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Henckollas, André, M.S.

San Jose State University, 1994

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THE FRANC ZONE
IS IT THE MONETARY UNION WHICH AFRICA NEEDS?

A Thesis
Presented to
the Faculty of the Department of Economics and
School of Business
San Jose State University

In Partial Fullfillment
of the Requirements for the Degree

Master of Science

By

André Henckollas
August 1994

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ABSTRACT

THE FRANC ZONE IS IT THE MONETARY UNION WHICH AFRICA NEEDS

by André Henckollas

This thesis addresses the effect of a monetary union on the economic growth of developing countries by examining the case of the Franc Zone. The increasing deficit of the current account of Franc Zone members raises a growing concern in the international financial community. The World Bank and the International Monetary Fund, especially, have, for many years pointed out the adverse effect of fixed parity between the French franc and the CFA franc, and have advocated the devaluation of the latter.

Research reveals that over nearly half a century the Franc Zone has played a pervasive role in the growth of its fourteen-French speaking African members.

After surveying the Franc Zone, as well as the possible birth of the European Monetary Union, this thesis suggests the disassociation of the CFA franc from the French franc and recommends a path to a new monetary union for the French speaking African countries.

To my late father and my late mother

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INTRODUCTION

French-speaking African countries enjoyed a remarkably stable currency for forty five years whereas most sub-Saharan African nations, with the notable exception of South Africa, have faced the side effects of a volatile currency, particularly after the breakdown of the Bretton Wood system in 1971. The reason for this stability is a monetary union, known as the Franc Zone (also referred to in this paper as the CFA zone), with the one time metropolis France. The major characteristic of the Franc Zone is the issuance of one single currency, the CFA Franc, used in fourteen African countries nowadays.

Backed by the French franc, the CFA franc was to some extent a "hard currency" (until the January 1994 devaluation). In other words, it was highly desired by the citizens of African countries (especially the neighboring countries of the CFA Zone members) whose currencies are less demanded because they are not convertible or have been weakened by a long-run hyper inflation ("soft currencies"). In fact, in some of such neighboring countries of certain Franc Zone members, like Zaire or Ghana, many traders used to refuse the domestic currency and rather traded with the CFA franc or other "hard currencies" (the US dollar, the French franc, the japanese yen, etc.). The CFA franc was regarded as a stable store of wealth as well as a means of acquiring imported goods which they do not have access to with their domestic currency. In these countries, a flourishing black market had developed where the CFA franc was exchanged at a rate above the official one, despite the government's effort to dismantle the black market. Yet, the link of the French franc and the CFA franc has affected CFA Zone members in different ways.

Whenever the French franc is devalued, CFA Zone countries experience the effects of that devaluation, particularly inflation of imported goods (discussed in Chapter One). Also, their export earnings have been undervalued over many years due to the association of the two currencies.

European attempts to establish a monetary union with a single currency, if they succeed, are another challenge to the CFA zone. Despite the French Government statement of support to its African partners, one question arises. Would the CFA franc be pegged to the European Currency Unit (ECU)? This is not obvious. It is reasonable to assume that this linkage would require the formal agreement of the other European Economic Community (EEC) members. No such agreement is certain. Moreover, the completion of the European Monetary Union is subject to many requirements in terms of budget deficit, inflation, deficit of the balance of payments, etc. Currently, few European countries meet these requirements. Appendix A presents the convergence criteria EEC members must satisfy in order to enter the European Monetary Union (EMU). In case the CFA Franc has to be pegged to the European currency, these constraints or like conditions would apply to them. Then, another question arises. Would Franc Zone members meet these conditions?

The uncertainty about the future of the Franc Zone with respect to the completion of the EMU, the recent devaluation of the CFA franc against the French franc, as well as France's own imperatives suggest that the disassociation of the two currencies should not be neglected. This may yield two options to CFA Zone members: 1) either each country decides to print its own currency, 2) or they decide to keep their common currency which would

no longer benefit from the support of the French franc. In other words, they would have to establish their own monetary union. This paper analyzes the costs and benefits of both options in terms of economic growth. The emphasis is put on the option which more likely will support an increase of the gross national product (GNP) of the member countries, that is a monetary union. The discussion is based mainly on the survey of the Republic of Congo but can be extended to other CFA Zone members, because the structure of their economies is similar.

The paper is divided into seven chapters. The first one presents the CFA Zone and its characteristics, then it analyzes its performance through the case of Congo. It reviews the concept and the conditionality of a structural adjustment program (SAP). This review is essential in order to understand the challenge CFA Zone members would face since most of them are currently under an adjustment program.

Chapter Two addresses France's imperatives vis a vis the European Monetary Union and the Franc Zone. Based on the data available, it relies on the assumption that the EMU does not foreclose French continuation of the Franc Zone, but it does not commit either to back the CFA franc. In other words, the decision as to continue or discontinue the Franc Zone depends on France. Then chapter two develops a costs/benefits analysis from France's standpoint in order to determine whether or not it is worthwhile continuing its support to the CFA franc.

Chapter Three analyses the costs and benefits of monetary sovereignty. This chapter surveys the case of Ghana, one of the first African countries which started to print its own currency back in the fifties.

Chapter Four presents the advantages and disadvantages of a monetary union.

Chapter Five describes some basic conditions for a successful monetary union. It focuses on the banking system, a key element of the monetary union.

The financial system in general, another cornerstone of the monetary union is discussed in Chapter Six. The focus on these two sectors rests on the premise that CFA Zone countries in particular, and developing countries in general, who now have limited access to foreign loans because of their already heavy debt burden need to raise substantial domestic savings to finance their economic growth. Chapter Seven addresses the role of the governments of African nations in the reform process. This part stresses the supervision of the financial system, the soundness of the economic policies and the need for a great coordination of these policies.

CHAPTER 1

FRANC ZONE

I. Origin and features

Founded after War War II, the Franc Zone is a monetary union of fourteen African countries which were formerly France's colonies with one exception, Equatorial Guinea which was a Spanish colony¹. The two main features of the Franc Zone are 1) a single currency used by the fourteen countries, 2) a fixed parity between the French franc and the CFA franc. Originally, the acronym CFA stood for franc of the Colonies Françaises d'Afrique, meaning franc of the French Colonies of Africa. After independence nationalistic African leaders voiced their disapproval over this denomination, which very smartly was converted into franc of the Communauté Financière Africaine, that is the franc of the African Financial Community, leaving the acronym unchanged. From 1948 to January 1994 the exchange rate between the two currencies was fifty CFA francs to one French franc except for the Comorian franc whose seventy-five units were needed to buy one unit of French franc. Three central banks supply money to the member countries:

1. The Banque Centrale des Etats de l'Afrique Occidentale (BCEAO), the central bank of west African countries;

2. The Banque des Etats de l'Afrique Centrale (BEAC), the central bank of central African nations;

¹ The Franc Zone includes: Benin (called Dahomey at the time Franc zone was created), Burkina Faso (Republic of Upper Volta), Cameroon, Central African Republic, Congo, Ivory Coast, Gabon, Mali, Senegal, Chad, Togo, Equatorial Guinea, Niger, Comoros.

3. The Banque Centrale des Comores , the central bank of Comoros. The CFA franc is convertible through the French franc, but in exchange for this facility CFA Zone countries are required to deposit sixty-five percent of their export earnings into an account at the French department of Treasury known as the Compte d'Opérations.

II. Evolution of the Franc Zone

A. The colonization era.

Most CFA Zone countries became independent from France in 1960. With the exception of countries bordering the Sahara like Mali, Burkina and Senegal, CFA Zone countries enjoy numerous natural resources and rich soil. Ivory Coast has been for many years one of the biggest coffee exporters of the world, whereas Gabon, Cameroon and Congo own valuable oil reserves, timber, mines, etc. Despite these assets, none of them had really developed a strong industrial sector, nor had they experienced continuous economic growth during the colonization era. This stems chiefly from the policy of France, the metropolis, toward its colonies. The following statement from D. K Fieldhouse (1986) is noteworthy:

After 1945 the metropolis regarded the colonies as essential to its economic recovery and, like Britain, invested more capital and showed greater interest, particularly public interest...metropolitan investment in the empire as a whole (in 1914 gold francs) amounted to some 11.9m. francs. What proportion of this went to French Africa territories is less clear.... It is true that much of this huge amount was used to pay the salaries of French "technicians" and "advisors," and that much of the money flowed back to France as repatriated salaries and payment for goods and services provided by France. (p. 12)

In other words, French Africa was treated as part of the metropolitan economy. Addressing France's two main plans for the overseas empire, Fieldhouse further notes that from the decisions of the Brazzaville Conference of 1944:

[France] envisaged a radical transformation of the colonial economies by creating an adequate infrastructure, including hydroelectric power, mechanization of agricultural production, and the construction of industrial enterprises. The result was a huge increase both of imports from France, which rose by 100 per cent between 1949 and 1955, and of exports to France, which increased even more, by 115 per cent in the same period. As in the British case, a considerable part of the French funds credited to the colonies was spent on unsuccessful grandiose projects to increase the supply of raw materials other wise needing dollars. (p. 13)

Fieldhouse's conclusion over the purpose of metropolitan policies helps understand the status of the CFA Zone members during the colonization era. Moreover it provides valuable insights for the analysis of the performance of the CFA zone in the post independence era, as well as the overall economic situation of the Franc Zone countries nowadays. Fieldhouse concludes:

What, in fact, was becoming evident by the mid-1950s was that the main function of French public investment in the colonies was to enable them to run enormous deficits in the balance of payments. Although exports from French Black Africa (including Madagascar) increased rapidly—from a total US \$291.1m. in 1948 to \$484m. in 1953—these could not cover the adverse balance on private transfers, consisting initially of visible trade, but, from 1955, increasingly of "invisible," including payment of interest and repatriation of capital and profits. Thus, for the franc zone as a whole, the overseas countries had an adverse balance with France. (p. 14)

B. Post independence era

Franc Zone members emerged from colonization with few managerial and business skills. The main feature of their economies was the heavy reliance on France for the supply of final products whereas the whole economy was fueled by the export of raw commodities and a limited number of manufactured products. This situation still applies today despite attempts to build a dynamic manufacturing sector. The case of Congo is worth surveying since it is in many respects typical of the structure of the CFA Zone economies. It shows how a stable monetary union, which supposedly promotes economic growth, rather hinders this process.

III. Congo

A. Background

The Congo is a small country about the size of New Mexico and is located in west-central Africa. Its population, roughly 2.5 million people, is highly urbanized and concentrated in the southwest part of the country, particularly in Brazzaville, the main city and in the Atlantic port city of Pointe Noire, the economic center.

The four major sectors of the economy are petroleum, forestry, minerals, and agriculture. The Congo, which is the fifth largest oil producer in Sub Sahara Africa after Nigeria, Angola, Gabon and Cameroon is heavily dependent on its oil sector. In 1985 oil accounted for about forty percent of GDP, almost ninety percent of exports and about two-thirds of government budgetary receipts. Oil reserves are estimated at some 340 million barrels.

