

## External Shocks, Exchange Rate Regime and Growth in Burkina Faso and Mali





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\* Thanks are due to all the officials and others in Bamako, Dakar (BCEAO) and Ouagadougou who devoted time to discuss with me the role and effects of the exchange rate regime in West Africa. Thanks are also due to seminar participants in Stockholm for constructive comments on a preliminary version of this study.

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# Foreword

This economic country study on Burkina Faso and Mali is part of a series of annual studies, undertaken by various Swedish universities and academic research institutes in collaboration with Sida. The main purpose of these studies is to enhance our knowledge and understanding of current economic development processes and challenges in Sweden's main partner countries for development co-operation. It is also hoped that they will have a broader academic interest and that the collaboration will serve to strengthen the Swedish academic resource base in the field of development economics.

This report has been prepared by Yves Bourdet at the Department of Economics at the University of Lund.

A handwritten signature in black ink, appearing to read 'Yves Bourdet', is positioned above the title 'Chief Economist'.

Chief Economist



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# Executive Summary

Structural characteristics of the economies of Burkina Faso and Mali (primary product exporters, landlocked countries, high dependency on emigrants' remittances, etc.) make the two countries vulnerable to various forms of external shocks or disturbances. Examples of external disturbances faced by the two countries during the past decade are terms-of-trade instability (in particular a sharp drop in the price of the main export commodity, cotton), volatile official development assistance and the socio-political crisis in the neighbouring Côte d'Ivoire. Burkina Faso and Mali have been severely hit by these external disturbances; the former more so.

Our study confirms that external shocks had adverse effects on the economic performance, in particular savings and economic growth, of the two countries. The impact on investment, and eventually of investment on growth, is less clear, which can be ascribed to the large role of public investment in both countries and to the kind of infrastructure investment preferred by the public sector. It is also due to the fact that the relation between savings and investment depends upon the economic policy response and the structure of incentives it helps to create. The lack of apparent positive effects of increased savings on investment may *ceteris paribus* contribute to limiting longer-term growth in both countries. In the case of Mali, the adverse effects of external disturbances on growth have been more than outweighed by the gold boom and the tremendous increase in the export of gold, which has become the top export commodity since 2000.

The impact of external shocks on economic performance, in particular growth, works through various channels and is dependent upon the economic policy responses. It is also dependent upon the kind of exchange rate regime. Flexible exchange rate regimes are more able to absorb negative real disturbances than fixed exchange rate regimes, resulting *ceteris paribus* in a less sizeable contraction of output. The huge drop in the price of cotton on the world market in the late 1990s and early 2000s was accompanied by a significant slowdown of growth, which tends to confirm this contention. The impact of real disturbances is more sizeable in the long term than in the short term, which suggests that the empirical evidence provided in our study understates the negative impact of the past decade's external shocks on economic growth.

How and to what extent external shocks affect growth thus depend to a large extent upon exchange rate policy. This raises the issue of the project of the enlarged monetary union of ECOWAS countries, including Burkina Faso and Mali, and of the external peg that the participating countries will choose for the common currency. The project has two main components, a monetary union of non-CFA ECOWAS countries, and in a second stage a monetary union that will include all the ECOWAS members. As it stands today the project is incomplete, with important issues and potential problems in the dark, and premature in view of the degree of real integration of the ECOWAS countries and the, from time to time, diverging macroeconomic stances of the participating countries. For the UEMOA countries the potential benefits of the planned monetary union are limited and the potential costs significant. There is also a risk that the discussion on the creation of an enlarged monetary union may distract from the issue of the external peg of the CFA-zone and the potential risks of misalignment (overvaluation and loss of competitiveness) that can be harmful to growth and poverty reduction policy.

# 1. Introduction

Mali and Burkina Faso have been severely hit by external shocks during the past decade, the main shock being related to the sharp drop in the price of cotton on the world market in the late 1990s and early 2000s. The price almost halved between 1995 and 2002, which resulted in a substantial deterioration in the terms of trade of the two countries. Cotton exports account for about a third and about a half of total exports from Mali and Burkina Faso respectively, which means that the drop in the price of cotton has had considerable effects on the export revenue of both countries. A second external shock has to do with the civil war in Côte d'Ivoire, making it more difficult for both Burkina Faso and Mali to trade because Côte d'Ivoire has historically been the major transit route for exports from and imports to the two landlocked countries.

