THE VIEW

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CFA FRANC TURNING 75: CENTRAL AFRICAN COUNTRIES UNDER PRESSURE

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- In 2020, the CFA Franc is turning 75 years old. The currency, used in two African regions[1], is backed by the French treasury and pegged to the Euro. Though the 2014 commodity price slump revealed vulnerabilities, the situation is not comparable with 1994, when the CFA Franc was devalued by -50% in Western (WAEMU) and Central (CEMAC) CFA Franc areas. Yet, divergence among members calls for cautious optimism about the stability of the currency.
- Looking at today's trade integration, mobility of the workforce, currency misalignment, debt sustainability and buffers of foreign exchange reserves in the zone (Optimum Currency Area criteria), we find that:
    - The CEMAC area is under pressure. Our model shows intra-zone trade is -USD200mn below what common borders, language and currency should provide for. There is evidence of currency overvaluation in the region (mainly in CAR, Gabon and the Republic of the Congo) as a result of lower oil prices. This has led to an increase of public debt and a fall in the foreign reserves-to-M2 ratio below the 20% threshold in Congo Rep. and Chad. In spite of these fragilities, a breakup or devaluation in the next five years is unlikely. If oil prices were to fall to USD 30/bl for long, the area would not be able to avoid a devaluation, but a breakup will remain unlikely. CFA Franc membership is an institutional fix that grants price stability to its members. Any exit would be a political choice, not an economic one.
    - The WAEMU area is under control. Public debt has increased but remained manageable, the CFA Franc parity does not look overvalued and the level of reserves is adequate. However, members are not making the most of the monetary union, since intra-zone trade flows look below what a monetary union would grant in five out of eight countries. The ECOWAS trade agreement and the ECO currency project with neighboring Anglophone countries like Ghana and Nigeria are game-changers. Yet, the CFA Franc may well celebrate its 100th anniversary before the ECO replaces it.

[1] Western CFA Franc: (Benin, Burkina Faso, Côte d'Ivoire, Guinea Bissau, Mali, Niger, Senegal, Togo)
Central African CFA Franc: (Cameroon, CAR, Chad, Congo Rep. Equatorial Guinea, Gabon)

14 African countries

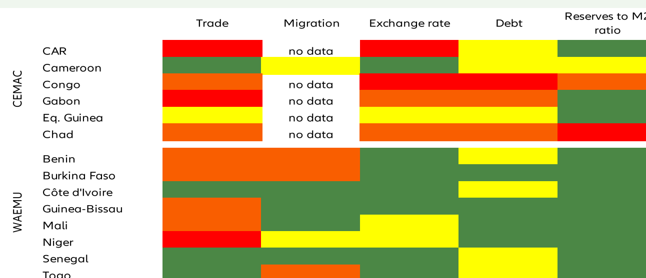
use the CFA Franc

DOES THE CFA FRANC STILL DO THE JOB?

The CFA Franc is a common currency arrangement established in 1945 that holds for two distinct areas in Central and Western Africa. Each area is organized through a fixed exchange with the Euro and a compensation account ruling that half of collective foreign reserves are deposited into the Banque de France.
Over the years, the arrangement allowed its members to avoid the recurrent depreciation pressures faced by peers (Ghana, Nigeria, for eg.) and to mutualize foreign reserves in order to use them when in trouble. While CFA Franc countries have performed better in terms of inflation stability, concerns have been raised as a result of lower commodity prices and (particularly for oil and metal exporters) lower growth since 2014. In this context, we analyze whether a significant depreciation of the CFA Franc is possible, and whether a breakup scenario is conceivable.