Apart from oil, the main resource exploited for export is timber from the huge forests that cover about fifty percent of the country's land area. The forestry sector has traditionally been a major source of export earnings for the Congo and still is second only to petroleum exports, but its contribution to GDP declined steadily for more than ten years. "The forestry sector has been a victim of persistent neglect in the Congo, particularly during the years of the oil boom." (The US Department of Commerce, 1992, p. 4) Congo owns sizable mineral reserves--which includes potash, phosphates, natural gas, iron, ore, zinc, copper, gold and diamonds; however, development of this sector has all but ceased in recent years.

Despite its considerable agricultural potential, less than one percent of the land is currently cultivated, and Congo continues to rely on imports for more than seventy percent of its needs. Once important cash-crop exports of coffee, cocoa and tobacco have declined sharply. Table 1 presents the trend in the production and export of cocoa from 1981 to 1990.

Table 1.

Congo's production of cocoa from 1981 to 1990 (tons)

Year	Quantity
1981-1982	2200
1982-1983	1587
1983-1984	1770
1984-1985	1839
1985-1986	1675
1986-1987	1287
1987-1988	2305
1988-1989	1611
1989-1990	957

Source: BEAC. Etudes et Statistiques

In summary, agriculture, forestry, small-scale manufacturing and mining were all victims of the emphasis on oil production, a choice the government of Congo made on the basis of the then lucrative price of crude oil. The mining industry particularly remained underexploited.

B. From colonization to independence.

Congo's economy by 1960 was not structurally different from the other French speaking African countries. The only notable point about its economic conditions is owed to the status of Brazzaville, the main city, during colonization. As capital of both France Libre and what was referred to as Afrique Equatoriale Française (French Equatorial Africa), Brazzaville made the Congo an important element of French policy in Africa at that time. One evidence of this strategic role is provided by the construction of the Chemin de Fer Congo Océan (CFCO), a railroad linking Pointe-Noire, the Atlantic port city to Brazzaville, which allows the Congo to be a transit country for Chad as well as the Central African Republic (which do not have access to the sea) via the Congo river. Many French concessionary companies were headquartered in Congo from where they also operated in neighbor countries. Some of these firms are still present like the Compagnie Française de l'Afrique Occidentale (CFAO). However, Fieldhouse observes that the contribution of the concessionary companies to the wealth of the Congo was trivial:

The case of the big French trading companies in West Africa -Société Commerciale de l'Ouest Africain (SCOA), and Compagnie Française de l'Afrique Occidentale (CFAO)- is more interesting. Both were late-nineteen-century enterprises which, like the big British firms, UAC and John Holt, dominated both the buying and the export of peasant crops and also the import of

trade goods. Neither of these companies had a large fixed investment in the colonies; their investment was in credit to producers and the goods they traded. (pp. 18-19)

B. The post independence era: the 1982/1986 five year development plan

In the mid sixties and early seventies, the Congo undertook different plans intended to diversify its economy and to establish an import substitute industrial sector. However, the first ambitious steps toward industrialization started in the eighties with Congo's first five-year development program. Following the oil boom of the early eighties, Congo adopted a five-year development plan under which approximately \$2.8 billion expenditures were forecast. Mainly, the plan aimed at improving the country's poor infrastructure (roads, railroad, bridges, etc.). The government made that choice on the grounds that no development was possible without access to the interland where agricultural resources, mines, timber and other commodities were located. Before the 1982/1986 five-year development program, the only reliable means of transportation in Congo were the Chemin de Fer Congo Océan (CFCO) built in the colonial period, and the Congo river. There were no reliable roads linking one part of the country to another. In fact, one reason for the heavy dependence of Congo on imported foods (mostly from the neighbor Zaire) rested on the lack of roads--or their poor condition--which did not allow for the shipment of food from interland farms to the cities. Likewise, the timber industry suffered from the total reliance on the Congo river to ship timber from the heavy rain forest of the north Congo to Brazzaville and then Pointe-Noire, the port city, because at certain periods of the year, the low level of water hindered the traffic. Many

timber companies reported a lead time of two to three months in those periods before the logs reached Pointe-Noire.

The private sector oil investments were to account for seventy percent of the development program.

C. The economic boom.

The large-scale infrastructure projects of the five year development plan allowed the Congo to enjoy substantial annual growth rates (among the highest in Africa) for a very short period. Table 2 shows the trend in the nominal growth rate of the GDP from 1972 to 1987.

Table 2.

Republic of Congo's GDP. Nominal growth rate from 1972 to 1987

Year	Rate
1972	0.6
1973	9.6
1974	25.9
1975	0.6
1976	1.3
1977	-8.4
1978	-0.1
1979	18.7
1980	32.0
1981	28.5
1982	16.4
1983	4.3
1984	6.4
1985	-4.5
1986	-35.8
1987	5.3

Source BEAC: Etudes et Statistiques

The economic boom which Congo experienced was mostly fueled by the oil sector as well as the infrastructure industry. The government became aware that a durable economic growth should not rest on one sector alone (or two). Rather, it should involve other industries. However, the government's decision to shift away from emphasis on oil, and to focus on non-oil sectors was difficult to implement in practice, since the private sector oil investment was to account for seventy percent of the financing of the plan. In other words, the development of the non-oil sector depended to some extent on the oil industry and the overall growth rate of the economy was affected by that of the oil sector. The fall in the growth rate of the GDP in 1983 as well as the negative growth of 1985 reflect the trend in oil output and export as shown in table 3.

Table 3

Congo's Production and export of crude oil (tons)

years	production	export
1981	4,100,935	4,100,893
1982	4,552,832	4,367,590
1983	5,365,122	4,796,397
1984	6,024,864	5,406,728
1985	5,937,132	5,239,522
1986	5,950,793	5,415,756
1987	6,316,847	5,748,896
1988	7,037,774	6,701,014
1989	7,961,506	7,424,458
1990	8,028,838	7,425,300

Source: BEAC. Etudes et Statistiques

D. The recession

1. Oil market

As mentioned earlier Congo neglected for many years the other sectors of its economy, particularly agriculture, and heavily based its economic policy on oil production and revenue. The collapse of oil prices in the mid 1980's led to a sharp drop in export earnings as well as government revenues. In 1983, the economic growth (measured with the gross domestic product) dropped to 4.3 percent. Along with the fall of oil prices, the major factors explaining this sharp deterioration include the leveling off in the rate of increase of oil output, and the depreciation of the U.S. dollar. The dollar is the means of payment used in oil transactions; the depreciation of the dollar against the CFA franc means that the dollar denominated oil receipts convert into less CFA franc revenue. Thus, the drop of budgetary resources led the Government of Congo to cancel many infrastructure projects and to slow down some others already in process.

2. State-owned companies

Another major factor of Congo's recession was the weak performance and the collapse of many state-owned companies. The state controlled sector was a key element in government economic policy. Despite subsidies from the government, poor management and the lack of marketing skills did not allow these companies to compete with the private sector. Weak project analysis led to overvalued investment and operating costs which could not be covered by cash inflow.

C. External debt

Congo's development plan was almost entirely funded by loans against future oil revenue. No real policy was developed to set up a domestic savings-financed economy. As a result of heavy external debt burdens and decreasing revenue, total debt services as a percentage of export earnings reached 34.3% in 1985 and nearly 50% the following year. In other words, in 1985, approximately half the export earnings were consumed in repaying the principal and the interest on external loans. In 1986, the magnitude of the financial imbalance forced the Republic of Congo to conclude a stabilization program with the IMF and to engage in a Structural Adjustment Program.

One characteristic of CFA zone countries is that many of them went into ambitious development programs funded by loans against future export earnings from one or two commodities, and ended with a heavy external debt burden as the expected revenues were not realized. The World Bank estimates that the fourteen CFA members' outstanding debt amounts to 46.8 billion dollars (Togo-Presse, 1994, p.6). Table 4 shows the total outstanding long term debt of CFA Zone countries as of 1992.

Table 4

CFA Zone total outstanding long term debts as of 1992 (bn of CFA franc)

Countries	Amount	% of GDP
Bénin	1,243.00	66
Burkina	259.00	31
Cameroon	1,242.00	41
Centrafr. Rep.	209.00	65
Comores	168.00	64
Congo	1,134.00	151
Côte d'Ivoire	3,676.00	139
Gabon	854.00	54

Equat. Guinea	62.00	147
Mali	765.00	110
Niger	325.00	67
Sénégal	679.00	43
Chad	168.00	49
Togo	1,222.00	75
Franc Zone	12,006.00	98

Source: Ministère français de la Coopération. Encours de la dette à moyen et long terme en 1992

IV. Stabilization program

A. Definition

Stabilization programmes refer to a set of fiscal and monetary policies that a country implements in attempt to correcting the deficit of its balance of external payments.

Most stabilization programmes start with a standby agreement between the country whose balance of payments is unbalanced and the International Monetary Fund (IMF). Under the agreement, the country commits to taking appropriate steps to restore the equilibrium and the IMF agrees to provide financial support to carry out the reform.

B. Core elements of a stabilization program.

A stabilization basically organizes into two types of actions: fiscal policy and monetary policy.

1. Fiscal policy.

Fiscal policies aim at reducing the budget deficit of the member country. Standard IMF inspired programs include reduction of government

expenditures, reduction and sometime total removal of subsidies to state-owned companies, as well as price subsidies. Along with budget cuts, the fiscal policy stresses the increase of government revenues, usually through additional taxation.

2. Monetary policy.

The focus is usually on credit allocation. Policies include among other elements the removal of controls on interest rates, credit, and a reduction in government borrowing. The core element of the monetary policy is without doubt the exchange rate policy which affects the number of units of the domestic currency traded for one unit of foreign currency.

Another major aspect of the monetary policy is the rescheduling of external debt as a means of temporarily relieving tensions on the balance of payments.

The International Monetary Fund plays a critical role here. Usually, creditors would not agree on debt rescheduling if the country has not concluded an arrangement with the IMF.

C. Structural Adjustment Program

In most cases stabilization programs go hand in hand with a structural adjustment program (SAP). Whereas the former addresses the demand side of the economy and is carried out with the assistance of the International Monetary Funds, the latter aims at improving the supply side and involves mainly the World Bank. These programs have two major objectives:

1. Improvement of the efficiency of the use of resources.

One of the goals of the Structural Adjustment Programs is to improve the efficiency of public sector investment. In many cases, this translates into the privatization of state controlled firms. The underlying idea beyond such an action is that the private sector which looks for profit maximization will manage the firm more efficiently than the government.

2. Market liberalization

This concept includes a set of measures intended to reform the structure of the economy, and to remove government restrictions and other non institutional barriers in order to allow the development of private business. In general it leads to trade reforms (e.g., removal of import licensing), financial liberalization, and deregulation of foreign exchange control.

