Reprinted from: Journal of Development Economics, 10/86

P. and S. Guillaumont, Zone Franc et Développement Africain (Economica, Paris, 1984) pp. 337, $16.00.

Two major issues in the assessment of monetary unions relate to the role of domestic policies in promoting adjustment to permanent external shocks and to the existence of adequate institutional arrangements that promote such adjustment. Under either a fixed or a floating exchange rate system,

NORTH-HOLLAND PUBLISHING COMPANY–AMSTERDAM

adjustment to an external shock, such as a terms of trade loss, would entail an eventual decline in real absorption to reflect the decline in the price of the country's production basket relative to its consumption basket. Under a floating exchange rate system, the burden of adjustment often falls on the private sector to the extent that the public sector maintains its own absorption through deficit spending financed by monetary creation. This is ruled out in a monetary union, where maintenance of a fixed exchange rate with union partners entails acceptance of a common money supply target. Membership in a monetary union thus implies recognition of the fact that inflation, while permitting the financing of government spending without resort to legislating unpopular taxes, entails a high cost in terms of resource misallocation. Under any exchange rate regime, adjustment can obviously be postponed through deficit spending financed by running down reserves or by borrowing abroad. This entails a cost in terms of using up previously accumulated savings or accumulating claims on future resources to service foreign debt.

To what extent do the West African and Central African monetary unions promote timely adjustment while avoiding that the burden of adjustment falls on the private sector? The rules of both unions limit credit to the government in any given year to 20 percent of fiscal receipts in the previous year. In theory, therefore, a deterrent to excessive fiscal deficits is thus built into the system, as the authors point out. Yet the origin of external imbalances in both unions in the 1980s has been the maintenance of large public sector deficits in the face of declining terms of trade. How was this possible despite observance of the 20 percent rule in all member countries? In practice, member governments circumvented the rule by borrowing abroad (which is not limited by the statutes), by diverting budgetary outlays for consumer subsidies to public enterprises (which are not included in the statutory definition of the public sector), or by accumulating arrears.

The authors tend to view the first of these as a strength rather than a shortcoming of the system, insofar as currency convertibility allowed member governments to smooth the adjustment process through bridging finance obtained from abroad. However, the franc zone countries have not escaped the widespread external payments difficulties which emerged in the late 1970s when the commodity boom ended and real interest rates rose. The governments of all union members without exception either rescheduled their debts or ran into external payments arrears in the six years to 1985.[1] In light of this, the foreign loans they obtained can hardly be viewed as 'bridging finance' justified by their future export earning capacity. A way of avoiding

[1]Ivory Coast, Niger, Senegal, and Togo among members of the West African Monetary Union and the Central African Republic among members of the Central African Monetary Union rescheduled their debts with official creditors; all other countries in both monetary unions ran into external arrears.

excessive foreign borrowing would be to limit total credit available to member governments instead of limiting internal credit only, as the existing statutes do. This could be achieved by modifying the statutes to reduce the internal credit ceiling in any given year by the extent of recourse to foreign borrowing beyond a given sustainable limit. Such modification of the statutes would require fiscal coordination to accompany monetary integration, insofar as it implied greater reliance on taxation, as opposed to foreign borrowing, to finance government spending. The absence of fiscal coordination could give rise to distorting trade and capital movements in response to disparate rates of taxation within a monetary union.[2]

Other issues explored by the authors include the extent to which membership in the franc zone has resulted in lower inflation, higher growth, and greater openness of member countries' economies compared to non-members at a similar level of development. Not surprisingly, the authors find it difficult to make definitive assertions in these areas because the results are highly sensitive to the comparator group and to the period chosen. Such comparisons are also obscured by the difficulty in attributing economic performance to membership in a monetary union as opposed to demographic and external factors, and by the rather disparate economic performances of individual member states. A full investigation of the impact of membership on economic performance would have necessitated an explanation of performance on the basis of its underlying determinants. Member states differ considerably in the extent to which they have given priority to investment and production in line with comparative advantage and adjusted domestic policies to external shocks. Although membership in a monetary union certainly constitutes a disciplinary force as the authors point out, much depends on domestic policies and the willingness to fully implement them.

Miranda Xafa
International Monetary Fund, Washington, DC

[2]This argument was advanced by W.M. Corden in 'Monetary Integration', Princeton Essays in International Finance, no. 93 (1972).