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THE CFA FRANC ZONE - REASON FOR PARTICIPATION

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Reason for Participation***



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Introduction

This paper deals with the question why the member countries of the CFA franc zone participate in that currency area. The CFA franc zone is a currency area in west and central Africa, with the special features that its currency is pegged to the French franc at a fixed rate¹, and that France is involved in the institutional arrangements which underlie the currency area.

The CFA franc zone has several interesting aspects. In this paper we deal with the question why its member countries participate. We focus on economic motives for membership in the CFA zone, and pay no attention to other motives based on social and historical factors. According to literature on optimal currency areas, an area with large intraregional trade, and a flexible price and wage system is most suitable for establishment of a currency area. However, intraregional trade in the CFA franc zone is low, while prices and wages are quite rigid. Hence, traditional theory can not successfully explain existence of the CFA franc zone.

This conclusion is not new, and several explanation for existence of the CFA franc zone have been advanced. These explanations concentrate on France's role in the system, elimination of exchange rate risk for trade with France, a reduction of exchange rate risk for trade with the rest of the EC, and the credibility of policies implemented by the CFA governments.

In this paper, we hypothesize that membership of the CFA zone may positively influence country risk assessment. This being the case, governments could be interested in participating in the CFA zone to lower risk premiums on loans originating outside the CFA zone to its country. Lower risk premiums imply a larger opportunity for obtaining short and long term credits. In this paper, we investigate this possibility theoretically. In a later paper, we will try to corroborate our theoretical hypotheses with empirical research.

This paper is set up as follows. In section 1, we discuss the development and institutional arrangements of the CFA zone. In section 2, we summarize literature on optimal currency areas, and we conclude that what we call the "*traditional optimal currency area theory*" has little to offer in explanation of the existence of the CFA franc zone. We subsequently deal with alternative explanations which have been offered, with special reference to the CFA franc zone. In section 3 we discuss country risk analysis (in general). Country risk analysis in its basic form consists of weighted summation of a country's score on a few indicators of a country's ability and willingness to repay its debt. In section 4, we discuss the influence of membership in the CFA franc zone on both the score on each indicator and its interpretation (possible influence on the country risk analysis). Section 5 concludes.

¹ On January 12, 1994, the parity of the CFA franc to the French franc was changed for the first time in history. The circumstances which lead to the devaluation are described in the appendix.

Section 1. Historical evolution and institutions of the CFA franc zone.

In this section we deal with the historical evolution of the CFA franc zone and the development of its institutions. First, we describe the origins of the CFA franc zone. Then we discuss each of the subzones separately. We end with a discussion of the monetary arrangements which serve to guarantee convertibility and parity of the CFA franc.

The origin of the CFA franc zone

The Franc zone emerged in the '30s when France created one single currency for her overseas colonies. That currency was pegged to the French franc. After the Second World War many of the currencies were united in either the CFA franc (Colonies Française d'Afrique) or CPF franc (Colonies Françaises du Pacifique). After their independence in the early 1960s most of the former colonies choose to continue their monetary cooperation with France. The CFA franc zone, part of the larger franc zone ("la zone franc"), is not a monolithic entity; it consists in fact of two separate zones, the Central African Monetary Area (CAMA) and the West African Monetary Union (WAMU).

As appears from table 1.1 the CFA franc zone nowadays consist only of African countries.² The location of the members of the CFA franc zone is shown in figure 1. Some countries that left the CFA franc zone created their own, free floating currency³, whereas others created their own currency which is also still pegged to the French franc; in the latter case, in contrast with the CFA zone members, the French authorities are not involved.⁴

The historical and institutional development of the two subzones since 1960

WAMU

In 1962 Benin, Burkina Faso (then still called Upper Volta), Ivory Coast, Mali, Mauritania, Niger and Senegal together established the West African Monetary Union (WAMU). The composition of the WAMU has changed over time, as Mali left and rejoined the WAMU (in 1962 and 1984 respectively), Mauritania left in 1973, and Togo joined the WAMU in 1963.

The origin of the WAMU's central bank goes back to the mid 1950s. In 1959 it obtained its name which it still carries: the "Banque Centrale des Etats de l'Afrique de l'Ouest" (BCEAO).

CAMA

Five countries has been member of the Central African Monetary Area (CAMA) right from the beginning in 1962: the Central African Republic, Cameroon, Chad, Congo and Gabon. In 1985 the sixth member, Equatorial Guinee, joined.⁵ The origin of its central bank dates also back to mid 1950. In 1959 it obtained the name "Banque Centrale des Etats de l'Afrique Equatoriale et du Cameroun" (BCEAEC). In 1972, after some organisational changes it got it's current name, Banque des Etats de

² This has not always been the case. Saint-Pierre-et-Miquelon, lying in the Northern Atlantic Ocean, for example took also part in this system. In 1975 they left the CFA franc zone, after which the French franc became legal tender.

³ Madagascar in 1963 and Mauritania in 1973.

⁴ Since 1981 the Comoro franc is legal tender at the Comoro Islands, with an similar rate of exchange as the CFA franc has to the French franc, which was maintained until january 12, 1994.

⁵ Equatorial Guinee was the first non-former French colony to become part of the CFA franc zone. Thus, the CFA franc zone does no longer consist of French colonies only.

l'Afrique Centrale (BEAC).⁶

Institutional development

In the early 1970 some institutional changes took place in the WAMU (in 1974) as well as in the CAMA (in 1972). The main goal of the reform was to "Africanise" the institutions: to obtain more African responsibility and influence in policymaking and coordination of monetary policy, taking account of developments within the zone and its member countries.

Since these changes the WAMU is formally headed by the *Conference of the Head of States*. This Conference decides on admission of candidate member countries. The Council of Ministers remained the most important policy formulating body and decides on the (global) monetary and credit policy for the zone. At the national level the monetary policy is implemented by the so called National Credit Committees.

In the CAMA two institutions at ministerial level were established at higher level of authority than the central bank: the *Monetary Committee* and the *Mixed Monetary Committee*. The first one consists of the Ministers of Finance of the 6 participating African countries and conduct the monetary cooperation between the African countries. The second committee differs from the first in that the French Minister of Finance is also a member. Its main responsibility is to guide the monetary cooperation between the African countries and France. At national level the monetary policy is implemented by National Monetary Committees (NMC).

The monetary arrangements

At the formal establishment of the two monetary zones in the early 1960s, the African and French governments set up some rules to guide the functioning of the zone(s).

1. The CFA franc was established at a fixed parity with the French franc equal to the parity of 1948 (1 FF = 50 CFAF).
2. Convertibility was guaranteed by France through the so-called operations account (see next section), which both central banks kept - each separately - at the French Treasury.⁷ In exchange, France got representation in the policy formulating bodies.
3. There is free movement of capital within the zone, including to and from France.
4. The foreign reserves were kept on the operations account at the French Treasury in French francs. At the start of the monetary arrangement all foreign reserves had to be kept in French francs; nowadays the requirement is that at least 65% should be kept as French francs.

The operations account

Both zones employ a separate operations account on which payments and receipts to and from countries outside the zone are performed and registered. The financial transactions are registered for each individual country separately. Since the institutional changes in the early '70 at least 65% of the

⁶ Some authors use the term BEAC-zone instead of CAMA.

⁷ This guaranteed convertibility is not unrestricted but depends on the balance on the operation account (of the WAMU resp. CAMA). Convertibility is namely guaranteed as long as this balance is positive.

total reserves must be kept (in French francs) at the operations account, except for gold and SDRs.⁸ There is no limit on the deficits of the central banks at the operations account. Any remaining deficit will be carried by the French Treasury (in casu granted credit).

In the Statutes of the banks is established that the banks need to maintain an adequate amount of liquidity/foreign reserves on their operations account. In line with this and in relation to the monetary and credit policy some rules have been set up.

If the balance of foreign reserves held at the operations account is less than 20% of direct claimable obligations for a period of 3 months on end, the African central banks have to take measures to limit supply of credit. The African countries are obliged to pay the following interest rates if their balance on the operations account is negative:

- for the first tranche (a deficit of 0 - 5 million FF): 1%
- for the second tranche (a deficit between 5 - 10 million FF): 2%
- for the last tranche (a deficit bigger than 10 million FF): the average interest on short term Treasury issues.

In return the French Ministry of Finance pays interest equal to the average interest on short term Treasury issues if the operation account shows a surplus above 10 million FF.

The instruments of monetary policy

The monetary policy is aimed at control over the domestic credit provision so that an adequate balance of foreign reserves results. However, the supply of credit to the public as well as to the private sector is limited. There is not much differences in instruments between the two zones. In both zones the domestic capital markets are not well developed so that the commercial banks are dependent on the credit provision of their central banks.

Rediscount ceilings are for both zones the most important instrument to influence the balance of foreign reserves held by the commercial banks. In the WAMU the central bank sets credit targets that are consistent with the balance of payments objective and with forecasts of the growth of nominal GDP for the individual countries. In practice, the Board of Directors relies on the targets for credit expansion proposed by the NMC's. The ceiling are principally based on macro-economic data and goals.

In the CAMA, the monetary policy is determined by the central bank's Board of Directors assisted, at the national level, by the National Monetary Committees. In this zone ceilings are also set for each commercial bank and for each individual entrepreneur with accounts at the bank (depending on i.e. of this financial situation and his relevance for the economical development). In the CAMA the main emphasis lies on establishment of a sound financial position for the commercial banks.

In both zones credit supply to the central government is also constrained. The ceiling is set at a maximum of 20% of the fiscal receipts of the previous year. This rule implies that the governments can not finance their deficits by increasing money supply without limits.

