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The exchange rate regime of the WAEMU: Monetary stability at the expense of current account deficits and rising external financial liabilities? A post-Keynesian view

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Zentrum für Ökonomische und Soziologische Studien (ZÖSS)
rouven.reinke@uni-hamburg.de
Universität Hamburg
Fakultät für Wirtschafts- und Sozialwissenschaften
Fachbereich Sozialökonomie
Welckerstr. 8
20354 Hamburg

Abstract

The West African Economic and Monetary Union (WAEMU) is a currency and customs union that is made up of the eight low-income countries Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, and Togo. Except for Guinea-Bissau, all member countries of the WAEMU have a shared history as former French colonies. The WAEMU's common currency, the CFA franc, is today pegged to the euro at a fixed exchange rate that is guaranteed by the French treasury. France's influence on monetary policy issues of the WAEMU is still highly present and increasingly contested by political economists, and part of the member countries' civil society. These critics denounce the bilateral exchange rate arrangements as monetary colonialism that outlasted the political independence process from 1954 till 1960 and prevents the West African countries from implementing growth-oriented macroeconomic policies.

The proponents of the fixed exchange-rate regime emphasize monetary stability in the form of relatively low inflation rates and a stable external value of the domestic currency. Indeed, the WAEMU zone has shown a remarkably long period of exchange rate stability for the past 30 years. This distinguishes it from Developing and Emerging Economies (DEE) in Latin American or Asian countries in the 1990s and early 2000s, which reacted to balance of payments crises with the introduction of floating exchange rate regimes. The present paper connects to that controversial debate and addresses the important research question if the argument of monetary stability holds considering the current development path of the WAEMU. More concretely, it contrasts the monetary union's resilience against the adverse effects of exchange rate volatility with international competitiveness and a long-term perspective on external debt.

On the theoretical level, the study draws on the post-Keynesian liquidity preference theory to elaborate the exchange rate challenges that DEE with internationally integrated financial markets are confronted with. This approach highlights the hierarchical structure of the international monetary system and the resulting adverse implications for peripheral currency areas regarding monetary stability. Furthermore, monetary Keynesian economist have worked out the limitations of an exchange rate-based stabilization strategy arguing that it comes at the expense of losing international competitiveness and a rising international debtor position. These findings serve as a theoretical basis for studying the sustainability of the WAEMU's development path.

Key words: WAEMU, CFA franc, Post-Keynesian Economics, international currency hierarchy

Introduction

The West African Economic and Monetary Union (WAEMU), established in January 1994, is a currency and customs union that is made up of the eight low-income countries Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, and Togo. Except for Guinea-Bissau[1], all member countries of the WAEMU have a shared history as former French colonies. The WAEMU's common currency, the CFA franc, is today pegged to the euro at a fixed exchange rate that is guaranteed by the French treasury. France's influence on monetary policy issues of the WAEMU is still highly present and increasingly contested by political economists, African politicians, and part of the member countries' civil society denounce it as monetary colonialism that outlasted the political independence process from 1954 till 1960 and prevents the West African countries from implementing growth-oriented macroeconomic policies.[2]

In response to demands for a strengthening of (formal) monetary independence, France and the WAEMU signed a new Treaty of monetary cooperation in 2019 that comprises changes regarding the organs and the reserve management of the BCEAO. Firstly, France is no longer represented neither in the Board of Directors, which also means losing its veto power in that body, nor in the Monetary Policy Committee of the BCEAO.[3] Secondly, after a successive reduction of the statuary foreign exchange deposits at the French treasury from 100 percent till 1973 over 65 percent till 2005 to 50 percent of the BCEAO's reserves, the African central bank has now reached full authority to dispose of its reserve assets. However, these concessions did not suffice to silent the ongoing criticism. By maintaining the French exchange rate guarantee for the CFA franc, the WAEMU also remains dependent on France as the foreign exchange lender of last resort in the event of balance of payments problems.

While there are vociferous calls for an complete ending of the monetary "(post)colonial link between France and its former West and Central African colonies" (Nubukpo 2007: 70, own translation), the proponents of the currency regime emphasize monetary stability in the form of relatively low inflation rates and a stable external value of the domestic currency (Hallet 2008; Gulde 2008; Vedie 2018; Banque de France 2024). Indeed, the WAEMU zone has shown a remarkably long period of exchange rate stability for the past 30 years. This distinguishes it from Developing and Emerging Economies (DEE) in Latin American or Asian countries, which reacted to balance of payments crises

[1] The former Portuguese colony Guinea-Bissau joined the WAEMU in 1997.

[2] For an overview of these criticisms see e.g. Pigeau and Sylla 2020; Sylla 2021; Ze Belinga 2017; Koddenbrock and Sylla 2019; Canac and Garcia-Contreras 2011. Further critique concerns the trade relations between the WAEMU and Europe, which, as in colonial times, continue to be shaped by the role of West African countries as suppliers of raw materials and sales markets for Europe, benefiting primarily French and Western multinational corporations, as well as a small African elite, which in turn has an interest in maintaining the asymmetrical trade structure (Taylor 2019).

[3] However, as France retains the possibility to request in the event of an imminent foreign exchange shortage an observer on the former organ and takes part in the appointment of an "independent and qualified" (Banque de France 2022) member of the latter, it keeps a backdoor open for exercising influence on the central bank's decision making.

with the introduction of a floating exchange rate regimes.[4] The present paper connects to that controversial debate and addresses the important research question of whether the argument of monetary stability holds considering the current development path of the WAEMU. More concretely, it contrasts the monetary union's resilience against the adverse effects of exchange rate volatility with international competitiveness and a long-term perspective on external debt. Furthermore, based on this analysis, the paper outlines a macroeconomic scenario that could initiate a process of de-peripheralization of the WAEMU as a currency area and reduce the dependence on France as the foreign reserve lender of last resort.

The study builds on the post-Keynesian liquidity preference theory to elaborate the exchange rate challenges that DEE with internationally integrated financial markets are confronted with. This approach highlights the hierarchical structure of the international monetary system and the resulting adverse implications for peripheral currency areas as the WAEMU regarding monetary stability. Furthermore, monetary Keynesian economists have worked out the limitations of an exchange rate-based stabilization strategy arguing that it comes at the expense of loosing international competitiveness and a rising international debtor position. These findings serve as a theoretical basis for investigating the sustainability of the WAEMU's development path. At the methodological level, descriptive data from the balance of payments and the international investment position of the WAEMU is used to show the dynamics of external debt under the current stability-oriented system hard peg system. By applying the post-Keynesian framework of an international currency hierarchy to study the WAEMU's monetary stability and exchange rate challenges, the paper fills an important research gap. To the knowledge of the author, this has only been done in the works of Lampe and Löscher (2021) and Lampe (2020).

The remainder of the paper is structured as follows. The next chapter both introduces the post-Keynesian approach of an international currency hierarchy and points out the limitations of a hard peg-based development strategy. The following part elaborates how the WAEMU maintains monetary stability despite the peripheral position of its local CFA currency. Chapter four analyses the impact of the WAEMU's exchange rate arrangements on the member countries international competitiveness and external debt. The fifth section briefly sketches out basic conditions for a monetary de-peripheralization of the West African currency union. The last section concludes.

[4] Following a severe liquidity crisis at the end of 2001, Argentina was forced to free up the exchange rate of the peso against the US dollar in January 2002 (Spiegel 2002). In the wake of the currency crises in Mexico in 1994 and the Asian crisis in 1997, Brazil also had to abandon the crawling peg of the real and, after a phase of free-floating, pursued a managed floating exchange rate policy (Barata 2019; Cruz and Walter 2010).

