DOCUMENT OF INTERNATIONAL MONETARY FUND AND FOR OFFICIAL USE ONLY

The contents of this document are preliminary and subject to change.

GRAY/08/1674

May 22, 2008

Statement by Mr. Heath and Mr. Parodi on WAEMU
(Preliminary)
Executive Board Meeting 08/45
May 23, 2008

The Staff Report provides a comprehensive and sobering overview of the numerous challenges that the WAEMU region continues to face. The two salient points that emerge from the report are that the real exchange rate is becoming more overvalued; and that the financial sector needs to be considerably bolstered. Going forward, we ask the staff to ensure proper follow-up of the Staff Report and FSAP recommendations in upcoming Article IV consultations and program reviews.

We commend the staff's efforts to adapt exchange rate assessment methodologies to the idiosyncrasies of the WAEMU region. The Selected Issues paper on a modified external stability approach expands on last year's econometric work on the equilibrium real exchange rate approach. We welcome this staff work as a very useful contribution.

The staff considers the exchange rate to be somewhat overvalued based on the results of two formal models, but emphasize that evidence of overvaluation is inconclusive. The regional authorities underscore the methodological uncertainties of the two approaches.

In our view, most evidence points to increasing signs of overvaluation, in clear contrast to last year's WAEMU staff report, where the staff assessed that the exchange rate "remains broadly in line with fundamentals." We have also begun to see growing evidence in country-specific contexts of overvaluation. Going forward, appreciation pressures may persist. Indeed, the nominal effective exchange rate has continued to appreciate this year, and inflation is expected to pick up. This is of particular concern for the region's competitiveness, noting in particular that the region's export to GDP ratio has been stagnating, and that real export growth has been erratic over the past few years.

The authorities value the exchange rate peg for its stability, and we recognize that it provides an adequate nominal anchor for regional monetary policy. In the context of the pegged exchange rate regime at the currency union level, however, the relevant authorities have no option but to redouble their pursuit of productivity-enhancing structural reforms. Directors have previously observed that the damaging effects of structural and regulatory impediments to private sector activity, as outlined in international surveys on the business environment, may be more constraining to export growth than price factors. Restraining expansionary fiscal policies and improving structural flexibility are critical to averting the buildup of imbalances in the zone.

It is disappointing that convergence among WAEMU members remains stalled, and that not a single member meets all the convergence criteria. The fiscal criterion was met by only one member country, and was missed by wide margins in several cases. The policy guidance and signaling value of the criteria are increasingly irrelevant.

In this context, we appreciate the excellent Selected Issues paper on the challenges of creating a monetary union in West Africa, which is a good example of the kind of probing and thoughtful work that we expect from the staff on such issues.. Although we fully support the regional authorities' vision of enhanced regional integration, it is very hard for us to see how a regional currency arrangement for ECOWAS could be implemented effectively under the envisaged deadlines. We urge the authorities' to consider the staff's analysis of whether ECOWAS is an optimal currency area, particularly given the likelihood of asymmetric external shocks on its members. We share the staff's view that, before a wider regional currency is created, the authorities should better focus on ensuring a solid foundation, as outlined in paragraph 29.

The FSAP lays out substantial evidence that the financial system is fragile and particularly susceptible to macroeconomic shocks. Weaknesses in the banking sector of some member countries represent an obstacle to the development of the private sector, and put financial stability in jeopardy. The staff provide several recommendations to both regional and national authorities to bolster the financial system. We look forward to rigorous follow-up of these recommendations in Article IV consultations and program reviews.