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Franc Zone, economic growth and poverty reduction*

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Abstract

Econometric analysis of the long term consequences of Zone franc membership for economic growth and poverty reduction in African member countries let evidence two main conclusions. First the possible costs linked to rate of exchange fixity seem limited. Second the benefits linked to monetary stability, while they have not been significant as for the economic growth of member countries, have been so for poverty reduction, meaning a more inclusive growth in Franc Zone.

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The main feature of the Franc Zone system is the fixed exchange rate between the CFA francs and the euro, which is backed by a guarantee from France. Since the African states that make up the zone gained independence, their exchange rate has only been modified once, in 1994. The credibility of this fixed exchange rate is contingent on a number of fac-tors. First, any change in the rate has to be agreed unanimously by all heads of state in each monetary union (WAEMU and CEMAC).

Second, the central banks (BCEAO and BEAC) in the unions have a "compte d'opérations", which gives them access to the foreign currencies they need to guarantee the convertibility of current account transactions, even when their external reserves have been depleted. Finally, the central banks' community statutes provide for their independence and define their main target as monetary stability. As a result, Franc Zone countries have enjoyed much lower rates of inflation than other African nations.

This monetary system is the focus of frequent criticism. Leaving aside the political criticism, which holds that the system is a hangover from colonialism, the main contention is that the currency risks becoming overvalued due its fixed peg to the euro, which itself has fluctuated sharply, primarily against the dollar but also against the yuan, the pound sterling and the yen. Critics claim the lack of flexibility in the CFA franc exchange rate could cause Franc Zone countries to lag behind other African or developing economies in terms of growth. The same thing could result from excessive monetary stability. As regards the purported benefits of monetary stability – that it makes growth in Franc Zone countries more beneficial for the poor as they are the ones worst affected by high inflation – even this has been called into question.

In view of these considerations, a Ferdi book[1] aims to answer three questions:

1. has the Franc Zone experienced any currency disequilibria, and what is their magnitude?;

2. how do the growth performances of Franc Zone countries compare to those of other developing economies?;

3. has economic growth in the Franc Zone been more favourable for the poor, and to what extent is this outcome the result of monetary stability?

Currency disequilibrium in Franc Zone

There are two major strands of the literature on currency disequilibria. The purchasing power parity (PPP) approach looks at the issue from a spatial perspective, comparing prices in different countries across the world. Meanwhile, the Behavioural Equilibrium Exchange Rate (BEER) approach examines the issue by looking at whether the exchange rate deviates from the rate associated with the fundamentals that determine the medium-term equilibrium of the balance of payments. PPP models are more suited to international comparisons of the long-run growth impact of exchange rates. Therefore, this approach was chosen here. Efforts were made to correct for price differentials between countries through growth in productivity – measured either by straightforward GDP per capita or by GDP adjusted for the impact of rents. This produced two kinds of exchange rate disequilibria and misalignments, which were used in the subsequent chapters.

Regardless of the misalignment measure used, the monetary unions have not overall experienced any lasting disequilibria in their exchange rates.

1. Feindouno S., Guérineau S., Guillaumont P., Guillaumont Jeanneney S.and Plane P., (2020) *Zone franc, croissance économique et réduction de la pauvreté*, Ferdi.

However, some countries have gone through periods of overvaluation caused by a sharp spike in oil revenues, such as Equatorial Guinea at the start of the 1990s. In addition, the overvaluations observed in countries that have suffered major political crises and whose landlocked status causes higher price levels (e.g. Central African Republic, Niger) need to be viewed against what could have happened if these countries had left the Franc Zone and abandoned the fixed exchange rate. In these specific contexts, such a move would have triggered a massive depreciation of their currency, coupled with a dollarisation of their economy manifested by an informal use of the CFA franc. However, the aim here was to analyse whether exchange rate misalignments could cause weaker economic growth in the Franc Zone.

Franc Zone membership and economic growth

To assess the impact of exchange rate policies on economic growth, it is important to take into account factors beyond individual countries' control (exogenous factors), such as initial structural weaknesses and external shocks. This was done using an econometric panel analysis. Some exogenous factors were found to be significant for all developing countries: initial GDP per capita, population growth, the under-five mortality rate (which represents the weakness of human capital), external shocks such as growth in oil revenues, changes in the terms of trade and droughts. Other factors that can be seen as being influenced by membership of the Franc Zone were also taken into account: intensity of conflicts, amount of external aid, type of political regime in place and the head of state's longevity in office. As expected, development aid has a positive impact on growth whereas conflicts have a negative one. The level of democracy has no significant effect on growth performance, whereas the head of state's longevity in office has a favourable impact to begin with and then an unfavourable impact in the longer run. However, taking these factors into account did not shed any light on whether being part of the Franc Zone leads to higher or lower growth than in other developing countries.