Post Keynesian literature on international currency hierarchy and the limitations of exchange-rate based stabilization policies

The monetary Keynesian strand of post-Keynesian literature applies Keynes' liquidity preference theory to an open economy where multiple currencies are competing against each other for the acceptance by global wealth owners (Andrade and Prates 2013, de Paula et al. 2017, Bortz and Kaltenbrunner 2018). Monetary Keynesian and Latin American structuralist authors understand international currencies as different asset classes that offer different degrees of liquidity to wealth owners and international investors. Liquidity is here founded in the ability to perform the essential functions of money at the international level, and constitutes a hierarchical relation between the hegemonic currency (currently the US dollar), leading currencies as e.g. the euro or the yen, and, peripheral currencies of DEE. In line with this reasoning, the 'Berlin School of Thought' (Riese 1986, Riese 1989, Lüken-Klaßen 1993, Lüken-Klaßen and Betz 1989, Nitsch 1999, Nitsch 1995) emphasizes the limited store of value function and acceptance as medium of contractual settlement of currencies of DEE as the central restriction for the latter's economic underdevelopment. Based on the currency hierarchy framework and integrating the Minskyan thoughts on financial instability, further work centres on the short-term liability side of DEE's balance-sheet as an indicator of external financial fragility (Bonizzi and Kaltenbrunner 2021) that underpins "the endogenous and self-perpetuating nature" (Kaltenbrunner 2015, p. 428) of the global monetary order (see e. g. Ramos 2019).

By treating currencies as portfolio assets for global wealth owners, financial assets denominated in different currencies can be compared based on their "own rate of interest," which encompasses the following components: the currency-specific liquidity premium (l), carrying costs of holding the asset, and the short term exchange rate expectations. Following Andrade and Prates (2013: 411) and Löscher and Kaltenbrunner (2022) carrying costs of a 'currency asset' (c) are interpreted as the restrictions on foreign outflows to which investors are exposed if they want to convert their financial investment into international reserve currencies. Carrying costs are therefore the lower the higher the degree of capital account openness. In a formal way, and, for reasons of simplicity, excluding expected short-term exchange rate devaluations, an equilibrium regarding the "own rate of interest" of two financial assets denominated in different currencies can be presented as shown in the equation 2 below.

This theoretical framework is used to argue that developing and emerging economies (DEE) typically have to deal with a structural devaluation pressure on their exchange rates that results from their currencies' low quality as an international store of value and restrained ability to meet outstanding external liabilities. In order to compensate the international investors' reduced non-pecuniary income in form of liquidity ($lp < lc$), financial domestic currency assets of DEE need to offer a higher pecuniary income ($ip > ic$), i. e. a higher interest rate, that corresponds to the liquidity differential (Fritz et al. 2022). Otherwise, assuming open financial markets, a constant capital outflow from peripheral (p) DEE to currencies areas

at the top of the global financial order (the US-dollar, the euro, the pound sterling etc.) (c) would lead to a permanent devaluation of DEE's exchange rates.

$$lc - lp = ip - ic \quad (1)$$

$$(i_p + l_p) - q_p = (i_c + l_c) - q_c \quad (2)$$

i_p: pecuniary yield of a peripheral currency, i_c: pecuniary yield of a center currency
l_c: liquidity premium of a peripheral currency, l_p: liquidity premium of a center currency
q_p: carrying costs of peripheral currency, q_c: carrying costs of a center currency

The need for restrictive monetary policies has adverse implications for the macroeconomic development and financial stability of these countries. High interest rates reduce the volume of profitable investments, leading to a decline in aggregate demand. Additionally, elevated interest rates not only constrain domestic private investment, hindering the growth of the real economy, but also attract speculative short-term financial investments, such as carry trades, which increase the risk of exchange rate volatility and financial instability (Bortz and Kaltenbrunner 2018: 384, Fritz et al. 2022). Rising capital inflows lead, in the case of a flexible exchange rate regime, to an appreciation of the investment currency that increases the investors' rate of return and contributes to the procyclical character of carry trade. But once the tide turns, a sudden reversal of these typically short-term financial investments can cause a massive devaluation pressure on the debtor country's exchange rate.

Summarizing a wider range of post-Keynesian literature on exchange rate determination, Kaltenbrunner (2015: 441) works out a set of policy and structural variables that affect the liquidity premium differential between centre and subordinated currencies. The former indicates the "ability and willingness to maintain [a currency's] store of value function", the latter refers to a currency area's "position in international debtor-creditor relations". Whilst policy variables include the exchange rate regime, central bank credibility, and the available stock of foreign exchange reserves, structural variables account for the stock of short-term external obligations and the autonomous foreign exchange productivity derived from the current account.

The discussion about the limitations of an exchange rate-based stabilization policy became particularly relevant in the context of the currency crises in emerging economies in Asia and Latin America in the late 1990s till the beginning of the 2000s (Flassbeck 2005). Confronted with rampant inflation rates, several Latin American countries attempted to enforce monetary stability through an external currency anchor or complete dollarization as in the case of Ecuador (Wolff 2002). For the case of Brazil, Fritz (2002) argues that although a fixed exchange rate regime can indeed be a powerful tool for lowering the inflation level effectively in a short period of time, it leads to an overvalued exchange rate in the medium to long term that deteriorates the competitiveness of the local export sector. Falling exports and rising demand for cheaper imported products compared to domestic production lead to a current account deficit and growing foreign debt (or a reduction in foreign claims in the form of foreign exchange reserves). High levels of external debt denominated in foreign currency will then weaken the confidence in the ability to defend the fixed exchange rate and thus counteract precisely the efforts to strengthen the quality of the domestic currency. At the same time, servicing the debt requires continued capital imports, which must be ensured by

a corresponding interest rate policy that further reinforces the high interest rate tendencies derived from the currency hierarchy.

Given the crisis-prone nature of the global financial system and the associated volatility of international capital flows, dependence on constant capital imports involve major financial risks, as was impressively demonstrated by the abandonment of the currency board introduced in Argentina in 1991. Unable to withstand the devaluation pressure of the domestic currency in the long term, Argentina was forced to liberalize the exchange rate in 2002 (Aschinger 2002, Ricottilli 2006). In her study of exchange rate-based stabilization policies in Brazil in the mid- to late 1990s, Fritz (2002: 7) concludes that

> [f]or the long-term sustainability of a development strategy not the short-term price and exchange-rate stabilization is of central importance, as neo-classic and monetarist approaches suggest, but the durable enhancement of the currency's quality. However, this quality of a nation's quality is undermined when a currency regime is chosen that achieves price and exchange rate stabilization at the cost of an increase in the country's foreign debt.

In this view, current account deficits and the accumulation of external debt on the side of developing countries undermine the trust of international investors in the stability of the external value of the debtor countries' currencies, in particular if the external debt burden is denominated in foreign currency (Heine und Herr 2000, p. 645, de Paula et al. 2017).

Drawing on the post-Keynesian insights on the exchange rate challenges of DEE in a hierarchical currency framework, the following part works out how the exchange rate arrangements and capital account regulations of the WAEMU effect the CFA member states' monetary stability.