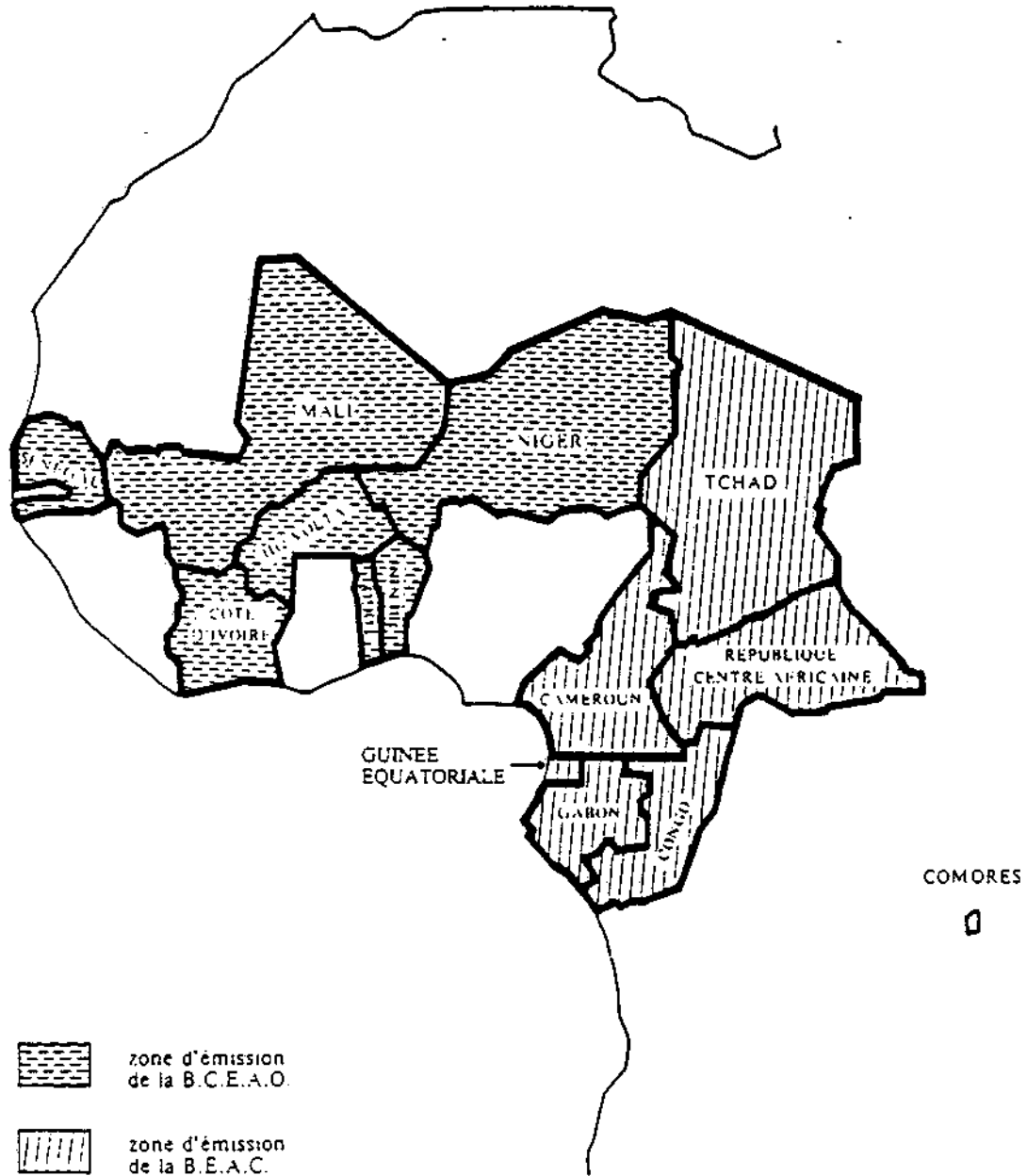
A second instrument for monetary policy is the rediscount rate. In the WAMU these are uniform throughout the zone. In the CAMA these can vary between the participating countries, because the NMC's have a certain degree of freedom - within the limits imposed by the Board - to set these ceilings.

⁸ Because of the possibility that the French franc devalues -which would result in a loss for the African countries - France guaranteed from then on the value of their French francs reserves in SDR's.

A third and fourth instrument are the minimum liquidity-ratio the central banks can impose to the commercial banks and the obligation to place financial assets in special deposits at the central banks.

Figure 1

LA ZONE FRANC EN AFRIQUE



Bron: Institut Technique de Banque, 1987

Table 1.1				
Participating countries CFA franc zone				
Country	Join (in) leave (out)	Region	Population (mln)	BBP (in mrd CFA franc*
Benin		WAMU	4,6 (1989)	516,9 (1990)
Burkina Faso		WAMU	2,9 (1990)	360,1 (1991)
Central African Republic		CAMA	2,7 (1987)	323,7 (1987)
Comoros	in 1981			
Djibouti	out 1949			
Equatorial Guinee	in 1985	CAMA	0,3 (1990)	43,8 (1990)
Gabon		CAMA	1,1 (1989)	1.284,5 (1990)
Guinea	out 1958			
Ivory Coast		WAMU	11,2 (1990)	2.705,0 (1990)
Cameroun		CAMA	11,6 (1990)	3.207,0 (1990)
Congo		CAMA	2,3 (1990)	788,8 (1991)
Madagascar	out 1963			
Mali	out 1962			
	in 1984	WAMU	8,3 (1990)	677,4 (1990)
Mauretania	out 1973			
Niger		WAMU	7,7 (1991)	644,8 (1991)
Réunion	out 1985			
Senegal		WAMU	6,7 (1987)	1.307,0 (1987)
St. Pierre en Miquelon	out 1975			
Togo		WAMU	3,5 (1990)	460,8 (1990)
Chad		CAMA	5,3 (1987)	213,6 (1987)

* NB: If nothing is said about joining or leaving the zones,
those countries take part in the zone since 1945

50 CFA franc = 1 French franc before the devaluation
Bron: IMF 1990, p 42

Section 2 The theory of the optimal currency area and the CFA franc zone

Starting from the seminal article of Mundell (1961) on economic unions, economic literature has extensively studied the optimal conditions for economic unions. The optimal currency area literature normally uses a Western perspective, concentrating on developed economies with a relative large amount of intrazonal trade. The theory of optimal currency areas is in that case based on maximum use of the gains from trade. We will call this theory the *traditional optimal currency area theory* in this section.

The development of a theory of optimal currency areas for developing countries is relatively neglected. Relatively little attention was paid to additional advantages currency areas especially with participation of developed countries could yield to developing countries. However, especially in relation with the CFA franc zone some literature has emerged in which additional advantages - relevant for developing countries - for participation in monetary unions are established. In this section, we elaborate on the advantages and disadvantages of economic unions for both developed and developing countries, and evaluate the motives of CFA countries to participate in the CFA franc zone. As in the relevant literature, we find that traditional (e.g., the theory based on Western countries) currency area theory can not satisfactorily explain participation in the CFA franc zone, while the additional advantages mentioned in literature can better explain participation in the CFA franc zone.

The advantages of currency areas according to traditional theory

The economic literature is not unanimous about the advantages of economic currency areas. Two advantages are always mentioned:⁹

*Reduction of transaction costs*¹⁰

An advantage of the formation of a currency area is the elimination of some types of transactions costs. Firstly, costs of exchanging currencies are avoided, because one currency is used for all intraregional trade. Though this is the main reduction of transaction costs, additional costs like transaction costs on forward or futures markets to hedge exchange rate risks and information costs are also avoided.¹¹

It should be noted that the reduction of transaction costs is solely confined to transactions within the zone itself. The relative advantage of the reduction of transactions costs is therefore more important as intraregional trade becomes more significant relative to total trade.

*Elimination of exchange rate risk.*¹²

Exchange rate risk is the risk associated with future cash flows nominated in foreign currencies. Because of possible changes in the exchange rate, it is possible that future receipts in foreign currencies lose their value in the local currency. Introduction of one currency for the whole area eliminates the exchange rate risk for intraregional trade, because payments and receipts of intraregional trade will be nominated in the currency of the economic zone. The exchange rate

⁹ Bakker (1991) p.654. An other advantage often mentioned is the elimination of speculative capital flows, which may upset monetary policy. See Ishiyama (1975) p.362. In this context Boonstra remarked with respect to the speculative assault on the French franc that financial markets function not only as an equilibrating force, but may be a source of disturbances themselves.

¹⁰ Ishiyama (1975) p.362.

¹¹ Naert (1981) p.44.

¹² Ishiyama (1975) p.362. For the various types of exchange rate risk see appendix 2.

risk of interregional trade will remain unaffected by the introduction of the currency area.

The disadvantages of currency areas according to traditional theory

The following disadvantages of introduction of currency areas are often mentioned:¹³

Loss of exchange rate modifications as a policy instrument

Within the zone, it is not possible to alter the nominal exchange rate, so that disequilibria on the balance of payments may persist. It should be noted that the real exchange rate, which is also affected by changes in wages and prices, and changes in labour and capital productivity, may change. Wage and price flexibility and/or high factor mobility may therefore compensate for the loss of the exchange rate instrument.

Inflation and unemployment trade-off determination

After introduction of the currency area, the monetary policy is centralised, so that independent national monetary policy becomes impossible. Therefore, the tradeoff between inflation and unemployment will become an exogenous variable. Assuming a negative relation between inflation and unemployment, and given the necessity of equal changes in prices and wages, high inflation countries will have to change their policy, causing lower inflation and higher unemployment. This disadvantage is less important the more equal the inflation in the member countries.¹⁴ Furthermore, it is important that some agreement exists on the relative importance of the goals of inflation reduction and unemployment reduction, as the policy in any member country may spill over into the other member countries.

Regional differences

Monetary integration not only requires harmonisation of the rates of inflation of the member countries, but also requires harmonisation of real cost increases. An increase in wages relative to labour productivity in some of the member countries will cause unemployment in these countries to rise, and will cause factor movements to countries with higher productivity growth. Monetary integration will therefore tend to increase regional disequilibria.

For an important part, real economic changes are caused by external factors, like export demand and oil price fluctuations. Therefore, regional differences will not be an important factor if the member countries of an economic union are simultaneously and equally affected by external changes, which is normally only the case if these countries have comparable export and import 'baskets'. Furthermore, external disturbances will be of less importance if intraregional trade is more important relative to interregional trade.

Conclusion

From the above, we can conclude that the advantages of a monetary union are large when intraregional trade is relatively large, while the disadvantages are small when wage and price elasticity are high, differences in productivity changes are high, factor mobility is high, inflation rates are comparable, and export and import structures are equal.

¹³ See, among others, De Grauwe et al (1976) pp.95-97.

¹⁴ This disadvantage disappears if one assumes no permanent trade-off of unemployment for inflation. See De Grauwe et al (1976) p.95.

The criteria for an optimal currency area, according to the traditional theory.¹⁵

Criteria for an optimal currency area can be found by maximization of the advantages, and minimization of the disadvantages of a currency area. Several factors compensate partly for the loss of the exchange rate instrument (see 1-4 below). Furthermore, the increase of gains from elimination of exchange rate risk and reduction of transaction costs, as well as reducing the influence of external disturbances is large when intraregional trade is important (see 5 below).

