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Competitiveness and growth within the CFA franc zone: Does the switch to the Euro matter?

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ABSTRACT

In this paper, we seek to analyze the impacts exerted by the substitution of the French franc for the euro on real and nominal effective exchange rates, competitiveness and growth within the CFA zone. Our findings show that, since the advent of the euro, the evolution of the real exchange rates and the competitiveness (measured by currency misalignments) have become increasingly dependent on nominal exchange rate movements and therefore on the evolution of the anchor currency. While the appreciation of the euro in the last decade did not translate into strong and generalized currency overvaluations—except in Central African Republic, Benin and Equatorial Guinea—it had however strongly reduced the extent of real undervaluations induced by the 1994 devaluation of the CFA franc. This has resulted in an increasingly negative effect exerted by real and nominal appreciations on growth rates of these countries since the switch to the euro.

1. Introduction

The CFA zone is an economic and monetary area composed by two completely separate and independent monetary unions: West African Economic and Monetary Union (WAEMU) and Central

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Africa Economic and Monetary Community (CAEMC), plus the Comoros.[1] The countries of this zone are mostly former French colonies which, after their independence, signed monetary cooperation agreements with France involving a guarantee of their currency convertibility and the pegging of the CFA franc to the French franc. The substitution of the French franc for the euro in 1999, following the European Monetary Union (EMU), was an important transition with considerable issues for the CFA zone countries. Irving (1999) states that the CFA zone is one of the three areas (with Central and Eastern Europe countries and Southern Mediterranean countries) which are more likely to be affected by the creation of the single currency. Nevertheless, the implications of this event for the CFA economies have not been investigated enough eventhough the euro's introduction has revived old questions about the future of this area as pointed out by Zafar (2005). This issue is indeed important since the monetary policy applied by the European Central Bank (ECB)—based on the model of the German central bank "Bundesbank"—is more restrictive than that of the Bank of France's one (see Didier et al., 2008).

The potential economic effects of the advent of the euro on the CFA zone were firstly analyzed by Hadjimichael and Galy (1997) which investigate the likely *ex-ante* economic impacts of the EMU on the real effective exchange rates (REER) and the external competitiveness of the CFA zone members. Indeed, as the monetary and exchange rate policies of the anchor country influence both nominal and real effective exchange rates of the pegged currency, it therefore impacts the competitiveness and economic performance of the pegged country. For instance, Bolle (1997) emphasizes that, in the 1970s, the CFA zone countries realized important competitiveness gains because their currency was pegged to a depreciating French Franc. On the contrary, the appreciation of the French currency (from mid-1980s to 1993), combined with inadequate internal economic policies, had dramatic effects leading to the devaluation of the CFA franc in 1994. Klau (1998) claims that the poor economic performance of the CFA zone members observed during this period was caused by the overvaluation of the CFA franc.

The peg of the CFA franc to the euro constitutes an exchange rate arrangement with EMU members and was expected to have several positive effects on the CFA zone economies. Irving (1999) has summarized all the channels by which African economies may be affected by the introduction of the euro. Overall, the creation of the EMU was supposed to make the euro a stable currency, to lead to low inflation and interest rates and to enhance its members' growth rates. Consequently, the CFA countries should firstly benefit from the stability of the euro with the reduction of uncertainty in exchange rate variability, in changes of relative prices, in exports and thus in fluctuations of government revenues expressed in local currency. Secondly, they should register higher growth rates due to "hypothetically" strong future growth rates in the EMU because of the important trade between the two areas (see Hadjimichael and Galy, 1997 or Dearden, 1999). Thirdly, pegging to the euro could lead to greater capital inflows from European countries through more financial integration. Borrowers from the CFA zone could thus raise funds more easily and at cheaper rates upon more competitive financial markets (see Irving, 1999). For authors such as Hallet (2008), beyond the CFA zone, the euro might have a more important role—via trade invoicing in euro, as international reserve currency, etc.—in Sub-Saharan Africa as a whole since the EMU members remain their main economic partners. However, since the mid-1990s, the trade of the CFA members with developed countries, especially European countries, has significantly declined making these benefits more uncertain.[2]

For the CFA zone economies, it was clear that their main concerns would be a strong euro after the shift of the anchor currency (see Hadjimichael and Galy, 1997 or Zafar, 2005). Indeed, an appreciation of the euro—leading to that of the pegged currency—could generate a currency overvaluation (i.e., a real appreciation higher than that consistent with the evolution of macroeconomic fundamentals), leads to a loss of competitiveness for the CFA zone members against their partners and therefore to a deterioration of their current accounts and their growth rates. As the nominal effective exchange rate (NEER) of the euro has continuously appreciated a few years after its creation (30% between 2002 and

[1] The WAEMU includes Benin, Burkina Faso, Côte d'Ivoire, Guinea Bissau, Mali, Niger, Senegal, and Togo and the CAEMC includes Cameroon, Gabon, Equatorial Guinea, Congo, Central African Republic, and Chad. The name CFA Franc means: "Communauté Financière Africaine" for the WAEMU member countries and "Coopération Financière en Afrique Centrale" for CAEMC member countries.

[2] Ehrhart and Jacolin (2012) indicate that the share of the euro area in exports from the CFA zone was reduced from 50% to 25% in the last 20 years in favor to countries such as China, Nigeria, India and Thailand.