D. Conditionality

Stabilization programs involve quarterly performance criteria that the country under adjustment must meet in order to receive the resources of the IMF. Performance criteria vary according to the type of arrangement concluded with the IMF. There are four types of arrangements. 1) The Stand-by arrangement (since 1952), 2) the Extended Fund Facility (EFF) (since 1974), 3) the Structural Adjustment Facility (SAF) (since 1986), 4) and the Enhanced Structural Adjustment Facility (ESAF) (since 1988). Basically the conditionality involves targets with respect to domestic credit, and credit to government as well as government expenditures. The International Monetary Fund defines fiscal adjustment in terms of an overall balance

referred to as the public sector borrowing requirement. The exchange rate policy is a key element which relates to another aspect of the conditionality, that is the balance of payments.

V. Devaluation of the CFA franc

A. Definition

" Technically, a devaluation refers to a decrease in the stated par value of a pegged currency, one whose value is set by the government" (Alan Shapiro, 1990, p.37). In other words, a devaluation is a statutory decision under which the monetary authorities of a country decide to modify the exchange rate of their currency.

On January 11th, 1994 the Communauté Financière Africaine members agreed to devalue their common currency, the CFA franc, against the French franc by fifty percent. The nominal rate of fifty CFA francs to one French franc which had prevailed since 1948 changed to one hundred CFA francs for one French franc.

B. Objectives of devaluation

Devaluation is considered one way to promote the economic growth of a country. An overvalued currency has a negative impact on the economy. It increases the foreign currency price of domestic products sold abroad. As a result, they become less competitive in foreign markets. "Alternatively, home currency depreciation [which is identical in its effects to a devaluation] results in a more competitive traded-goods sector, stimulating domestic

employment and including a shift in resources from the non traded-to the traded-goods sector..." (Shapiro, p. 38).

Otherwise stated, devaluation tends to discourage import of foreign goods and to encourage production as well as export of domestic products. Ceteris paribus, it results in an increase of the gross domestic product, creates jobs and improves the current account of the balance of payment.

C. Effects of devaluation.

"...The bad part [of devaluation] is that currency weakness also results in higher prices for imported goods and services, eroding living standards and worsening domestic inflation"(Shapiro, p. 38).

As mentioned above, devaluation benefits mostly exporters. In other words, an export-oriented economy would benefit more from a devaluation than one which is mainly oriented toward domestic consumption. Few CFA Zone countries would, at least in the short run, benefit from the exchange rate modification--in particular, countries from the Sahel subarea, like Mali and Burkina whose the demand for their commodities exports is price inelastic. These countries were facing "the bad part" of devaluation. As soon as the decision was announced, prices jumped in many capital cities (Niamey, Lome, Abidjan, etc.) causing social unrest (Togo Presse, 1994, p. 6).

CHAPTER 2

FRANCE, THE EUROPEAN MONETARY UNION, AND THE FRANC ZONE

The European Monetary Union, which France is part of, is moving (uncertainly) toward a single currency, the European Currency Unit (ECU) and a single central bank. This raises a critical point for the Franc Zone members. Does the European Monetary Union foreclose French continuation of the Franc Zone? The 1992 Maastricht summit which laid down the grounds for the European Monetary Union did not explicitly address the issue. No significant debate took place about joining the CFA franc to the ECU in the future. But, the attitude of the EEC after the recent devaluation of the CFA franc indicates implicitly the views of the European Economic Community about the future of the Franc Zone.

Since 1993 France has engaged in private talks with its European partners about the effects of the devaluation of the CFA franc (Jeune Afrique Economie, 1994, p. 27). However, the EEC did not commit to helping their African partners remove the side effects of the devaluation. France wrote off a \$4 billion bilateral debt. The International Monetary Fund promised low interest loans worth \$1.5 billion to the Franc Zone. Furthermore, the IMF, known for its disapproval of price subsidies, surprisingly agreed that CFA countries subsidy for the time being the prices of basic imported goods which low income people would not afford otherwise. Instead, the EEC proved reluctant to examine the problem of the Franc Zone as a whole. Rather it favored bilateral talks with individual countries on the grounds of existing agreements. Based on this fact as well as the mechanism of the Compte d'Opérations (described later) it is reasonable to assume that the EEC will also be

reluctant to support the CFA franc. The long-term forecast of the downward trend of the Franc Zone economy as well as its export earnings implies that its members will have little to offer in exchange for the support of the ECU.

Having no formal statement in the Maastricht summit talks prevents the EEC members from engaging in a monetary cooperation with non-EEC members. If such is the case, France's decision as to continue or discontinue the franc zone will be dictated by a costs/benefits analysis which involves all pecuniary as well as non-pecuniary costs and benefits. Data to conducting such a formal analysis are not available. Following is an approach to a costs/benefits analysis done from France's standpoint.

I. Benefits of the Franc Zone

A. Non-pecuniary benefits

This thesis does not address political issues. However, in analyzing the benefits of the Franc Zone to France it would be a mistake to disregard certain non-pecuniary advantages (some of which are political) which France has gained from its African partners and can (or can no longer) expect in the future if it continues backing the CFA franc.

Through the franc zone, France has maintained a tied relation with its ex-empire more than did other colonial powers (Spain, Portugal, Great Britain) with their former colonies. Commenting on this issue The Economist notes:

French Governments, by and large believe multilateral bodies should keep their noses out of ex-imperial affairs; on top of which, many French political parties have also had financial

backing from African leaders who rather liked the cheap imported vintage wines and holidays in Paris that an overvalued CFA franc enabled them to enjoy. (p. 45)

The question is whether or not France will obtain these favors from its CFA Zone partners in the future. With respect to this point, France should not disregard the pro-democracy movement which started in some CFA countries in 1990 (Congo, Bénin). Though it is not yet wide spread in the CFA Zone, in the future this move toward a multiparty political system certainly would prevent CFA countries from granting the type of favors the Economist refers to.

B. Pecuniary benefits

The historical benefits of the Franc Zone to France are described in Fieldhouse's statements quoted in Chapter One.

Based on the mechanism of the Compte d'Opérations, an analysis of the benefits France may expect from its African partners in the future requires a formal long-run forecast of their economic growth and, most important to France, of their export earnings. A present value analysis (discussed in Chapter Six) can then be useful. The present value of the stream of interest France will pay to its partners (using the statutory interest rate as the discount factor), compared with the present value of the income France obtains from managing the Franc Zone's assets is one reliable indicator of the advantages of continuing or discounting the Franc Zone.

Another pecuniary benefit of CFA Zone's assets to France may consist of financing France's own deficit. One way to finance government deficits is to issue bonds. The cost of issuing bonds on France's domestic market or the euro-market compared with the cost of using CFA Zone's assets on this

purpose can also be taken into account. The present value of the cost of future bond issues can be compared to that of using the Franc Zone's reserves in the Compte d'Opérations. If the French government anticipates increasing the deficit in the future, and if financing this deficit in issuing bonds proves to be more expensive than using franc zone's assets, France may consider continuing the Franc Zone (provided that Franc Zone's reserves are expected to increase in the future).

II. Costs of the Franc Zone

The discrepancy between the level of development of France, on the one hand, and its partners on the other hand, not surprisingly implies more pecuniary costs to France than non-pecuniary ones because French-speaking African countries request more and more financial assistance from France (grants, bilateral aid, debt write-off, etc.) Some of these costs are statutory, some are not.

A. Pecuniary costs.

1. Statutory

The major statutory cost of the Franc Zone is the obligation to pay interest on the assets held in the compte d'Opérations. Given the downward trend of the economies as well as the export earnings of the Franc Zone members, one can forecast a decrease of this cost (unless CFA countries ask for a higher return on their assets) . However, a formal estimate can be done using the present value analysis. The stream of interest payment to the Franc Zone members discounted on the basis of the statutory interest rate will provide a valuable

estimate of the future costs of maintaining the CFA zone. Like the benefits, this analysis depends on the forecast of the CFA zone's export earnings. If the Franc Zone survives the European Monetary Union, and if France is to continue its support of the CFA franc, in the long-run the growing deficit of the balances of external payments of the Franc Zone may lead France to use its own resources to insure the convertibility of the CFA franc. In fact, fearing this event, France pressed its partners to devalue the CFA franc.

2. Non-statutory

Non-statutory costs of the franc zone should be analyzed in a broad range and involves the so-called Francophonie . Franc zone members are part of a wide organization referred to as the Francophonie, which can be defined as an informal and loose commonwealth of French-speaking countries led by France, with no formal goal or mission other than maintaining friendship among the members. From France's standpoint, aside from friendship (which undoubtedly leads to economic benefits), the Francophonie is also a matter of prestige and allows the promotion of the French culture. However, it also implies subtle non statutory costs to France in various forms, ranging from preferential trade agreements to grants, low interest loans , etc.

III. Prospective costs: a weak CFA franc

France may consider continuing the franc zone under new conditions such as a drastic cut in the imports of the Franc Zone's members, in order to reduce their need for foreign currencies, so that the demand for these currencies equates to the amount of resources available in the Compte d'Opérations. Such a condition is to some extent in process, since most CFA countries are under stabilization programs, which aim (among other objectives) at reducing their imports. However, the efficiency of such policies is questionable because a drastic cut of the imports can lead to shortage of goods which in turn may end with social difficulties. Also, CFA countries still need foreign assets to repay the external debt (despite debt rescheduling).

Another incentive for France to lower its costs could consist of reducing the statutory interest rates France pays to its partners on their assets.

The recent devaluation of the CFA shows another aspect of the disadvantage (from France's standpoint) of maintaining the Franc Zone. The rise in the price of the imported goods resulting from the weakening of the CFA franc will likewise increase the operating costs of French companies established in the franc zone. The overall cost of the devaluation to French companies approximates FF10 billion (Jeune Afrique Economie, 1994, p. 30). Although many firms benefit from the devaluation (mostly the oil companies and those in the tourism industry), the CIAN, the council of the French businesses established in Africa estimates that the number of the companies which are adversely affected outweighs that of the winners (Jeune Afrique Economie, 1994, p. 32).

The success of the devaluation depends on many factors, the failure of which may lead to further devaluation in the future, and even to the collapse of the Franc Zone (Jeune Afrique Economie, 1994, p. 32).

The equilibrium of the Franc Zone is a long-term process, the result of which is uncertain. Based on Fieldhouse's analysis (mentioned in chapter one) as well as the mechanism of the Compte d'Opérations, it can be inferred that the Franc Zone is no longer as important to France as it used to be. In September 1993, the Prime Minister of France expressed this fact in a subtle way as he "told the leaders of CFA countries that France will no longer bridge their budget deficits or service their debts unless they swallowed the stern economic reform programmes of the IMF." (The Economist, p. 45)

In short, time may have come for the CFA Zone members to consider alternatives to their current monetary union with France.