- 1) Wage and price flexibility;
- 2) Factormobility;
- 3) Similar export and import structures within the zone;
- 4) Equal inflation rates;
- 5) Relatively much intraregional trade.

Do the CFA countries satisfy the optimality criteria?

Wage flexibility

It is not easy to analyze wage flexibility, due to the poor availability of wage data. However, some circumstantial evidence can be provided. The minimum wage in most of the CFA countries was frozen.¹⁶ As the wage structure in relative terms is often constant, wage flexibility was probably low and rigid downward in nominal terms.

Price flexibility

To analyze the price flexibility with respect to external changes producer prices were analyzed.¹⁷ Most of the CFA countries try to stabilise their export revenues by introducing producer prices¹⁸ to guarantee a minimum income for the producers. These prices are set by so called stabilisation funds or marketing boards. These marketing boards buy the products and sell these subsequently on the world markets. A survey of producer and world market prices in the eighties is given in table 2.1. The producer prices are shown to be rigid downward, so that the competitiveness of exports has declined.

Concluding, the little evidence available suggests that both wages and prices were quite rigid downward in the CFA countries.

Factor mobility

Under this heading we analyze the labour and capital mobility within the CFA franc zone. It should be noted beforehand that it is not possible to ascertain whether these factor movements reflect underlying differences in scarcities, which is a necessary optimality condition.

Labour mobility

The CFA countries occupy an area approximately 14 times the size of France, while its population is only one third of that of France. Hence, population density is low. Labour mobility is therefore not only affected by differences in wages, but also by large distances between population centers, combined with poor transport and communication facilities.

¹⁵ See, among others, Mundell (1961) and Fleming (1971).

¹⁶ IMF (1990) p.28.

¹⁷ We concentrate on prices of export products because decline of competitiveness is here of most importance.

¹⁸ Minimum prices to producers of primary commodities.

According to Condé en Zachariah there exist a long tradition of international labour migration in West Africa. From 1960 onwards, the Ivory Coast has been the country to which the migration flows (especially from Burkina Faso and Mali) are directed. Senegal also attracts a large number of labourers from Burkina Faso, Mali and Gambia. Surprisingly, the authors found that economic factors are significant causal factors of the migration flows.¹⁹

Condé and Zachariah's conclusions are corroborated by a more recent World Bank study, which also found that migration in West Africa is large, and that the main flows are directed from Burkina Faso and Mali to the Ivory Coast.²⁰

Capital mobility

In the CFA franc zone exists complete capital mobility. One should expect capital flows to be directed to those countries in which the return on investment (ROI) is highest. Whether this is true in reality is difficult to ascertain: According to a study by Honohan it is not clear whether capital flows reflect underlying scarcity differences.²¹ Loans are to a large extent determined by policy considerations, rather than based on economical considerations:

"A permanent pattern of persistent borrowers and patient lenders might be justified on the basis of a higher marginal product of capital in the borrowing countries, in which case the lending countries might achieve a better return than if they had increased domestic expenditure. However the fact that much of the credit has gone to banks which have failed, proves that credit has not sought out high-yielding activities."²²

Summarizing: The CFA countries are characterized by large labour mobility, which reflects differences in (labour) productivity. Capital mobility, however, is seemingly not related to differences in scarcity.

Similar export and import structures within the zone.

Whether the member countries of a currency area are similarly affected by external disturbances is to a large part determined by the (absence of) comparability of export and import structures. Concentrating on the differences in export structures we find that the two zones differ strongly in export structure (see table 2.2). In the WAMU countries, with the exception of uranium exporting Niger, the major export products agricultural commodities (especially coffee and cocoa). In the CAMA countries, the most important export products are minerals.

Summarizing, the export structure of the CFA countries roughly follows the two zones within the CFA zone, with little intra-subzone differences, but large differences between the subzones.

Equal rates of inflation

In the special case of the CFA franc zone, the rates of inflation among the CFA countries should be approximately equal. There are no rules within the CFA franc zone which guarantee equal inflation rates, so that inflation rates could diverge. However, the inflation rates of the CFA countries do not diverge too much (see figure 2.1), and are comparable with that of France.

Intraregional trade

¹⁹ Condé en Zachariah (1981) p.10.

²⁰ Russell and Teitelbaum (1992) p.20.

²¹ Honohan (1990) p.5.

²² Honohan (1990) pp.11-12.

From table 2.3 it appears that the intraregional trade of the CFA countries is quite low, while the (interregional) trade with France and Europe is relatively high.

Conclusion

Based on traditional theory, it is difficult to explain the existence of the CFA franc zone. The member countries of the CFA franc zone do not satisfy most of the above mentioned optimality criteria, so that the advantages are relatively low, while the disadvantages are relatively high. We can conclude that it is not possible to explain the existence of the CFA franc zone satisfactorily on base of traditional theory. In the next section, we will investigate some additional factors which can explain the existence of the CFA franc zone.

Additional considerations for participation in the CFA franc zone.

A large number of African countries has pegged its currency to some Western currency. Devarajan and De Melo state that:

"Developing countries do not face the same choices as developed countries (...): whereas developed countries face a range of alternatives from independent floating to a fixed exchange rate, a developing country's choice is simply 'what to peg to?' The alternative of independent floating is not open to developing countries because of thin foreign exchange markets, restrictions on capital flows and limited capital markets."²³

So the pegging of a national currency to some Western currency is quite normal; however, the CFA franc zone is special in that its members peg collectively to the French franc, while France itself is an active member of the system.

As we found out in the preceding sections, traditional theory of economic unions can not explain the existence of CFA franc zone. Here, we investigate some additional considerations which may explain why the CFA franc zone exists. To cite Boughton:

"In addition to benefits that might accrue from belonging to a currency union, the CFA franc countries may derive benefits from adhering to a monetary standard vis à vis the French franc: in effect becoming part of a broad European monetary zone."²⁴

The advantages which accrue to the CFA countries are not so much associated with the economic union itself, as associated with the institutions which are necessary for the functioning of the CFA franc zone.

First, we consider the effects of pegging to the French franc, which affects the advantages to be obtained from traditional theory. Thereafter, we investigate additional advantages like discipline, credibility, competitiveness and, in later sections, the evaluation of credit risk to CFA franc zone countries.

1. The advantages are larger according to traditional theory, because of the collective peg to the French franc, which increases the regional spread of the "zone".

According to traditional theory, the advantages of an economic union are larger the larger the relative importance of intraregional trade. However, because of the peg to the French franc and, indirectly, the "peg" to the other countries of the EC, both transaction costs and exchange rate risk with France and the other EC countries are to a large extent reduced. Within the context of

²³ Devarajan and De Melo (1987) p.484.

²⁴ Boughton (1991) p.17.

the traditional theory of optimal currency areas, France and the other EC countries might be properly viewed as part of the currency area; therefore intraregional trade is much larger than appears at first.

Another effect of the CFA franc zone is the stimulation of regional investments. Due to elimination of (a large part of) exchange rate risk for investors from the EC and the necessity of comparable inflation rates in France and the CFA franc zone, investments in the CFA franc zone are relatively safe. This may reduce the interest rate, because of a lower risk premium, and therefore could stimulate investments and economic activity.

2. Advantages related to the operations account.

Because of the pooling of the foreign currencies on each of the two operations accounts it is possible for countries with a positive balance of payments to compensate those countries with a negative balance of payments. Furthermore, because of the existence of the operations account, no CFA country will ever lack foreign exchange, as long as the balance on the operations account (summing the balances of each country) is positive, because under these conditions, convertibility is guaranteed. Devarajan and de Melo point out that this is especially important for developing countries, who are often forced in a what they call stop-go policy (restricting resp. stimulating demand) depending on availability of foreign exchange.

3 Discipline

As the inflation rates of France and the CFA franc zone countries should not diverge too much, it is clear that introduction of the CFA franc zone causes some monetary discipline. Furthermore, a clear penalty exists on violation of this discipline, so that an announced low inflation policy is more credible than without the CFA franc zone membership (see also the next section). From table 2.4, it appears that the CFA member countries are characterised by relatively low inflation rates, compared with the rest of sub-Saharan Africa.

4. Credibility

The effectiveness of a policy aimed at reduction of price instability is largely dependent on the credibility of the policy. The same holds for a fixed exchange rate policy:

"An obvious way to make the fixed exchange rate regime credible would be for the authorities to surrender the power to alter the exchange rate. This could be achieved, for example, by forming a currency union under which a group of countries adopts a common currency - the CFA franc zone provides an example of such an arrangement."²⁵

The CFA franc zone increases the credibility of the policies announced by its member countries by reducing the autonomy of its member countries, while at the same time increasing the penalty on non-compliance. Furthermore, membership of the CFA franc zone enhances the possibilities to follow a fixed exchange rate policy by decreasing the problem of shortages of foreign currencies. From table 2.5 it appears that the economic growth in the CFA franc zone in the period 1973-1989 is higher than in the rest of sub-Saharan Africa. However, in table 2.4 we find that growth rate in the CFA countries declined substantially in the later part of the eighties, so that growth in the CFA franc zone was then lower than in the rest of Africa.

We find a similar pattern for the exports of the zone and for investments in the zone. It therefore appears that the role which increased credibility might have had in causing growth of some macro aggregates has ended in the second half of the eighties.

²⁵ Aghevli et al (1991) p.16.

5. Competitivity

Changes in the real exchange rate is a good proxy for the changes in the international competitiveness of some country.²⁶ The real exchange rate in an economic union can change because of differences in inflation rates. Because of relatively low inflation rates within the CFA franc zone, there is no tendency of systematic overvaluation of the CFA franc zone, so that the international competitiveness of the CFA franc zone is relatively good.

"as domestic prices [in non CFA countries, MR and CT] rose considerably faster than developed country trading partners' prices and exchange rates remained pegged to the US-dollar, SDR (...). In the franc zone there was lower inflation and, to a lesser extent, nominal devaluation of the French franc peg against other international currencies: i.e. franc zone members were pegged to a weaker currency than NFZ [non CFA countries]."²⁷

This pattern was reversed in the later part of the eighties, however.

"The recent depreciation [of the REER's of non-franc zone countries, MR and CT] has returned exchange rates to a relatively competitive level vis-à-vis franc zone countries. We (...) show that the foreign exchange equivalent of costs in NFZ are now likely to be substantially lower than in the franc zone."²⁸

2.4.6 Country risk assessment

A possible additional motive for participation in the CFA franc zone is a more positive assessment in a country risk analysis. This will create a more easy access to international financial markets. The postulated higher creditworthiness is the result of a number of factors, like low inflation, guaranteed convertibility, etc. and will be investigated in section 4, after a brief introduction into country risk assessment in general in section 3.

