

THE CURRENCY BLOCKS: THE EURO ZONE AND THE CFA FRANC ZONE

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Summary

Two of the most important monetary unions are the euro zone and the CFA franc zone. The euro zone is a monetary union of 11 member countries (Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain) belonging to the European Union. The euro zone came into being on January 1, 1999 when the euro became the common currency of these countries. The euro is managed by the European Central Bank that has a mandate to implement a common monetary policy and maintain price stability in the euro zone. The initial exchange rate between the euro and the U.S. dollar was around US\$1.18 per euro. This continuously depreciated during the ensuing period, reaching US\$0.85 per euro by the end of 2000.

The CFA franc zone, on the other hand, is a monetary union of countries in West and Central Africa that grew out of the financial arrangements between France and some of its colonies in the region. The zone consists of the eight countries of the West African Economic and Monetary Union—Benin, Burkina Faso, Cote d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, and Togo—and the six countries of the Central African Economic and Monetary Community—Cameroon, the Central African Republic, Chad, Equatorial Guinea, Gabon, and Republic of the Congo. The two unions have a common currency unit, the CFA franc, and the exchange rate between the CFA franc and the French franc remained fixed for more than forty years at CFAF 1 = FF 0.02. In January 1994, it was devalued (by 50%) to CFAF 1 = FF 0.01 to redress a longstanding currency

misalignment. The peg of the CFA franc was changed from the French franc to the euro, at a rate of CFAF 655.957 per euro, with effect from January 1, 1999.

1. The Euro Zone

The movement towards the formation of the European monetary union (EMU) entered a crucial phase with the formal advent of the euro on January 1, 1999. The euro is a supranational currency accepted in place of their national currencies by 11 member countries of the European Union (E.U.): Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain. The other four E.U. member countries—the United Kingdom, Sweden, Denmark, and Greece—remain outside the monetary union.

The advent of the euro as the common currency essentially means that the committed member countries adopt a single monetary policy. The task of managing the euro by implementing a common monetary policy has been given to the European central banking system (Eurosystème). It has a clear mandate to implement a common monetary policy and maintain price stability in the euro zone. Like the Federal Reserve System of the United States, the Eurosystème is organized as a federal system. At the center of the system is the European Central Bank (ECB), based in Frankfurt am Main, Germany. Monetary policy decisions affecting the euro zone are taken by the Governing Council of the ECB, which is comprised of the six members of the ECB's Executive Board and the governors or presidents of the national central banks (NCB) of the countries that have adopted the euro. The members of the Governing Council are appointed in a personal capacity; they do not represent their country or even their NCB.

Not only has the EMU permanently altered the monetary policy framework within the euro zone, it has also given single currency representation to a large economic block that rivals in size the other two leading world economies, the USA and Japan. Decisions being made in the EMU affect a market of more than 340 million customers with a combined gross domestic product (GDP) (in 1999) of over US\$6 billion (all dollar amounts in this article are U.S. dollars). The combined GDP of the 11 countries in 1999 amounted to over \$6 billion (27% of world GDP) compared to \$5.5 in the USA and \$2.8 billion in Japan. The euro–U.S. dollar foreign exchange market is the largest in the world and around 40% of international debt securities issued during 1999 and 2000 were in euros.

1.1. Evolution of European Monetary Integration

The introduction of the euro is just one, albeit an important, part of the European economic integration process that began in the late 1950s. Although the 1957 Treaty of Rome that created the European Economic Community (EEC) made no explicit mention of monetary union, the architects of the treaty did envisage the EEC developing into a fully-fledged economic union with full monetary integration among its members. The treaty provided for a customs union (free trade between the member nations but a common external tariff) and envisaged a common market with free movement of goods, services, people, and capital. By the late 1960s much progress had been made in these areas and there was growing conviction among the then-six members of the EEC

(France, Germany, Belgium, the Netherlands, Luxembourg, and Italy) as to the potential role of a single European currency as a means of further increasing economic integration.

At the Hague Summit of December 1969 the member countries agreed in principle to establish complete economic and monetary union in stages. The summit appointed an investigative committee, which delivered what is known as the Werner Report on Economic and Monetary Union in 1972. The report envisaged a fully-fledged monetary union between the members of the EEC by 1980. Apart from being over ambitious, there were some fundamental reasons for failure to achieve this target. These included accession negotiations relating to the entry into EEC of Ireland, the United Kingdom, and Denmark in 1973; international financial instability created by the collapse in the early 1970s of the Bretton Woods system of fixed exchange rates; the first oil shock of 1973/74 that inflicted significant and uneven adjustment burdens on the member countries; and, above all, lack of the necessary political will and commitment on the part of the member countries.