CHAPTER 3

MONETARY SOVEREIGNTY

The concept of monetary sovereignty used in this thesis refers to the countries which have their own currency, their own monetary authorities (central bank, supervisory bodies, etc.), and have direct control over their monetary policies, as opposed to a monetary union.

The decision as to devalue the CFA franc should have been taken long ago, particularly in the mid 1980s when the prices of export commodities began to drop, and the French franc to strengthen against the US dollar. CFA Zone oil producers (Gabon, Cameroon, Congo) could have gained tremendously but did not because the CFA franc pegged to the French franc was overvalued. For instance, Ivory Coast, which used to dominate the cocoa market for many years, lost its share whereas Ghana and Nigeria, whose currencies are relatively competitive, gained (The Economist, p. 45).

Is monetary sovereignty a better option for African nations? A survey of the case of Ghana, a former British colony, provides valuable insights on the advantages and the disadvantages of monetary sovereignty.

I. Black African contrast: the case of Ghana

During the colonization era, Britain's West African colonies were part of the Sterling Zone, a monetary union with their metropolis. They were gathered in the West African Currency Board, which required that the

common currency be backed one hundred percent by the pound sterling into which it was convertible.

Ghana began its independent life in 1957 when it established its own central bank, the Bank of Ghana, a few days before its political independence.

The main functions of the Bank of Ghana, as described in the Bank of Ghana Ordinance of March 4, 1957 are "to issue and redeem bank notes and coins; to keep and use reserves and to influence the credit situation with a view to maintaining monetary stability in Ghana and the external value of the Ghana pound; and to act as banker and financial adviser to the Government." The Ordinance also specified that there was to be a separate Issue Department which would be responsible for ensuring that the currency needs of the country were adequately provided for and that the currency in circulation was sufficiently backed by gold, foreign exchange, acceptable securities, and other acceptable bills.

On July 14, 1958, the Bank of Ghana issued Ghana's own currency, thus replacing the West African pound issued by the West African Currency Board. In the middle sixties the government introduced a new currency whose the major unit was called the cedi and the minor unit the pesewa.

II. Advantages

Countries who print their own currency enjoy a freedom of action that allows the government to conduct its economic policy without constraints unless the government itself sets such constraints and commits to meeting them. Ghana is no exception to this statement. From 1957 until recently, Ghana used its central bank to develop its financial system and to implement

its economic policy. Especially important is the fact that , through the Bank of Ghana, the government funded the key sectors of its development programs.

A. Economic policy tool

As stated in the 1957 Ordinance, the Bank of Ghana was to advise the Government. It actively did and, in fact, it was both an adviser and a major instrument of the economic development policy of the Government in addition to its regular activities as a central bank. The Bank of Ghana participated directly in projects; it provided credit guarantees to commercial banks with respect to loans to small borrowers in the industrial and agricultural fields. It also handled the agricultural product marketing bills which were discounted by the other banks. It supplied funding to many private companies like the Export Promotion Company and the Ghana Tourist Development Company.

The Bank of Ghana was very active in funding and establishing financial institutions such as the Agricultural Development Bank, the National Investment Bank, the Bank for Housing and Construction and many rural banks. The rural banks are an innovative outcome of the Bank of Ghana which discovered in the middle sixty's that the Agricultural Development Bank was not meeting the needs of the small-scale rural farmers and industrialists. Nationwide research by the Bank of Ghana in 1971 came up with the idea that rural banks owned and managed by the local people themselves would provide better financial services to rural communities than city-based institutions. Based on the conclusions of this research several rural banks were created. In contrast, none of the three

central banks of the CFA zone took such an active part in the policies of their member countries.

B. Money creation

The 1957 Ordinance empowered the Bank of Ghana to issue fiduciary money, though it did not do until 1960. The Bank of Ghana continued to back its currency 100 percent with the pound sterling. Beginning in 1960, it moved away from a rigid relation between the currency supply and the balance of payments. In that year it started to provide rediscount facilities, and for the first time commercial banks could acquire government treasury bills. The Bank of Ghana issued fiduciary money as it rediscounted those treasury bills. Today, whenever the government of Ghana needs money to spend above its revenue, it just issues securities which are sold by the Bank of Ghana to commercial banks, firms and the public. If the securities are not attractive enough, and are unsold, the Bank of Ghana buys them and pays by crediting the government's account in its books. The government issues checks to pay its expenditures; this results in the creation of money which adds to the stock of money already in circulation.

C. Credit supply

Through the Bank of Ghana, the government established a selective credit policy. Substantial numbers of loans were directed into the sectors the Government intended to develop whereas sectors judged less important received relatively little credit.

M.M. Huq (1989) notes:

There was a shift in the sectoral distribution of commercial bank credit over the years. For example, the share of credit in import trade fell sharply from the mid-1970s, while that for services dropped sharply from 1970. On the other hand, there has been in general a notable rise in credit for agriculture and export trade in recent years. The underlying reason for this shift is the direction of government policies which encouraged agriculture and exports. (p. 178)

III. Disadvantages

A. Risk of excess money supply

The soundness of the functions of Ghana's central bank as described in the 1957 Ordinance is hardly questionable. These functions are the basic functions of every central bank. However, the risk of monetary sovereignty as defined in this chapter is that the government may use the central bank to finance its budget deficit. Table 5 shows the trend of Ghana central government deficit for a selected number of years.

Table 5

Central Government Budget Deficit, 1961-82 (selected years)

	1961	1965	1970	1975	1980	1981	1982
Deficit (million of cedi)	72.5	159.4	88.5	356.7	1645.4	4440.2	4299
As % of total government expenditures	26.6	35.9	19.3	30.7	35.2	57.2	48
As % of total government revenue	36.2	56.1	24	44.3	54.4	135.4	92

Source: CBS/Statistical Services, Quarterly Digest of Statistics

The money supply, defined as currency in circulation and demand deposits with the banks (except the bank of Ghana), has been rising with the government deficit. M.M. Huq (1989) notes:

Most of the financing has been from domestic sources, mainly from the banking sector and to a lesser extent from the Social Security Fund. Net credit to the government by the banking system was C258.8 million in 1970, C964 million in 1975 and C6522.2 million in 1980.... The Bank of Ghana has been the biggest lender of the government. In the year 1977 alone the claims of the Bank of Ghana on government increased by 66.4 percent over the year before. By the end of 1980 nearly 85 percent of the Bank of Ghana's assets consisted of credit extended to the government and other public sector. (pp. 176-177)

B. Inflation

Ghana started to experience sharp inflation in the mid-1960s. The rate of inflation increased from 10 percent in 1964 to 26.4 the following year, reached 117.1 in 1981 and peaked at 122.8 percent in 1983.

In discussing the causes of inflation during the late 1970s and the early 1980s, "the Central Bureau of Statistics put the blame squarely on the huge borrowings by the Government from the central bank, which continued to increase year after year" (M. M. Huq, p. 216). Inflation was enhanced by the decline in the foreign exchange rate subsequent to the fall of export earnings (particularly from cocoa). However, it appears that the main source was the excess borrowing of the government to cover its increasing budget deficit.

C. Black market

It is estimated that in 1981 one cedi commanded only one tenth of its 1971 purchasing power. Government's failed attempts to control price, combined with the depreciation of the domestic currency as well as the overvaluation of the cedi led to a flourishing underground economy known as Kalabule (profiteering) which in 1981 may have been as large as two-fifths of the Gross Domestic Product (GDP) of Ghana (M. M. Huq, 1989, P. 5).

The development of Kalabule is a major feature and a result of the freedom of action a government enjoys under what this thesis referred to as monetary sovereignty, freedom which is restricted in a monetary union. Commenting on this phenomenon, Georges B. Ayittey (1992) notes:

[Nkrumah] imposed a bewildering array of legislative controls and regulation to assure state participation in the economy. There were controls on imports, capital transfers, ... prices, rents and interest rates

The plethora of controls brought in its wake two interrelated and pernicious problems: bribery and corruption. By imposing price controls that required producers to charge prices lower than the free-market prices, the Nkrumah government caused a shortage of commodities as producers cut output. State enterprises that were supposed to make goods available to ease the shortage failed in their tasks; they produced only small quantities of goods. Because supply did not meet demand, the government resorted to rationing ... (p. 166)

CHAPTER 4

MONETARY UNION

In order to fully understand the challenge African nations face, an analysis of two disturbing samples of monetary union will be helpful. On the one hand the Franc Zone was stable and functioned without major problems during half a century. On the other hand, the European Economic Community is hardly making its steps toward a European Monetary Union, the birth of which seems unlikely at the present time. The following major characteristics of a monetary union as well as its advantages and disadvantages are offered next.

I. Characteristics

A. Common currency or fixed exchange rates

Traditionally monetary union refers to a group of regions or countries which use a common currency, or whose currencies are linked by permanently fixed exchange rates. A monetary union can be managed in a decentralized or a centralized way. An example of a decentralized monetary union is the gold exchange standard in which countries have their individual and autonomous central banks that operate under the constraint of maintaining a fixed parity with gold. More recently Europeans have set the Exchange Rate Mechanism under which currencies of the European Monetary System are allowed to fluctuate within predetermined margins. A centrally managed monetary union is one with a unified central bank which

manages the currency and supplies money to the whole union. The CFA Zone is an example of a centralized monetary union.

B. Economic unification

The second major characteristic of a monetary union is economic unification. In other words, a monetary union requires an integrated market for goods and services and the removal of any barrier to the mobility of persons, capital, or goods and services. With such conditions resources can circulate within the monetary union and be used more efficiently than in a single country.

II. Disadvantages

A monetary union implies at least two principal constraints: 1) the lack of freedom for individual governments who no longer can conduct their economic and monetary policies independently and, 2) the need for coordination of the economic and monetary policies of the member countries

A. Lack of freedom

The major constraining burden in a monetary union is that it deprives individual countries of the freedom that they may desire in conducting their economic policies. A country which is not bound by a monetary union could print money as needed to finance its budget deficit, as indicated in chapter two. None of the CFA Zone countries has the authority to print money. This is the privilege of the central banks only, which create money on the basis of the economic performance of different countries as well as the needs assessed

through the economic policies of individual countries. This means that the stock of money the central bank injects into a country at a given time may differ from the stock of money in another member country. The lack of total control over the supply of money affects the ability of the different governments of the monetary union to implement their economic policies.

B. Coordination

In a monetary union members need to coordinate their economic policies. Referring to the European Monetary System, Alan Shapiro (1989) mentions.

Perhaps the most important lesson that the EMS illustrates is that the exchange rate stability afforded by any target-zone arrangement requires a coordination of economic policy objectives. Nations should achieve convergence of those economic variables that directly affect exchange rates--variables such as fiscal deficits, monetary growth rates, and real economic growth differentials. (pp. 81-82)

Until recently coordination of economic policies did not really appeared critical to the members of Zone Franc. But, ambitious development plans, excessive expenditures over revenues, and heavy foreign borrowing to cover the gap have led the CFA countries as a whole into a huge external debt burden. The balance of payments has deteriorated as an increasing amount of revenue is needed to repay the principal and the interest on foreign loans. This situation calls for more communication and coordination of economic and monetary policies which the IMF and the World Bank have for many years advocated.