Conclusion

Traditional theories of economic unions are not able to explain the existence of the CFA franc zone. Many additional factors can explain why the CFA franc zone could be attractive to its member countries, among which the peg with the French franc, which increases the advantages mentioned in the traditional theory, and a number of additional factors, like increased credibility of government policy, monetary discipline, guaranteed convertibility, etc. In this section, we have hypothesized the possibility of additional gains resulting from higher creditworthiness in a country risk assessment study. This will be the subject of the following two sections.

²⁶ "A (...) indicator of a country's international competitiveness is the real effective exchange rate which takes account of relative movements in domestic and international prices. A rise in the real effective index generally implies an appreciation (loss of competitiveness) and a fall, a depreciation (gain in competitiveness), although (...) depending upon how they have been calculated." Rawinks, 1989, p.43.

²⁷ Lane and Page (1991) p.7.

²⁸ Lane and Page (1991) p.8.

Table 2.1										
Selected agricultural producer prices, 1980-89										
Year	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Coffee *	141	127	166	215	274	247	233	140	128	110
Ivory Coast	300	300	300	300	350	380	400	400	400	400
Cameroon	310	320	330	350	390	430	440	440	440	440
CAR	na	330	337	347	367	397	418	483	483	na
Togo	200	200	215	235	290	315	365	400	400	350
Cocoa beans	113	116	118	166	215	208	147	124	97	81
Ivory Coast	300	300	300	300	350	375	400	400	400	400
Cameroon	290	300	310	330	370	410	420	420	420	420
Togo	220	220	225	235	275	300	330	360	360	300
Cotton	90	103	108	145	160	122	75	102	86	110
Burkina F.	55	55	62	62	70	90	100	100	95	95
Chad	50	50	60	70	80	100	100	100	100	100
Niger	62	62	80	120	120	120	130	130	110	100
Senegal	55	60	68	70	70	70	100	100	100	100
Peanuts	181	283	192	271	444	407	197	150	176	248
Benin	40	50	60	65	80	80	95	85	95	50
Burkina F.	54	81	131	131	131	131	150	90	90	95
Ivory Coast	50	50	50	50	50	50	50	50	50	na
Niger	75	75	85	90	90	100	130	130	95	na
Senegal	46	50	70	70	70	80	90	90	90	70
Corn	27	36	36	52	59	50	30	23	32	36
Burkina F.	40	45	50	60	60	85	80	40	50	45
Ivory Coast	30	30	30	40	40	40	40	50	45	na
Congo	43	47	59	65	68	73	73	85	na	na
* Robusta coffee										
Source: IMF 1990										

Table 2.2 a								
Structure of the export in the WAMU (in percentages, 1983-1985)								
	Benin	Burkina Faso	Ivory Coast	Mali	Niger	Senegal	Togo	Tot.
Vegetable oils	8	19	2	3	1	30	2	6
Palm oil	6		2		1			
Peanuts and oil				1		24	2	2
Oil. seeds and fruit		17						3
Oilcake	2	2		2		6		1
Beverages	22		54				20	38
Coffee	7		24				7	17
Cocoa	15		30				13	21
Other Food	1	3	4	4	6	31		8
Living animals		3		4	6			1
Fish	1		2			31		6
Bananas			1					1
Sugar			1					1
Agricultural products	17	49	16	65	1	4	9	15
Wood			12					8
Cotton	17	41	3	62		3	9	6
Tobacco		8	1	3	1	1		1
Furs and skins		7		3	1	1		
Rubber		1	1					1
Minerals	40		9		80	14	45	16
Uranium					80			5
Petroleum	40		9				2	7
Aluminium								
Calcium phosphates						14	43	4
Magnesium								
Total	88	71	85	72	88	79	76	83
Other exports	12	29	15	28	12	21	24	17
Total	100	100	100	100	100	100	100	100
IMF 1990								

Table 2.2 b							
Structure of exports in the CAMZ (in percentages, 1983-1985)							
	Cameroon	CAR	Chad	Congo	Gabon	Equat. Guinea	Tot.
Vegetable oils	1						
Palm oil	1						
Peanuts and oil							
Oil containing seeds							
Oil cake							
Beverages	24	31				59	9
Coffee	11	31				5	4
Cocoa	13					54	5
Other Food	1		51	1		3	3
Living animals			51				3
Fish						1	
Bananas	1					2	
Sugar				1			
Agricultural materials	13	23	49	2	7	33	10
Wood	6	8		2	7	32	5
Cotton	5	11	49				5
Tobacco	1	3					
Furs and Skins		1					
Rubber	1						
Minerals	46			91	92		70
Uranium					3		1
Petroleum	43			91	83		65
Aluminium	3						1
Calcium phosphates							
Magnesium					6		2
Total	85	54	100	94	99	95	92
Other exports	15	46	0	6	1	5	8
Total	100	100	100	100	100	100	100
Source: IMF 1990							

Table 2.3					
Intra regional trade (percentages, 1982-1985)					
	% of total exports	% of total imports	% of total trade	% of tot. trade to France	% of tot. trade to rest Europe
CFA franc zone	6,6	10,7	8,6		
WAMU	11,6	15,4	13,7	26,9	
Benin	4,7	25,5	21,2	20,2	38,8
Burkina Faso	17,9	56,5	49,8	32,9	20,3
Ivory Coast	11,5	7,8	9,9	22,7	37,6
Mali	25,3	37,8	34,6	25,6	29,9
Niger	3,0	13,7	9,0	55,2	16,6
Senegal	13,7	6,4	9,0	32,5	23,7
Togo	12,0	10,3	10,9	24,6	37,2
CAMZ	1,7	3,2	2,3	34,4	
CAR	0,6	8,4	4,8	44,9	24,2
Eq. Guinea	0,6	2,6	1,6	1,7	79,4
Gabon	0,4	1,5	0,7	40,3	22,1
Cameroon	5,2	2,4	3,6	33,3	40,5
Congo	0,2	2,2	1,0	26,5	29,5
Chad	6,9	28,5	19,6	32,6	42,1
Source: IMF, 1990, p. 16.					

Table 2.4		
Movements of economic indicators in the eighties		
	1982 - 85	1986 - 89
Average growth real GDP (in %)		
CFA (11)	3,5	1,8
others		
SSA (20)	1,0	3,0
Low income (41)	2,4	3,4
Primary (52)	4,8	2,9
Total investments/real GDP		
CFA	21,3	16,6
others		
SSA	18,4	17,1
Low income	20,7	18,8
Primary	20,6	18,2
Average yearly inflation		
CFA	8,6	1,0
others		
SSA	26,2	35,7
Low income	19,5	50,4
Primary	28,9	64,4
Average yearly growth of exports		
CFA	3,0	0,1
others		
SSA	0,1	5,0
Low income	1,2	8,8
Primary	7,6	7,7
Source: Devarajan and De Melo, 1990, p. 10.		

Table 2.5			
Movements of economic indicators, 1973 - 1989 (Weighted with GDP)			
	Average 1973 - 1981	Average 1982 - 1989	% Increase (+)/ Decrease (-)
Average yearly inflation (in %)			
CFA (11)	11,6	4,1	-7,5
WAMU (7)	11,1	3,8	-7,3
CAMZ (4)	11,7	5,7	-6,0
others			
SSA (18)	14,0	17,3	3,3
LIDC (25)	13,5	12,3	-1,2
Average yearly growth of GDP (in %)			
CFA (11)	5,7	1,6	-4,1
WAMU (7)	4,0	1,4	-2,6
CAMZ (4)	8,2	2,0	-6,2
others			
SSA (18)	2,8	1,3	-1,5
LIDC (25)	5,5	6,2	0,7
Average yearly growth of real exports (in %)			
CFA	7,0	-0,4	-7,4
WAMU	5,1	0,0	-5,1
CAMZ	9,9	-1,0	-10,9
others			
SSA	1,2	2,5	1,3
LIDC	7,6	8,9	1,3
Ratio investments to GDP (constant prizes)			
CFA	28,5	21,4	-7,1
WAMU	25,5	16,3	-9,0
CAMZ	33,0	29,1	-3,9
others			
SSA	28,0	15,7	-12,3
LIDC	25,7	27,1	1,4
Ratio Savings to GDP (constant prizes)			
CFA	23,0	20,5	-2,5
WAMU	16,5	11,6	-4,9
CAMZ	32,9	34,1	1,2
others			
SSA	20,9	11,7	-9,2
LIDC	17,9	15,2	-2,7
Source: Elbadawi and Majd, 1992, p. 13.			

Section 3 Country risk and country risk analyses

One of the possible additional advantages of participation in the CFA franc zone is a positive influence on country risk and/or country risk analysis.²⁹ The influence of participation in a monetary union on country risk analysis is neglected in literature. In this section we describe the country risk analysis itself. In the next section we deal in more detail with the specific influence of CFA franc zone membership on country risk.

What is country risk?

Lending across borders adds an extra element to credit risk analysis. Apart from commercial risk (which needs to be assessed in any case) one should now also consider country risk. When lending to an foreign borrower (i.e. a bank or an enterprise) it is not only important to check the creditworthiness³⁰ of the debtor itself (commercial risk), but also the creditworthiness of the country of the borrower (country risk³¹). Even if the borrower is able to service its debt, it needs to be able to obtain foreign exchange and (in some cases) permission of the government in order to do so. This last aspect, the risk that either foreign exchange or government permission to use foreign exchange is not obtainable, is referred to as country risk. When analyzing the country risk one has to analyze the economic capability as well as the political willingness to (re)pay the debt. Country risk is composed of political and transfer risk.

Political risk is the risk that due to political situations (war, revolution etc.) in which a country is involved may influence the ability to repay debt. *Transfer risk* is the risk that economic circumstances may force a country to impose restrictions on remittances of capital, dividends etc. to foreign lenders/and or investors.

"Transfer risk is structured around the relation between a country's cross-border liabilities as well as its need to incur new debt, and its ability or inability to earn or obtain the necessary foreign exchange to service those liabilities as well as to get new credits."³²

Both risks can influence and reinforce each other.

