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The CFA Franc Zone and the EMU[1]

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Abstract

Whether the prospective shift of the peg of the CFA franc to the euro would constitute an exchange rate arrangement with EMU countries would depend critically on the interpretation of the free convertibility of the CFA franc guaranteed by France. Nonetheless, this shift is likely to leave the CFA franc arrangements and operating features of the zone essentially unchanged. The current parity of the CFA franc could be considered in line with fundamentals. The potential economic consequences for the CFA franc countries could be positive over the long term, but there is a risk of a weakening of external competitiveness.

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Contents

SUMMARY

The prospective shift of the peg of the CFA franc from the French franc to the euro raises a number of questions. Will this change require simply a decision by the CFA franc countries themselves together with France, or will it involve the other members of the European Economic and Monetary Union (EMU)? What would be the likely economic impact of the EMU on the real effective exchange rate of the CFA franc and the external competitiveness of the CFA franc zone?

This paper argues that, while the provisions of Article 109 of the Maastricht Treaty leave some room for interpretation, the potential free convertibility of CFA francs into euros guaranteed by France could be considered as a budgetary arrangement between the French treasury and the regional central banks of the CFA franc zone, and not as an exchange rate arrangement affecting all EMU countries. The shift in the link of the CFA franc will leave the CFA franc arrangements and operating features of the zone essentially unchanged. The current parity of the CFA franc could be considered as broadly in line with fundamentals. The potential economic consequences on the CFA franc countries could be positive over the longer term, given the general expectation that the creation of the EMU would likely result in a stable euro, low inflation and interest rates, and stronger-than-otherwise output growth in EMU countries. The main risk is a potential weakening of the external competitiveness of the CFA franc countries, arising from possible complications in the EMU process and the likelihood that the euro might be unduly strong and volatile. Fundamentally, the CFA franc zone would remain substantially more vulnerable to exogenous shocks than the EMU countries, given the zone's high dependence on the production and export of several primary commodities, and the still limited intrazone trade.

I. Introduction

The process of economic and monetary integration among the member countries of the European Union (EU) is scheduled to reach a critical milestone on January 1, 1999, with the envisaged introduction of a single currency—the euro—and the creation of the Economic and Monetary Union (EMU). Decisions as to which EU countries will participate in the euro area are to be made at the beginning of May 1998, based on the observance in 1997 of a range of convergence criteria established by the Treaty on the European Union (Maastricht Treaty). While there are some uncertainties about how strictly the various EU countries will observe these convergence criteria, particularly as regards the 3 percent of GDP reference value for the budget deficit, it is expected that France will be among the initial countries joining the euro area.

The CFA franc zone currently comprises 14 sub-Saharan African countries, of which 12 countries had been French colonies. Formally, these countries belong to two separate monetary areas, sharing their respective single currencies (which have the same acronym, CFA franc) issued by two regional central banks, located in Dakar (Senegal) and Yaoundé (Cameroon). The two CFA francs are, by design, pegged to the French franc at the same rate. What makes the CFA franc zone unique in the world is that it is a monetary union with a fixed exchange rate, and the anchor currency country, France, guarantees the convertibility of the CFA franc into French francs, participates in the executive boards of the two regional central banks, and provides extensive financial and technical assistance to the member countries of the CFA franc zone.

In view of these institutional features, a number of questions arise concerning the likely impact on the CFA franc arrangements of the introduction of the euro and the establishment of new institutions within the EMU. As a minimum, the peg of the CFA franc would need to be shifted to the euro. Will this change require simply a decision by the CFA franc countries themselves together with France, or will it involve the other members of the EMU? Will the guaranteed convertibility of the CFA franc by France need to be modified? What would be the likely economic impact of the EMU on the real effective exchange rate of the CFA franc and the external competitiveness of the CFA franc zone? How will the EMU affect the ongoing efforts by CFA franc countries to enhance their regional economic and monetary integration? These issues have naturally been the focus of discussions among the authorities of the CFA franc countries and the regional central banks, but have received relatively marginal attention within the European Union. The clarification of the likely modalities of linking the CFA franc to the euro is also being awaited by economic operators in the CFA franc zone, affecting to some extent expectations about the sustainability of the prevailing exchange rate of the CFA franc in the wake of the 50 percent devaluation of the CFA franc in January 1994, after more than 40 years of stability.

It has been argued by Carré (1997) and others that the EMU would not cause any substantive change in the CFA franc arrangements, except for the replacement of the peg against the French franc with a peg against the euro. Carré notes that the convertibility of the CFA franc is provided by the French Treasury and not by the French central bank, and that the budgetary—rather than monetary—nature of this arrangement makes it compatible with the requirements of the Maastricht Treaty.[2] Moreover, in recent public statements, the CFA franc countries and France have indicated their intention to maintain the existing arrangements in the CFA franc zone, including the parity of the CFA franc.[3]

This paper addresses the above questions and issues, focusing in particular on the modalities for linking the CFA franc to the euro, the likely economic impact of the EMU on the CFA franc zone, and the likely implications of the EMU on the economic and monetary integration of the CFA franc countries. The paper suggests that the key feature of the CFA francs arrangements that could raise questions of competence within the new European institutions under the EMU is the guarantee by the French Treasury of the free convertibility of the CFA franc into French francs—it should be noted that the free convertibility per se of the CFA franc into foreign currencies offered by the regional central banks is not the issue. The paper suggests that this feature might be interpreted as a budgetary arrangement between France and the CFA franc countries and not a monetary arrangement subject to the approval of the Council of Ministers of EMU countries, thus supporting the view of Carré (1997). The prospective shift in the link of the CFA franc from the French franc to the euro will constitute a significant political and psychological change for the economic operators in the CFA franc zone. However, the shift will leave the CFA franc arrangements and operating features of the zone essentially unchanged, while the current parity of the CFA franc could be considered as broadly in line with fundamentals. The potential economic consequences on the CFA franc countries could be positive over the longer term, given the general expectation that the creation of the EMU would likely result in a stable euro (vis-à-vis major non-EU currencies), low inflation and interest rates, and stronger-than-otherwise output growth in EMU countries.

Fundamentally, however, the CFA franc zone would remain substantially more vulnerable to exogenous shocks than the EMU countries, given the zone's high dependence on the production and export of several primary commodities priced in U.S. dollars, and the still limited intra-zone trade. If anything, the linking of the CFA franc to the euro and the declared intention of EU countries to support exchange rate stabilization schemes and the development of intra-regional trade among developing countries offers CFA franc countries the opportunity to intensify their adjustment efforts, as well as step up their ongoing initiatives to enhance

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[2]This view was shared by a number of participants in a conference on the EMU and the international monetary system, organized by the Camille Gutt Foundation and the IMF, which was held in Washington, D.C., during March 17-18, 1997. However, this assessment was challenged by some other participants, who suggested that the linking of the CFA franc to the euro was an exchange rate arrangement, which under the Maastricht Treaty needed to be considered by the Council of Ministers.

[3]Such statements were reiterated on the occasion of the meetings of finance ministers of CFA franc countries, in mid-April 1997 in Cotonou, Benin, and in mid-October 1997 in Paris.

regional integration. The potential exposure of CFA franc countries to asymmetric shocks relative to EMU countries, and the potential risk of a strong and volatile euro, reinforce the importance for the CFA franc countries of accelerating their structural reforms so as to encourage a diversification of their production and export bases and help facilitate the preservation of the existing arrangements in the CFA franc zone.

The paper is organized as follows. Section II reviews briefly the history, operating features, and economic performance of the CFA franc zone. This section provides also a brief assessment of the relative observance by the CFA franc countries of the conventional criteria for optimum currency areas, and highlights the trade links between the CFA franc zone and France and the EU countries in general. Section III highlights the process of establishing the EMU, as laid out in the Maastricht Treaty, and reviews the implications for the CFA franc zone of the Treaty's institutional provisions concerning the EMU's external relations with non-EU countries. Section IV assesses the possible short-term and long-term economic impact of the linking of the CFA franc to the euro. Section V offers some concluding remarks.

II. The CFA Franc Zone Arrangements: Institutional Aspects and Performance

The unique features of the CFA franc zone find their origin in the political and economic relations between France and its former African colonies. During the 1930s and 1940s, France established currencies in each of its colonies that were pegged to the French franc. By the end of the second world war, the currencies of the French colonies in Africa were consolidated into "*le franc des Colonies Françaises d'Afrique*," or the CFA franc; its parity was set in October 1948 at 0.5 CFA franc per French franc.[4] The CFA franc was issued initially by the central bank for France's overseas territories (*Caisse Centrale de la France d'outre mer*). However, following the independence of France's former African colonies in the early 1960s, responsibility for issuing currency and overseeing the functioning of the zone was shifted to two regional central banks; these banks had originally been dominated by France, but by the early 1970s their control shifted to the member countries.[5]

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[4]This rate remained unchanged until January 1994, except for the adjustment necessitated by the French currency reform of 1968, when a new French franc was introduced equivalent to 100 old francs; the CFA franc rate remained unchanged relative to the old franc, but rose to 50 CFA francs against the new French franc.

[5]For the history of the CFA franc zone, see Yansané (1984) and Vinay (1988). The institutional structure that existed prior to the implementation of major reforms in 1974 is described in IMF *Staff Papers* (1963 and 1969), while the subsequent economic structure is reviewed by Bhatia (1985) and McLenaghan and others (1982). Boughton (1991) provides a broad overview.