Obviously, exchange rate topics are often too sensational and things need to be examined with objective criteria. We propose in this paper to analyze the CFA Franc country members according to the following list of topics: Trade relationship, labor mobility, consistency of the exchange rate level, fiscal and debt convergence, and monetary convergence (See Figure 1 for summary).
Unlike the period before 1994, large asymmetries between member countries persist, reducing the need or the probability of a large depreciation of the CFA Franc: High growth in the West (WAEMU), missing growth in the Center (CEMAC). In contrast, the 1994 devaluation ended a lost decade of poor commodity prices, large deficits and clear over-indebtedness that spread throughout the region. With too low foreign reserves, the condition for CFA Franc devaluation was also met prior to 1994. This time is different, since the reserves to M2 ratio shows no overall consistency problem.
However, a close monitoring is required for certain economies. Current concerns are the strongest in Central Africa. Depreciation pressures are more likely in this area as a result of exchange rate misalignment, debt levels and hard currency shortages. These indicators also mean some divergence between the countries, which is not the best thing for the sustainability of a monetary union. A central scenario is the continuation of a low growth period, persisting exchange rate misalignment and debt tensions. In a downside scenario for oil prices (USD 30/bl for long), a new devaluation would be difficult to avoid in the five-year horizon.
In the WAEMU, the risk is not the same. There is no exchange rate misalignment currently, meaning that the CFA Franc does not entail sustainability risks. The question is more about the consistency between the monetary agreement and the trade agreement (ECOWAS which is broader than the CFA Franc area). Most of the countries appear to be able to live with the CFA Franc and currency choice is just a matter of what should be the overall economic project in the years to come. A monetary union for the broader ECOWAS can be consistent but such an eventuality would take (a long) time.

Figure 1: Heat map of the main pre-conditions for CFA Franc optimality

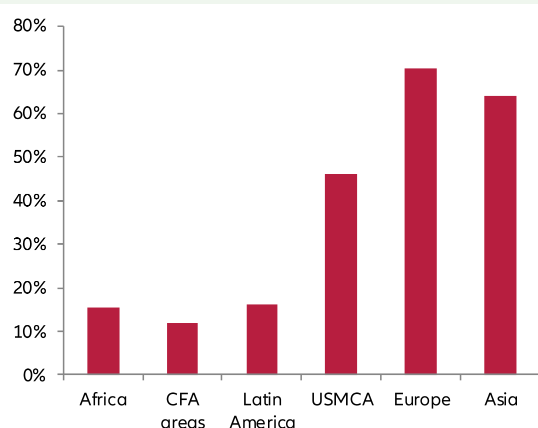


Source: Allianz Research

[2] For each criterion, each country is ranked from green to red, according to its position on the following indicators. For "Trade": countries with intra-zone exports above our estimates are in green (below 20% in red). For "Migration": countries with their strongest ties with the CFA Franc members of Eurozone members are in green, countries with the strongest outside are in orange, and countries with a balanced landscape are in yellow. For "exchange rate", countries with an overvaluation above +20% are in red (no overvaluation grants a green). For "debt", countries with a debt to GDP ratio above 100% are in red; orange is given to countries with either significant debt or high debt service. For "Reserves to M2 ratio", red is for countries with a ratio well below 20%, and orange when this ratio is slightly below.

LOW TRADE BETWEEN CFA FRANC MEMBERS

Figure 2: Share of intra-regional in % of total trade



Sources: Unctad, Allianz Research

Table 1: Export to other CFA Franc economies, observed vs. estimation through a gravity model

	Observed flow	Gravity model	Missing (-) / additional (+) flow
CEMAC	**619**	**837**	**-218**
CAR	2	82	-79
Cameroon	356	174	182
Congo Rep.	96	162	-66
Gabon	14	172	-158
Eq. Guinea	123	163	-40
Chad	28	84	-56
WAEMU	**2821**	**1477**	**1344**
Benin	74	206	-132
Burkina Faso	71	174	-103
Côte d'Ivoire	1298	333	965
Guinea-Bissau	15	62	-47
Mali	28	132	-104
Niger	10	141	-131
Senegal	683	202	481
Togo	641	227	414

Sources: Euler Hermes, Allianz Research

A high level of intra-regional trade is a key pre-requisite to have a common currency area that works, because it increases the likelihood that its country members do not evolve in different directions, which would increase the likelihood of a currency union breakup. But the proportion of intra-regional trade in the CFA Franc area is lower than in many other regions, particularly those where a strong regional trade agreement had driven more regional integration (EU, USMCA, Asean).