III Advantages

A Common market

In issuing one single currency to be used in a group of countries, a monetary union provides, *ceteris paribus*, a relatively big market to the firms of the member countries. Provided that transportation costs are not prohibitive, individuals can purchase goods and services in either country free of exchange constraints. Thus, a monetary union enhances competition not only within a country but also between countries; firms must improve their management and marketing skills as well as the quality of their products, and produce at the minimum cost to cope with competition. Likewise, competition among financial institutions will increase, since firms and individuals will have access to a wide range of lenders. Competition between financial intermediaries will provide relatively inexpensive funds to companies allowing them to reduce their production. The overall result for the countries is positive. Consumers enjoy improved and inexpensive products and services. Larger markets and the benefit of the economies of scales will permit companies to function cost efficiently and to maximize their profit. Government benefits from the broadening of the tax base.

B. Control of inflation

One of the principal sources of inflation is an excessive stock of money. In preventing individual countries from printing money to cover the budget deficits, a centralized monetary union allows controlling inflation. Other things being equal, a low level of inflation will support durable economic growth.

C. Common pool of foreign currencies

One major characteristic of the Franc Zone is that the member countries have to deposit sixty-five percent of their export earnings into an account at the French Treasury. This pool of foreign assets is used by all the member countries to finance their import of goods and services and to repay external debts. This feature has been useful to CFA members because it allows a country which is temporarily short of foreign currencies to finance its imports without seeking external, and expensive funds. Especially, non-oil producer CFA members enjoyed the benefits of the common pool of currencies during the oil shocks which affected the world economy. The gains realized by the oil producers (therefore the increased reserves of the whole union) allowed them to cope with the imported inflation that they would have faced severely. However, some drawbacks of the system will be discussed in the next chapter.

CHAPTER 5

AN ALTERNATIVE TO THE FRANC ZONE

Section One: Why another Monetary Union?

The Franc Zone has displayed the basic characteristics of a monetary union described in chapter three. In the recent history (and before the devaluation) no CFA zone country experienced hyperinflation as did many non-franc zone African countries. There is no doubt that the centralized money supply is one of the factors of such a performance. The reputation of stable currency and the convertibility of the CFA franc through the *Compte d'Opérations* is insurance to foreign investors who anticipate conducting business in a franc zone member country. So why another monetary union? An in-depth analysis of the franc-zone shows the real cost of the French franc backing.

A. The mechanism of the Compte d'Opérations.

As mentioned earlier, CFA zone members are obligated to deposit sixty-five percent of their export earnings into the *Compte d'Opérations* in the French treasury in exchange for the convertibility of the CFA franc. In practice, many countries have deposited up to ninety-five percent of their foreign assets (*Jeune Afrique Economie*, p.20). This account records not only the export earnings, but also grants and aids from foreign governments, and withdrawals on external loans. In short, part of all foreign currency denominated revenues of the member countries are held in the Compte d'Opérations.

The French Treasury pays interest on these deposits, but for many years the interest rate was close to eight percent whereas interest rates in international financial markets were higher.

Whenever an individual, business, or whatever organization from the CFA Zone needs to wire money to a foreign country his/its bank completes the transfer. In practice, the central bank of the CFA zone subarea from which he/it is sending the money completes the transaction through a debit of its account at the French treasury (the compte d'opérations). In other words, the central bank involved in the transaction uses its own resources to settle the payment. Put otherwise, the three central banks of the Franc Zone themselves assure the convertibility of the CFA franc. So why should they deposit their reserves at the French treasury and have this institution complete transactions they can perform themselves like ordinary central banks? This question has always been a matter of controversy among the African intelligentsia. The debate has become more passionate since the devaluation of the CFA franc.

B. leadership of the economy

This concept refers to a less obvious but subtle and pervasive aspect of the Franc Zone related to the point mentioned above. The BEAC, the central bank of central African states, the BCEAO, the one from the western states as well as the central bank of Comoros can hardly be considered as central banks. They do not perform the different transactions ordinary monetary institutions do in order to reach the stability of the currency. This stems from the nature of the tie between the French and the CFA franc. The Banque de

France and the French economy in a broader picture defend the stability of the French franc. Whatever affects the French franc impacts the CFA. A rise in the value of the first one induces the same trend to the second, and so does a decline. In other words the three central banks do not really have any control of the economies to whom they are supposed to supply money, and in fact, they play a passive role in the development policies of their countries whereas the active role is rather played by French government through the French franc. The importance of money, and therefore, of the institutions that create and supply money need not to be stressed. What makes them more important for Africa in general and the CFA zone in particular is the magnitude of the external debt which implies a major drawback: no more or limited access to external borrowing since foreign creditors are reluctant to extend new loans or to allow withdrawals on existing ones. Table four (see chapter one) presents the total outstanding debt of the fourteen CFA zone members as of 1992. Deprived from external funds, CFA countries would hardly support their economic growth. Poor economic growth would further weaken the value of their currency, which in turn will erode any chance of growth, and so forth. It seems that the only viable option left to these countries is to develop an efficient financial system capable of raising domestic saving through attractive investment instruments, and efficiently funding sound projects. Such a financial system would improve the wealth of the population through the return on their investment, and it would constitute the cornerstone of the economic growth. The financial system in many Franc Zone countries is far away from playing such a role. An analysis of Congo financial system shows the weakness of this sector.

The overall result is that the central banks of France's African partners did not really develop the skills required to lead their economies. The collapse of Congo's banking system since the mid eighty's (section two below) perfectly reflects the inability of CFA zone monetary authorities to play their leading role.

Section Two: The Banking System

I. Historical preview

A brief preview of the history of Congo helps understand the weakness and the performance of the banking system in the CFA Zone and therefore the challenge the countries face for the monetary union to fulfill its role.

A. Legacy of the colonial period

Banking activities in Congo began with the extension of Banque du Sénégal, and later on of Banque de l'Afrique Occidentale (BAO), both founded in the twentieth century, to Afrique Equatoriale Française (AEF). A.E.F as well as the government of Cameroon held 2857 shares of BAO. By 1939, these banks were joined by the Belgian Banque Belge d'Afrique. Development of business in the colonies brought new comers so that by 1955 three other French banks were operating in the Congo: Banque Nationale pour le Commerce et l'Industrie (BNCI), Credit Lyonnais, and Société Générale. In 1955 a bill derived from the French bank law of 1945 was passed

in order to regulate depository institutions and banking activities in the colonies.

In 1960 most of France's African colonies became independent. In 1963 and 1966 the new government of Congo amended bank regulation and extended its authority over the branches of the colonial banks. By 1963 Congo's banking system was made of four banks:

- 1) la Banque Commerciale Congolaise, thirty four percent of whose shares were held by the French Credit Lyonnais;

- 2) Banque Internationale pour le Commerce et l'Industrie.

The French Société Financière pour les Pays d'Outre-Mer held fifty-one percent of the shares whereas la Banque Nationale de Paris controlled thirty two percent of the capital.

- 3) la Banque Internationale pour l'Afrique Occidentale (BIAO).

Of all banks, Banque Internationale pour l'Afrique Occidentale was the only bank with notable non-French interest. Beside la Compagnie Financière France-Afrique which held fifty-one percent of the shares, First National City Bank owned a non negligible forty-nine percent of the total capital of BIAO.

- 4) Société Générale de Banques au Congo. Affiliated to Société Générale which owned sixty percent of the bank, other French and European banks held the remaining shares

- 5) la Banque Nationale de Developpement du Congo (BNDC) was owned chiefly by the French Caisse Centrale de Coopération Economique (25.8%) and the Government of Congo (58.4%).

B. Conflict of interest

The main declared goal of most of the newly-independent African nations was to industrialize their economy, which required substantial bank financing. This policy did not always fit in with the mission and the goals of the banking system which, in the case of Congo, failed to adjust to the new environment. Beginning in 1966, the lack of a dynamic indigenous private sector led the Government to base its economic policy on state owned companies which were managed by government officials, most of whom had few managerial and business skills. Banks were reluctant to supply loans to these state-controlled firms. A government report (Le Système Bancaire Congolais, undated) notes:

...That banking system was oriented toward specific goals. Up to 1963 the structure of the economy relied on a private foreign dominated sector. So did the banking system. That rudimentary and poorly diversified system, made only of commercial banks mostly located in the cities, had a limited effect on the economy... (p. 6)

Addressing the relation between the banking system and the public sector the same report further notes:

This new comer [the public sector] was an embarrassment to the banking system which was intended to make profit but also to maintain the state of economic dependence. That is dependence vis a vis the former metropolis... (p. 6)

As a matter of fact, by august 1974, only 9.5 percent of the total loans of the banking system went to the then fourteen state controlled firms (Le Système Bancaire Congolais, p. 7).

As the public sector grew, so did the inability of the banks to adjust and to promote the development of this sector. The clash between government goals and those of the banking system led to a new development. Government Control over the banking system began to appear as the cornerstone of the nation's economic growth. Thus, the government engaged in bank mergers and chose to hold the majority of the shares in all banks in order to control their credit policy and ensure that they were in tune with its own economic policy. The bottom line was to provide financing in the sectors judged of high priority.

C. Structure of the banking system

As a result of the new orientation of the government policy, the banking system in Congo was condensed to three commercial banks and one development bank beginning in 1974. Later in the 1980s two foreign banks, and la Banque Française de Commerce Extérieur and la Banque Française Intercontinentale (FIBA) entered the market.

Unlike regular corporations where the president is appointed by the board of the directors, bank presidents in Congo are appointed by the Government. This policy which stems from the desire to control the banking industry in order, supposedly, to promote economic growth, is one of the reasons for the poor performance of most banks. This performance can be analyzed through their functional efficiency as well as financial intermediation.

B. Functional efficiency

Functional efficiency refers to banks' ability to intermediate between savers and investors and "involves risk pooling, resource allocation, general insurance, administering the payments mechanism, and mobilizing saving for investment" (Maxwell, 1991, p. 237). Among the pointers for assessing functional efficiency, stand, the quality and speed of services, and the amount of red tape involved, particularly in routine financial transactions like making a deposit (Maxwell, 1991).

Maxwell observes that banks in many developing countries are too bureaucratic (in the Indian subcontinent) and often ill-trained (in Africa). This perfectly applies to Congo where all four banks are crowded with poorly or, sometimes, untrained employees. Assessing risks is not a major preoccupation to banks. All Congolese banks currently face difficulties; one of the reasons is the poor quality of their loan portfolios. For instance, bank loans increased at 286 percent from the 1974 date of bank reform to 1979. However, the greatest part of these loans went to unsound projects initiated by state controlled firms, according to a Government report (Le Système Bancaire Congolais, p. 17). The same report points out the lack of dynamism from banks.