One direct result of the Werner Report was the setting up of the “snake in the tunnel” exchange rate arrangement that commenced operation on April 24, 1972. Under this arrangement, exchange rates among the member currencies could vary by a maximum of 1.125% in either direction against each other (the snake), while they could float by 2.25% in either direction against the U.S. dollar (the tunnel). The system had a checkered history, with the U.K. abandoning it after just six weeks on June 23, 1972 followed by Italy in February 1973. The tunnel was demolished in March 1973 (leaving the snake for the time being) amid mounting speculative pressure against the member currencies, placing them on a joint float against the U.S. dollar in March 1973.

On June 17, 1978, at a conference held in Bremen, six of the EEC member countries (Belgium, Denmark, France, Germany, Ireland, Italy, Luxemburg, and the Netherlands) committed themselves to setting up the European Exchange Rate Mechanism (ERM) to replace the snake. The ERM commenced operation on March 13, 1979; Portugal and Spain joined in 1986; the U.K. joined in 1991. The brainchild of the French president Valéry Giscard d’Estaing and the German chancellor Helmut Schmidt, the ERM was intended to create “a zone of currency stability” in Europe by bringing back into the fold countries like Italy and France, who had left the snake.

The system had three features, some of which built upon the arrangements of the snake: the ERM, European Currency Units (ECU), and the proposed setting up of a European Monetary Fund (EMF). Under the ERM, each member had to peg its currency to the ECU, which was defined in terms of a basket of currencies. The pegged rate could wobble around a central value and, more importantly, when there was a “fundamental disequilibrium” the peg could be moved. The general obligation was that actual cross rates could not deviate by more than 2.25% from the central cross rate (the band was set at 6% for the U.K., Italy, Spain, and Portugal). If divergence exceeded 75% of the maximum allowable divergence, government authorities were obliged to adopt policy measures (in particular, interest rate policy) to affect market exchange rates. When a currency threatened to break through its limits, there were also provisions for a member country to obtain balance of payments support credit from other central banks in the

form of a very short-term financing facility. In the last resort, finance ministers of the member countries could agree to change the band up or down, thereby depreciating or appreciating a currency relative to the ECU. As noted, the original European Monetary System (EMS) plan contained a proposal to set up an EMF to monitor the operation of ERM and to act as a lender of last resort to ensure the smooth functioning of ERM. However, because of controversy surrounding its power and role, this proposal was never implemented.

By the mid 1980s, there was fairly widespread agreement among European policy makers that the EMS had successfully reduced exchange rate instability, with favorable implications for expansion of trade and economic growth in the region. These (perceived or real) gains set the stage for further moves towards greater monetary unification in Europe; the Delors Report in 1989 and the Maastricht Treaty in 1991 were milestones on this route. A high-powered committee, consisting of the members of the central banks of European Community (E.C.) members states, a representative of the E.C. Commission, and three independent experts, and headed by then-president of the European Commission (a former French economic affairs minister) Jacques Delors, met eight times in 1988 and 1989 to consider proposals for monetary union. Its report (the Delors Report), like the Werner Report before it, supported the achievement of monetary union within a decade, although it did not set an explicit deadline. In June 1989 the European Council accepted the Delors Report and agreed to convene an intergovernmental conference to negotiate the amendments to the Treaty of Rome required to implement it. The intergovernmental conferences, which commenced in 1990 and met for the last time at Maastricht a year later, accepted the EMU and political union as goals of European economic unification and agreed on a treaty for transition to be completed in three stages.

Stage I, which commenced in 1990, was to accomplish the removal of capital controls. Member countries were also to fortify the independence of their central banks and to otherwise bring their domestic laws into conformity. Stage II, which began in 1994, was to achieve further convergence of national policies and by the creation of a temporary entity, the European Monetary Institute (EMI), was to encourage the coordination of macroeconomic policies and plan the transition to a monetary union. If a majority of countries met the preconditions for unification at this stage, the Council of Ministers was to recommend the inauguration of Stage III, monetary union, and set a date for that event. If no date were set by the end of 1997, Stage III was to commence on January 1, 1999, if even a minority of member states qualified.

The transition towards a single currency was not smooth, however. The Council of Ministers failed to set a date for commencing Stage III by the end of 1997 because of difficulties in achieving the macroeconomic policy coordination/convergence required for monetary union. It was subsequently decided to allow any E.C. member country that satisfied the Maastricht conditions (basically, that had a budget deficit less than 3% of gross national product, a history of stable exchange rates, low interest rates, and a public debt of less than 60% of gross national product) to become a member of the monetary union automatically. On this basis, the EMU was launched on January 1, 1999, with 11 member countries adopting the euro as their common currency, and the European

System of Central Banks (ESCB) assuming responsibility for monetary policy in the euro area.

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Biographical Sketch

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