The composition of the CFA franc zone has changed over time with the departure (and subsequent reentry in the case of Mali) of some former French colonies and the entry in recent years of two sub-Saharan African countries that had no colonial relations with France and are not French-speaking (Equatorial Guinea in 1985 and Guinea-Bissau in 1997). The zone currently comprises eight west African countries (Benin, Burkina-Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, and Togo) that are members of the West African Monetary Union (WAMU). Their common currency is the "*franc de la Communauté Financière de l'Afrique*" (CFA franc), which is issued by the "*Banque Centrale des Etats de l'Afrique d'Ouest*" (BCEAO). The zone also comprises the six countries (Cameroon, the Central African Republic, Chad, the Republic of Congo, Equatorial Guinea, and Gabon) that are members of the Central African Monetary Area (CAMA) and of the "*Banque des Etats de l'Afrique Centrale*" (BEAC). The BEAC issues the "*franc de la Coopération Financière Africaine*" (CFA franc).

The two CFA francs are legal tenders only in their respective regions.[6] However, because of the guaranteed convertibility into French francs, the free capital mobility between each region and France, and the fact that the two CFA francs have the same parity against the French franc, the CFA franc zone has traditionally been considered as one currency area with a single currency. France is represented in the executive boards of the two regional central banks and has traditionally been the main trading partner and the provider of extensive technical and financial assistance to all member countries of the CFA franc zone. The structure of the CFA franc zone, as a currency union with a fixed exchange rate and a significant operational involvement of the anchor currency country in the functioning of the union, is fairly unique, even among monetary areas.[7]

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[6]The Comoros is also a member of the French franc zone, but its currency (the Comorian franc, introduced in 1981) is issued by the Central Bank of Comoros at a rate that until January 1994 had been equal to that of the CFA franc; in January 1994 the Comorian franc was devalued by only 33 percent relative to the French franc, compared with 50 percent for the CFA franc.

[7]The Rand Monetary Area, the only other monetary union in Africa, involves South Africa, Lesotho, and Swaziland. Lesotho and Swaziland peg their currencies to the South African rand, but retain their independence in changing the parities without the involvement of the other parties; there is also no coordination of monetary policy. Similarly, in the Eastern Caribbean Monetary Union among nine Caribbean island countries, the common currency (the Eastern Caribbean dollar) is issued by a regional central bank and is pegged to the U.S. dollar, but the United States is not involved in any way in the functioning of the union. See Cobham and Robson (1994) and Boughton (1991).

A. Operational Features

The CFA franc zone functions under a number of key operating principles: (a) a fixed parity against the French franc, adjustable if required by economic reasons after consultation with the French government and unanimous decision of all member countries within each monetary area; (b) convertibility of the CFA franc into French francs without any fluctuation margins (at a rate of CFAF 100 = F 1 as of January 12, 1994); (c) guarantee of convertibility by France through the establishment by each regional central bank of an operations account with the French Treasury with market-related yields or charges (these accounts can have a positive or a negative balance, thus providing an—in principle—unlimited overdraft facility to each central bank); (d) free capital mobility between the two regions and France; and (e) the pooling of foreign exchange reserves of each regional monetary area.[8] The two regional central banks act independently from each other. In practice, however, given the experience leading up to the devaluation of January 1994, changes in the CFA franc parity require a unanimous decision of all member countries of the two monetary areas and of France.

To preserve these principles, and as a means of encouraging financial discipline, a number of operating rules are stipulated in the statutes of the central banks. These rules require that each central bank: (a) maintains at least 65 percent of its foreign assets in its operations account with the French Treasury; (b) maintains a foreign exchange cover of at least 20 percent for its sight liabilities; and (c) limits its credit to each government of member countries to a ceiling equivalent to 20 percent of that country's government revenue in the previous year.[9] Taken together, observance of these operating rules limits in practice the potential drawings by the two central banks from their overdraft facility with the French Treasury.

B. Economic Performance and Structure of the CFA Franc Zone

In broad terms, during the period from the early 1950s to the mid-1980s, the economic performance of the CFA franc countries compared favorably with that of other sub-Saharan African countries, being characterized by stronger real GDP growth and lower inflation. However, during 1986-93, in the face of a sharp cumulative deterioration in the terms of trade of around 40 percent, combined occasionally with deflationary procyclical fiscal policies, the growth performance of the CFA franc zone weakened considerably. The worsening of the terms of trade led to a substantial depreciation of the equilibrium real effective exchange rate

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[8]In practice, the principle of free capital mobility has been constrained by a number of administrative regulations, prudential limits on the net holdings of net foreign assets by commercial banks, very high bank commissions for capital transfers abroad (Ossie, 1995), and, indirectly, the discontinuation since August 1993 of the purchases by the two central banks of their banknotes held by economic agents outside the respective regions.

[9]These rules were defined in two cooperation agreements signed between France and CAMA members on March 13, 1973 and WAMU members on December 4, 1973.

of the zone.[10] However, in the absence of nominal exchange rate flexibility, and in the context of a sizable firming of the French franc against the U.S. dollar following the Plaza Accord among the G-5 countries, the CFA franc appreciated markedly in nominal effective terms. The internal adjustment efforts pursued by most CFA franc countries gave rise to only a modest depreciation of the real effective exchange rate of the CFA franc countries as a group, that was not sufficient to offset the impact of the terms of trade loss, thereby giving rise to competitiveness problems (Figure 1, and Tables 1 and 2).

The operating rules, and in particular the statutory limit on government borrowing from the central banks, did not prove adequate to instill fiscal discipline.[11] Against the background of narrowing government revenue bases, these statutory ceilings were exceeded significantly by several CFA franc countries, particularly during the early 1990s. Moreover, the fiscal imbalances and the external public debt of the CFA franc countries increased substantially in relation to their GDP during 1986-93. The large fiscal imbalances also contributed to the emergence of sizable domestic and external payments arrears, as well as to a major weakening of the soundness and financial position of the banking systems in the CFA franc zone. In addition, the two regional central banks sustained large declines in their net foreign assets, necessitating a rundown of their deposits in the operations accounts with the French Treasury and a limited use of their overdraft facilities.[12]

Against this background, the CFA franc countries decided to devalue their currency by 50 percent in January 1994, and to implement broadly restrictive incomes and credit policies and a range of structural and institutional reforms. This policy package, with the devaluation as the critical element, has contributed to a resumption of growth in real per capita incomes in

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[10]Khan and Ostry (1991) show that the adjustment in the equilibrium real exchange rate to a change in the terms of trade could be quite large. Specifically, if the substitution possibilities between nontradables and importables in domestic consumption are limited and the compensated price elasticity of import demand is correspondingly low, for every percentage point deterioration in the terms of trade, a depreciation of the real exchange rate of as much as 0.8 percent may be required to maintain macroeconomic equilibrium.

[11]Recognizing the inherent weaknesses of the operating rules, the French government announced formally, at the Abidjan Summit on September 21, 1993, its intention to subject any future disbursement of financial assistance to CFA countries to the existence of Fund-supported programs that remained on track.

[12]The BCEAO's operations account was in deficit from 1980 to 1984 and again in 1988-89, with a maximum debit equivalent to 0.13 percent of the GDP of France in 1983. Drawings on the operations account were generally much smaller and less frequent in the case of the BEAC countries and were concentrated in 1993 and the first four months of 1994. However, thanks to the pooling of reserves, the CFA franc countries' total balances in the operations accounts remained most of the time in surplus, except for negligible amounts in 1983, 1987, and 1988.

the CFA franc zone at a rate of 0.8 percent a year during 1994-96, after annual declines of 2.6 percent during 1986-93; also, after a sharp initial increase following the devaluation, the zone's inflation rate was brought down to single-digit levels by end 1996.[13] Fiscal imbalances have been reduced, with the primary balance shifting to a modest surplus after sizable deficits during 1986-93. The overall balance of payments deficits have also been contained, while the external public debt burden has been eased significantly for most CFA franc countries through concessional debt relief. By May 1997, about half of the gains in external competitiveness—as measured by changes in the consumer price-based real effective exchange rates—brought about by the devaluation are estimated to have been preserved; the real effective exchange rate for the CFA franc countries as a group depreciated by 26 percent between December 1993 and May 1997, while the terms of trade improved modestly. However, competitiveness gains are believed to have been substantially larger in terms of relative unit labor costs, as evidenced by the very small increases, or even declines in some countries, in nominal civil service wage rates.

As an integral part of the adjustment efforts undertaken by the CFA franc countries, the two regional central banks have shifted away from direct instruments of monetary control toward indirect market-based instruments, and they have established interbank money markets and new central bank financial instruments issued through auctions. The CFA franc countries have also intensified their efforts to restore the financial health of their banking systems through the restructuring, privatization, and liquidation of insolvent and/or illiquid commercial banks. The reform efforts of most CFA franc countries have been supported by financial and technical assistance from the IMF, as well as from other multilateral and bilateral donors, including debt relief from the Paris Club and other creditors. Within the CFA franc zone, progress has been more notable in the WAMU area, whereas in several countries of the BEAC area the adoption and effective implementation of comprehensive adjustment programs has been somewhat slow (except for the implementation of a far-reaching trade liberalization), and has been complicated in the case of two countries by internal armed conflict (the Central African Republic and the Republic of Congo).