"This is especially the case if one of the two risks is worsening. The other risk is then frequently drawn along. An example is the situation where the economy of a country has suffered substantially due to changes - e.g. in international commodity prices such as copper - which then leads to enhanced political instability due to economic difficulties. This instability obviously brings with it a worsening of political risk. Transfer risk can also be very much influenced by political decisions."³³

²⁹ Indeed, it is useful to distinguish between country risk analysis and country risk itself, as country risk analysis of some type of countries might be systematically biased. For example, with underestimation of country risk in the country risk analysis for CFA members, CFA members would be able to obtain larger foreign loans with better conditions than comparable non-members.

³⁰ Creditworthiness can be defined as the ability to repay the credit at the corresponding conditions.

³¹ A definition of country risk is "the possibility that a sovereign state of sovereign borrowers of a particular country may be unable or unwilling, and other borrowers unable, to fulfil their obligations towards a foreign lender and/or investor for reasons beyond the usual risks which arise in relation to all lending and investments". Krayenbuehl, 1987, p 3.

³² Krayenbuehl, 1985, p. 37.

³³ Krayenbuehl, 1985, p 23.

Elements in country risk assessment

In assessing a country's ability to service debt many different elements need to be considered, such as economic growth, the current account deficit, internal tensions etc. Commonly, those elements are combined in three different groups of indicators: political indicators, the internal economic indicators and external economic indicators. The internal economic and external economic indicators are relevant to assess transfer risk, the political indicators are of course relevant to political risk. The risk indicators which are normally used by commercial banks in assessing country risk are presented in table 3.1.

Internal economic indicators

The creditworthiness of a country depends in a major way on the internal economic situation. The following risk indicators are relevant for assessing a country's ability to generate a surplus income above the necessary minimum, which possibly (i.a., depending on the ability to exchange local currency for future currency) could be used to repay debt.

Gross Domestic Product (GDP) per capita

The GDP per capita roughly gives a general impression of a country's wealth. The higher the wealth of a country, the larger its ability to service debt. If the GDP per capita is low one can assume it will be more difficult to cut in the (already low) consumption in order to repay foreign debts, so that (all other factors constant) the ability to service debt will be lower when GDP per capita is low.

Economic growth per capita

To increase its wealth a country has to realise an economic growth which is higher than population growth. High growth per capita figures therefore indicate that a country's ability to service debt will increase in the future; therefore, high growth of GDP/capita is regarded favourably in country risk analysis.

Degree of investment

The degree of investment is the ratio of gross investments to GDP. It can be used as an indicator of economic growth in the near future, with higher degree of investment indicating higher future growth. But note that the productivity of the investments should also ideally be considered, because unproductive investment will lower growth. What may help is to use the incremental capital output ratio (ICOR), but this indicator is not perfect either.³⁴

Inflation

The rate of inflation, its recent changes and its trend are indicators for economic stability. In general, high rates of inflation, and uncertain fluctuations in the rate of inflation increase the risk and uncertainties of investments and therefore cause declines in investment.³⁵ Furthermore, if the rate of inflation is relatively high (with respect to other countries) and not compensated by a devaluation the currency will become overvalued. As a consequence of this, exports may decrease and imports might grow resulting in a deterioration of the current account. Summarizing, high rates of inflation (and especially, if accompanied by large fluctuations in rates

³⁴ As an example of the caution one should exercise with interpreting the ICOR, investment in infrastructure may contribute in an important way to growth, while a first glance at its low ICOR would suggest otherwise. Bird, 1989, p 40.

³⁵ "Relative price variability increases with inflation which implies that producers will be more prone to making errors in their input and output decisions because of their inability to predict changing relative prices." A second explanation is that "monetary variability adds noise to the ex-ante real returns and hence may lead to a decline in marginal propensity to invest". Devarajan and De Melo, 1987, p 495.

of inflation) will lower growth, and therefore, limit capacity to service debt, and therefore increase country risk; furthermore, the ability to earn foreign exchange to service debt will decline with high rates of inflation.

Fiscal deficit

The relationship between the fiscal deficit and country risk is elaborated on by (i.a.) Rawkins:

"The size of the fiscal deficit can have significant impact on the balance of payments. (...): a deterioration in the first often leads to a crisis in the second. An expansionary fiscal stance drives up expenditure relative to output, invariably causing consumption to spill over into imports, thus narrowing the trade surplus or increasing the deficit. The additional saving required may lead the government to borrow abroad to finance the deficit. This imposes an additional burden on the current account through higher interest payments. Alternatively, domestic sources of financing may have inflationary consequences that give rise to an overvalued exchange rate, growing uncertainty and private capital flight abroad."³⁶

External economic indicators

The risk-indicators for the external economic sector yield an assessment of the inflow of foreign exchange, both in the short and long term, in relation to the time related need for foreign exchange to pay off debts. The following indicators are commonly used for analysis and monitoring of the external economic factors influencing transfer risk.

Diversification of exports

Both geographical diversification of export markets and product diversification of the exports is important. A country that heavily depends on the exports of just a few products or on exports to few countries will more severely be affected by fluctuations of international prices or downturns in their export countries than countries with more diversified exports, both in terms of products and product markets. As a result the country risk will be higher with exports concentrated in a few products and export markets.

Export ratio

A higher ratio of exports to GDP implies that a large part of production factors are allocated to the international sector rather than to the protected domestic sector. The former is often more productive and competitive. In addition, a high export ratio strengthens the capacity to pay off debts as the export sector generates foreign exchange. On the other hand a high export ratio can imply a high dependence on international developments.

Ratio of total foreign debt to exports

This ratio is an essential indicator for the long term ability to pay off debt, as the foreign debt must eventually be paid off by foreign exchange receipts from exports. The higher this ratio the higher the country risk.

Debt service ratio

The debt service ratio is the proportion of annual interest payments of foreign debts to export

³⁶ Rawkins, 1989, p 39. Later on, he explains that "monetizing the fiscal deficit is one of the most common causes of inflation in developing countries and invariably leads to balance-of-payments difficulties. Initially the supply of money exceeds demand, driving up prices. If exchange rate fails to adjust, the currency becomes overvalued, stimulating imports and depressing exports. Confidence starts to erode and capital flight ensues."

income. The lower the ratio, the lower the country risk.³⁷ Rather than the ratio of total foreign debt to exports, this ratio focuses on the short term, and is indicative for liquidity problems.

"An increase in the debt service ratio indicates increased vulnerability to foreign exchange crises. Any shortfall in foreign exchange earnings or capital imports which is not covered by exchange reserves must be met by reducing imports: since debt service is a fixed obligation, the higher the debt service ratio, the greater is the relative burden on import reduction for a given shortfall in foreign exchange."³⁸

This indicator has some disadvantages:

"The debt service ratio is merely an indicator of the proportion of foreign exchange earnings which are free to purchase imports. If foreign exchange earnings are high relative to import demand, a high debt service ratio can be maintained. Furthermore, a country with a good credit standing in international money markets may be able to finance a higher debt service ratio, for a time at last, through a high level of borrowing."³⁹

Arrears on interest payments

This indicator yields an impression of willingness and capacity to service debt combined. Most countries with financial problems continue to service debt as long as possible. Therefore, a country with arrears in interest payments should not be considered a reliable debtor.

Proportion of short term debts to total debts

The higher ratio of the short term debt (less than 1 year) to total debt, the higher the country risk. Ceteris paribus a high ratio implies that the country is more sensitive for assessments of its country risks by the international financial community. The short term loans can easily be pulled back, so an acute liquidity crisis may occur.

Import coverage

Import coverage indicates how long the foreign exchange reserves will suffice to pay imports in total absence of any export receipts. A low import coverage indicates high vulnerability to reductions in export earnings and therefore the lower the import coverage the higher the country risk.

Short term debt in relation to the foreign exchange reserves

This indicator shows the ability of a country to pay its foreign debt (due within one month) out of foreign exchange reserves in case the country would not be able to borrow on the international financial market

Financial means in relation to the quota by the IMF

This indicator shows the amount on financial means the county has already used in relation to it IMF-quota. A high ratio indicates high country risk, because there is not much room for additional financing from official sources.

³⁷ Kraysenbuehl writes that a ratio of (lower than) 10% should be considered very good, while ratios reaching values of 25% or more indicate severe difficulties in servicing debt. Kraysenbuehl, 1985, p 53.

³⁸ Frank and Cline, 1971, p 329.

³⁹ Frank en Cline, 1971, p 330.

Market discount on traded debt

In case public debt is traded, any discount on the nominal value of the debt indicates the probability the debt will be repaid. A high discount implies that the market consensus is that the country risk is high. Some caution has to be exercised in interpreting market discounts, because the market is, with exception of Latin American debt, illiquid so that a small number of relatively small transactions can influence the perceived market discount in a major way.

Political indicators

It is very difficult to use ratios to establish political risk. The analysis is more qualitatively than quantitatively oriented. It aims to establish the influence of foreign or domestic politics on the liquidity and solvability of the country. The debt service capacity may for example change when there is a change of government (by force or regular). The following elements are commonly used in the political analysis.

Evaluation of domestic policy

Under this heading, the financial and economic policies of the government are evaluated, as well as its ability to effectively implement its policies. Continuity in the policies is also a major factor, as a country with f.e. a highly variable legislative framework will be unattractive to invest in. However, the government must be able to react quickly when needed; as minority coalitions or otherwise weak governments often show some inertia, these are generally viewed disfavouredly.

Risk of internal conflicts

The risk of internal conflicts is assessed on basis of the kind of government (dictator/no dictator), the composition of the population, regional or ethnic contrasts, religious tensions, armed opponents of the government or civil war.

The chance of foreign conflicts

Here the risks of military conflicts affecting the country are assessed.

The weights of risk indicators in a country risk analysis

Normally, an overall score for country risk is obtained by a weighted summation of the scores on the indicators mentioned above. However, as country risk analysis is a commercial activity, it is very difficult to find literature on the weights of various indicators used in country risk analysis. Apart from the fact that commercial interest cause some secrecy about the weights used, the objectively correct weights are difficult to assess. Nevertheless we will give some impression of the weights used in practice.

Transfer risk can be separated into liquidity risk (in casu short term capacity to repay debts) and solvability risk (in casu the long term capacity to repay debts). Depending on the conditions of the loan either may be the major determinant of transfer risk. Robinson, as economist working for Chase Manhattan Bank, and Thompson give weighting factors for the liquidity risk analysis.⁴⁰ Thompson also provides a model for the solvability analysis.⁴¹ Both authors use a index from 0 to 100, which is obtained by a weighted summation of scores on individual indicators.