We model bilateral trade through a gravity model and compare its fitted value with observed trade data. We find that bilateral trade between CFA Franc members is below what would be granted by just gravity in 10 countries out of 14. A case in point is the CEMAC where Cameroon is the only country to benefit from significant intra-CFA Franc area trade flows.

Looking at the kind of commodity that is dominant in each country's exports, we identify that the countries that tend to have regional trade flows below normal are oil and metals exporters. Conversely, the share of food commodities traded regionally is wider. As CEMAC members tend to be more oil-driven, they tend to trade less regionally than WAEMU ones, for which food is often a key export sector. A higher number of outperformers in the West also host existing trade hubs (e.g. Togo, with the Lomé port, where the traffic outpaces the one in Lagos). As a result, WAEMU members seem to be more solid in terms of trade integration.

What comes next can be a game-changer. Among key trade projects, the African Continental Free Trade Area (AfCFTA) is likely to favor more trade and in particular more intra-African trade, with symmetric effects on the WAEMU and the CEMAC. As a project of further economic integration, the ECO (which is designed to be a unit of account, like the ECU from the 70s in Europe) in the ECOWAS region will certainly play in favor of further integration for the WAEMU.

[3] The (short) distance, a common frontier, a common language, a situation where one country is landlocked and the other is its natural access to a sea, a common trade agreement or a common currency are all likely to favor more trade between two countries. A gravity model includes all this data in order to explain the bilateral trade between two countries.

THE CFA FRANC IS NOT A BORDER

Labor mobility is one way to cope with income shocks that are not the same in two members of the same currency area, encouraging migrant remittances that are vital for stability and sustainability. The latter can be a good indicator of the economic ties between two countries.

We observe, however, that bilateral remittance flows in West and Central Africa are not always determined mainly by CFA Franc membership. Past migration flows had other triggers, such as common borders, income divergence or geographical position (for e.g. citizens of Burkina Faso tend to migrate to Ghana). In the WAEMU, four countries have their closest relationship with a non-CFA Franc ECOWAS country (Benin with Nigeria, Burkina Faso with Ghana, Niger with Nigeria and Togo with Ghana). For the other four members of the WAEMU, countries in the peg are the main source of migrant remittances (own CFA Franc area + other CFA Franc area + Eurozone). Overall, aggregate ties within ECOWAS are often strong (adding CFA Franc and non-CFA Franc shares), representing at least half of migrant remittances for six out of eight countries in the West. So, historical, cultural and geographic factors are more decisive in explaining remittance flows, underlining the fact that the CFA Franc area is not fully optimal in terms of circulation of the workforce.

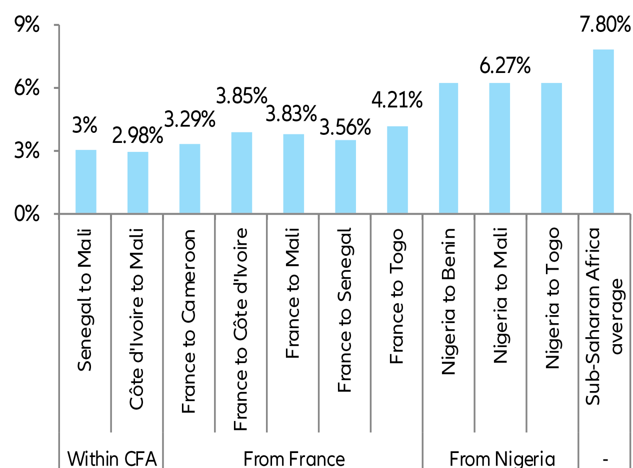
However, there are some advantages for member countries vis-à-vis non-member ones. Remittance transfer costs in the Western African CFA Franc area are the cheapest between CFA Franc members (e.g. Senegal to Mali) and are just slightly higher compared with France. This shows that financial integration is stronger within the monetary union. Conversely, transfer costs can ascend to sizeable levels when one of the countries is not a CFA Franc member (for eg. Nigeria, see Figure 3). Another advantage of being a member of a CFA Franc area deals with the strength and stability of this currency. However, when a migrant goes outside of the CFA Franc, he incurs income losses that can arise from exchange rate depreciation or a delayed transfer as a result of capital controls in the migration country (Ghana Cedi or Nigerian Naira), which had often generated frustration.