Notwithstanding the considerable progress achieved since 1994, the CFA franc zone remains confronted with sizable domestic and external imbalances, bears a heavy external debt burden, and continues to be subject to structural rigidities and vulnerable to exogenous shocks. Additional reform efforts are required by all individual CFA franc countries so as to help

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[13]A detailed assessment of the economic performance of the CFA franc zone is beyond the scope of this paper. For a comprehensive assessment of the recent economic performance of the CFA franc countries relative to other sub-Saharan African countries, see Hadjimichael and others (1995), Hadjimichael and Ghura (1995), and Ghura and Hadjimichael (1996). For a review of the aftermath of the CFA franc devaluation, see Goreux (1995), and Clément and others (1996). Honohan (1996) provides a comprehensive critical assessment of the adequacy of the operating rules in maintaining financial discipline in the CFA franc zone. Parmentier and Tenconi (1996) assess the performance of the banking systems in the CFA franc zone.

achieve a sustainable expansion of output as well as to promote regional integration and preserve the exchange rate arrangement. In this context, it is generally recognized that the CFA franc zone does not meet the conventional criteria for the formation of optimum currency areas, even after some 50 years of existence. According to the literature on optimum currency areas, the benefits usually associated with participation in a monetary area—in terms of lower transaction costs, reduced uncertainty about exchange rate variability and relative price changes, and enhancement of confidence in the direction of policies—would exceed the costs associated with the loss of monetary independence and nominal exchange rate flexibility. Furthermore, the benefits from participating in a currency area are most likely to be higher the more similarly member countries are affected by exogenous shocks, the greater the degree of factor mobility among these countries, the greater the flexibility in their wage and price structures, the greater the similarity in their inflation preferences, the higher the share of intra-group trade, and the greater the diversification of their production and export bases.[14] The CFA franc countries do not meet most of these structural features.[15]

With a population of some 90 million and a per capita income of about US$690 in 1996, the zone is dominated by Cameroon and Côte d'Ivoire, which account for 48 percent and 40 percent of their regional output, respectively. The per capita income of the richest country, Gabon, at US$3,390 in 1996, was 27 times larger than that of the poorest country, Chad (Table 3). The CFA franc zone remains a fairly heterogenous entity, composed of countries fairly open to international trade but with very limited intra-regional trade, and highly dependent on the production and export of a limited number of primary commodities, with a narrow industrial base, making them highly vulnerable to external shocks (Table 4). For example, during the period 1989-92, crude oil accounted for 50 percent of the exports of Cameroon and almost 80 percent of the exports of the Congo and Gabon (and, more recently, of Equatorial Guinea); uranium accounted for 50 percent of the exports of Niger; phosphate constituted 25 percent of the exports of Togo; and cocoa accounted for 33 percent of the

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[14]For the seminal contributions to this literature, see Mundell (1961), McKinnon (1963), and Kenen (1969). Ishiyama (1975), and Tower and Willett (1976) provide surveys of the early literature, while Masson and Taylor (1993) and Tavlas (1994) survey the more recent literature. For a more recent theoretical treatment see Bayoumi (1994) and Ricci (1997).

[15]A detailed assessment of the relative observance of the criteria for an optimum currency area by the CFA franc zone is beyond the scope of this paper. For a detailed review, see Boughton (1991) and Bayoumi and Ostry (1995). Boughton (1991) nuanced his conclusions by arguing that "*it was essential to view the zone as part of a broad currency area that includes France and that the role of France in supporting the system is also germane to the discussion*" (page 6). Hoffmaister, Roldós, and Wickham (1997) argue that, given their exchange rate arrangement, the variability of the output of CFA franc countries has been heightened by the very limited flexibility of their real exchange rates; see also Savvides (1996). Figure 1 indicates that the deviations of real GDP from its long-term trend during 1980-94 were substantially larger than those for the other sub-Saharan African countries.

exports of Côte d'Ivoire and 17 percent of the exports of Equatorial Guinea. Intra-regional trade has traditionally remained modest, because of the limited size of domestic markets, the existing poor regional transportation and communication facilities, and the high protection of domestic producers (Boughton (1991), Michaïlov (1995), and Honohan (1996)).[16] Estimates by Bayoumi and Ostry (1995) indicate that during the period 1970-93, intra-regional trade amounted to about 11 percent of the total external trade of the WAMU countries, 6 percent of the BEAC countries, and 9 percent of all CFA franc countries (Table 5). By comparison, intra-regional trade in the European Union exceeds 60 percent of EU total international trade (European Monetary Institute, 1997).

In contrast, trade and general economic links between France and the CFA franc zone have been substantially more important, even though from the point of view of France economic relations with the CFA franc zone have not been as significant. During 1981-95, annual exports to France by CFA franc countries represented on average about 21 percent of their total exports, but accounted for only 1.2 percent of the total imports of France (Table 6). Over the same period, annual imports by CFA franc countries from France represented 35 percent of their total imports, but accounted for only 1.8 percent of the exports of France. Similarly, the GDP and the stock of broad money of the CFA franc zone were on average equivalent to 4.5 percent and 1.5 percent of the same aggregates of France. Direct investment by the French corporate sector in CFA franc countries represented less than 1 percent of France's total gross foreign direct investment during 1989-95. Finally, although the CFA franc countries as a group are by far the largest recipient of official development assistance from France, amounting on average to about 3 percent of their combined GDP and 35 percent of the total ODA of France during 1983-95, this financial support was equivalent to 0.13 percent of the GDP of France.

It should be noted, however, that the trade relations of the CFA franc countries with EU countries other than France are also fairly significant, raising the export and import shares of EU countries to more than half of the CFA franc countries' trade. During 1990-96, EU countries absorbed 50 percent of the exports from, and provided 53 percent of the imports by, the CFA franc countries, of which 18 percent and 31 percent, respectively, were accounted for by France alone (Table 7).

C. Regional Integration

The degree of economic and financial integration and of regional cooperation among the member countries of the CFA franc zone had remained fairly limited until 1994. This process had been hampered by a host of administrative restrictions, tax distortions, and protectionist trade policies that stifled competition in the markets for goods and labor and in the financial sector, and precluded the development of intra-regional trade and of a single market. Political

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[16] It is generally believed that a sizable part of the intra-regional trade is informal, and thus it is not recorded in official statistics.

considerations and a perceived need to preserve the special economic and political links to France appeared to have dominated the decisions of policymakers in the CFA franc zone, at the cost of regional economic considerations. These factors help in part explain the protracted process of reaching a consensus on the need for a devaluation of the CFA franc. In the event, the devaluation reinforced the efforts to rationalize economic decisions within the zone and to give more prominence to economic considerations over political ones.

The devaluation of the CFA franc has also given an impetus to the efforts to enhance regional economic and monetary integration. The treaty creating the West African Economic and Monetary Union (WAEMU) was signed by the Heads of State of the WAMU members in January 1994 and became effective in August 1994. The institutions and the legal, administrative, and financial framework required to ensure the functioning of the WAEMU were established by August 1995. However, in the Central African region, progress toward establishing a full-fledged economic and monetary union has been slower. The treaty creating the Central African Economic and Monetary Community (CAEMC), comprising two conventions on the Central African Monetary Union (containing the revised statutes of the regional central bank) and the Central African Economic Union, was signed by all Heads of State of the CAMA countries by June 1995. The adoption and ratification of the CAEMC treaty have so far been delayed by difficulties encountered in agreeing on the revised statutes of the BEAC, which have been signed by all BEAC countries except Chad; Chad is expected to sign the statutes in the next few months. The CAEMC will replace the CAMA.[17]

In both subregions, the objectives of the treaties are the establishment of a common market based on a customs union and the harmonization of indirect tax legislation, and the coordination of economic policies between member countries through, inter alia, regional surveillance procedures.[18] To this end, far-reaching reforms of import tariffs and indirect tax rates were implemented in the BEAC area under the aegis of the regional customs union in 1994-95. These reforms entailed the reduction of import tariffs to a range of 5-30 percent, the abolition of import quotas and their replacement with temporary import surcharges of 30 percent, the establishment of a preferential internal import tariff which is to be abolished by January 1998, the harmonization of turnover tax rates, and the ongoing replacement of turnover taxes with value-added taxes. Similar reforms under preparation in the WAEMU area are expected to be implemented by January 1998; the envisaged measures would include a reduction of import tariffs to a range of 5-20 percent and the introduction of a low common external tariff for intra-group trade by WAEMU countries. A regional stock exchange was established in early 1997 in the WAEMU area and is expected to become operational by the end of the year, while

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[17]For a detailed review of the progress of economic integration within the two unions of the CFA franc zone until September 1995, see Annex II in Clément and others (1996).

[18]It is interesting to note that the CFA franc zone is a monetary union that is aspiring to establish a common market, while the European Union is a common market that is on the verge of establishing a monetary union.

a similar regional capital market is under study in the CAEMC area. The surveillance procedures, inspired mainly by the convergence criteria of the Maastricht Treaty, establish nonbinding fiscal rules that focus mainly on primary balances, civil service wage bills, and domestic and external government arrears. However, adherence to these rules and the general observance of the surveillance procedures has so far been partial.

In parallel with the reinforced efforts to enhance regional economic and monetary integration, a number of zone-wide initiatives have been pursued since 1994, aimed at harmonizing on a regional basis the legal and institutional framework in critical areas. In this context, independent banking commissions have been created in the two subregions to monitor and enforce the observance of prudential regulations by financial institutions. Similar supervisory agencies have also been created for insurance companies and social security institutions. At the same time, a regional project was launched in 1995, with donor assistance, for the harmonization of the regional framework for business law and the establishment of a regional court of justice; this framework is expected to become operational in 1998.