" Banks rarely keep in touch with their clients to assess the soundness of their business....They chose the easy path of awaiting for the clients instead of seeking to reach them....The monopoly status, employees behavior as well as banks policies are the major reasons of their inefficiency" (p. 18). As a matter of fact, the US Department of Commerce notes that "while competent

in trade finance, Congolese banks are often expensive, slow, and dominated by French interest"(The US Department of Commerce, 1988, p. 6).

C. Financial intermediation

Financial intermediaries create money and administer the payments mechanism. This is one of their major functions; another one is financial intermediation. "The process of financial intermediation involves gathering savings from multitudinous savers and channeling them to a much smaller but still sizable number of investors" (Gillis, Perkins, Roemer, Snodgrass, 1992, p. 337).

Congo's banking system has displayed little aggressiveness in raising private deposits. First of all there is no savings bank except a postal one whose massive investment in real estate in the eighties led it to bankruptcy as the real estate market collapsed. Second, none of the banks has ever developed a consistent marketing strategy to attract depositors, although deposits in the major commercial banks increased on average 13 percent per year since 1974 when a bank merger took place, a Government report notes.

" Bank deposits have notably increased. But they are unstable. [This increase] does not stem from banks' policy. Rather, it is the result of population growth in urban areas and as well as change in individuals' behavior. The trend is enhanced by the government decision to open a bank account for each civil servant regardless of his income." (Le Systeme Bancaire Congolais, pp. 15-16)

II. Causes of inefficiency

A. Monetary policy.

As stated above the Congo is member of Zone Franc, and shares one central bank (BEAC) with other central African nations. As the result of being part of that monetary union, the Congo does not have direct control over the money supply. In other words it cannot (nor can another member country) print CFA francs when needed to finance its deficit. Money is supplied by BEAC to every member in accordance with the supply and the demand the year before, the state of the economy, etc. This has proved to be a relatively efficient way of controlling inflation throughout the union. However, interest rates within the union are not determined by the laws of supply and demand. Two categories of rates prevail for discountable and non-discountable credit. Commercial bank lending rates for rediscountable loans are based on those charged by BEAC, to which specific margins are added. Until 1988, the basic rate of the central bank for these loans was 9% to which commercial banks used to add a four point margin. Rates for non-discountable credits are higher and in some cases approach 18 percent.

B. Lack of competition

The fact that interest rates are determined by the central bank deters any competition between commercial banks. The same deposit rates of interest apply to all banks, as do rates of lending. Within such an environment, in which banks cannot compete on the basis of interest rates, quality of service should be an important objective of a bank's policy. None of the commercial banks, however takes a significant lead over the others with

respect to the speed, quality of services, quality of loan portfolios, or operating costs.

C. Government intervention

The banking system in Congo was, for a long period of time, under pressure to make loans to state-owned companies. There is no written regulation about granting special treatment to state-controlled companies. However, the public sector was the main sector on which the Government relied on to carry out its economic policy (chapter four). Therefore, loans to that sector were a sensitive issue. Denial of financing to a project submitted by a public firm, but judged unfeasible by a bank, could be disapproved by the Government, or political leaders, especially if the project was for development in an area where those people have interests. For instance, the Banque Nationale de Development du Congo had been constantly requested to extend seasonal credits to state controlled agricultural firms regardless of the high rate of default on previous loans. Moreover, bank presidents like CEOs of other state controlled firms are appointed by the Government. As a result, few of them are really inclined to deny a loan or inquire about the soundness of the project because their careers rely on government or political favors more than on their achievement. As a matter of fact, a great part of the current insolvency of most Congolese banks stems from huge arrears of state-owned companies. In addition, banks had been requested to finance the Government deficit, especially to finance service payroll. This worsened their financial conditions.

D. Bank management

Congo's banking system has suffered from poor management for many years. This is partially due to the lack of competition, and to the nature of its relation with the Government, as mentioned above. They are staffed by poorly trained or sometime untrained people. Some executives or staff members have attended college but did not receive proper training for the position they hold. Training is a key element of bank performance. The World Bank notes: "The most successful international commercial banks appear to be those with the best in-house training programs, where top managers train and assess future managers" (The World Bank, 1990, p. 87). No such programs exist in Congolese banks. In most cases, there are no formal written lending policies, which makes it difficult to manage risk. Often lending activities are not subject to the financial soundness of the loan applicant, his creditworthiness, or an appraisal of the project for which funds are sought.

Lucrative compensation relative to other industries did not improve bank employees' commitment to achievement. In fact, bank employees and executives are not compensated on the basis of their performance, rather on the basis of agreements with unions that guarantee the salaries associated to each position no matter how the individual performs the task he is assigned.

III. Recommendations for a dynamic banking system

A. Monetary policies.

Because of its membership in the franc zone, any recommendation to improving the banking system in Congo (as well as any other CFA zone

members) should take into account the policy of the monetary union. As already indicated, the central banks of the franc zone have a tight control over the interest rates charged or paid by banks. This is consistent with economic policies of the member countries and supposedly allows them to channel credits toward the sectors they would like to develop. This policy leaves no room for competition. It would be appropriate to let the market determine the interest rates paid to savers. At present this statement is meaningless because there is no financial market in the franc zone. Banks have limited access to international financial markets usually through their correspondents, the most important of which is in all cases the former metropolitan parent bank. Therefore, the central banks are the major sources of financing. As a financial market develops, supply and demand influences will determine interest rates. In this case, banks would have to offer competitive interest rates in order to stay in business and the economy in whole would benefit because savers would have incentives to save. One feature of the CFA zone is that The BEAC has control of creating money. In other words, a country which has a budget deficit cannot create money itself to finance that deficit. This centralized system of supplying money has proved efficient in controlling inflation in the monetary union. A low level of inflation is a key determinant of saving decisions. Long-run inflation erodes the purchasing power of the money saved. In other words, few goods can be acquired with the same amount of money because of the high price level. Therefore, the money supply should remain determined by the BEAC.

B. Universal banks versus commercial banks

Banks and the financial system in general need to offer a relatively high rate of interest in order to attract depositors. In other words, savers' assets must be invested in sound and profitable projects and firms who benefit from banks loans must be properly run. However, not all business people have the entrepreneurial skills to undertake and efficiently manage a project. For this reason, banks should take the lead in monitoring the use of the resources they lend. This is to say that they should to some extent influence the policies of the firm without substituting for its management. Universal Banks could be an option to most CFA Zone members and to developing countries in general. "This term has different meanings but usually refers to the combination of commercial banking (collecting deposits and making loans) and investment banking (issuing, underwriting, placing, and trading companies securities)" (The World Bank, 1990, p. 32). The example of Germany's banking system in the early stages of that nation's industrialization is a good example of such a policy.

"The German investment banks--a powerful invention, comparable in economic effect to that of the steam engine--were in their capital-supplying functions a substitute for the insufficiency of the previously created wealth willingly placed at the disposal of the entrepreneurs. But they were also a substitute for entrepreneurial deficiencies. From their central vantage points of control, the banks participated actively in shaping the major-and sometimes even not so major-decisions of individual enterprises. It was they who very often mapped out a firm's path of growth, conceived far-sighted

plans, decided on major technological and locational innovations, and arranged for mergers and capital increases. " (Gerschenkron, 1968, p. 137).

One of the major difficulties of many business people in Congo is the lack of sharp managerial and marketing skills required to undertake projects and sell the output. Many projects (public or private) are adopted without a formal cost/ benefit analysis which would take into account all costs to be incurred, and the expected cash flow. Concepts like net present value or internal rate of return of a project are unknown to many business people.

Most of the time, the clients have to go toward the product; even when a new product is put into the market there is no strong marketing policy to attract customers. As one may expect, with such poor marketing ability it is more difficult to compete in international markets. Therefore, a universal bank is an appropriate option; such banks would help the borrowers to carry out their projects and to market the output domestically as well as internationally. This means that banks may consider funding services from specialized marketing firms . In the short run this would increase the operating costs of the banking system. However, in the long run it would increase benefits, because success of the project will guarantee the repayment of the loans. This in turn will be reflected in bank's income statements. Savers are then likely to obtain the return they expect from their savings and their propensity to save will increase.

Another advantage of universal banks lies in their ability to act as an investment company. In small and still developing economies, a wide variety of financial institutions may not be the cost-effective way to carry out financial intermediation. By playing both the role of the commercial and the

investment bank, an universal bank will raise savings and invest money efficiently, benefiting from economies of scales.

C. Bank management

A successful management of the financial system in Congo raises at least three issues:

1. Training

Banks need to design consistent training programs with the assistance of their foreign partners. Top executives should be particularly trained in project appraisals and in investment analyses. Employees would benefit from formally learning how to handle customers' needs in the most effective and rapid way. Quality of services should be a major goal. This means that when needed, an executive (supervisor or manager) should intervene quickly to respond to a customer's request. In others words, redtape should be minimized. Bank executives and employees should be trained to avoid bureaucratic management styles.

2. Marketing

Another important part of the training deals with the marketing of the bank's products and services. Bank advertising can be accomplished by means of TV, radio, magazines or posters ; in fact, some banks already use these marketing tools. However, in a culture mostly dominated by personal contact based on relationships, banks should train salespersons to do presentations to individuals, or groups. A particular emphasis would be put

in the power of compound interest (since few people are aware of it) and the return they can expect from saving . Salespersons would then be compensated on the basis of the volume of savings they bring.

3. Accountability

Use of independent profit centers will increase responsibility within banks and encourage managers to act in responsible way. Under this formula, each branch or unit providing services is judged and rewarded according to the profit it generates (The World Bank, 1990, p. 87). Such a policy leads managers to care about overhead, and obliges them to take appropriate measures to control operating costs as well as to increase the profit of their branch or unit.

D. Financial services

Congo's banking system offers a limited range of financial instruments to the public. None of its members issue certificate of deposits, for instance, or other traditional investment instruments. The lack of a bond market or a equity market restricts savings into time deposits. Also, banks have shown no interest in investing in high return instruments in the euromarket for instance or to acquire foreign governments' securities for their clients.

CHAPTER 6

THE FINANCIAL SYSTEM

Section one Structure

I. The Central Bank

A. Structure of the central bank

In the current monetary union, three central banks, BCEAO, BEAC, and the central Bank of Commoros print money respectively for western African states, central African states and the commoros. Each central bank has a national branch in each country of its subarea. The national branches act like clearing houses for bank transactions. They supervise the banking system of the country and provide rediscount facilities. They also have custody of the legal reserves.

The new monetary union suggested in this thesis would rely on one single central bank for the whole monetary union instead of three. This would yield economies of scale which will reduce its operating cost. The structure of the new central bank will not differ from the current one. National branches would remain and they will perform their current tasks.