The liquidity analysis

The liquidity analysis concentrates on the short term capacity to repay debt, and therefore

⁴⁰ Robinson, 1981, p 74 respectively Thompson (on cit in Krayenbuehl), 1985, p 65.

⁴¹ Thompson on cit. in Krayenbuehl, 1985, p 68.

concentrates on the possibility to create a sufficient surplus of national income over necessary expenditures, and the possibility to obtain foreign exchange to transfer this surplus. As a result, long term growth and indicators for changes in long term growth like degree of investment, savings rates etc. are less relevant for the liquidity analysis, which mostly concentrates on a going concern analysis of the ability to repay debts based on foreign exchange earning from exports, the probability of large departures from "normal" going concern (diversification), and the ability to withstand such large departures from normal going concern (import coverage). Thompson's analysis uses the indicators and weights of table 3.1

According to Krayenbuehl, an important indicator is absent in Thompson's analysis. Krayenbuehl advocates the use of the so-called 'liquidity gap ratio'.

"It consists of the one-year-short-term debt minus the balance on the current account. Such a calculation gives a gap in liquidity if the total figure is positive. (...). Under normal market conditions one can assume that a liquidity gap ratio of 20 percent can be covered through additional short-term borrowing. The reasoning behind this ratio is that, bearing in mind changing market conditions, it will always be possible to fund a liquidity gap of a certain size as a measure to overcome short-term liquidity problems. The higher the percentage of the liquidity gap ratio, however, the more difficult it will be for the country concerned to manage successfully its short-term financial requirements."⁴²

The solvability analysis

Thompson uses 9 indicators for assessing the solvability of a country. The main weight (45%) is attached to those indicators which measure the possibility to obtain foreign exchange. Other indicators are related to the management of the economy as a whole, while a third groups of indicators are related to the performance of the economy as a whole. However, the last group of indicators is less important.

Total combined country risk analyses

The total combined risk analyses tries to give an overall view of the creditworthiness of the specific country. To establish the overall country risk the political and transfers risk (in terms of liquidity and solvability) are aggregated. Krayenbuehl states that

"in the overall index (...), political risk is often assigned a 30 per cent weight. Within transfer risk, the liquidity part can account for up to 50 per cent of the weight."⁴³

Several of the weighting systems commonly used are presented in tables 3.2 to 3.4.

⁴² Krayenbuehl, 1985, p.57.

⁴³ Krayenbuehl, 1985, p 70.

Table 3.1	
Indicators of the liquidity-index	
Indicator	Weight
Reserves/imports	40%
Debt service/exports	20%
Big loss of foreign reserves	10%
Recent payments experiments	10%
IMF credits/quota	20%
Source: Krayenbuehl, 1985, p 68.	

Table 3.2	
Indicator	Weight %
1. Per cent change in consumer prices:	
(a) most recent year	5
(b) five-year average	5
(c) most recent year/five-year average	5
2. Per cent change in money supply (M1) 1 year/ per cent change in real GDP (five-year average)	10
3. Change in central bank financing government/ monetary base (most recent year)	5
4. Purchasing power parity	5
5. Growth of exports:	
(a) most recent year	10
(b) four-year average	10
6. Exports/GDP (most recent year)	10
7. Debt/exports (most recent year)	15
8. Savings/GDP (four year average)	10
9. Growth of real per capita GDP (five-year average)	10
Source: Krayenbuehl (1985)	

Table 3.3

	Approximate weighting %
1. Legal considerations	10
2. Political considerations	25
3. Economic considerations:	
- Power of the government (e.g. a Danish-type minority government which find it difficult to introduce unpopular measures compared with a British first-past-the post-system)	6
- Assessment of current plans for the economy; feasibility of development plans, main bottlenecks, etc; resource base - natural and human resources, etc.	15
- Recent events and present state of the economy	
GNP growth	0.3
Rate of inflation	0.6
Government budget position	0.6
Money supply growth	0.3
Current account balance of payments	0.3
Unemployment	0.6
Level of external debt	1.2
Debt service ratio	1.2
Latest date of published statistics	0.9
	<hr/>
	6
- Future prospects for the economy if present trends and policies continue	
GNP growth	0.7
Rate of inflation	1.3
Government budget position	2.0
Money supply growth	0.7
Current account balance of payments	2.0
Unemployment	1.3
Level of external debt	2.5
Debt service ratio	2.5
	<hr/>
	13
- Ability of the country to correct adverse implications of present binds and to withstand unforeseen shocks (vulnerability)	
Imports as a proportion of GDP	0.7
Exports as a proportion of GDP	0.7
Diversification of imports by category and by geographical area	4.6
Diversification of imports by category and by geographical area	4.6
Compressibility of imports (i.e. extent to which imports consist of 'non-essentials')	6.4
Vulnerability to the economy to changing exports and imports; energy dependence	8.0
	<hr/>
	25
	<hr/>
	100
Source: Robinson (on cit. in Kraysenbuehl, 1985)	

Table 3.4

Commercial banks' attitude to country risk assesment: a schedual of factors used in the individual systems												
Measure (1)	Systems Reviewed											
	A	B	C	D	E	F	G	H	I	J	K	L
Debt service ratio	x	x	x	x	x		x	x	x	x	x	x
Import/Reserves ratio	x			x		x		x	x		x	
Capital/Debt ratio	x			x		x		x		x		
Income per capita	x	x	x	x				x	x	x	x	x
Income growth rate	x	x	x		x	x	x	x	x		x	x
Export growth rate	x		x	x	x		x	x	x		x	x
Export analysis		x	x		x	x	x	x	x	x	x	
Imports/Exports ratio		x	x	x	x	x				x	x	
Economic diversity		x	x			x			x		x	x
Export/GNP		x	x	x						x	x	
Level of IMF Reserve ratio		x		x	x	x	x	x			x	
Debt structure		x					x	x	x	x	x	
Inflation/Monetary/ Fiscal policy		x	x	x	x	x	x				x	x
Physical resources			x	x		x	x	x	x		x	
Debt			x	x		x	x	x	x	x	x	
Import analysis			x	x	x		x	x		x	x	
Basic strenght		x	x	x			x				x	
Ability to change peacefully		x		x		x	x	x			x	
Likeliness of internal conflict		x				x	x	x	x		x	x
Policies of ruling group		x	x			x					x	x
Philosophy of ruling group		x									x	x
Ability of government officers		x				x	x	x			x	x
Flexibility of the political systems		x						x				
External relations		x				x		x	x		x	
Minority groups		x	x		x		x		x		x	x
Religious problems		x			x		x		x	x		
Unemployment		x	x				x				x	
External ethnic problems		x		x			x		x		x	
Government support			x				x					x
Type of system			x				x	x	na		x	
Opposition groups						x	x		x		x	
Wealth disparity			x				x		x		x	

1. In some cases similar measures from to or more systems are grouped together under one heading. 'Income per capita' and 'Income growth' are taken in terms of either GNP or GDP.

Key to the systems reviewed:

A Feder/Ross: World Bank (G. Feder and K. Ross; 1977)
 B C.M. North, University of South Carolina, Ex First National Bank of Chicago
 C J.N. Robinson, Chase Manhattan Bank NA (1981)
 D K. Janoeri, Union Bank of Switzerland (1980)
 E Amsterdam and Rotterdam Bank NV (1981)
 F Business International Country Risk Assessment Service (1981)
 G P.J. Nagy, Bank of Montreal (1978)
 H H.R. Heller, Bank of America (1980)

Table 3.4, continued

I P. Gutmann, National Westminster Bank Ltd (1980)
J America Express Bank (1980)
K A. van Agtmael, Bankers Trust Co (1976)
L C. Johnson, Lloyds Bank (1985)

Source: Bird (1989)

Section 4 Influence of CFA franc zone membership on risk analysis

Introduction

In this section we (theoretically) investigate how CFA franc zone membership influences country risk assessment. As we showed in the previous section, country risk analysis mostly consists of evaluation of some social/political and economic indicators. The CFA franc zone membership can possibly effect these indicators in three basically different, non-exclusive manners:

1. The CFA franc zone membership directly influences the value of the indicator.
2. The CFA franc zone membership influences the meaning attached to a specific value of some indicator.
3. The CFA franc zone membership influences the perceptions on policy with respect to this indicator by the credit institutions outside the zone.

In the first case, the CFA membership alters the value of an indicator. A possible example is that CFA franc zone membership may have a decreasing influence on inflation.

In the second case some indicators of a CFA franc zone member country can take on values which in "normal" cases would be considered critical without (in this specific case) being so. This is especially the case for those indicators which focus on liquidity problems; because of the guaranteed convertibility of the CFA franc liquidity problems will not likely escalate into default.⁴⁴ In general, for the interpretation of a certain value of an indicator to alter, CFA membership should influence the "mechanism" behind the relation between the indicator and higher likelihood of default.

With regard to the third possibility, some indicators are perceptions about policy and likely policy changes. As the CFA franc zone decreases the degrees of freedom for economic policy, there will be less uncertainty about future policy. This is especially the case for announced anti-inflationary policy; this will obtain more credibility in a CFA franc zone member than for a non-CFA franc zone member, as low inflation (comparable with France's rate of inflation) is a necessary precondition for continuation of CFA franc zone membership. Similarly, the fixed peg to the French franc is more credible for a CFA-member than an announcement of a fixed peg by a non CFA franc zone country, as the cost of a possible devaluation will be much higher for a CFA franc zone member.

This suggests that CFA franc zone membership can be used as a device for **Financial Signalling by the Government**, as CFA franc zone membership enables a developing country in Africa to signal that it will follow some specific policy, enhancing the observed creditworthiness, and hence, enhancing the opportunities to obtain foreign loans.

In the next section we investigate for each of the indicators mentioned in the previous section whether CFA franc zone membership (theoretically) should influence the indicators, in any of the manners described above. If there is no influence in the manner indicated, we give our arguments in case this is not self-evident; otherwise we, just skip it. If possible, we combine our theoretical discussion with results from empirical literature. We concentrate on a fixed debt to GDP ratio, and invoke the c.p. condition throughout. Subsequently, we investigate whether CFA franc zone membership will enhance creditworthiness. The analysis is summarized in table 4.1.

⁴⁴ It should be noted that CFA countries can fulfil their obligations in two basically different ways: By payment out of own foreign currency income, or by exchanging CFA Francs for French Francs. In the latter case, the balance of the operations account (of the CAMA or of the WAMU, depending on the country under consideration) should be positive. Only if this is the case, the meaning attached to the liquidity indicator will be influenced.