III. The CFA Franc Zone and the EMU

The European Council confirmed in December 1995 that the third and final stage for the creation of the European Economic and Monetary Union (EMU) is slated to begin on January 1, 1999, the latest possible date envisaged in the Maastricht Treaty (Article 109j(4)).[19] Stage 3 will entail the introduction of the single currency, the euro, and the implementation of a single monetary policy under the control of the European Central Bank (ECB) that will replace the European Monetary Institute set up at the outset of Stage 2.[20] The European Union countries that will participate in the EMU from its inception will be decided by the Heads of State of the EU in May 1998, based on the observance in 1997 of the convergence

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[19]The Maastricht Treaty, which amends the previous treaties establishing the European Economic Community and other European institutions, was adopted by the governments of its 12 members (Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, and the United Kingdom) on December 10, 1991 and signed by their Ministers of Foreign Affairs on February 7, 1992. Following ratification by national parliaments, the Treaty came into force on November 1, 1993, with two members (Denmark and the United Kingdom) retaining an opt-out clause allowing them not to participate in the final stage (Stage 3) of monetary integration, if they so choose. On January 1, 1995, membership to the European Union increased to 15 members with the entry of Austria, Finland, and Sweden, which accepted the obligations of the Maastricht Treaty.

[20]The ECB will be formally established during Stage 2, after the decision on the initial member countries of the EMU is made.

criteria established by the Maastricht Treaty.[21] These criteria include reference values on the budget deficit (3 percent of GDP or lower), the public debt (60 percent of GDP or lower), inflation, long-term interest rates, and exchange rate stability under the Exchange Rate Mechanism (ERM) of the European Monetary System. The remaining EU countries could enter the EMU once it is judged by the European Council, meeting in the composition of Heads of State or government, that they have observed the convergence criteria (Article 109k(2)). In the meantime, the exchange rates of these countries could be linked to the euro under a new exchange rate mechanism (ERM2), broadly similar to the present mechanism (ERM1); however, foreign exchange market intervention by the ECB to defend agreed central rates under this mechanism would remain subject to its primary task of maintaining price stability in the euro area.

Which countries would initially participate in the EMU is not entirely clear at this stage. Impressive progress has been made in lowering inflation rates and reducing long-term interest rate differentials, as well as in maintaining exchange rate stability among most EU countries' currencies.[22] However, progress in reducing fiscal deficits, while substantial since 1993, was projected in early 1997 to fall somewhat short of the 3 percent reference value in 1997 for a number of major EU countries. In response, a range of additional fiscal adjustment measures were announced in mid-year by several EU countries. These measures, combined with a stronger-than-initially-expected expansion in output, have improved the prospects for fiscal adjustment. The latest WEO projections suggest that the budget deficits of the major EU countries in 1997 would be only slightly above the reference value, while the authorities of these countries have declared their intention to strictly satisfy the reference value. On balance, it is expected that the euro will be introduced on schedule in January 1999 and that France will be among the initial members of the EMU.

A. EMU Framework for Exchange Rate Arrangements with Non-EU Community Countries and the CFA Franc Zone

Once France enters the EMU, the French franc will be replaced by the euro and the CFA franc parity will need to be fixed in terms of the euro.[23] Whether this arithmetic adjustment of the CFA franc parity and the linking to the euro would constitute an exchange rate arrangement between the EMU members and the CFA franc countries—thus requiring the endorsement and support by EMU institutions (the Council of Ministers and the European Central

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[21]The convergence criteria are specified in Articles 104c and 109j of the Maastricht Treaty and clarified in two Protocols of the Treaty (European Commission, 1990-95).

[22]For an overview of recent progress toward the establishment of the EMU, see IMF *World Economic Outlook*, October 1997.

[23]The French franc will initially co-exist as a sub-unit of the euro during a 3-year transition period.

Bank)—hinges critically on the interpretation of the present arrangement under which France provides an unlimited guarantee for the convertibility of CFA francs into its own currency (that is, euros under the EMU). This key feature of the CFA franc zone arrangements constitutes a contingent liability of the French Treasury in case of a rundown of the outstanding balances in the operations accounts of the two regional central banks. If left unchecked, such a reduction in the foreign assets of the CFA franc zone and a possible use of the overdraft facilities with the French Treasury could, theoretically, if not offset by corrective fiscal measures by France, raise the financing need of the French Treasury, putting upward pressures on EMU interest rates. In the absence of the guaranteed convertibility, the pegging of the CFA franc to the euro would be entirely an issue for the CFA franc countries to consider, without any involvement by EMU countries.

The CFA franc countries and France have already indicated on a number of occasions their intention to preserve the existing CFA franc zone arrangements, including the guaranteed convertibility of the CFA franc by the French Treasury. This feature has traditionally been considered by the CFA franc countries as crucial for maintaining confidence in, and preserving the stability of, their currency. It is also considered as the justification for the participation of France in the decision-making process of the regional central banks, and for the preservation of the close political and economic links between the CFA franc countries and France. The authorities of the CFA franc countries recognize that in the absence of French involvement, it would be very difficult to maintain cohesion and cooperation within the zone. For its part, through this guarantee, France exercises influence in the CFA franc zone. For these reasons, it is unlikely that the guaranteed convertibility of the CFA franc will be modified in the foreseeable future, even though some commentators have argued (for example, Honohan, 1996) that this feature had contributed prior to 1994 to the observed weak fiscal discipline of several CFA franc countries.

Formally, the issue of the envisaged linking of the CFA franc to the euro has not been considered by any European institutions, and thus there is no official position on whether such a link would require the involvement of EMU countries, other than France. In that respect, the provisions of the Maastricht Treaty on the framework for establishing or modifying exchange rate arrangements with non-EU countries leave some room for interpretation. Under Article 109(1) of the Maastricht Treaty (reproduced in the Appendix), the Council of Ministers is empowered to conclude exchange rate arrangements for the euro in relation to non- EU currencies, and to adopt, adjust, or abandon the central rates of the euro in any such arrangements. In the absence of an exchange rate system in relation to one or more non-EU currencies, the Council of Ministers may formulate general orientations for exchange rate policy in relation to those currencies; these orientations should be consistent with the ECB's primary objective to maintain price stability (Article 109(2)). Article 109(3) stipulates that where agreements concerning monetary or foreign exchange regime matters need to be negotiated by the EMU countries with one or more States or international organizations, the Council of Ministers shall decide the arrangements for the negotiation and for the conclusion of such agreements. However, the power conferred to the Council of Ministers by these provisions does not preclude independent actions by member states in these matters.

Article 109(5) expressly allows EMU member states to negotiate in international bodies and conclude international agreements, provided these agreements are "*without prejudice to Community competence and Community agreements as regards economic and monetary union*" (see Appendix).

In the light of Articles 109(1), 109(2), and 109(3), the free convertibility of the CFA franc into euros guaranteed by France could be interpreted as an exchange rate arrangement that affects all EMU countries, and thus subject to the approval of the Council of Ministers as a matter of principle, irrespective of its practically negligible quantitative impact on the monetary policy of the EMU. This view could be supported by the fact that the arrangements between France and the CFA franc zone have not been explicitly considered under the Maastricht Treaty and excluded from the purview of the Council and the ECB, as was the case of the relations of France with its overseas territories and the parity of the CFP franc (*le franc des Colonies Françaises de Pacifique*) (see the *Declaration on France*, included in the Maastricht Treaty, and reproduced in the Appendix). Similar transitional arrangements have been included in the *Declaration on Monetary Relations with the Republic of San Marino, the Vatican City, and the Principality of Monaco* (reproduced in the Appendix).[24]

In contrast, it can be argued that the free convertibility of the CFA franc guaranteed by France is a budgetary arrangement between the French Treasury and the two regional central banks of the CFA franc zone, which does not require approval from the Council of Ministers. The arrangements between France and the CFA franc zone could be interpreted as specific agreements designed to facilitate a more effective use of the financial and technical assistance provided by France to these countries. Agreements of this nature seem to be authorized by Article 109(5) of the Maastricht Treaty. The guaranteed convertibility is not an arrangement of a monetary nature; it does not involve the French central bank and will not involve the ECB

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[24]There are two ways of interpreting the absence of protocol on the CFA franc in the Maastricht Treaty. On the one hand, the absence of such a protocol may suggest that the CFA franc arrangement does not fall under the Council's purview. Alternatively, it could be argued that the other protocols, notably the one for the CFP franc, were needed to keep matters out of the Council's purview, but not such need was felt for the CFA franc arrangement. Unfortunately, there is no known official interpretation of the understandings underlying these protocols. Nonetheless, on the occasion of a meeting of the Finance Ministers of the French franc zone in mid-October 1997, the Minister of Finance of France declared that France will continue to manage the CFA franc zone without any interference from its European partners once the euro is introduced. He indicated that, whatever legal situation emerges after the start of the euro, the French Treasury will have sole responsibility from the point of view of EMU countries in dealing with the CFA franc zone.

either.[25] Changes in the outstanding balances in the operations accounts of the BCEAO and the BEAC with the French Treasury have only fiscal implications for France. It has always been up to France to decide whether to offset the impact of such changes in its treasury position through corrective fiscal measures or to accommodate it, with an associated impact on the borrowing requirement of France and the market yields on French treasury bills, however marginal in practice. A rundown of the outstanding balances in the operations accounts will only crowd out private sector credit in the EMU through a potentially upward adjustment in market interest rates. In practice, given past experience, such an impact will be fairly marginal, if not zero.[26] Moreover, it will be transitory as any significant support provided by the French Treasury through the operations accounts will have to be offset by corrective measures to maintain fiscal discipline in line with the provisions of the *Growth and Stability Pact* adopted by the EU countries in the Amsterdam Summit of early June 1997—this pact requires the correction of budget deficits in excess of 3 percent of GDP for EMU countries, unless brought about by exceptional circumstances.