We therefore looked at whether the specific characteristics of the Franc Zone's monetary system can explain growth rates in its member countries. In relation to the rules of the Franc Zone, we took into account monetary stability as measured by the rate of inflation, and currency misalignments as measured in Chapter 1, or as measured by the deviation of the real exchange rate from its long-term trend, which is a simple and standard measure of currency disequilibrium inspired by BEER analyses. The results show that there is no significant difference between growth rates in Franc Zone countries and those in other developing countries, in Africa or elsewhere, that can be attributed to the zone's monetary system, except during short periods, for example before the devaluation in 1994. These results are consistent with the lack of significant community-level exchange rate misalignments observed in Chapter 1. Given the benefits that could be expected from monetary stability, the absence of a significant growth difference can be regarded as disappointing. However, it is an important element that can help to clarify the debate over the Franc Zone.

Franc Zone membership and poverty reduction

To analyse the relationship between poverty levels and membership of the Franc Zone, different expressions of poverty were used: first, the percentage of the population living below the poverty line, defined as income of USD 1.90 per inhabitant per day, and then two measures related to the intensity of this poverty. The depth of poverty is measured as the gap between the average income of the poor and the USD 1.90 threshold (the poverty gap), while the severity of poverty is measured by the poverty gap squared, which gives a higher weight to those households furthest below the poverty line. A reduction in inequality among the poor will lead to an improvement in this indicator.

The analysis was carried out using household survey data from the World Bank's PovCalNet database. PovCalNet is one of the most important and reliable data sources for poverty measurement due to the large size of the sampled population and the fact that households are questioned directly on their living conditions. However, one of the limitations for our analysis was the relatively low number of surveys carried out in Franc Zone countries, especially in CEMAC.

The elasticity of poverty to household income or consumption is liable to differ during periods when income is growing and during periods when it is declining. Moreover, while a high elasticity indicates that growth is favourable for the poor during periods of income growth, in periods of decline it indicates that growth is unfavourable for the poor. For this reason, the estimates were done for the entire sample as well as for two restricted samples – one that only included periods of growth in per capita consumption, and one that only included periods of decline.

In Franc Zone countries and during periods of income growth, elasticity is almost twice as high as in other countries, and the gap widens further, when we look at the elasticity of the depth and severity of poverty. Thus, growth in the Franc Zone appears to be particularly inclusive, especially in WAEMU for which we had a sufficient quantity of data to carry out an econometric estimation. The higher elasticity persists when structural factors are introduced into the estimation.

However, these favourable results for the Franc Zone need to be qualified for two reasons. First, during periods when income is falling, the elasticity of the depth and severity of poverty is higher than during periods when income is rising. This result should be interpreted with caution due to the small size of the sample. However, it would appear that poor countries in the Franc Zone are more vulnerable to recessions, which clearly shows the extent to which the fight against poverty in the Franc Zone hinges on economic growth. It is therefore reassuring to see that the average rate of economic growth in WAEMU between 2012 and 2018 was in excess of 5% per year, that aggregate GDP growth in the union was around 6% per year, and that in each year aggregate growth exceeded rates in other African countries, as well as in all other developing countries. Second, rates of poverty in the Franc Zone are higher than in all other African countries, as this greater capacity to reduce poverty via average per capita income growth is offset by structural factors that hinder poverty reduction when growth in per capita consumption is too slow (below 3% per year).

The analysis also confirms that inflation increases the proportion of poor people and the depth of poverty during episodes of income growth, but has no effect during periods of income decline, when the increase in poverty is explained by the economic contraction. It is notable that when inflation is introduced, the elasticity of poverty to income in the Franc Zone no longer differs from elasticities in other countries. This suggests that the higher elasticity in the Franc Zone is due to the lower level of inflation. In other words, growth is particularly inclusive in the Franc Zone in that it protects the poor from excessively high inflation.

Conclusion

With regard to advantages and disadvantages of a fixed exchange rate, which is the main characteristic of the Franc Zone, two conclusions can be drawn: (i) the costs linked to the fixed exchange rate appear to be limited in size (smaller disequilibria in the real exchange rate, small impact of these disequilibria on growth performances and poverty); and (ii) although monetary stability has no significant benefit in terms of growth in the Franc Zone, it does have an impact in terms of poverty reduction, which makes Franc Zone growth more inclusive.

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