zone arrangements. There are three main options: repudiation of the franc zone by France, devaluation or shifting to a new peg.

Box 2: The case of Côte d'Ivoire: an economy in trouble

In November 1989, Côte d'Ivoire reached agreement with the IMF on a short term programme of economic reform, with financing from the IMF's stand-by facility. This agreement was essential to enable continued progress in foreign debt rescheduling and obtain new donor pledges of financial support. The main policy objective was to cut government borrowing (the budget deficit in 1989 is estimated to be \$1.5bn or 16.1% of GDP) and lower the balance of payments deficit. The main measures were cutting government expenditure, particularly wages, and raising tax revenues.

Côte d'Ivoire seems almost bound to have difficulties with its adjustment programme despite a recovery in cocoa prices in 1990. Efforts to cut wages by 15 to 40% in February 1990 were thwarted by personal appeals to the President by key groups of workers; press reports claim there has been no downward adjustment to the President's personal budget of US\$ 470m. Corruption and inefficiency still impede tax collection. The main barrier to economic reform has been the resistance to any fundamental political change on the part of the leadership.

A breakdown in the stand-by agreement would place full responsibility upon France to support convertibility for the CFA franc in Côte d'Ivoire. Shifting the policy dialogue over to France will not fundamentally alter the reforms required and the French are likely to insist on a reduction in borrowing from the heavily overdrawn operations account. Failure in this sphere could provoke exchange rate devaluation or expulsion from the franc zone (see impending reforms).

2. Monsieur Zaki Laïdi, *International Herald Tribune* 12 June 1990.

Repudiation

Outright French repudiation of the franc zone arrangements is unlikely, as the convertibility guarantee through the operations account gives the French authorities the lever to alter exchange rates unilaterally. This has always given Paris a powerful voice in economic policy-making in franc zone African countries such that the threat of repudiation or expulsion of individual franc zone members is sufficient for French views on reform to prevail in these circumstances. In the past, the currency zone gave France a stronger global economic voice than she would have had on her own, but this is now becoming a liability rather than an asset, the more so as the French franc and the German mark are tied within the European Exchange Rate Mechanism.

Devaluation

Devaluation has been categorically rejected as an option by both African regional central bank governors, because nominal constancy or stability is seen as essential.

But a permanently fixed nominal exchange rate is no guarantee of relative economic success; in fact overvalued fixed exchange rates are seen as a key factor in the relative decline of non-franc zone Africa in the 1970s and early 1980s. In this context the devaluation taboo in the franc zone can be a constraint to economic policy-making. Exchange rate credibility is not necessarily enhanced by refusing to consider devaluation.

The fixed exchange rate has shifted the burden of adjustment for franc zone economies squarely onto fiscal and monetary policies and to a lesser extent onto wage policy. Exchange rate flexibility is not a substitute for domestic action but it may make this more effective. For example, the experiences of neighbouring Ghana and Nigeria have shown that devaluation can substantially reduce real wages, whereas in the franc zone more transparent nominal wage cuts have sparked political unrest and proved difficult to implement. Although governments cannot continually 'surprise' workers into lower real wages with devaluation there is evidence that a one-off devaluation can have real effects. In 1968, for instance, France implemented a devaluation which eroded the real wage gains made a few months earlier by worker and student protests.

In practice the discussions will centre around the views of France, as guarantor, and the major franc zone economies of Côte d'Ivoire and Senegal in the West African Monetary Union and Cameroon and Gabon in the Central African Monetary Union. The countries most able to benefit from devaluation are these same coastal commodity exporters which have more dynamic, diverse and flexible economic systems and historically have had the fastest rates of export growth in the franc zone. They also appear in general to be the countries with the most severe currency overvaluation, on the basis of real exchange rate trends, relative wage costs and relative prices of domestic products.

It would not be the first change in parity. In 1948 there was a 17% revaluation of the CFA franc, shifting from 58.82 to 50 CFA francs to the French franc, which occurred in response to French inflation during the reconstruction period after the Second World War. The relative price inflation in franc zone countries since 1948 has not been uniform, therefore different degrees of real devaluation are now required; either domestic prices or nominal exchange rate adjustments must differ.

This could in principle be achieved by a uniform devaluation accompanied by one-off inflationary credit expansions in countries which require more moderate devaluation. In practice the risk of launching an inflationary spiral is sufficient to exclude this option. However, in the medium term it should be possible to eliminate the more serious levels of currency under-valuation by loosening fiscal and monetary policy. A one-off devaluation without compensating adjustments is more likely to penalise the

poorer Sahel countries whose economic imbalances could be tackled without exchange rate changes.

Alternatively, differential rates of devaluation could be implemented whilst maintaining full fixed convertibility between the various CFA franc currencies (eliminating the one-for-one conversion rate). This could increase transactions costs within the regional monetary unions, but on a significant scale only in countries which import large amounts of currency from migrant labour (Burkina Faso, Chad, Mali). Differential devaluation could quickly restore approximate uniformity of costs in the franc zone.

Changing the peg

For some countries, such as Côte d'Ivoire, the economic situation and external pressures have become so critical that the choice is now not whether to implement effective reforms but whether, in addition to devaluation against the French franc, the franc zone members need a more fundamental reassessment of how the exchange rate is determined. As franc zone trade has diversified away from France towards other European Community members and Japan, many of the fixed rate of exchange benefits with the franc have been eroded. In 1990 the CFA franc is effectively pegged to the European Currency Unit (ECU), as realignments between the Franc and other European currencies become more infrequent.

Current speculation about a realignment of the franc within the European Exchange Rate Mechanism (ERM) highlights the absence of control African franc zone countries have in their exchange rate determination. If exchange rate change is delayed, the CFA franc may have a new peg by default if European currencies move towards a European Monetary Unit as proposed in the Delors Report. The principal worry for CFA franc countries will be that this may intensify their difficulties in maintaining a fixed exchange rate. Inflation in a European Monetary Union is likely to follow what have been historically low German rates dictated by the tight monetary policy of the Bundesbank rather than the somewhat higher rates that had been tolerated in France until relatively recently. This will place further pressure on franc zone competitiveness. An explicit shift to an ECU-peg of a fixed but adjustable type would require financial support for an intervention fund to support the exchange rate under pressure if France abdicated full responsibility for this role.

Conclusion

The franc zone exchange rate and monetary arrangements, designed to foster economic confidence, have been unable to respond to the shocks of the 1980s. The combination of economic decline and the forced reliance upon unpopular adjustment measures has fostered political instability, and expectations of currency change have exploded the myth of franc zone payments reliability.

In France, both the financial cost of the franc zone and the current unease at supporting inefficient and often corrupt one-party administrations has forced a reassessment of existing ties with franc zone Africa: devaluation is a card that can only be played once to any effect, but some form of monetary reform may herald further changes in the economic and political linkages between France and Africa.

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