In addition, the arrangement between France and the CFA franc zone appears to be consistent with the intention of the EMU to develop monetary cooperation with non-EU countries, consistent with the Maastricht Treaty's *Declaration on Monetary Cooperation with Non-Community Countries*. This declaration affirms that EMU countries shall aim to contribute to stable international monetary relations, and are prepared to cooperate with other non-European countries with which they have close economic ties (see Appendix). More concrete support for these initiatives by EU countries is provided in the latest *Green Paper* of the European Commission on the relations between the EU and the African, Caribbean, and Pacific (ACP) Countries (European Commission, 1997). The *Green Paper* stresses that a stable monetary and financial environment in ACP countries constitutes a prerequisite for an effective implementation of cooperation and aid policy. Accordingly, the European Union intends to develop or strengthen monetary cooperation with the ACP countries—or other interested developing countries—maintaining important trade and financial relations with its membership. In addition, the paper suggests that the credibility and effectiveness of monetary policies in ACP countries would be enhanced if they were to peg their currencies to a stable currency like the euro, while preserving their competitiveness. This would also contribute to stabilizing bilateral exchange rates among the developing countries willing to join this

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[25]Under Article 21.1 of the Maastricht Treaty's Protocol on the statute of the ECB, national governments of EMU members or other public entities are prohibited from having access to any direct financing from the ECB or the national central banks.

[26]The largest one-year swing in the combined operations accounts of the two central banks, prior to the CFA franc devaluation, occurred in 1990 and amounted to F 3 billion (0.1 percent of the broad money of France). However, in the aftermath of the devaluation, the outstanding balance in the operations accounts increased by F 10.5 billion (0.3 percent of the broad money of France) during 1994.

exchange rate stabilization scheme and help promote intra-regional trade among participating countries, as well as the implementation of regional integration projects.

B. Operating Modalities Under a CFA Franc/Euro Peg

The shift of the peg of the CFA franc from the French franc need not require any modifications in the operating principles and rules for the two regional central banks, given the likely continuation of the guarantee by the French Treasury of the free convertibility of the CFA franc into euros. Obviously, the two central banks would need to monitor more closely economic developments, and in particular interest rate and exchange rate developments, in the EMU and not just in France. The existing administrative impediments to free capital mobility to all countries (and not only France) will need to be formally lifted so as to facilitate a smooth functioning of the exchange rate system of the CFA franc zone and allow the zone to fully benefit from globalization. Such a liberalization of capital movements would also be necessary to help eliminate the existing large excess reserves of commercial banks in the CFA franc zone, thus helping to reduce the fiscal costs of monetary management (in the case of WAEMU) and enhancing private sector confidence in the CFA franc.

IV. Potential Economic Impact of the Linking of the CFA Franc to the Euro

The introduction of a single currency, managed by an independent and conservative central bank, and the establishment of the EMU could have significant positive effects for the world economy in general in terms of exchange rate stability, low inflation and nominal interest rates, higher output growth, and access to the international capital market. Over the longer term, the sustained progress toward economic convergence among EU countries in terms of macroeconomic performance is likely to encourage stepped-up efforts to reduce labor market rigidities and an alleviation of the structural unemployment problem. This would contribute to a stable euro and a stronger-than-otherwise expansion of output in the EMU, which as an economic entity would be larger in size than the United States. The potential development of an integrated, liquid, and efficient European financial market in euros could facilitate easier access to international bond financing by governments and the corporate sector of non-EU countries.

Developments in the EMU could affect the CFA franc zone through three main channels: output effects, price effects, and improved access to world capital markets. Over the longer term, the CFA franc zone is likely to derive clear positive gains from a linking of the CFA franc to the euro through all three channels, even though the quantification of these benefits is obviously difficult. As already noted, EU countries account for about half of the external trade of the CFA franc countries. Thus, a potential strengthening of output growth is bound to stimulate the demand for exports by the CFA franc countries. The benefits for the

CFA franc zone would be reinforced by the prospective entry into the EU and the EMU of several central and eastern European and Mediterranean countries.[27]

As regards price effects, the linking of the CFA franc to the euro will add to the benefits derived from exchange rate stability by CFA franc countries, without necessarily adding to the costs of the lack of nominal exchange rate flexibility;[28] the size, nature, and frequency of exogenous shocks likely to affect France would be broadly similar to those that would impinge on other EMU countries. Moving the fixed peg from the French franc to the euro would contribute to the stabilization of the nominal effective exchange rate of CFA franc countries, stimulate bilateral trade with EMU countries, and encourage higher inflows of EU foreign direct investment in the CFA franc zone.[29] The benefits from exchange rate stability for the CFA franc countries would be stronger the higher the stability of the euro vis-à-vis the U.S. dollar and to the extent that the euro replaces the dollar as the currency of denomination of world commodity prices.[30] At present, the exports and government revenue of all CFA franc countries are highly dependent on a range of primary commodities, whose world prices are expressed in U.S. dollars; these prices have tended not to adjust quickly to changes

[27]At present, 10 central and eastern European transition economies have negotiated association agreements with the EU—Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic, and Slovenia—as a first major stage toward EU memberships, while three Mediterranean countries have already applied for membership (Cyprus, Malta, and Turkey). In July 1997, the European Commission announced that negotiations will begin in 1998 with Cyprus and recommended (in *Agenda 2000)* that accession discussions be initiated in 1998 with five transition countries (the Czech Republic, Estonia, Hungary, Poland, and Slovenia).

[28]However, the additional benefits from price stability might not be substantial, given the fact that the French franc has already been fairly stable vis-à-vis other EU currencies.

[29]The variability of the effective exchange rate of CFA franc countries is significantly biased downward as the weights are based on trade rather than currency composition. Retaining the latter would give more importance to the U.S. dollar, which is the main currency of denomination on the export side, and translate into a higher exchange rate variability.

[30]Bergsten (1997) suggests that the establishment of target exchange rate zones among the G-3 (the United States, Japan, and the EMU) might not be desirable in the short term because of prevailing uncertainties, and might not be feasible over the longer term because of the absence of a central agency in the EMU for fiscal policy and exchange rate issues, similar to the ECB for monetary policy issues. A potential substitution of the euro for the U.S. dollar in the denomination of world commodity prices would also be a very gradual process, especially if account is taken of the fact that the demand for primary commodities by the United States and other non-EMU countries significantly exceeds that by EMU countries.

in the value of the dollar against other major currencies, resulting in fluctuations in government revenues and exports in CFA franc terms.[31]

The positive price effects would be reinforced and supported by the potential improved access by the CFA franc countries to the EU money market and the prospect of liberalized capital movements between the CFA franc zone and the EMU—freedom of capital movements currently exists between the zone and France, which could, de facto if not de jure, be expected to be broadened to all EMU countries. This openness, combined with the ongoing trade liberalization in the CFA franc zone, would help allow the CFA franc countries to reap the full benefits from globalization, and as a minimum avoid the risk of marginalization. Obviously, these benefits would materialize over time and only to the extent that CFA franc countries establish and maintain sound macroeconomic policies and pursue appropriate structural policies.

The main risks to the CFA franc zone from the linkage with the euro would be a potential appreciation of the real effective exchange rate of CFA franc countries and a heightened volatility of the euro in terms of other major currencies, both in the transition and early years of Stage 3, as well as over the long run. CFA franc countries will continue to be subject to the risk of asymmetric exogenous shocks relative to the EMU countries, as well as among themselves, but this asymmetry would not be higher than is currently the case between the CFA franc zone and France. In the short term, the principal risk is that complications in the EMU process might have adverse implications for economic activity and the financial markets in EU countries. CFA franc countries would obviously be adversely affected by a weakening of activity in their main export markets and an increase in interest rates in France and the EMU in general. Higher interest rates would tend to lower credit demand and investment in CFA franc countries and raise service payments mainly on external private debt (even though about 30 percent of external debt is denominated in U.S. dollars).[32] More important, however, would be the adverse impact on the exchange rate of the CFA franc and the zone's external competitiveness from a potential (a) appreciation of the French franc vis-à-vis the U.S. dollar before the introduction of the euro; (b) unduly strong euro; and (c) higher volatility of the euro against major non-EMU currencies than is currently the case between EU and non-EU currencies.

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[31]A notable example of such developments is the appreciation of the U.S. dollar against the French franc and other major currencies during 1982-85, at a time when the world oil price declined markedly, thus shielding and delaying the impact of the decline in the terms of trade of the CFA franc countries that are oil exporters.

[32]The impact on external public debt service will be minimal, as a large share of the external public debt of all CFA countries, except Gabon, was granted or rescheduled on concessional terms at fixed interest rates.

The rate at which the CFA franc will be pegged to the euro will depend on the conversion rate which will be adopted to link the French franc to the euro.[33] This conversion rate could be expected to be close to the present exchange rate of the French franc against the ecu. Indeed, with the general convergence of short- and long-term interest rates taking place in EU financial markets, the present constellation of bilateral exchange rates among major EU currencies is unlikely to change markedly before January 1999. The present parity of the CFA franc vis-à-vis the French franc does not seem to be out of line with fundamentals, given the improved economic performance of CFA franc countries since the devaluation. It should also be noted that the ongoing structural reforms in several CFA franc countries would, if implemented effectively, further strengthen the supply response of these economies. At any rate, the authorities of the CFA franc countries have already announced their intention to maintain the parity of the CFA franc vis-à-vis the French franc in shifting the peg to the euro, thus precluding any new devaluation of their currency.