Monetary stability

Inflation

The central bank's credibility to maintain a stable price level that fits the announced inflation target sustains the store of value function of the domestic currency. Although foreign financial investors might not be concerned about the domestic inflation rate as long as it does not affect the exchange rate, hence the expected profit rate of their investment, price stability is the key condition to make domestic wealth owners accept the local currency as a stable store of value. The BCEAO pursues price stability as primary objective of its monetary policy operations. Since the institutional reform of the central bank in 2010, price stability is explicitly defined as an inflation rate of 2 percent with a margin of 1 percent above or below that target for a period of 24 months. The adoption of an inflation target that coincides with the one of the eurozone reflects the fixed peg between the CFA franc and the euro.

Price stability is commonly put forward as the central argument in favor of the WAEMU's fixed exchange rate arrangement. Relatively low and stable inflation rates are indeed a remarkable characteristic of the WAEMU compared to other regional non-CFA countries with more flexible exchange rate regimes. From 2014 to 2023, the annual average

inflation rate in the WAEMU ranged from -0.6 to 7.2 percent, whereas non-CFA countries in West Africa, such as Ghana (8.7 to 41.7 percent), Nigeria (8.1 to 24.2 percent), Gambia (5.9 to 12.9 percent), Guinea (7.2 to 12.6 percent), and Liberia (7.6 to 27 percent), experienced higher and more volatile exchange rates (AFDB 2024). However, there is only a weak impact of monetary policy on inflation and a particularly weak transmission mechanism between the interest rate on the interbank market and the inflation rate (Kireyev 2016b) in the WAEMU due to a highly concentrated banking sector and low credit to GDP ratios (BCEAO 2012; BCEAO 2016). Import prices on food and energy are more important drivers of overall regional inflation. Since the second quarter of 2021, the surge of global prices for agricultural products and oil has pushed the inflation rate of the WAEMU far above the BCEAO's upper 3 percent target reaching 8 percent in October 2022. Aggravated by climate change, crop shortfalls and food underproduction are the most frequent causes of recent domestic supply shocks (Melo Fernandes 2023). This situation suggests that, on the one hand, the fixed exchange rate anchor has kept the inflation rate in the WAEMU relatively stable since the last devaluation of the CFA franc, but that external factors have a major influence on price changes (e. g. through imports).

Interest rate differentials

Since the 1994 devaluation of the CFA franc, the BCEAO has followed largely the direction of the ECB's/Banque de France's interest rate changes (Dufrénot 2011; Shortland and Stasavage 2005).[5] Notwithstanding the strict controls on capital outflows, key interest rate differentials between the eurozone and the WAEMU seem to guide the BCEAO's monetary policy (Lampe 2020). Over the observation period from 1994 till 2022, the West African central bank upholds constantly higher main refinancing rates than its European counterpart. In line with the above elaborated concept of international currency hierarchies, nominal interest rate differentials between these two currency areas are to be considered as the counterpart of the currencies' varying ability to fulfil their function as a store of value, medium of contractual settlement, and unit of account on the international level. Based on the developed criteria that determine a currency's liquidity premium (l), the CFA franc of the WAEMU can clearly be regarded as a currency that ranks at the bottom of the international currency order as its use as a store of value and medium of contractual settlement is limited to the union's member states with the exception of a very small amount of CFA-denominated government bonds held by foreign investors. Furthermore, the WAEMU's strict capital controls, in particular on capital outflows, imply high carrying costs (c) attributed to the constraint convertibility of the CFA franc into international reserve currencies. Following the reasoning of a currency asset's own rate of return formalized in the equation above, a low liquidity premium and high carrying costs would result in high interest rates if the exchange rate can be assumed to be stable in the short term. The strong hierarchical relation between the euro and the CFA franc should thus be expected to be expressed by large differences in the level of interest rate

[5] However, Kireyev (2016b) comes to different conclusions for the period from 2008 to 2013.

between CFA and euro-denominated bonds. In deviation from these theoretical considerations, nominal interest rate differentials between sovereign local currency bonds and Eurobonds issued by the member states of the WAEMU are small compared to this type of interest rate differentials in neighbouring non-CFA countries Nigeria and Ghana that have both a higher degree of financial openness and a larger participation of foreign investors in local currency bond markets (Lampe and Löscher 2021, Imam 2016, p. 353).

These findings underline the effect of the exchange rate arrangements between France and the WAEMU with its strong focus on the protection of the CFA franc's internal (low inflation rates) and external (fixed exchange rate) value. The convertibility guarantee provided by the French treasury secures the fixed peg of the CFA franc to the euro which in turn eliminates the risk of currency mismatches connected to an investment in CFA-denominated financial assets. Even though the last devaluation of the CFA franc in 1994 has shown that the French backstop guaranty is de facto limited, it represents, at least in the short to medium term, a credible safeguard as long as the BCEAO does not use FX credit facilities excessively. Therefore, it can plausibly be assumed that French backstop guarantee compensate for low interest rates on CFA-bonds.

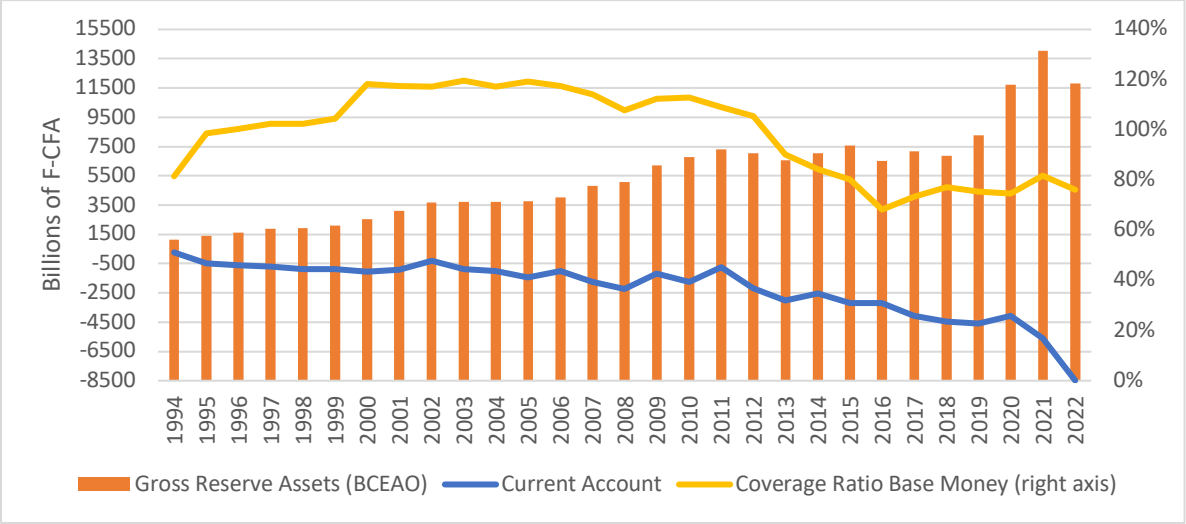
A protected currency: Capital controls and reserve pooling

Restrictions on capital outflows can be a tool for countries at the lower-end of the international currency hierarchy to avoid that domestic wealth owners' demand for foreign-currency denominated assets causes downward pressures on the exchange rate and/or a depletion of central bank reserves. According to reserve pooling regulations, residents or non-residents with a bank account within the WAEMU need to transfer their foreign currency deposits to the BCEAO or an intermediary bank in exchange for domestic CFA francs. Foreign exchange earnings derived from the member states' exports or from private financial investments abroad are pooled at the BCEAO and hence contribute to the backing of the central bank's domestic currency issuances. A large set of regulations protects the WAEMU against uncontrolled and excessive capital outflows that would drain on foreign reserves and put devaluation pressure on the domestic currency. The exchange of the CFA franc into foreign currency is highly regulated. Foreign exchange transactions and movements of capital involving countries outside the WAEMU must go through the BCEAO or accredited intermediaries. It is not allowed to use CFA francs as medium of exchange for current international transactions and use of CFA banknotes outside the WAEMU is prohibited. As a general rule, the exchange system does not place constraints on payments related to current account transactions. However, virtually all outward capital transfers from residents to non-residents require prior authorization of the national ministry of finance. Exceptions include the amortization of foreign debt, the repayment of short-term commercial or industrial loans and returns resulting from the liquidation of investments by non-residents. Moreover, residents intending to invest outside the currency union must finance at least 75 percent of their investment with external loans. In contrast, capital inflows are, in principle, free and require declaration

mainly for statistical reasons (Kireyev 2015: 8 f.). The strict regulation of capital outflows plays an important role in the exchange rate stability of the West African monetary union, as it reduces the risk of balance of payments crises, at least in the short term, in the event of an unexpected loss of confidence in the domestic currency due to economic and political factors.