B. Autonomy

Under the current status BCEAO, BEAC and the Central Bank of Commoros enjoy a remarkable autonomy. The new central bank would need more autonomy in order to implement monetary policy efficiently.

II. Supervision

The recent failure of Banque Commerciale Congolaise, as well as Union Congolaise de Banques before it, displayed a weak control of BEAC over the banking system. As mentioned earlier the major cause of their bankruptcy stands in the poor quality of their loan portfolio, as well as loose control of their management. The 1990 Ordinance creating the Commission Bancaire in BEAC subarea is a step to a more effective control .

A. The Commission bancaire

It has several functions: First, its approval is required before any bank licenses are granted as well as for change in the capital of a bank. Second, it sets liquidity requirements and other rules intended to assure the balance of financial institutions. If a financial intermediary does not comply with bank law, the Commission Bancaire has full authority to cancel its license and take appropriate actions to protect customers' assets.

Although the Commission Bancaire looks like a step to more bureaucracy in an industry whose efficiency depends partly on limited red tape, the new institution, if it is fully empowered, would protect savers and prevent the further collapse of financial intermediaries in the BEAC subarea. Under the new monetary union the Commission Bancaire would be empowered to control the entire banking system of the fourteen countries. Like the central bank, it would have national branches in each member country.

III. Deposit insurance

A. The issue

The failure of the Union Congolaise de Banques, as well as that of Congo's unique postal savings bank followed recently the bankruptcy of the Banque Commerciale Congolaise, the major commercial bank of Congo. These events have ruined depositors' trust in the banking system. Many small depositors' assets have been frozen since then with no prospect of any kind of settlement in the near future. Attempts to regain confidence would be worthless without a deposit insurance system that will guarantee a compensation to savers in case of failure of a financial institution. But, creating a deposit insurance mechanism in many CFA zone countries nowadays is a real challenge. On one hand domestic saving is needed to finance growth. Therefore all steps should be taken in order to encourage savers to deposit their assets in banks. On the other hand the governments of these countries who would have to take these steps have themselves lost trust from the citizens. Huge budget deficits raise concerns over the creditworthiness of the government institutions or agencies. Two questions then arise: 1) what would be the appropriate structure of a deposit insurance system and how would it function; 2) and what would be the strategy to set such a system and how would it be financed. The United States Federal Deposit Insurance Corporation (FDIC) is certainly one of the most famous insurance of bank deposits plans nowadays. Its functioning raises many questions especially after the near collapse of the Continental Illinois National Bank and Trust Company of Chicago in 1984. Also, the diverse structure of the banking system in the United States prohibits creating in

Africa a system entirely based on the model of the FDIC. Nevertheless, it is worth studying some of the basic principles of the FDIC that can provide a useful hint about insuring bank deposits in the CFA zone countries.

B The Federal Deposit Insurance Corporation (FDIC)

The FDIC, an independent federal agency, was established by the Banking Act of 1933. Originally its maximum insurance on bank deposit was limited to \$2400 but this ceiling increased many times and is now \$100,000 per insured account.

The premium that banks must pay for FDIC insurance was set by statute at one twelfth of one percent of total "assessable deposits." The banks pay half this premium twice a year on their average "assessable deposits" in the preceding half -year. The assessable deposits are approximately equal to a bank's total deposits, plus uninvested trust funds and minus some deductions. The FDIC was formed as a corporation, with its entire income consisting of assessments on insured banks. The corporation is authorized to use, but never has used, borrowing privileges of up to \$3 billion from the US Treasury. (Auerbach, 1988, p. 134).

"The FDIC has the powers to examine insured banks, to prescribe various rules and regulations, and , in some cases, to pass on mergers or consolidations. It has the power to subpoena any officer or employee or any books or records of insured banks that are relevant to its investigations. In addition, the financial Institutions Regulatory Act of 1978 gives to financial institutions supervisory agencies, such as the FDIC, other powers, such as civil money penalties, cease-and-desist orders, the power of removal and

suspension of insiders (those who own a significant portion of the stock in the bank), and the power to approve or disapprove of foreign branches of state nonmember banks" (Auerbach, p. 135)

C The FDIC: recent development

When the FDIC deposit insurance began in 1935, there was a \$5,000 limit that covered 35 percent of deposits in insured banks. In 1984 there was a \$100,000 limit that covered 63 percent of the deposits. In the mid 1980s, many banks were in difficulties or failed. This brought up issues about insurance deposit and led to proposals intended to reform the system.

a) Risk-based premium system

The main characteristic of the proposals was the establishment of a risk-based premium system instead of the flat proportion of assessable deposits which applied to all banks regardless of the risk they represent. The premiums for most private insurance are determined by the probability of the insured event occurring. This principle applied to banks' deposits raises at least two major questions.

1. First of all, a massive and adequately trained personnel would be required to examine loan and investment portfolios of insured depository institutions and properly rate them according their risk assessment. Moreover, it is difficult to predict the failure of a bank, which may stem from various factors. For this reason, creating standards for evaluating risks is challenging task.

2. The announcement of a low rating for a particular commercial bank and the requisite increase in its premium could itself provoke a run on the bank, especially by those with uninsured deposits. Only nearly 100 percent deposit insurance could guarantee against this destabilizing effect. (Auerbach, p. 141)

b) Capital requirement

Since the risk-based premium system raises questions that have not been solved, another approach suggested the imposition of capital requirements, in other words, banks investments in high return assets would have to comply with a certain capital-asset ratio. This system raises two conflicting points of view. From the regulators standpoint, a high capital requirement is likely to protect savers deposits because it imposes more discipline on depository institutions in managing their portfolios. From the depository institutions' standpoint, which actually would be the point of view of firms in general, based on finance considerations, a low capital asset ratio is more profitable. One of the management's goals, and certainly the chief one, is to maximize the value of the firm's stock, which equates the sum of the present value of future revenues. Therefore, a low capital-asset ratio allows investing more and to achieving that goal. This proposal brings up another issue as of defining the capital. The Federal Reserve distinguishes between primary and secondary capital.

" Generally, primary capital is the value of common stock, perpetual stock, surplus and undivided profits, and reserves held for capital services. Secondary capital is the value of limited-life preferred stock and some debt

instruments such as unsecured long term-term debt. In 1983, the minimum capital ratios for banks--even the largest banks that were not formerly subject to capital requirement--were set at 5 percent and in 1984 were raised to 5.5 percent. In 1985 the ratio of capital to total assets for all commercial banks was 7.49 percent, having steadily climbed from 1980, when it was 6.65 percent" (Auerbach, 1988, p. 142).

The Cabinet Council recommended a capital ratio of 8 to 10 percent (one third of which could be met by certain debt instruments), and the FDIC recommended an increase to 9 percent. An attempt to raise all this new capital would impose many problems for commercial banks.

As of December 31, 1984, 8,101 banks (55 percent of all insured commercial banks, with 82 percent of the assets) were below the 9 percent level.

Approximately \$50 billion in additional capital would be needed to bring these banks into compliance with such a requirement. Generally the value of stock has been declining since 1974, and in 1985 the market value of many bank stocks was near the bank's book value (their net worth). An attempt to sell more stock to raise capital could dilute the ownership of stock and result in a decline of the firm's value, thereby reducing the capital-to-asset ratios.

Another way to raise capital ratios would be to sell assets, which means reducing the banks' size. How an increased capital ratio would reduce bank's failure rate is still a question. A nine percent capital ratio was thought appropriate. However, if the public loses confidence in a bank's ability to allow withdrawal of its deposits, a capital ratio of 9 percent will have little effect. Instead, this could lead to a huge cost to the banking system for raising capital.

c) Proposals for a new deposit insurance coverage

Both capital requirement and risk-based premium coverage raise unsolved questions about the task of insuring banks deposits and call for reform of the system. Four proposals have been suggested.

The first one recommended is to scale back deposit insurance coverage. This was recommended in the FDIC's 1983 report to Congress. Some proposals would reduce the coverage to \$50,000. Depositors with accounts over this amount would deposit at their own risk. One problem with this plan is that checking account money would not be safe, and it is the principal medium of exchange in the United States. Therefore, deposits would be diversified and other goods might be substituted-such as short-term Treasury instruments for use as media of exchange.

The second proposal is to extend the deposit insurance coverage, with some proposals suggesting 100 percent coverage while at the same time limiting to the very safest the assets that banks could buy. This insurance coverage would stabilize the country's payments system and prevent bank runs. The asset requirement, however, would inhibit innovations, put US banks at some disadvantage compared with banks in countries with fewer restrictions, and cause a transfer of banking business to other countries that allowed banks to buy a broader range of assets.

The third proposal is to extend insurance coverage, possibly to even 100 percent, and let the banks diversify their assets. A bank's safety would be guided by government activities. This would allow banks to compete worldwide and might even result in a safe portfolio of assets for many banks. But the rules would be difficult to establish, as they would be based on the

assessment of risk, which would differ from among banks examiners and agencies. Finally, there are not enough examiners to enforce the rules, as banks make millions of loans and investments each year.

The fourth proposal is to extend insurance coverage, possibly to even 100 percent, and to let the banks diversify but close them as soon as they become insolvent (that is their net worth becomes zero or less). If the insurance coverage is not near 100 percent, as was the case in 1987 with the \$100,000 limit, a run could be started by large depositors, as happened at Continental Illinois National Bank and Trust Corporation of Chicago, in May 1984. If the coverage had been near 100 percent, there would not have been a run in the first place.

D. Steps toward a deposit insurance system in the CFA Zone

The issues discussed in the previous section show the importance as well as the complexity of a deposit coverage system. In the United States, the magnitude of the task is amplified by the relatively high number of depository institutions. As of December 1994, the United States banking system counted nearly thirty-six thousand financial intermediaries. The banking system in the fourteen CFA zone countries would account for approximately two hundred banks and non-bank institutions. The relatively small number of depository institutions makes them more manageable with respect to the insurance issue. Two major questions need to be solved:

- 1) which strategy should be used for a successful implementation of the system and
- 2) what sources of funds would be diverted in case of a bank run.

a) Strategy

Poor creditworthiness of the governments of CFA Zone countries makes it necessary to back the deposit insurance system (at least at the beginning) of the monetary union through sound and well-known multinational companies. The new monetary union could contract with an insurance company or a consortium of insurance companies, or best with oil companies already in place in some member countries. For instance, Congo, Cameroon and Gabon are among the big oil producers of the region and the market is dominated by foreign firms whose financial soundness is, in general, better than that of domestic firms. These companies would then be the parent company of the insurance deposit institution and substitute for it in case of a massive bank run. Depositors would be more inclined to save their money through the banking system confident that they could rely on these oil companies or its affiliate.

b) Feature of the deposit insurance system

The important role financial intermediaries would play in the new monetary union prohibits taking actions capable of limiting their growth. Therefore, a measure (like capital requirement ratios) that restricts the amount or types of assets in which they could invest might be an obstacle to the goals of the monetary union. The relatively small number of depository institutions suggests the merit of a risk premium approach. Well trained inspectors and external audits would permit determining the risk each bank presents and setting the premium accordingly. The Commission Bancaire whose role is primarily to supervise the banking industry would help assess the risks.