Concerns have been raised by a number of commentators that the euro could be a strong currency, with obvious adverse consequences for the external competitiveness of the CFA franc countries. Alogoskoufis and Portes (1997) and Bergsten (1997) argue that the introduction of the euro will induce an immediate reallocation of existing asset portfolios toward euro-denominated assets, resulting, in an initial strong appreciation of the euro (overshooting). This appreciation of the euro would cause the EMU countries to run external current account deficits, thereby increasing over time the supply of euro assets and permitting a subsequent partial reversal of this appreciation of the euro. Alogoskoufis and Portes also argue that the attractiveness of the euro as a reserve asset, rivaling the U.S. dollar, and the prospective deepening of the euro capital market, would reinforce the upward pressures on the euro. Masson and Turtelboom (1997) indicate that the creation of the EMU and the replacement of the European currencies with the euro would result in an overhang of U.S. dollar-denominated official reserves of EU countries in relation to their modest external

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[33]Formally, the parities that will be used to lock in the currencies of the countries that will participate in the EMU need not be announced until the beginning of Stage 3 in January 1999; the Maastricht Treaty provides some flexibility in locking individual exchange rates, provided the external value of the ecu (the European currency unit) is not modified and that the euro is set at a rate of one-for-one with the ecu. However, in order to help reduce uncertainty in financial markets, the EU Finance Ministers and Central Bank Governors agreed at an informal meeting on September 13, 1997 to announce the bilateral exchange rates of the currencies of the countries initially participating in the EMU in May 1998, at the same time the list of these countries will be decided. The conversion rates of these currencies vis-à-vis the euro will be formally determined on January 1, 1999 on the basis of the already chosen bilateral rates and the weights in the ecu basket; these weights could be subject to some slight revisions, mainly to ensure consistency between the resulting exchange rate of the euro and the market rate of the ecu on December 31, 1998.

(non-EU) trade.[34] If this overhang is unloaded on the world market, it would weaken the U.S. dollar and firm up the value of the euro. Finally, it has been argued that the perceived desire by the ECB to quickly establish its credibility in attaining its primary objective of price stability would result in a tighter stance of monetary policy than was the case in EU member countries before monetary integration and therefore with an associated strong euro. Artus (1996) argues that the tighter stance would result, inter alia, from the fact that national central banks, which previously tended to depreciate their currencies in the face of increased unemployment, would not be able to do so after monetary integration. Bénassy-Quéré and others (1997) also argue that heightened volatility of the euro would result mainly from the fact that the ECB would pay less attention to exchange rate developments than the Bundesbank, as such developments would have very little effect on inflation, given the small openness of the EU.

The above views and concerns, however, appear to be somewhat exaggerated, according to other commentators.[35] Portfolio reallocation decisions and a rundown of excess reserve holdings are likely to be slow, given the inertia in such major decisions evidenced in the past. A large reduction in EU reserve holdings would also interfere with the monetary policy objectives of the ECB and would be scaled down substantially or be compensated with sterilization; in the early stages of the EMU, high official reserve holdings might be desirable to enhance credibility and for precautionary purposes. Furthermore, the macroeconomic framework for the conduct of monetary policy by the ECB is likely to be based, given the weaknesses of EMU-wide monetary aggregates or inflation targets (for example, measurement problems, and lack of familiarity and monitoring by the general public), on an eclectic approach and the use of a range of indicators. Prominent among these indicators would be the exchange rate of the euro. The ECB could resort to unsterilized intervention in an attempt to contain an undue appreciation of the euro or dampen its excessive volatility, but the effectiveness of such a policy will be limited by the potentially very large size of international capital flows in relation to official reserve holdings. Moreover, it could be argued that the lingering uncertainties about the strict observance of the convergence criteria by potential EMU countries, which had already contributed to a temporary weakening of EU currencies during the period June-August 1997, might affect the credibility of policies and keep the euro under pressure. Overall, the external value of the euro is likely to be influenced by the credibility of the ECB; the policy mix in the EMU; the observance of the convergence criteria by the initial

[34]In 1995, total exports of EU countries amounted to the equivalent of 23 percent of the EU GDP, of which some 60 percent represented intra-EU trade and only some 40 percent or 9 percent of the EU GDP was exported outside the EU (European Monetary Institute, 1997). In this respect, the openness of the EU is similar to that of the United States and Japan.

[35]Including several participants at the conference on the EMU and the international monetary system, held in March 17-18, 1997 at the IMF. See also Masson and Turtelboom (1997).

member countries of the EMU; and the progress in reducing labor market rigidities and other structural impediments to growth.

V. Concluding Remarks

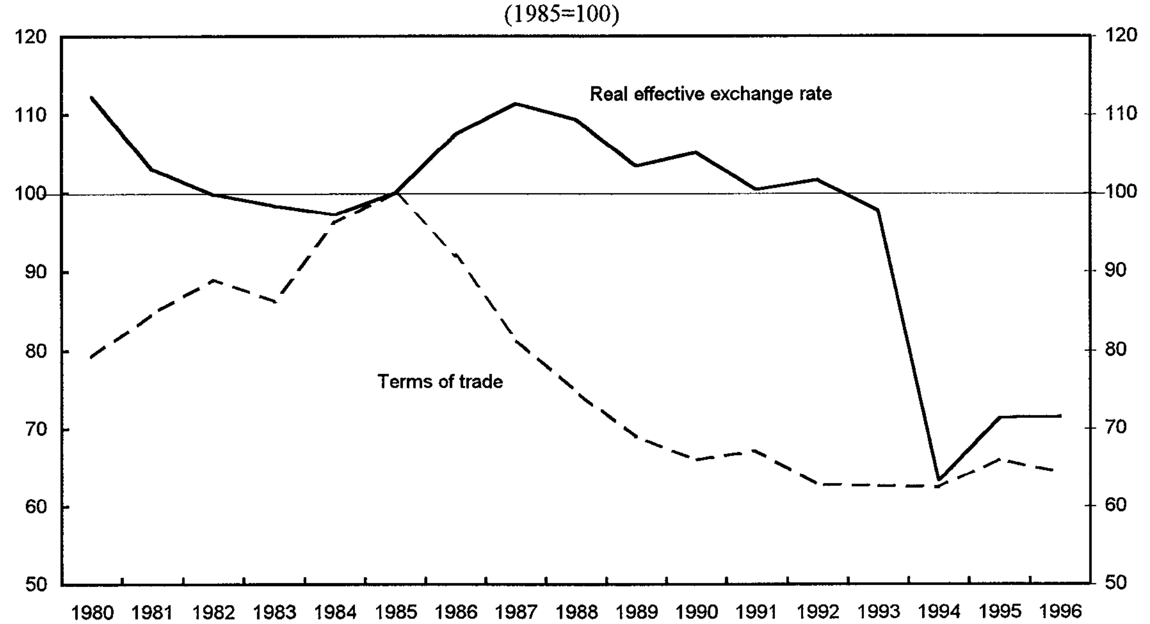
The prospective shift in the link of the CFA franc from the French franc to the euro will constitute a significant political and psychological change for the economic operators in the CFA franc zone, but will leave the CFA franc arrangements and operating features of the zone essentially unchanged. The CFA franc countries have made significant progress since the devaluation of January 1994 in establishing macroeconomic stability and alleviating the impediments to growth. However, the reform process is ongoing, and much more remains to be done, particularly on the structural side. The linking of the CFA franc to the euro would not fundamentally change the external environment or the policy priorities of the CFA franc countries. It will, nonetheless, offer some prospective advantages, pose some likely risks, and possibly strengthen the incentives of persevering with, if not accelerating, the effective implementation of appropriate adjustment policies.

The potential economic consequences on the CFA franc countries could be positive over the longer term, given the general expectation that the creation of the EMU would likely result in low inflation and interest rates, and stronger-than-otherwise output growth in EMU countries. The main risk would be a potential appreciation of the real effective exchange rate of CFA franc counties, both in the transition and early years of Stage 3, as well as over the long run. Potential complications in the EMU process might affect adversely economic activity and financial markets in EU countries, while an unduly strong and volatile euro might weaken the external competitiveness of CFA franc countries.