Despite the liquidation of the Operation Accounts France still formally guarantees the convertibility of CFA francs into euros at the fixed exchange rate through an unlimited overdraft facility. However, a situation in which CFA countries need to use French credit facilities to meet payments on foreign currency obligations is politically considered to be the very last resort and should only have an exceptional character. In fact, since the CFA devaluation in 1994, the French treasury has not supplied the BCEAO with euro-denominated credits dedicated to currency convertibility as the West African central bank was able to maintain the fixed exchange rate parity on its own.

Figure 1: Gross FX Reserves, Current Account Balance and Base Money Coverage



Data: BCEAO, Annual Reports of the years 1995–2022

The availability and management of foreign exchange reserves are of crucial importance for the WAEMU's exchange rate policy. High levels of reserve holdings support confidence in the ability to defend the fixed exchange rate and to meet outstanding external foreign currency obligations. In the case of the WAEMU, the fixed parity between the CFA franc and the euro does not rely on a strict currency board regime. Nonetheless, statuary regulations require a 20 percent minimum coverage of sight liabilities at the BCEAO by official foreign exchange reserves. If the backing of base money threatens to become insufficient, the central bank would be compelled to tighten its monetary policy. In practice, the coverage ratio has been largely above the 20 percent threshold. From 1999 to 2012, it varies between 100 and 105 percent but, since then, shows a falling trend, reaching a nadir in 2016 with 68 percent and recovers to 76 percent in 2022 (Fig. 1). De Resende et al. (2022) find evidence that the BCEAO reacts to a reduction of foreign reserves if its stock falls below the 85 percent threshold. Besides, testing the

responsiveness of base money supply to foreign reserves in the short-run, Veyrune (2007) finds a statistically significant cointegration for the 1994–2005 period.

International integration of the local currency debt market

In the WAEMU, financing through domestic credit markets has until recently played a marginal role. Private companies in the WAEMU continue to be highly reliant on loans from the banking sector (Illy and Ouedraogo 2022). Besides, bi- and multilateral financial development aid including concessional loans represented for decades the main source of foreign funding. Nonetheless, the regional market for (mainly public) securities issued in local currency is rapidly growing (Magnan-Marionnet 2016, Diouf and Boutin-Dufresne 2012). The stock of sovereign debt issuances denominated in CFA franc increased by almost 20 percent annually on average between 2010 and 2020, rising from less than 5 percent to 15 percent of GDP. During this period, the proportion of total government debt issued by WAEMU states on the regional security market more than doubled, from 14 percent to 30 percent (IMF 2022a). Moreover, euro- or US dollar-denominated sovereign Eurobond emissions of Senegal, Côte d'Ivoire, and Benin have to an increasing extent contributed to foreign financing since the first issuance by Senegal in 2009 (IMF 2019).

An important reason for these developments is the successive abandonment of the BCEAO's direct public lending that was accompanied by increasing private investments in market-based public funding. – and institutionally promoted through the establishment of the public agency UEMOA-Titres (UT) in 2007. The UT is dedicated to facilitate the emission of WAEMU government securities by assisting member states, market intermediaries as well as private investors. From an international perspective, globalised financialization gave rise to an intensified funding of peripheral countries by private international investors. The weak performance of financial investments in industrialized countries resulting from the low interest rate policy conducted by the FED, the ECB and the Bank of England in the aftermath of the global financial crisis pushed the global financial investors' demand for debt instruments in the Global South as they offer higher interest yields (Rozo and Maldonado 2017: 150). However, in spite of the growing market for (public) local currency bonds in the WAEMU, foreign investments in CFA-denominated marketable debt obligations[6] had been rather stagnant at a low level. In Senegal the union's second biggest issuer of LCB, non-WAEMU-residents hold an estimated share of 2.5 percent of overall domestic marketable public debt, with France as the only non-SSA country holding 1.1 percent (Imam 2016). For the WAEMU as a whole, the IMF (2022a, p. 52) estimates the participation of international investors in local currency debt securities to less than 1 percent. In contrast, foreign investments in LCBM in the regional non-CFA country Ghana increased from a virtually non-existing level in 2005 to over 20 percent in 2012 (Imam 2016, p. 352).

[6] Excluding local currency debt issued by the states of the CEMAC.

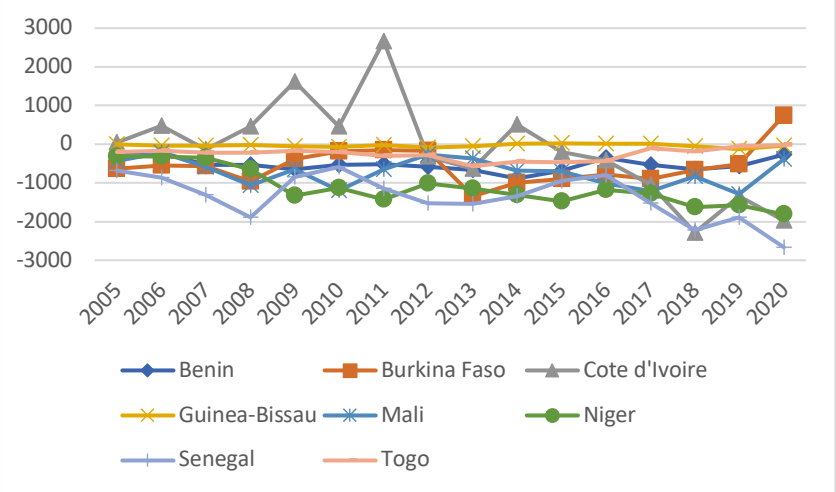
The low participation of foreign investments in CFA-denominated is insofar surprising as they do not involve the risk of an exchange rate-related loss in nominal value and the withdrawal of foreign capital associated with the liquidation of foreign financial assets is exempt from the principally high controls on financial outflows. Diouf and Boutin-Dufresne (2012) and Imam (2016) point to institutional conditions and see the small size of the WAEMU's local currency bond market, an undiversified issuers base, the low depth of the secondary market, the segmentation into two institutionally distinct issuance mechanisms, and a lack of communication targeting the international investor base as impeding factors in attracting more foreign participation. However, it should be stressed here that domestic debt securities held by non-residents represent a risk of balance of payments problems as foreign investors can sell off these assets at short notice as a reaction to rising uncertainty in the global financial system or regional political tensions. Hence, a low level of international integration of the union's LCB market limits the risk of abrupt capital outflows that could cause a depletion of foreign exchange reserves.