1. Internal economic indicators

The Gross Domestic Product (GDP) per capita

1. The GDP per capita within the zone is on average two times higher than in the rest of Sub-Saharan Africa.⁴⁵ Of course, this may be just a fluke, without any causal relation. On further thought, three forces appear, which work in opposite directions:
 - Lower rates of inflations (see below) will (c.p.) limited exchange rate risk attract more investment, and therefore cause a higher growth of the GDP in the long term;
 - CFA countries lose their ability to stimulate the economy by increasing the supply of money, which may cause underemployment of production capacity, lowering GDP per capita;
 - CFA countries lose the possibility to devalue their currency in order to stimulate exports by increasing the competitiveness of the country. This factor is increasingly important in the last few years after the devaluation of Ghanese and Nigerian currency, which has increased the competitiveness of exports from these two countries relative to exports from the CFA countries.

Summarizing, on theoretical grounds it is not possible to tell whether CFA franc zone membership will increase GDP per capita in general.

2. As there is no clear mechanism which connects a higher GDP per capita with lower country risk,⁴⁶ it is difficult to tell whether CFA membership should exert any influence on the meaning attached to a particular value of GDP. Therefore, it seems improbable that CFA membership will have any influence on country risk assessment.
3. Influence on perception is essentially only important in those cases that an indicator is directly related to policy decisions, as is the case for domestic money supply, exchange rate policy, etc. As the GDP per capita is not a direct function of policy, CFA membership has no influence on perceptions on relevant policy decisions regarding GDP per capita. For the same reason, perceptions of policies with respect to some specific indicator is not relevant for most of the indicators used in country risk analysis.

Economic growth per capita

1. As discussed above, CFA franc zone membership will cause higher investment, while at the same time reducing the possibilities to influence competitiveness by devaluation. We conclude that CFA membership will increase economic growth, with a possible exception for those cases that devaluation in competitor countries decrease competitiveness to such a degree, that the overall assessment should be negative.
2. This indicator influences the repayment capacity of a country, with higher growth (c.p.) meaning better repayment capabilities. The CFA membership has no influence on this mechanism, so that the meaning attached to this factor will remain unaffected.

Investment to GDP ratio

⁴⁵ Lane and Page (1991) p.18.

⁴⁶ See Kraysenbuehl (1985) pp.48-49. Nevertheless, this indicator is traditionally used in country risk assessment. Presumably, this indicator is used because in case of problems with repayment it is possible to increase the repayment capacity by decreasing non-necessary imports. If this is the case, GDP per capita is a proxy for the compressibility ratio. Therefore, it is not surprising that Feder en Just (1977) found that higher GDP per capita is related with a lower chance of delay in repayment.

1. Reduction of the rate of inflation, reduction of exchange rate risk and reduction of uncertainty regarding policy will increase the attractiveness of investments within the zone. It should be noted that devaluation elsewhere after 1985 caused a reduction in the competitiveness of the zone, reducing the attractiveness of the zone for investment. Therefore, we observe a decrease in the investment to GDP ratio after 1985.
2. The investment to GDP ratio influences growth, which influences country risk. This causal chain is unaffected by the CFA membership and its institutions, so that the meaning attached to a specific value of this indicator will remain unaltered.

Rate of Inflation

1. The CFA countries should have rates of inflations comparable to France's. This is not directly formalised in the rules of the zone (the restrictions on credit expansion are meant to influence the balance on the operations account), but at the same time a necessary precondition for survival of the CFA franc zone, and is quite strictly adhered to. Therefore, inflation is low relative to the other African countries.
2. The rate of inflation influences investment behaviour as well as international competitiveness. A high rate of inflation will deteriorate the international competitiveness of the country, decreasing export and increasing imports, which will negatively affect the repayment capability of the country. Most countries are able to combat the negative consequences of a high rate of inflation on the balance of payments by a devaluation of their currency. As this possibility does not exist for the CFA franc zone countries, a high rate of inflation should be considered more critical than for a non-member.

Very high rates of inflation should be considered even more critical, as membership of the CFA franc zone will be in danger of discontinuation.

3. Membership of the CFA franc zone implies that a country will be committed to a policy directed to low rates of inflation, comparable with that of France. The credibility of policy directed to low rates of inflation will be higher for a CFA franc zone member than for a non-member. Therefore, the perceptions regarding relevant policy are influenced by CFA franc zone membership.

Budgetary Deficit

1. In the CFA franc zone, there are no norms regarding the budget deficits. However, there are restrictions on the credit the government can obtain: the maximum equals 20% of the government receipts of the previous year. Large budgetary deficits should therefore partly be financed on the international financial markets. The interest costs associated herewith are presumably enough to prevent explosive growth of the budgetary deficit.
2. Normally, budgetary deficits are positively related with country risk, because of the possibility that these will be financed monetary. Budgetary deficits are viewed as precursors of increasing rates of inflation. This specific risk is not so high in CFA countries, as monetary financing is statutory limited (see above). However, because the budgetary deficits should (partly) be financed on the international financial markets, the total foreign debt will increase. This effect will be monitored by other indicators, while the future higher rate of inflation in the non-CFA countries will be noticed only on a later date. We conclude that given equal external debt to GDP and equal rates of inflation, a high value of the budgetary deficits will be seen as less critical than in a non-CFA country.
3. As described under 1. above, budgetary deficits should for a large part be financed internationally. It will therefore become more difficult to finance a high budgetary deficits. Therefore, the credit institutions in the West will expect lower budgetary deficits in the future than for non-CFA countries.

2. External economic indicators

Diversification of export

1. Diversification of the export has two dimensions: diversification of the products and services exported, and diversification of the countries to which is exported. Membership of the CFA franc zone implies a reduction in the exchange rate risk with the EC, while the exchange rate risk for trade with France is even completely eliminated. This will lead to a concentration of export to the EC and especially France. Therefore diversification is probably slightly reduced.

However, it seems that the diversification of goods exported is unaffected by CFA Franc zone membership.

2. The meaning of a certain value for diversification of products and services exported remains unaffected by CFA membership. A higher concentration of exports to certain countries should be viewed less negatively than normal, as the countries in questions are characterised by high economic stability.

Exportratio

1. Because exchange rate risk for export with the EC is much reduced, it is likely that exports and the export ratios of CFA countries will be higher than without the CFA membership. In general, CFA members are characterised by higher export ratios.⁴⁷
2. Eventually, the capacity to repay debts is determined by the ability to earn foreign exchange. Ultimately, this depends on the export possibilities of the country in question. A high export ratio generally implies a higher repayment capacity; this is equally true for CFA zone countries.

Ratio of total foreign debt to export

1. CFA zone membership exerts two opposing forces on this ratio. Exports are higher for CFA zone countries, because of elimination of exchange rate risk. However, the requirement that a high percentage of the budgetary deficits should be financed on the international financial markets exerts a positive pressure on total foreign debt. Indeed, the average total foreign debt of CFA countries is twice as high as in non-CFA countries.⁴⁸

As these forces pull in different directions, it is not possible to conclude on theoretical grounds what will happen to this ratio. However, from the statistics it appears that the CFA countries generally have a lower ratio of total foreign debt to exports than other comparable, non-CFA countries.⁴⁹

Debt Service Ratio

1. The influence of CFA membership on export income has already been dealt with. The debt service is affected by a number of factors, including the unit cost of capital, amount of foreign debt, time to maturity, percentage of concessionary loans, etc. As indicated above, CFA membership will generally imply higher level of foreign debt. There seems to be no influence of CFA membership on the date to maturity. The percentage of concessionary loans is influenced by two opposing forces: greater ease of access to non-

⁴⁷ IMF (1990) p.33.

⁴⁸ Lane and Page (1991) p.18.

⁴⁹ IMF (1990) p.33.

concessionary loans on the capital markets, while the historical linkage to France results in relatively much concessionary loans from France.

On theoretical grounds it is not possible to predict which of these opposite forces will prevail. Empirically, we observe that the debt service ratio is lower for CFA countries than for non-CFA countries.⁵⁰

Arrears on interest payments

1. The convertibility of the CFA franc implies that arrears on interest payments will be less common for CFA countries.
2. Arrears in payments for CFA countries are more critical than for non-CFA countries, because with a well functioning CFA franc zone, these arrears should be easily avoided.

Percentage of short term debt.

2. A high percentage of short term debt generally implies a higher country risk, as these loans can be retracted at short notice, causing severe liquidity problems. Within the CFA zone, this is of no importance, as short term liquidity problems can be solved by using the convertibility of the CFA franc.⁵¹

Import coverage

1. Because of the guaranteed convertibility of the CFA franc, it is possible to use low reserves, so that the coverage ratio need not be high.⁵² Therefore, import coverage is likely to be low for CFA countries.
2. As the reserves of the CFA countries are pooled, the value of this indicator loses its normal meaning. For CFA countries, it is the possibility to use the CFA franc which is of importance, not the level of reserves itself.

Ratio of short term debt to reserves

1. As discussed directly above CFA countries need to hold only very low amounts of reserves. Therefore, this ratio will have a high value for the CFA countries.
2. As discussed above, because of pooling of reserves this ratio will lose its normal significance.

Use of the credit facilities of the IMF

1. CFA countries less often need to rely on the credit facilities of the IMF, as they are able to use the convertibility of the French franc, and they can make use of other countries' reserves, as these are pooled.
2. As it should be easy for CFA countries to avoid use of the IMF facilities, its actual use should be considered a red herring.

Balance at the Bank of International Settlements

All remarks made for use of the credit facilities of the IMF are equally valid here.

⁵⁰ IMF (1990) p.33.

⁵¹ Of course, the total balance on the operation account should be positive.

⁵² Lane and Page (1991) p.17.

Market discounts on debt

This indicator is not relevant for the CFA countries, as there is no market for second hand debts of these countries.

3 Social-political indicators

Evaluation of domestic policy

1. This is a general indicator, which assesses the appropriateness of domestic policy choices of the CFA countries. The factor is influenced by increases in the costs of inappropriate policies, reduction in degrees of freedom and the formal influence of France. Therefore, we may assume that domestic policy will be more favourably evaluated.
3. As appears from the discussion under 1. here it is the perception which is directly influenced.

Risk of internal conflicts

This indicator is not influenced by CFA membership.

Risk of international conflicts

This indicator is not influenced by CFA membership.