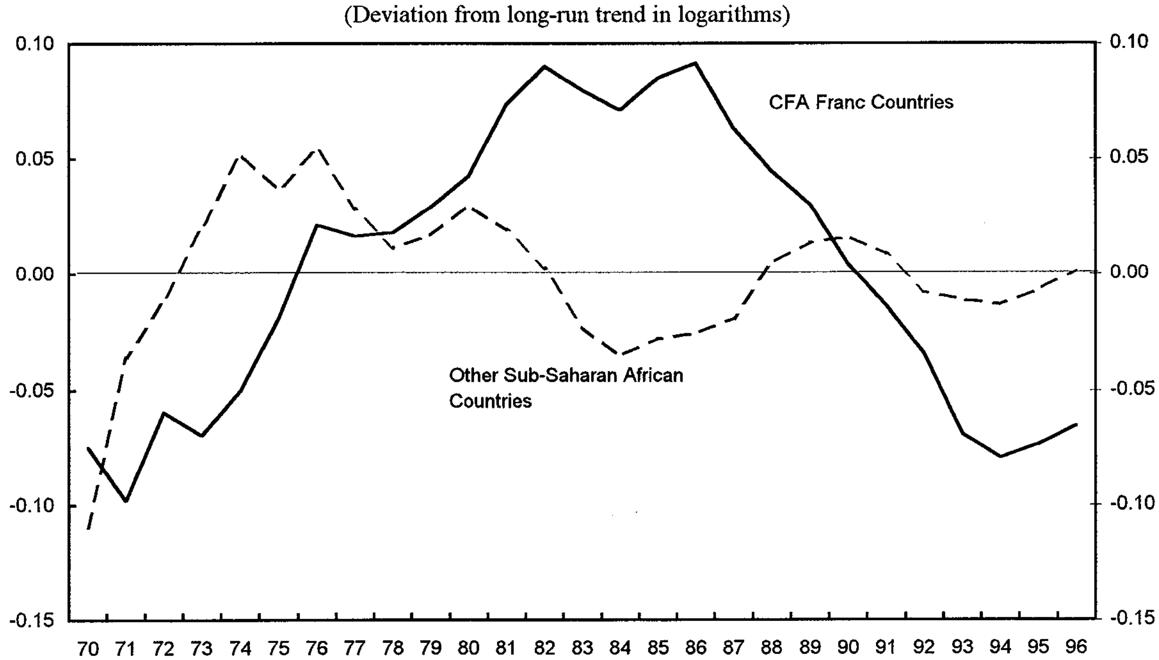
Fundamentally, however, the CFA franc zone would remain substantially more vulnerable to exogenous shocks than the EMU countries, given the zone's high dependence on the production and export of a limited number of primary commodities, and the modest intra-zone trade. One cannot exclude, in particular, that output in CFA countries might experience higher cyclical fluctuations than in the past due to the potential heightened volatility of the exchange rate of the euro against the U.S. dollar. If anything, the linking of the CFA franc to the euro offers CFA franc countries the opportunity to intensify their adjustment efforts, as well as step up their ongoing initiatives to enhance regional economic integration. The potential exposure of CFA franc countries to asymmetric shocks relative to EMU countries and the risk of a firming of the euro reinforce the need for the CFA franc countries to accelerate their structural reforms so as to encourage a diversification of their production and export bases. These reforms are essential for minimizing the potential tensions between the two subregions, as well as the pressures on the competitive position of the CFA franc zone as a whole, thus facilitating the preservation of the existing arrangements.

FIGURE 1
CFA FRANC ZONE
TERMS OF TRADE, REAL EFFECTIVE EXCHANGE RATE, AND OUTPUT VARIABILITY

TERMS OF TRADE AND REAL EFFECTIVE EXCHANGE RATE
(1985=100)



VARIABILITY OF REAL GDP IN SUB-SAHARAN AFRICAN COUNTRIES
(Deviation from long-run trend in logarithms)



Sources: IMF, *Information Notice System*, World Economic Outlook database; and Fund staff estimates.

Table 1. CFA Franc Zone: Selected Economic and Financial Indicators, 1986-96 1/

	Average 1986-93	Average 1994-96	1994	1995	1996
			(Annual percentage changes)		
Real GDP	0.4	3.8	1.8	4.6	5.1
Real GDP per capita	-2.6	0.8	-1.2	1.6	2.1
GDP deflator	-0.3	14.6	29.0	12.0	4.1
Consumer prices	0.9	15.6	26.9	15.1	5.7
Nominal effective exchange rate	6.9	-16.4	-45.3	6.1	0.8
Real effective exchange rate	-1.5	-9.9	-35.2	12.7	0.2
Terms of trade	-5.6	0.9	-0.3	5.6	-2.4
			(In percent of GDP)		
Total consumption	86.7	84.1	85.5	83.7	83.1
Gross investment	15.1	17.1	15.3	16.2	20.0
Gross national savings	8.6	11.5	10.4	11.4	12.6
External current account balance	-6.5	-5.7	-4.9	-4.9	-7.4
Exports of goods	19.8	25.6	25.4	25.9	26.0
Imports of goods	17.3	21.7	20.8	21.2	23.1
Government revenue	19.8	18.6	17.8	18.8	19.3
Government expenditure	26.3	22.1	23.7	21.8	20.9
Overall fiscal balance	-6.5	-3.5	-5.9	-3.1	-1.6
Primary fiscal balance 2/	-5.6	-1.7	-4.5	-0.9	0.2
Public external debt	66.8	115.1	128.9	111.3	105.1
External public debt service	21.1	18.0	20.8	16.3	16.9
			(Annual percentage changes)		
Broad money	-1.9	18.5	36.4	12.2	8.7
Net domestic assets	1.8	4.8	5.9	6.6	2.1
			(In percent of GDP)		
Net foreign assets of the central bank	-4.7	2.0	1.0	1.9	3.0
			(In percent)		
Short-term interest rate	10.2	8.5	9.3	7.7	8.0
Real short-term interest rate	9.6	-9.7	-13.3	-6.2	2.3

Sources: Data provided by the authorities; and Fund staff estimates.

1/ Benin, Burkina Faso, Côte d'Ivoire, Mali, Niger, Senegal, Togo, Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea, and Gabon.

2/ Defined as the overall fiscal balance excluding interest payments on domestic and foreign debt.

Table 2. CFA Franc Zone: Nominal and Real Effective Exchange Rates, 1985-97 1/

(Index December 1993=100)

	Nominal					Real				
	1985 Dec.	1993 Dec.	1997 May	1993/1985 (Cumulative percentage changes)	1997/1993	1985 Dec.	1993 Dec.	1997 May	1993/1985 (Cumulative percentage changes)	1997/1993
Benin	90.5	100.0	51.2	10.5	-48.8	101.1	100.0	78.6	-1.1	-21.4
Burkina Faso	88.5	100.0	54.2	12.9	-45.8	115.0	100.0	65.4	-13.0	-34.6
Côte d'Ivoire	36.3	100.0	56.2	175.1	-43.8	84.3	100.0	69.3	18.7	-30.7
Mali	93.4	100.0	51.5	7.0	-48.5	141.6	100.0	69.2	-29.4	-30.8
Niger	99.6	100.0	50.5	0.4	-49.5	151.5	100.0	74.1	-34.0	-25.9
Senegal	63.5	100.0	54.3	57.5	-45.7	123.6	100.0	68.1	-19.1	-31.9
Togo	62.2	100.0	53.7	60.8	-46.3	115.5	100.0	72.6	-13.4	-27.4
Total WAMU 2/	65.6	100.0	53.9	52.4	-46.1	110.0	100.0	70.5	-9.1	-29.5
Cameroon	51.0	100.0	56.0	96.1	-44.0	105.4	100.0	73.4	-5.1	-26.6
Central African Republic	49.9	100.0	66.8	100.5	-33.2	119.5	100.0	74.4	-16.3	-25.6
Chad	84.8	100.0	55.6	18.0	-44.4	138.8	100.0	76.0	-28.0	-24.0
Congo, Republic of	77.9	100.0	53.9	28.4	-46.1	96.4	100.0	71.9	3.7	-28.1
Equatorial Guinea	66.2	100.0	61.2	51.0	-38.8	142.0	100.0	87.1	-29.6	-12.9
Gabon	59.4	100.0	53.3	68.4	-46.7	122.7	100.0	75.2	-18.5	-24.8
Total CAMA 2/	57.1	100.0	56.3	75.0	-43.7	108.6	100.0	73.7	-7.9	-26.3

Source: IMF, *Information Notice System*.

1/ An increase indicates an appreciation and a decrease a depreciation.

2/ Nominal and real effective exchange rate indices for WAMU and CAMA are calculated on the basis of PPP-based GDP weights.

Table 3. CFA Franc Zone: Nominal GDP per Capita, 1980-96

	Average GDP per Capita (in US$)	Relative GDP per Capita (Total CFA Franc Zone Index=100)												
Year	Total CFA Franc Zone	Cameroon	Centr. Afr. Rep.	Chad	Congo, Rep. of	Equatorial Guinea	Gabon	Benin	Burkina Faso	Côte d'Ivoire	Mali	Niger	Senegal	Togo
1980	1012.7	76.5	34.1	14.6	94.9	11.5	576.0	31.9	26.0	119.0	31.9	44.3	52.9	44.0
1981	896.4	84.2	33.3	12.1	96.4	10.6	506.7	29.6	22.1	96.4	26.0	37.1	43.9	35.3
1982	816.8	78.6	29.6	11.4	120.5	12.3	463.3	28.4	20.0	83.3	22.8	33.3	45.7	30.0
1983	762.6	77.1	26.3	11.1	114.4	13.5	432.8	24.4	17.9	71.5	19.4	28.8	41.3	26.5
1984	740.5	79.3	24.6	12.0	115.8	14.5	406.0	23.0	15.4	69.4	18.5	22.5	37.6	24.1
1985	729.4	80.7	31.7	14.4	111.1	25.7	417.2	25.4	16.6	68.1	17.9	21.5	39.9	24.8
1986	857.9	102.4	40.0	14.5	92.3	31.1	532.7	31.5	21.2	87.6	22.5	27.6	56.6	33.6
1987	890.4	115.3	42.1	15.7	111.2	36.7	393.2	35.7	23.9	92.9	26.7	31.3	67.2	38.3
1988	880.0	113.7	43.4	19.2	104.0	38.0	423.0	35.9	25.8	93.6	26.2	31.0	70.6	41.0
1989	816.8	98.4	41.9	18.1	109.0	32.6	454.0	32.2	25.1	85.6	26.3	28.7	63.6	39.1
1990	916.9	95.6	48.0	21.4	124.3	37.5	625.6	38.4	28.4	91.0	30.8	31.7	76.0	45.5
1991	886.7	103.4	44.1	22.6	117.6	36.1	554.0	38.3	28.1	85.0	29.2	28.8	71.2	43.5
1992	875.4	91.9	44.1	22.1	123.1	42.7	559.5	42.2	29.2	86.9	33.4	28.0	76.7	43.1
1993	827.1	93.1	39.2	16.8	109.5	40.6	527.7	40.2	26.7	77.9	30.4	26.2	68.6	30.9
1994	563.4	59.7	26.7	13.2	70.1	32.9	399.0	28.2	17.1	53.7	20.5	17.9	46.3	22.9
1995	657.1	58.9	32.8	16.8	80.8	45.0	474.5	37.1	20.9	70.0	26.5	20.9	56.4	31.1
1996	687.2	65.1	31.3	18.3	87.9	68.7	492.9	38.4	22.7	71.4	27.4	21.3	57.1	33.4

Sources: IMF, *International Financial Statistics*; and Fund staff calculations.