The deposit insurance body would be incorporated as a private investment company whose activities would consist mainly of investing in sound and geographically diversified portfolio. In fact, the lack of bonds market and equity markets in the franc zone suggests that the organization would be chiefly an international business-oriented firm. Such an orientation would allow making sufficient profit and holding enough resources to insure against a bank run.

A problem may arise with the private ownership of an important policy instrument of the monetary union which could dilute its authority. Also, the goals of a profit-oriented firm could conflict with those of the public sector. Although foreseeable, it should be possible to settle such a conflict in the best interest of both the Government and the private firm. Profit maximization would not necessarily interfere with the policy of the monetary union which is to set a agency capable of protecting depositors. In order to provide such a protection, the deposit insurance company must be profitable and hold sufficient assets. In fact, Auerbach notes that "the most important results of the creation of the FDIC have been the virtual elimination of bank runs and the substantial reduction in the number of bank failure until the 1980s." (p. 135).

Section two: Financial Markets

A monetary union which will allow to issue a stable currency, and the conditions under which this is can be accomplished is the focal point of this thesis. Raising domestic savings and passing them to the investors is another

one. In order to do so, financial intermediaries need to operate within well functioning financial markets.

In short, financial markets can be defined as those in which financial assets are traded. Financial markets are classified under several criterion, but fundamentally they are ranked according to the maturity of the instruments traded. Short-term debt instruments trade in the money market and longer terms securities, like bonds and stocks are traded in the capital market. CFA Zone countries need a sound financial market which offers reliable debt instruments. Within such a market the individuals or the institutions who want to invest their money can buy these instruments. Doing so, they supply the savings which, other things being equal will fuel the economic growth. The success of the financial market will depend on many external as well as internal factors. Among the latter, the role of the governments of the CFA Zone members, especially the supervision of the whole system (discussed in chapter seven) is critical. Following is a discussion of two types of markets and the instruments they can offer.

I Money Market

The term money market refers to a "group of markets in which low-default-risk, very liquid, large-denominated debt instruments are traded" (Auerbach, 1988, p. 267). Originally money markets specialized in short term instruments but nowadays they also trade long term financial assets like the US Treasury bills that are normally traded on capital markets. The money market provides a way for large firms and large financial intermediaries to economize on their cash balances by lending them for a short period of time

as they temporarily have excess reserves. Likewise, they have a ready market where they can borrow when they face a temporary cash shortage. Certificates of deposit and Treasury securities are some of the most widely traded short term instruments in the money market.

A. Certificates of Deposit

Certificates of deposit can be defined in reference with time deposits. A time deposit is a bank account in which money is held with a specified maturity, meaning that it cannot be withdrawn before a certain date. Beginning in 1961 individuals and firms have increasingly deposited money in special time deposit accounts for which large-denomination marketable certificates of deposit (CDs) (over \$100,000) are issued as evidence of their claims. CDs are negotiable; put in other words they can be sold before the maturity date. They pay market-determined rates of interest. CDs of denomination less than \$100,000 are not negotiable. Certificates of deposit are issued by four types of financial intermediaries: US banks issue domestic CDs; banks outside the United States issue Euro CDs, that is dollar-denominated CDs; US branches of foreign banks issue Yankee CDs; finally thrifts issue thrift CDs.

B. Treasury securities

The United States Treasury sells government securities, namely bonds, notes, and bills to finance government operations and to refinance debt.

1) Bonds and notes

A bond or note is a financial contract which stipulates a series of fixed payments from the issuer to the holder of the bond or the note. The payment is usually semi-annual, or annual, but can also be made quarterly. Notes have short maturity (in general ten years maximum), whereas bonds have any maturity. Interest payment on bonds is called coupon. A bond can be callable, meaning that it may be redeemed before maturity.

2). Bills.

Bills are debt instruments that mature in one year or less. Unlike bonds they yield no interim payment but only a lump-sum payment at maturity.

II. Corporate bond market

Like the government, firms issue bonds to finance their investment in fixed assets. These bonds are sold through private placements, meaning they are placed directly with particular lenders. This form of placement of bonds had declined in the sixty's. Nowadays bonds are mostly sold by public offerings handled by underwriters (investment companies). Like government bonds, corporate bonds yield fixed interest payment. At maturity a bond pays interest coupon plus its face value, that is, the value indicated on it.

III. Financial investment

In general, investment in financial assets bear a greater return than savings accounts and time deposits, especially if the firms issuing debt claims are profitable.

One objective of a new monetary union would be to develop a bond market as a means to raising domestic savings. Since few financial intermediaries in the franc zone have adequate skills to underwrite securities, universal banks referred to in section two would play a key role. They would buy and sell debt instruments issued by government, firms, and other banks for their customers. Two key elements of financial investment decisions are the expected return as well as the risk associated with various debt instruments. Financial theory holds that risk can be reduced with a diversified portfolio. Universal banks would seek maximization of their customers' assets by domestic as well as global investment (investment in foreign securities).

CHAPTER 7

ROLE OF THE GOVERNMENTS OF FRANC ZONE COUNTRIES

I. Management of the reform

Creating a monetary union of fourteen countries with different goals, different political constituencies and various domestic difficulties is a real challenge. The success of the project depends in great part upon the ability of the fourteen countries to monitor the reform. An option would be to set an autonomous task force made of experts in money, banking, finance, economics, and law to conduct a comprehensive survey of the project. The task force would study in detail all the implications of the reform as well as all constraints that could occur. It would be provided adequate resources. In addition it would be granted full authority to implement the reform and initiate any appropriate actions when needed.

II. Legal foundations

The success of the monetary union depends in great part on its legal framework, the settlement of commercial disputes, and the prudent regulation of financial institutions and markets.

The collapse of the banking system of Congo is an example of a weak legal framework. The government is the principal owner of the banks that failed. Many small depositors lost their assets and feel frustrated and powerless. In theory, they can sue these banks. But in practice, chances are limited that such a legal action will result in a satisfactory settlement to them. The World Bank (1990) notes:

Procedures for setting private disputes are set forth in most company laws, commercial codes, and special banking acts, but the development of a sound financial system requires additional measures. Prudential supervision by government authorities is warranted for banks and some other financial institutions and markets. Banks hold an important part of the money supply, create money, are the main means of implementing monetary policy, administer the payments system and intermediate between savings and investments. Problems in one bank can quickly spread to the entire financial system. Bank failures have monetary and macroeconomic consequences, disrupt the payment system, and lead to disintermediation (which decreases the mobilization of resources and the availability of finance for investment).

As financial systems develop, different institutions evolve to take over some activities formerly performed by banks and to provide new services. All these institutions, old and new, are integrated in an increasingly complex financial system. This complexity limits the ability of creditors to exercise effective control and calls for prudential regulation and supervision.
(p. 73)

The governments of the CFA zone need to fully empower the supervisory bodies as well as other legal institutions of the monetary union so that they have the authority to initiate any appropriate action needed to insure the proper functioning of the system and to protect individuals and businesses.

III. Economic policies

A. Investment decision

1. Fiscal impact analysis

Beside the collapse of the oil market, one of the major causes of the downfall of Congo's economy lies in the poor analysis and mismanagement of the projects included in 1982-86 five year development program.

Most projects were adopted without a formal fiscal impact analysis. This concept refers to an analysis of total costs and total revenues accruing to government or governmental units. Many projects were adopted and implemented without any analysis of alternatives . A fiscal impact analysis could have allowed an evaluation of expected benefit to the country in the most efficient manner possible..

2. Discounting present value analysis

Fiscal impact analysis rests on the discounting present value analysis which is a method for comparing current and future costs and benefits of an investment. The discounted present value of a stream of benefits or costs is the sum of the discounted values for each year. Net present value, which results from the comparison of the stream of benefits to the stream of costs determines whether or not the project is worthwhile

B. Benefits of Adjustment programs

Both the International Monetary Fund and the World Bank face severe criticism from African intelligentsia for the ineffectiveness of stabilization as well as adjustment programs. Despite their weaknesses (which this thesis will not address), one objective of a stabilization program and a structural adjustment program is to restore financial and economic balances, and to set a financial discipline. The lack of such a discipline is one major reason for the huge budget deficits and the heavy indebtedness of the CFA Zone countries. Consequently, the success of the monetary union requires that CFA Zone members implement stabilization programs and adjustment programs.

CONCLUSION

A growth-oriented monetary union, as opposed to what the franc zone has been for over half a century, is a sine qua non for improved performance of French-speaking African countries. Heavy indebtedness and limited access to foreign capital require that domestic savings be increased greatly in order to finance economic growth. This could be done through a monetary union which rests on a dynamic financial system and an efficient banking system. Although challenging, such a monetary union can be created. The achievement depends upon on many factors, among which is the ability to establish and empower a strong legal and regulatory system.

Under a reliable legal foundation the financial system would successfully intermediate between savers and investors and allocate resources efficiently.

The regulatory bodies need to supervise not only the compliance vis-a-vis bank and financial regulation, but also they need to protect savers' assets and to inspire trust, the cornerstone of the whole monetary union. A deposit insurance system is a key element of the monetary union. The case of the United States' Federal Deposit Insurance Corporation (FDIC) illustrates the problems associated with such a task.

The development of a money market and a large variety of investment instruments is another vital condition of the whole system. The financial system needs to develop a global investment strategy which would permit holding a diversified portfolio of investment instruments and maximizing the return.

Economic reform in all countries combined with close coordination of economic policies will guarantee the stability of the common currency.

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Appendix A. EEC: The Convergence Indicators (1992)

	Criteria				Criteria Satisfied			
	Inflation	Long term	Budget	Public Debt	Inflation	Long term	Budget	Public
	Rate	Gvt. Bonds %	Deficit	% of GDP	Rate	Gvt. Bonds %	Deficit	Debt
France	2.5	8.8	-1.5	47	yes	yes	yes	yes
Luxembourg	2.4	8.1	2	7	yes	yes	yes	yes
Denmark	1.8	8.8	-1.7	67	yes	yes	yes	no
Britain	3.7	9.7	-1.9	44	yes	yes	yes	yes
Germany	4.1	8.1	-3.6	46	no	yes	no	yes
Belgium	2.8	8.9	-6.4	129	yes	yes	no	no
Ireland	3.5	9.3	-4.1	103	yes	yes	no	no
Holland	4.8	8.6	-4.4	78	no	yes	no	no
Italy	6.2	12.6	-9.9	101	no	no	no	no
Spain	5.5	11.7	-3.9	46	no	no	no	yes
Greece	17.6	20.8	-17.9	96	no	no	no	no
Portugal	9.8	14.1	-5.4	65	no	no	no	no

Source: National statistics, JP Morgan; European Commission