Exchange rate stability at the expense of current account deficits and increasing external debt

Over the last 25 years, the WAEMU has exhibited a high degree of monetary stability in terms of both the inflation and the exchange rate. Backed by France as the external lender of last resort, the fixed exchange rate arrangements foster trust in the external and internal value of the CFA franc which is reflected by a relatively low nominal interest level. These features are untypical for most DEEs that have to deal with exchange rate volatility. But does the development strategy to import monetary stability through an external nominal anchor also offer a sustainable long-term perspective on the WAEMU's external trade and foreign finance?

Current account and foreign financing

Figure 2: Current Account Balance WAEMU Countries, in Millions US dollar (current)



Data: World Bank (2023) World Development Indicators: https://databank.worldbank.org/source/world-development-indicators

Looking at the current account in aggregate, the WAEMU records increasing deficits. If we turn to the country level (Fig. 2), only Côte d'Ivoire could frequently record surpluses until 2014 but runs increasingly deficits since then. Recently in 2020 and 2021, Burkina Faso showed a positive current account against the overall trend in the WAEMU.

*Table 1: Population, GDP per Capita, Export Structure and Shares of the WAEMU in 2022**

	Population, in millions	GDP per capita, current USD	Main export products in percent of country's/union's total exports	Share of WAEMU's total exports, in percent
Benin	13.3	1325	Cotton (32.8), gold (32.1), cashew nuts and coconuts (10.4), soya beans (6.8)	9.2
Burkina Faso	22.9	855	Gold (76.4), zinc ore (6.1), raw cotton (5.5)	13.2
Ivory Coast	27.9	2499	Cocoa beans (30.8) and paste (8.5), caoutchouc (14), gold (10.8)	42.2
Guinea Bissau	1.9	946	Cashew nuts and coconuts (80.8), petroleum gases (12.3)	0.6
Mali	23.6	790	Gold (96)	13.1
Niger	25.1	588	Gold (68.7), Refined petroleum oils (6.6), other oil seeds (9.8)	3.2
Senegal	15.9	1723	Gold (19.8), Refined petroleum oils (11.7), phosphoric acid (8.8)	14.7
Togo	8.2	1011	Refined petroleum oils (28.6) and bituminous mixtures (8.1), gold (14.7)	3.7
WAEMU	138.9	1281	Gold (29.4), cocoa products (13.1), petroleum products (9.2), cotton (7), caoutchouc (4.9)	100

* Main export products as share of country's/union's total exports are from 2021

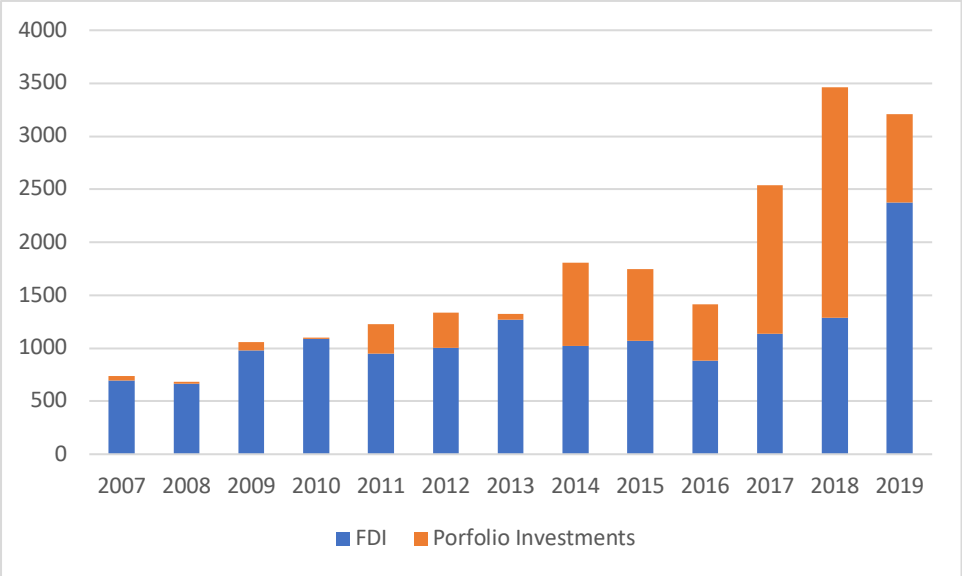
Data: BCEAO (2022) and Atlas of Economic Complexity (2024) https://atlas.cid.harvard.edu

Exports of the WAEMU countries rely heavily on a small number of raw materials and primary products, specifically gold and a few agricultural goods as cocoa, cotton and caoutchouc, which makes the trade balance particularly sensitive to price fluctuations of these primary commodities on international markets and results in a high susceptibility to a deterioration of the terms of trade. Côte d'Ivoire is by far the biggest exporter representing around 42 percent of the zone's total exports (Tab. 1). Like most West African countries, the WAEMU depends heavily on imports of manufactured goods. This trade balance structure points a failed industrialization strategy (Bibow 2022; Otoo 2013) in the West African CFA countries.

Despite low inflation rates, which in principle favour the competitive position in foreign trade, the WAEMU countries were unable to reduce their current account deficits. Due to the fixed exchange rate peg between the CFA franc and the euro, the competitiveness of West African CFA countries is strongly influenced by the nominal exchange rate development of the euro against the US dollar. In particular, the appreciation of the euro between 2001 and 2008 led to a pronounced overvaluation of the CFA franc against the currencies of the WAEMU's main trading partners (Nubukpo 2017). Gnansounou and Verdier-Chouchane (2012) point out that the cocoa-producing CFA countries in particular are affected by the overvaluation of the CFA franc and are confronted with a loss of export shares to regional non-CFA countries. Thiam (2011, 791) finds that "[p]eriods of euro appreciation generally correspond to a drop in exports from countries in the WAEMU

Zone". For the period from 1975 to 2017, Keho (2021) shows that the WAEMU trade balance, measured as the ratio between exports and imports, is negatively correlated with the real effective exchange rate in the long run, meaning that a real appreciation is associated with a deterioration in the trade balance. Regarding the effect of variations of the nominal exchange rate, Ousseini et al. 2017 present similar results underlying the argument that while the fixed exchange rate of the CFA franc ensures a high degree of price stability in the WAEMU, it also makes foreign trade dependent on the strength or weakness of the euro against the U.S. dollar.

Figure 3: FDI and Portfolio Investments, Net Inflows in Billions Franc CFA



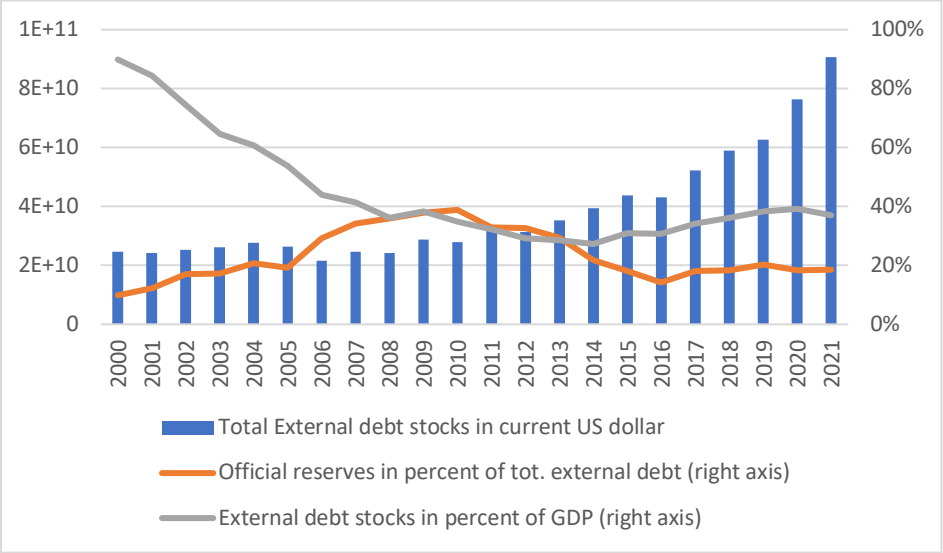
Data: BCEAO, Annual Reports of the Balance of Payments and Foreign Investment Position of the Years 2008–2020