Summary

Some values of internal indicators are positively influenced: inflation and budgetary deficits are both lower than without CFA franc zone membership. Also, some values of external indicators (debt service ratio, export ratio, payment arrears, use of IMF facilities, balance at the BIS) are positively influenced, and the evaluation of domestic policy will be much more favourable. All these factors seem to work to decrease country risk as found by country risk assessment; however, some other indicators (coverage ratio, ratio short term debt to reserves) are negatively influenced, while in other cases (GDP per capita, economic growth, diversification of exports) the effects are mixed. Furthermore, it should be noted that these effects are sometimes partly negated, as the meaning attached to a specific value of an indicator will be changed by CFA membership. The various effects as hypothesized in this section are summarized in table 4.1.

Furthermore, we like to digress on the influence of the recent devaluation of the CFA franc on country risk analysis. The conclusions based on reduction of exchange rate risk with France and the rest of the EC should be qualified, as it is proven that there really still exists exchange rate risk. How this affects country risk analysis is also indicated in table 4.1. As speculations about a possible devaluation of the CFA franc are longstanding, it is likely that country risk analysis has been influenced in the indicated way for some time.

Conclusion

From the discussion above it is not clear whether CFA franc zone membership will lead to lower observed country risk for the CFA franc zone members, as the effects on the indicators used is mostly positive, but sometimes negative. However, a signalling effect (CFA franc zone membership influences the anticipations and perceptions in the West about future policy decisions by the countries involved) could theoretically exist and could empirically be relevant. Whether CFA franc zone membership indeed increases creditworthiness (as would seem more likely, given the discussion above) can only be decided after empirical analysis, which will be the subject of a

subsequent paper.

Table 4.1			
Way indicator is changed			
Indicator	1	2	3
GDP/capita	+/- lp	0	n
Growth GDP/Capita	+ /(-) lp	0	n
Investment/GDP	+ /(-) lp	0	n
Rate of Inflation	+	-	y, +
Budgetary Deficit	+	+	y, +
Diversification of Exports	-/0	+	n
Export/GDP	+/- +,e lp	0	n
Total Debt/Export	+/- +,e lp	0	n
Debt Service Ratio	+/- +,e	0	n
Payment Arrears	+	-	n
Perc. Short term Debt	0	+	n
Coverage Ratio	-	+	n
Short Term Debt/Reserves	-	+	n
Use Credit Facilities IMF	+	-	n
Balance at the BIS	+	-	n
Market Discounts on Debt	nr	nr	nr
Evaluation of Domestic Policy	+	0	y, +
Risk of Internal Conflicts	0	0	n
Risk of External Conflicts	0	0	n
<p> + = positive influence; country risk decreases - = negative influence; country risk increases (-) = situations with negative influence possible 0 = neutral +/- = influence unclear y = yes (3) n = no (3) +,e = empirically positive influence -,e = empirically negative influence + /(-) = mostly positive influence; may be negative 0/- = neutral or negative nr = not relevant lp = evaluation less positive if devaluation is considered possible </p>			

Section 5 Conclusions

In this paper we analyzed the reasons for participation of the CFA member countries in the CFA franc zone. As in the literature, we found that theories which are normally used to explain existence of and participation in monetary unions are not satisfactorily in the CFA case. Several alternative explanations have been considered, and another possible explanation has been offered: membership of the CFA franc zone can be used as "*Financial signalling by the Government*"; as a method to ameliorate its country's score in a country risk assessment. This is obviously attractive, as inflows of capital are related with country risk assessment, given same rate of returns.

On a theoretical level, membership in the CFA franc zone may exert a possible influence on country risk assessment in a number of different ways.

First, membership may directly influence the score on some indicator of country risk. We have argued that levels of indicators are probably favourably affected for the following indicators: growth of GDP per capita, degree of investment, rate of inflation, the budgetary deficit, payment arrears, use of credit facilities of the IMF, and balance held at BIS. Some other indicators are probably disavourably affected; arguably, this is the case for the coverage ratio and short term debt to reserves.

Second, a specific score of an indicator might be different interpreted in case of membership of the CFA zone. The interpretation of a specific score are probably positively changed for the following indicators: budgetary deficit, diversification of exports, percentage of short term debt-coverage ratio, and short term debt to reserves. Negatively affected are the interpretation of same scores on rate of inflation, payment arrears, use of credit facilities of the IMF, and balance held at BIS.

Third, expectations regarding governments' policies are favourable changed with respect to the following indicators: rate of inflation, budgetary deficit, and quality of domestic policies in general.

The preceding analysis suggests that membership in the CFA franc zone could historically have exerted a positive influence on the possibility to attract foreign capital. However, it is difficult to assess whether this is still the case after this year's devaluation of the CFA franc.

The present paper is of course theoretical in nature. An empirical analysis of the hypotheses offered in this paper has not been done yet, and promises to be interesting. An empirical analysis of the influence of CFA zone membership will be provided in our next analysis of this topic.

Appendix Some background information about the devaluation of the CFA franc

On January 12, 1994 in France, the 13 members of the CFA franc zone as well as the Comoros decided to adjust the parity of the CFA franc exchange rate and the Comoros franc respectively. The CFA franc devalued 50%, while the Comoros franc devalued one third against the French franc. This is the first parity change since the creation of the CFA franc zone.

After years of speculation and rumours about the possibility of an devaluation this finally happened. In the second half of the '80 the economic and financial situation of the CFA countries deteriorated significantly. Since that time speculation against the CFA franc as well as capital flight started. To stem the huge outflow of capital through the export of banknotes, the African authorities suspended on August 2, 1993 to repurchase any CFA franc bank note in circulation outside the territories of the CFA franc zone. The convertibility of the CFA franc into French franc remained, with this exception, unchanged. This was the prelude to the devaluation half a year later. After the devaluation an anonymous economist was quoted in the Financial Times saying:

"[that the devaluation was the] most foretold and least well prepared devaluation in economic history".

Until 1985 the CFA franc zone served its members well assuring low rates of inflation, reasonable and sometimes high economic growth as well as a reasonable high rate of (foreign) investment. Since 1985 the African countries got economical and financial problems. The economic growth was low (some years even negative), export growth was low, wages high, low levels of (direct) investments, liquidity problems of the commercial banks (some bankruptcies), and high national and international public debts. Two major external shocks caused the deterioration, which finally resulted in the devaluation.

First, the external competitiveness of the zone weakened as a result of the nominal appreciation of the French franc against currencies of the zone's major trading partners and a lack of appropriate policy response by African franc zone members to this appreciation. Since 1986 France fixed its currency to the German mark within the framework of the EMS. This was a totally different exchange rate policy from that of early '80s. In those years the French franc devaluated several times in an effort to improve France's competitiveness.

This policy change occurred at the same time as start of the spectacular fall of the US dollar. Because most of the export prices of the CFA franc countries are expressed in US dollars, their export receipts declined in terms of CFA francs. Finally some neighbouring countries as Ghana and Nigeria, competitors on the world market, devalued their national currencies several times since 1986. The resulting appreciation of the CFA franc caused the zone to lose the benefit of its natural comparative advantages.

Second, the zone's terms of trade deteriorated, owing mainly to the fall in world market prices for its major exports (cocoa, coffee and petroleum in particular) and to the increase in import prices.

Political resistance against devaluation

For many years, the World Bank and the IMF advocated a realignment of the CFA franc. Because of social, political and economical reasons it lasted until 1994 before the CFA franc devalued. First there were conflicting interest between the member countries as well as within the member countries itself. The overvaluation of the CFA currency benefitted those CFA countries that were heavily dependent on foreign imports (i.e. Chad). Because of the overvaluation these imports were relatively cheap. On the other hand, the overvaluation was a disadvantage to the exporting countries (especially Ivory coast and Cameroon).

Within the national boundaries the overvaluation benefitted the African elite and its civil servants, mostly living in the urban areas, as they could buy cheaply imported luxury goods. These groups traditionally support the government. Some countries were afraid of riots as a possible consequence of devaluations. (And indeed, in some countries riots broke out after the devaluation).

Second, France was for a long time also a major opponent against devaluation. One should know that the zone was not just strictly monetary, but it has political and military aspects as well. The CFA franc zone guaranteed mutual support in case of attacks from outside the zone. In practice this meant that France sent military help to aid allied regimes. Above this, French companies favoured the currency-alignment as it insured them of a less risky access to the CFA franc zone-market.

Finally, because the currency peg worked pretty well in its influence on for example economic growth and inflation until 1986, one can imagine strong opposition against a devaluation.

Influence of the devaluation on the country risk analysis

The influence of the devaluation on country risk and its perception is difficult to predict. The first short term effect of a devaluation is that it makes (necessary) imports more expensive. This will harm those countries which are heavily dependent of imports such as Mali, Chad and Niger. (To overcome this, the IMF and the World Bank donated 2 billion US\$.) Besides this, the international debts (in local currencies) will double. This will cause much harm to those countries which are already highly internationally indebted (Ivory Coast).

The medium and long term effects will depend on the implementation of a macro-economic stabilisation policy and the dynamic abilities of the CFA franc zone countries to adjust to and profit from the improved export possibilities.

The realignment, accompanied with measures to control demand and foster a recovery in supply, may lead to considerable increases in productivity, in both traditional and non-traditional sectors. This strategy may enable zone member countries to regain a level of competitiveness that will allow them to benefit fully from their comparative advantages. The realignment can lead to a shift from the less growth-oriented sectors (which are often artificially protected) to the more dynamic and competitive sectors of the economy. The agricultural sector might be the first to benefit from such an operation.

Furthermore the realignment may stimulate export growth, because the CFA products may become cheaper on the world market. Especially the exporting countries, like Cameroon, Ivory coast, Ghana will benefit mostly. Direct foreign investment will also be more attractive. International structural aid may increase, because the realignment was an prerequisite of the IMF for providing structural aid to the CFA zone. This multilateral aid is a prerequisite for debt restructuring in the Paris Club by the zone's international creditors. France has already remitted debts of a total amount of Ff 25 billion. Debt arrangements are especially important for the richer countries in this area, like Gabon, Cameroon, Congo and Senegal, because they have the highest international debts relative to GDP.

It is exactly this group of countries that did violate the rules of the CFA most strongly. In the '80s they kept an almost permanent deficit on their operations account. Partly because of the actions of this group of countries, the functioning of the systems was put under severe stress. On the other hand, these countries have the benefit of a relatively well developed and export oriented economy. With a lower external debt for this group of countries the CFA system may get a good second start to perform as it is supposed to, as this group determines to a large extent the economic performance of the CFA franc zone.

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