Table 4. CFA Franc Zone: Composition of Output in 1995

	Primary Sector	(Of which) Crude oil	Secondary Sector	Tertiary Sector
Benin	33.9	...	13.9	52.2
Burkina Faso	37.9	...	18.2	43.9
Cameroon	40.8	6.4	15.8	43.4
Central African Rep.	54.5	...	16.8	28.7
Congo, Republic of	45.3	34.1	11.6	43.0
Côte d'Ivoire	31.5	...	18.4	50.1
Gabon	53.8	42.4	11.0	35.2
Equatorial Guinea	71.7	23.1	8.3	20.0
Mali	46.4	...	14.1	39.5
Niger	36.6	...	15.6	47.8
Senegal	20.3	...	30.5	49.2
Chad	37.1	...	22.1	40.8
Togo	34.8	...	22.7	42.5
Average (Weighted)	36.4	4.8	18.3	45.3

Sources: Banque de France, *Rapport annuel de la Zone Franc 1995*; and Fund staff estimates.

Table 5. CFA Franc Zone: Intra-Zone Trade, 1970-93

(In percent of total external trade)

	Share of Intra-CFA Franc Zone Trade
CFA franc countries	
Benin	5.1
Burkina Faso	22.0
Cameroon	6.1
Central African Republic	3.5
Chad	14.5
Comoros	0.0
Congo, Republic of	1.5
Côte d'Ivoire	7.6
Equatorial Guinea	16.6
Gabon	2.6
Mali	23.3
Niger	6.3
Senegal	9.0
Togo	6.5
Average for CFA franc countries	8.9
West African CFA franc countries	
Benin	4.9
Burkina Faso	21.9
Côte d'Ivoire	6.5
Mali	23.2
Niger	6.2
Senegal	6.0
Togo	5.8
Average for West African CFA franc countries	10.6
Central African CFA franc countries	
Cameroon	4.3
Central African Republic	3.2
Chad	13.3
Congo, Republic of	0.7
Equatorial Guinea	16.2
Gabon	0.8
Average for Central African CFA franc countries	6.4

Sources: IMF, *Direction of Trade Statistics.* Reproduced from Tanin Bayoumi and Jonathan Ostry "Macroeconomic shocks and Trade Flows within Sub-Saharan Africa: Implications for Optimum Currency Arrangements,". IMF Working Paper 95/142

Table 6. CFA Franc Zone: Economic and Financial Relations with France, 1981-95
(In percent)

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	Period Average
GDP ratio (CFA franc zone/France)			5.6	5.8	6.0	5.6	5.0	4.7	4.5	4.3	4.1	4.0	3.9	2.5	2.8	4.5
Money supply ratio (CFA franc zone/France)	1.7	1.8	1.7	1.9	2.0	1.9	1.7	1.6	1.6	1.5	1.6	1.5	1.3	0.9	0.9	1.5
Trade																
Share of CFA franc zone imports from France in total French exports	2.9	3.2	3.0	2.5	2.5	2.4	2.1	1.7	1.6	1.4	1.3	1.5	1.3	1.0	1.3	1.8
Share of CFA franc zone exports to France in total French imports	1.3	1.4	1.5	1.9	1.7	1.4	1.2	1.2	1.0	1.0	1.1	0.8	0.8	0.7	0.7	1.2
Direct foreign investment of France in CFA franc zone in percent of France's total foreign investment									0.5	0.4	0.6	0.4	1.8	1.0	1.0	0.8
France's official development assistance to the CFA franc zone																
In percent of the GDP of France			0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.1	0.1
In percent of CFA franc zone GDP			1.9	2.4	1.9	1.9	2.2	2.4	2.8	3.4	3.2	3.4	4.0	6.6	4.0	3.1

Sources: IMF, *Direction of Trade Statistics;* and *International Financial Statistics*; Banque de France, *Rapport de la Zone Franc, 1993*; and the French Ministry of Finance.

Table 7. CFA Franc Zone: Trade Links with France and the European Union, 1990-96

(In percent)

	Exports 1/		Imports 1/	
	France	EU	France	EU
Benin	1.7	30.5	23.5	51.2
Burkina Faso	11.8	26.9	22.5	34.4
Côte d'Ivoire	14.5	54.2	28.9	52.0
Mali	3.9	37.2	18.9	35.0
Niger	68.2	77.6	22.0	39.6
Senegal	24.6	40.9	33.1	57.4
Togo	5.5	26.6	16.5	34.1
WAMU	16.2	49.3	25.6	46.3
Cameroon	26.0	73.4	37.6	69.7
Central African Republic	7.2	53.1	42.4	56.2
Chad	8.5	67.5	43.1	60.2
Congo, Republic of	10.0	48.9	44.7	68.1
Equatorial Guinea	5.7	49.8	13.6	54.5
Gabon	20.7	31.6	44.2	64.7
CAMA	19.5	50.2	40.7	66.3
Total CFA franc zone	18.0	49.8	30.6	53.4

Source: IMF, *Direction of Trade Statistics* .

1/ Shares of France and all European Union countries in the exports and imports of the CFA franc countries.

Extracts from the Maastricht Treaty

DECLARATION
ON MONETARY COOPERATION WITH NON-COMMUNITY COUNTRIES
The Conference affirms that the Community shall aim to contribute to stable international monetary relations. To this end the Community shall be prepared to cooperate with other European countries and with those non-European countries with which the Community has close economic ties.

DECLARATION
ON MONETARY RELATIONS WITH THE REPUBLIC OF SAN MARINO, THE VATICAN CITY AND THE PRINCIPALITY OF MONACO
The Conference agrees that the existing monetary relations between Italy and San Marino and the Vatican City and between France and Monaco remain unaffected by the Treaty establishing the European Community until the introduction of the ECU as the single currency of the Community. The Community undertakes to facilitate such renegotiations of existing arrangements as might become necessary as a result of the introduction of the ECU as a single currency.

PROTOCOL
ON FRANCE
THE HIGH CONTRACTING PARTIES,
DESIRING to take into account a particular point relating to France,
HAVE AGREED upon the following provisions, which shall be annexed to the Treaty establishing the European Community.
France will keep the privilege of monetary emission in its overseas territories under the terms established by its national laws, and will be solely entitled to determine the parity of the CFP franc.

ARTICLE 109

1. By way of derogation from Article 228, the Council may, acting unanimously on a recommendation from the ECB or from the Commission, and after consulting the ECB in an endeavor to reach a consensus consistent with the objective of price stability, after consulting the European Parliament, in accordance with the procedure in paragraph 3 for determining the arrangements, conclude formal agreements on an exchange rate system for the ECU in relation to non-Community currencies. The Council may, acting by a qualified majority on a recommendation from the ECB or from the Commission, and after consulting the ECB in an endeavor to reach a consensus consistent with the objective of price stability, adopt, adjust or abandon the central rates of the ECU within the exchange rate system. The President of the Council shall inform the European Parliament of the adoption, adjustment or abandonment of the ECU central rates.

2. In the absence of an exchange rate system in relation to one or more non-Community currencies as referred to in paragraph 1, the Council, acting by a qualified majority either on a recommendation from the Commission and after consulting the ECB or on a recommendation from the ECB, may formulate general orientations for exchange-rate policy in relation to these currencies. These general orientations shall be without prejudice to the primary objective of the ESCB to maintain price stability.

3. By way of derogation from Article 228, where agreements concerning monetary or foreign exchange regime matters need to be negotiated by the Community with one or more States or international organizations, the Council, acting by a qualified majority on a recommendation from the Commission and after consulting the ECB, shall decide the arrangements for the negotiation and for the conclusion of such agreements. These arrangements shall ensure that the Community expresses a single position. The Commission shall be fully associated with the negotiations.
Agreements concluded in accordance with this paragraph shall be binding on the institutions of the Community, on the ECB and on Member States.

4. Subject to paragraph 1, the Council shall, on a proposal from the Commission and after consulting the ECB, acting by a qualified majority decide on the position of the Community at international level as regards issues of particular relevance to economic and monetary union and, acting unanimously, decide its representation in compliance with the allocation of powers laid down in Articles 103 and 105.

5. Without prejudice to Community competence and Community agreements as regards economic and monetary union, Member States may negotiate in international bodies and conclude international agreements.

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