A structurally negative current account balance causes an increased demand for foreign currency, which, ceteris paribus, would result in a nominal depreciation against the foreign currency if the domestic currency were freely tradable. But even in the case of a guaranteed fixed nominal exchange rate, a structural deficit is expected to have a diminishing effect on foreign exchange reserves and thus create a devaluation suspicion among asset holders. Contrary to their persistent current account deficits, the gross international reserves of the WAEMU and BCEAO, respectively, have increased steadily since 1994. This constellation is only possible as long as net capital imports more than compensate for current account deficits. The high level of capital imports ensures that the stock of gross international reserves both far exceeds the requirements for covering the monetary base and appears sufficient in terms of other reserves adequacy measures, such as the reserves to import ratio or reserves to short-term external debt. However, foreign exchange reserves generated by capital imports instead of current account surpluses increase the debtor position of WAEMU countries vis-à-vis the foreign investors' countries.

The result of this development path is revealed in the WAEMU's international investment position that shows an accumulating net debit balance. It is notable that foreign portfolio investments have gained in importance in relation to foreign direct investment over the past 15 years which is mainly due to the rising weight of Eurobonds emissions in the WAEMU's

foreign financing (Fig. 3). Portfolio investments tend to exhibit higher volatility because they are not based on a strategic long-term entrepreneurial interest as in the case of direct investments. Besides, regarding foreign currency portfolio liabilities, the debtor bears the exchange rate risk in the event of an unexpected depreciation of the domestic currency. As long as the WAEMU states fail to improve their international competitiveness and generate current account deficits, their debtor position vis-à-vis foreign countries will also rise, with the associated financing risks. An increase in external debt negatively affects the liquidity premium of the domestic CFA currency and leads to depreciation expectations in the medium to long term.

Figure 4: External Debt and FX Reserves



Data: World Development Indicators, https://databank.worldbank.org/source/world-development-indicators

A development path à la Growth cum deb

The WAEMU's current development strategy can best be described as 'growth cum debt' in the context of an exchange rate-based stabilization policy. In the orthodox view, a net capital import is assumed to be the necessary condition to finance the real resource gap in less-developed countries where (real) capital is relatively scarce and productive investments are constrained by aggregate savings. The ideal growth-cum-debt-cycle had been most prominently illustrated by the World Bank (1985): At the initial stages, developing countries meet part of their domestic demand by way of current account deficits that have capital account surpluses as their financial counterpart leading to a rising external debt level. As domestic savings are identified as the limiting factor of economic activity, additional resources from abroad allow for an increase in productive investments that should initiate a "take-off" moment on the path of catch-up development. This process of importing real resources and external debt accumulation continues till, at the latter stages of the debt cycle, domestic savings exceed domestic investments, and the current account turns from a deficit to a surplus so that the external indebtedness can be repaid.

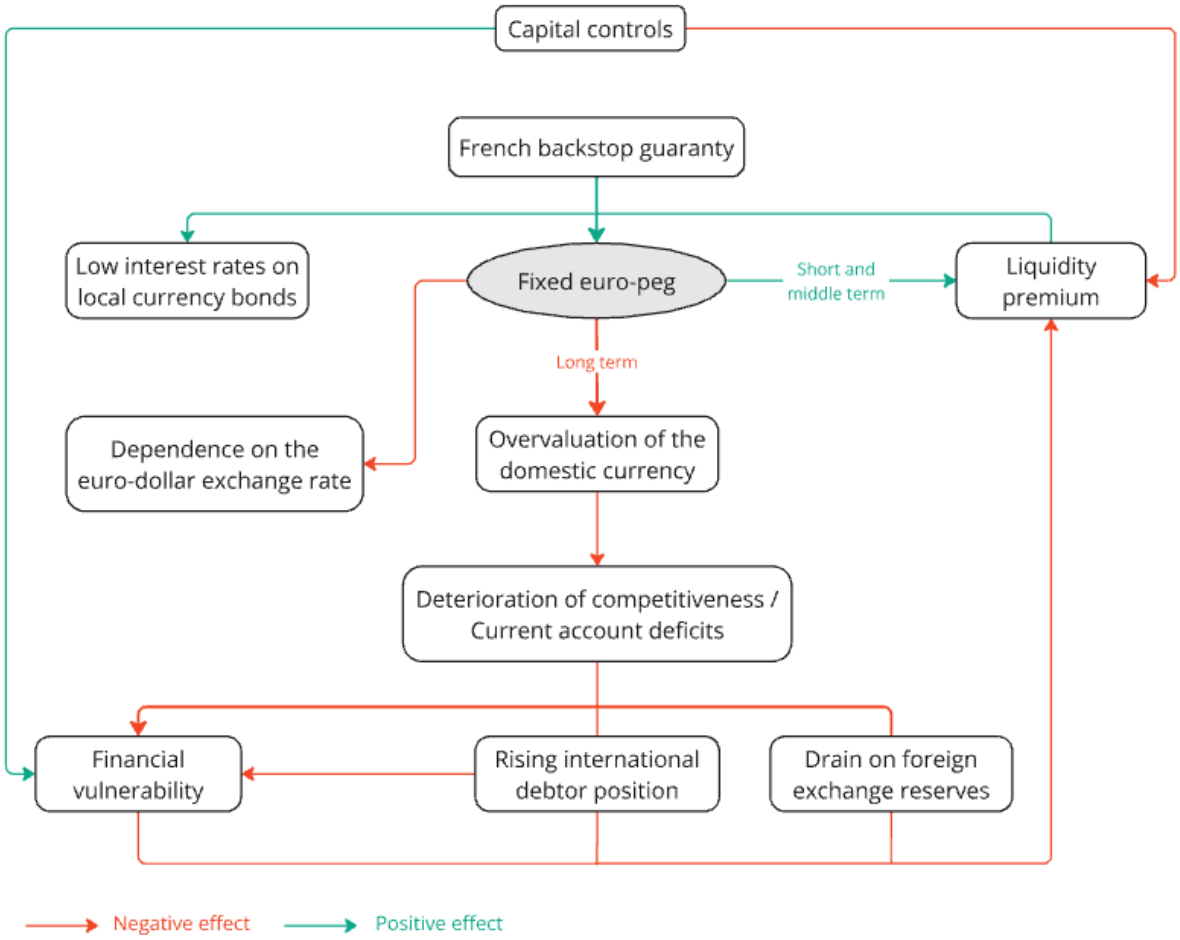
With the outbreak of the Latin American debt crisis in the 1980s, the weaknesses of this development model were clearly demonstrated and, in response to double or even triple digit

inflation rates, the majority of Latin American countries adopted an exchange rate-based stability and development strategy with fixed or quasi-fixed exchange rates during the 1990s. The signaling effect of the nominal currency anchor led to a rapid success in lowering the inflation rates to a largely normal level with at the same time solid GDP growth rates. Nevertheless, the Asian crisis of 1997/8 and the turbulence it triggered on the international financial markets exposed that even a nominal exchange rate anchor cannot ensure the financing of deficits in the trade or current account balance through capital imports, and that the sustainability of external debt depend primarily on external factors (Fritz 2000).