Table 2: Inward remittances, % from each source

	Own CFA area	Other CFA area	Eurozone	Non CFA Ecowas	Main source (% of Total)
Benin	15%	18%	11%	55%	Nigeria (50%)
Burkina Faso	21%	5%	23%	48%	Ghana (43%)
Cameroon	20%	0%	41%	-	France (25%)
Cote d'Ivoire	58%	1%	19%	19%	Burkina Faso (49%)
Guinea-Bissau	16%	0%	61%	14%	Portugal (45%)
Mali	17%	19%	31%	31%	France (24%)
Niger	37%	8%	10%	42%	Nigeria (38%)
Senegal	3%	8%	64%	19%	France (29%)
Togo	13%	7%	23%	53%	Ghana (29%)

Sources: Inward remittances, % from each source

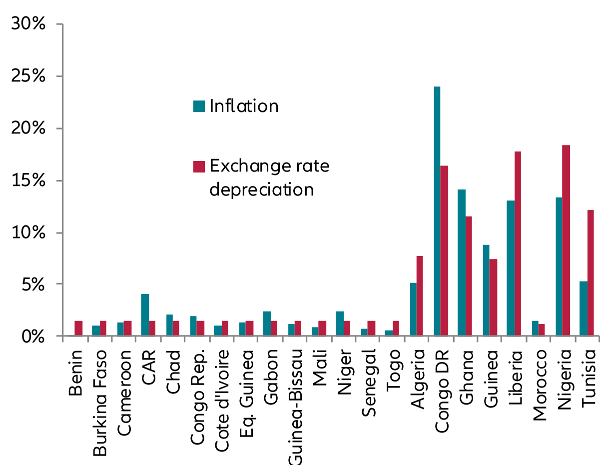
Figure 3: Transfer costs (in % of the remittance transferred)



Sources: INSEE, Allianz Research

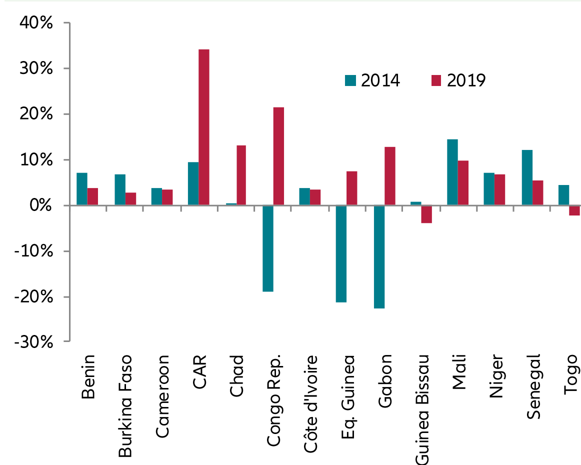
PARITY: AN ISSUE IN THE CEMAC, NOT IN THE WAEMU

Figure 4: Inflation rate vs. exchange rate change (yearly averages on 2015-18)



Sources: Allianz Research

Figure 5: Average overvaluation (+) / undervaluation (-) *24-months average*



Sources: IHS Global Insight, Allianz Research

Since the CFA Franc is pegged to the Euro, it tends to appreciate nominally against the currencies of countries outside of the union, potentially hampering the competitiveness of member countries. However, as inflation is far lower in CFA Franc economies, exchange rate movements are not the only variable to have an impact on relative competitiveness between CFA Franc and non-CFA Franc members. Overvaluation is not granted for all CFA Franc countries or at all times.