While exchange rate pegging in Latin America was applied to fight high inflation rates, the colonial context of origin of the WAEMU's exchange rate regime is very different as the parity between the CFA franc and the at that time French franc was designed to assert France's economic and geopolitical interests. Also, regarding the forced massive devaluation of the franc CFA in 1994, inflation did not play a role albeit Niger had double-digit deflation rates in 1991 and Mali in 1992. Despite the different reasons for adopting an exchange rate-based development strategy, parallels can be found between the development paths of the economies of Latin America in the 1990s and the countries of the WAEMU in terms of the negative effects for their international competitiveness. To put it more concretely, the rising current account deficits and accompanying foreign debt call into question the sustainability of the fixed exchange rate peg and exacerbate dependence on foreign capital imports. This has implications for the conditions for abolishing the French convertibility guarantee. If the WAEMU is to become independent of France as the foreign exchange lender of last resort, improving its current account to limit or reduce external debt must be addressed as a key necessary condition.

As summarized in figure 5, the exchange arrangements of the WAEMU impact on the quality of the domestic currency both directly and indirectly. Based on the French backstop guaranty, the fixed exchange rate peg reduces uncertainty of wealth owners regarding the external value of the CFA currency and thus strengthens its store of value function likewise currency premium. At the same time, the fixed exchange rate has a disciplining effect on the inflation rate, making CFA-denominated bonds more attractive, particularly from the perspective of domestic asset owners. These two factors explain why the interest rates on local currency government bonds are currently only slightly higher than those on Eurobonds issued by WAENU countries, despite the fact that the CFA Franc has virtually no function as a means of international contractual settlement and payment. The downside of this exchange rate-based stabilization is the loss of international competitiveness, current account deficits and a rising international debtor position. In the long term, the development will lead to external financial vulnerability and increasing devaluation pressure, which will have a negative impact on the liquidity premium of the West African CFA currency. The strict controls on capital outflows have a twofold effect: On the one hand, they increase the carrying costs associated with the liquidation of CFA-denominated financial instruments. On the other hand, they reduce external financial vulnerability by avoiding abrupt, massive financial outflows.

Figure 5: Causal chains of effects of the WAEMU exchange rate regime



Own presentation

Monetary de-peripheralization of the WAEMU's CFA franc

From a monetary Keynesian perspective, given the hierarchical structure of the global monetary system, further monetary emancipation vis-à-vis France while preserving monetary stability is only promising if the West African CFA countries succeed in strengthening the international quality of their domestic currency and thus initiate a process of de-peripheralization. The key condition for such a monetary development strategy is the gradual reduction of the WAEMU's external debt in foreign currency and, in the long term, the establishment of an international creditor position. In the ideal scenario, increasing the liquidity premium of the West African CFA franc would in turn counteract the structural overvaluation of the domestic currency and reduce the dependency on a nominal exchange rate anchor whilst widening the scope for a more growth-oriented monetary policy. Authors of the Berlin School (cf. Nitsch 1999, Wolmuth 1993, Lüken-Klaßen 1993, Lüken-Klaßen and Betz 1989) outline the macroeconomic conditions that allow for a development path of monetary de-peripheralization.

Since the domestic currency can only be ‚hardened' in the long term by reducing the international debtor position, trade policy measures for selective protection, especially of

the export sector, are of crucial importance. In the case of the WAEMU, these would first have to address the dominant agricultural sector. In addition, national investment policies would be necessary to increase the share of processed goods in export products, which would be equivalent with a larger share of domestic producers in the value chain and thus counteract the role of West African CFA countries as mere suppliers of raw materials in international trade. An export-oriented development strategy would further need to foster the diversification of the WAEMU's countries exports that are highly concentrated on a few raw materials.

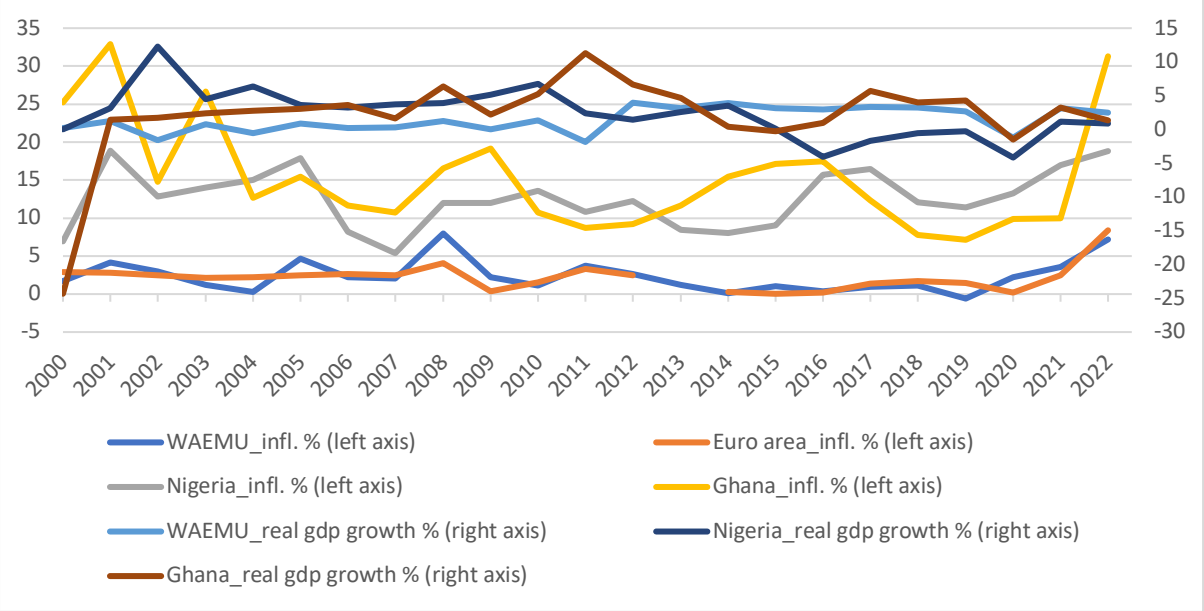
Wohlmuth (1993, 424f.) emphasizes that strengthening exports (e.g., through selective protection of the industrial or agricultural sectors) must always be linked back to a corresponding investment and growth dynamic of the domestic market. This stance is based on the premise that strong domestic demand is necessary to develop an industrial sector capable of manufacturing exportable products. Given the weak private investment rate of the West African CFA countries (Shapiro and Zdzienicka 2016), providing credit for private sector investment purposes in the real economy should be a developmental policy focus. In this context, the highly oligopolistic commercial banking sector needs to be tackled with the aim of improving private finance conditions by lower interest rates on investment loans. In the long run, strengthening the currency quality of the West African CFA franc should increase the BCEAO's scope for a more expansionary monetary policy and thus encourage investments in the WAEMU.

Furthermore, it is important to consider that an industrialization process of the preponderantly informal economy also depends, at least to some extent, on technology transfer from abroad and the import of modern machinery for manufacturing. As these imports are not traded in domestic but in foreign currency, the financing of these products requires a corresponding capital import, which is associated with the accumulation of foreign debt. Regarding the instruments of foreign private finance, directs investments have the advantage over portfolio investments in that they are of a long-term nature and cannot be liquidated or withdrawn quickly without major costs. Eurobonds issued by the states of the WAEMU or other public entities as developments banks have a higher average term to maturity than local currency bonds but debt servicing is to be paid in foreign ‚hard' currency. The expansion and further development of the WAEMU's local currency debt market with issuances of longer maturities can be a means to mitigate the WAEMU financial vulnerability to a devaluation of the CFA franc in a more flexible exchange rate scenario, provided that the proportion of foreign creditors on this market can be increased.