Terms of trade are a key mean reversion item. Terms of trade are the ratio between export and import prices (each denominated in the same currency). When the exchange rate is consistent with terms of trade valuation, the external sector tends to have a balanced situation: no overvaluation / no undervaluation of the exchange rate.

It does not mean that the current account has to be balanced every time. A country that is in a development process tends to export low value-added goods and import high value-added goods (typically capital goods that help build infrastructure), which means a current account deficit. For sustainability purposes, it isbetter if this deficit is financed through stable (foreign direct investment) inflows.

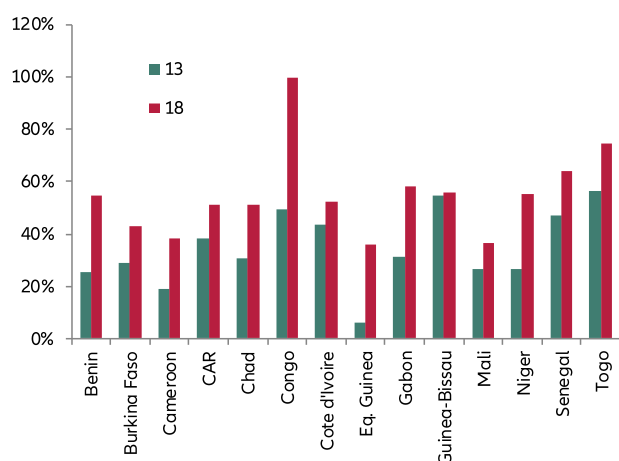
We computed the difference between current real effective exchange rate levels (weighted average of real exchange rate levels with trade partners) and observed terms of trade. The results show an overvaluation in many of the CEMAC countries and more benign divergences in the WAEMU ones. Overall, the situation today is very different from 1994 where a -50% depreciation was implemented in order to correct an overvaluation of quite the same size.

The results also show that oil is the key commodity to rank economies. In countries where oil is an export (Gabon, Congo Rep., Eq. Guinea), terms of trade have lowered markedly since 2014 and current exchange rate levels are consistent with a sizeable overvaluation. Things are totally different when oil is imported and food is exported. Agricultural prices have also decreased, but this was more than matched by the oil prices slump and these economies did not exhibit sizeable overvaluation (e.g. Côte d'Ivoire or Senegal).

All in all, we can say that members of the CEMAC tend to suffer relatively more from an overvaluation of their currency, which is another element of fragility

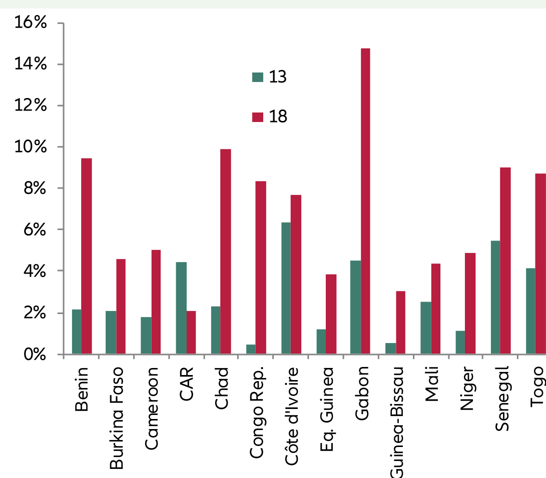
PUBLIC DEBT AND FISCAL BALANCES CAN POSE A RISK

Figure 6: Public debt in % of GDP, 2013 vs. 2018



Source: Allianz Research

Figure 7: Interest expenditures in % of total expenditures



Source: IMF, Allianz Research

Even when the level of the exchange rate is consistent, a monetary union can experience bad times when some member countries are unable to repay their debts (Greece in the Eurozone, for eg.).