In terms of international competitiveness, the WAEMU is a special case in that it has an exceptionally low average inflation rate, not only on a regional scale but even relative to the euro area (Fig. 6). In fact, the WAEMU's average inflation rate of 1.4 percent from the first quarter of 2008 to the second quarter of 2020 is lower than that of the euro area, which averages 1.6 percent (De Resende et al. 2022). The overvaluation of the domestic currency is therefore not due to an inflation differential against the anchor currency area, but rather to

the anchor currency's exchange rate performance against the U.S. dollar or the currencies of its main regional trade competitors, Nigeria and Ghana.[7] However, the constellation of a structurally overvalued domestic currency combined with a fixed exchange rate peg poses a weighty obstacle when it comes to reducing current account deficits. Connecting to the critique that the fixed peg of the West African CFA franc to the euro negatively affects the current account of the WAEMU's member countries, Nubukpo (2012), Amato and Nubukpo (2020)[8], and Gnansounou and Verdier-Chouchane (2012) propose a more flexible exchange rate regime for the WAEMU. In this case, the BCEAO could led the CFA franc fluctuate within a certain range against a basket of currencies with a similar composition as the IMF's Special Drawing Rights (SDR). As another option, rule-based exchange rate adjustments or devaluations in accordance with trade balance deficits could help support the competitiveness of West African CFA countries.

Figure 6: WAEMU, Nigeria (non-CFA), Ghana (non-CFA) and the Eurozone: Inflation and Real GDP Growth Rates



Data: African Development Bank (2023), Africa Information Highway (AIH), Database on Socioeconomic Indicators, https://dataportal.opendataforafrica.org/nbyenxf/afdb-socio-economic-database-1960-2022

Fritz (2002: 150 ff.) and Lüken-Klaßen (1993: 404) argue that the long-term success of a strong one-time nominal devaluation or a crawling peg-like exchange rate policy depends decisively on the extent to which the real wage loss caused by the devaluation is accepted by employees or, in the worst case, offset by a corresponding increase in nominal wages. In the

[7] Nevertheless, it should be noted at this point that even an inflation-induced real appreciation in former times has a lasting negative impact on the competitive situation as long as this appreciation is not compensated for.

[8] In their ideal scenario, Amato and Nubukpo (2020) refer to a flexible exchange rate regime with fiscal policy coordination for the envisaged common currency union of the Economic Community of West African States (ECOWAS), which, in addition to the WAEUM countries, also includes the English-speaking countries Nigeria, Ghana, Liberia, Sierra Leone, the Gambia, the former French colony Guinea, and the former Portuguese colony Cape Verde. Nevertheless, this hypothetical scenario also addresses the disadvantages of the WAEMU's current fixed exchange rate regime in terms of international competitiveness.

economies of the WAEMU, which are dominated by small and micro-enterprises, the pricing decisions of these entrepreneurs, most of whom operate informally and are often family-based, are also of crucial importance. Assuming a rising domestic price level as a reaction to the nominal exchange rate devaluation, a more restrictive monetary policy is needed to counteract an inflation-devaluation spiral. A controlled devaluation also entails the risk of a loss of confidence in the value preservation function of the domestic currency and the suspicion of further devaluations on the part of wealth owners which further increases the pressure on monetary policy. What is last, a depreciation of the West African CFA franc against the euro implies that external foreign currency-denominated liabilities will increase, making debt servicing costlier, which could lead to balance of payments problems. Therefore, the increase in the share of domestic currency debt in overall foreign liabilities is also to be understood as a prerequisite for a more flexible exchange rate regime.

Conclusion

Against the backdrop of the increasing demands for further monetary decolonization of the West African CFA countries, the paper analysed the WAEMU's macroeconomic development path under the current fixed exchange rate regime. It was found that the WAEMU has enjoyed a high degree of price and exchange rate stability since the last nominal devaluation of the domestic CFA franc in 1994. This sets the WAEMU apart from other DEE, which, as peripheral currency areas, are typically affected by monetary instability and balance of payments problems. In this context, it is worth highlighting the low interest rate differentials between CFA bonds and Eurobonds issued by the WAEMU member countries. In monetary Keynesian theory, these interest rate differentials are interpreted as the counterpart of diverging degrees of liquidity provided by different currencies.

The fact that the WAEMU has been able to keep the external value of the domestic CFA franc stable for 25 years despite its subordinate position within the global currency hierarchy can mainly be attributed to two factors: Firstly, the de jure unlimited French convertibility guarantee theoretically offers the possibility of defending the fixed exchange rate against the euro even in the event of a currency shortage. France's role as foreign exchange lender of last resort promotes trust in the WAEMU's currency among domestic wealth owners and foreign investors despite the inability of the CFA franc to fulfil the functions of money on the international level. Secondly, the strict capital controls protect against the volatility of international financial flows, particularly with regard to capital outflows.

However, the primacy of monetary stability comes at a high price: The rigid peg of the CFA franc to the euro means that the countries of the WAEMU are heavily dependent regarding their competitiveness on the exchange rate pattern of the euro against the US dollar. The WAEMU's current account balance with the rest of the world shows permanent and increasing deficits, which are driving up foreign debt. While the current exchange rate regime therefore ensures monetary stability in the short to medium term, it increases the risk of balance of payments problems in the long term and cements dependence on an external lender of last resort. In view of rising foreign debt and persistent current account deficits, the countries of the West African Monetary Union run the risk of undermining the confidence of domestic asset owners and international investors in the domestic CFA currency. As experience with a

fixed exchange rate anchor in Latin America has shown, growing foreign debt that is not used to build up an internationally competitive industrial sector leads to a perpetuation of dependence on capital imports. Therefore, the WAEMU's development path à la growth-cum-debt under the current fixed exchange rate regime cannot be considered suitable for de-peripheralising the domestic currency and further emancipating itself from France as the guarantor of exchange rate stability.

The brief outlook on an alternative development strategy argued that the reduction of the WAEMU's current account deficits is crucial prerequisite for a monetary de-peripheralization. Therefore, on the side of the real economy, a key development policy priority should be to promote and diversify the export sectors of member states, which are currently solely reliant on raw materials. At the monetary level, a slight liberalization of the fixed exchange rate peg could reduce the competitive disadvantages of the CFA countries resulting from a strong euro. By linking to a basket of currencies consisting of the currencies of the main trading partners, it would also be possible to reduce the one-sided dependency on changes in the exchange rate of the euro against the US dollar. However, such reform measures carry the risk of diminishing confidence in the domestic currency, thereby, leading to devaluation pressure.

The most important stability element of a more flexible exchange rate policy is certainly the maintenance of capital controls. Given the volatile and pro-cyclical nature of international capital flows, which are largely driven by the liquidity preferences of globally acting financial investors, and the growing importance of portfolio investments in the foreign financing of West African CFA countries, strict capital account management is required to protect a peripheral currency area such as the WAEMU in the context of the global currency hierarchy (de Paula et al. 2017, Fritz et al. 2018: 216). An insight that is also increasingly shared by the economic mainstream (IMF 2022b, Fritz and Prates 2014, Claessens and Gosh 2013).

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