African economies are now not collectively affected by the same kind of excesses seen in the nineties when the Heavily Indebted Poor Countries initiative helped to cut their debt ratios. However, debt has increased fast, particularly in countries that experienced sharp reversals from twin surpluses to twin deficits (current account and fiscal balances).

Another issue is stock-flow reconciliation: Debt evolutions are not only driven by fiscal deficits, since there are also off-budget items that are debt-generating. Some of them can arise from state guarantees on state-owned enterprises, but more generally, as off-budget financing is less reported and often financed through opaque mechanisms, this debt can be hidden even with close monitoring.

Combining all of these reasons, it appears that too much debt is once again an issue in some countries in the CEMAC area, such as Congo Rep., and liquidity drying up is an issue in other parts of the region even with a low debt to GDP ratio (e.g. CAR). In the WAEMU region, the level of debt is not residual and its forward-looking dynamics will have to be monitored carefully since some member countries are still not financing their current account deficits through FDI (e.g. Senegal).

The increase of public debt in the last few years has already had an impact on debt servicing. Interest expenditures have risen quite fast. This shows that the economies in the region have less leeway now. Though cooperation with international financial institutions has helped to smooth this difficult period, the debt criteria shows a progressively increasing fragility of both regions.

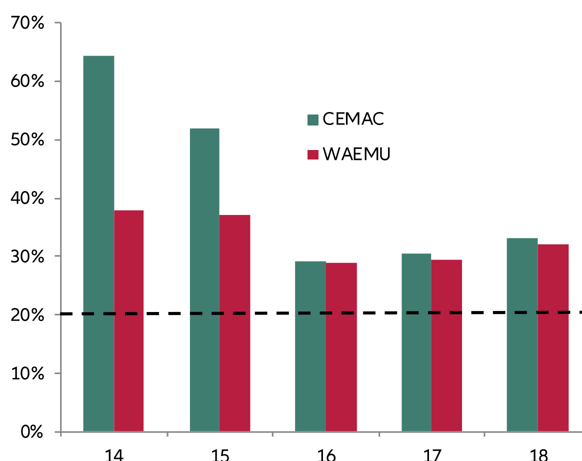
DOLLAR SHORTAGES MAY DRIVE (TOO MUCH) MONEY PRINTING

For this criterion, we go to the basics of CFA Franc areas, considering the ratio of foreign reserves to money supply (M2), which should not be under 20%. Each of the two CFA Franc areas is ruled by a Central Bank that manages money supply in order to keep money balances in check. The level of foreign reserves is today far higher than in 1994, alleviating a collective liquidity pressure that was strong 25 years ago. However, the oil price slump has radically changed the situation in the CEMAC region. An ample amount of foreign exchange reserves vanished and many countries have had to learn to live without them. Since, past high reserve levels were used as a kind of collateral for debt accumulation, debt ratios now appear less sustainable (e.g. in Congo Rep. or Gabon).

The WAEMU region faced a different situation, since the ratio was always lower, pushing its members to have a reserve pool and alleviating speculative bets on the liquidity position of its country members.

Foreign reserves data is public information in the CEMAC. They reveal the sudden fall in the import cover of the foreign reserves ratio in several countries after the decline of commodity prices post 2014. In Gabon, this has led to a diminution of the money supply that eventually worsened the economic slump, but helped the FX reserves to M2 ratio to close 2018 at 29.6%. In some other countries, the ratio went below the threshold (e.g. 13% in Congo Republic), prompting a rescheduling of some debt loads and the intervention of the IMF. In this case, and potentially in other cases of country members of the CFA Franc area, the phenomenon of hidden (public debt) can play an important role in destabilizing or blurring the signal of this important reserves to M2 ratio. A constant and in-depth analysis of this fundamental is therefore required to ensure the viability of the CFA Franc areas.

Figure 8: Foreign reserves to M2 ratio



Sources: IMF, Allianz Research

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