The trade shocks in Mali and Burkina Faso have hit countries that share the same currency (the CFA franc), which is pegged to an external anchor, earlier the French Franc and since 1<sup>st</sup> January 1999 the Euro. Therefore, an important question that arises is how the trade shocks have affected economic growth given the fixed exchange rate between the CFA franc and the Euro. Some recent studies have suggested that terms-of-trade shocks have larger and more long-lasting adverse effects on real growth under fixed exchange rate regimes than under flexible exchange rate regimes. The issue is a debated one, however, and more needs to be known about the experiences of individual countries in order to come to more definite conclusions regarding the effect of trade shocks on real growth under alternative exchange rate regimes. The question of the impact of the fixed exchange rate CFA-Euro on growth is also topical because of the large appreciation of the Euro relative to the US Dollar during the past two years (by more than 20 percent) and the concomitant appreciation of the CFA franc relative to the US Dollar.

The rate of economic growth is critical for the development, depth and geographical distribution of poverty. For example, an average growth of some 4 percent, as has been the case in Burkina Faso and Mali during the past decade, has a limited effect on the growth of *per capita* income and the reduction of poverty. A 4 percent GDP growth associated with a 2.8 percent population growth signifies actually that it will take some 50 years for both countries to attain an income *per capita* of 400 US dollars!

The nature and distribution of growth across regions (and thus indirectly the kind of exchange rate regime) is also critical for income distribution and regional distribution of poverty. This is so because growth is unevenly distributed across sectors (and regions) and because the choice of the exchange rate regime and changes in the exchange rate influence the distribution of growth over space. A better understanding of the relations between external shocks, the nature of the exchange rate regime and the patterns of growth is thus necessary in order to improve the design of poverty reduction programmes and to evaluate their impact on poverty.

There is yet another reason for reflecting on the nature of the exchange rate regime in Mali and Burkina Faso. Both countries belong to the Economic Community of West African States (ECOWAS) whose member countries decided in April 2000 (through the Accra Declaration) to work towards the creation of an enlarged monetary union, including both CFA and non-CFA countries (such as Nigeria and Ghana) by 2004. Only Cape Verde has formally opted out but the current Cape Verdean government led by the PAICV (*Partido Africano da Independencia de Cabo Verde*) is more committed to regional integration than its predecessor and this may change the position of the country if the planned monetary union materialises. The creation of such an ECOWAS-wide monetary union is likely to actualise the issue of the external peg of the new currency. Since it is very unlikely that France (or the EU) will guarantee the external convertibility and the fixed parity of the new currency, it is urgent to start a reflection on what kind of exchange rate regime to choose and its pros and cons when it comes to its effects on economic performance and poverty reduction.

## 2. Trade and Economic Shocks

Developing countries are vulnerable to various and stochastic kinds of trade and economic shocks that increase macroeconomic instability, in particular GDP and income volatility. Macroeconomic instability is often regarded as a problem because it can have a detrimental effect on savings, investment and growth, and make it more difficult for exposed countries, firms and households to plan for development.<sup>1</sup> The adverse impact of macroeconomic instability on growth is more perceptible in low-income countries mainly because of their low level of financial development and their difficulties in conducting counter-cyclical macroeconomic policies.<sup>2</sup> The nature and magnitude of external shocks, that is shocks that originate abroad and thus are out of control for the domestic government, vary greatly from country to country and over time. Burkina Faso and Mali have been hit by various kinds of trade and economic shocks during the past decade. The most important have been the sharp fluctuations in the countries' terms of trade, the high volatility of official assistance flows and the political crisis in neighbouring Côte d'Ivoire, the main transit country for export from and import to land-locked Burkina Faso and Mali. In different ways and to different extents, these shocks might have contributed to increasing income volatility and to affecting growth negatively in the two countries.

### **Diverging and volatile terms of trade**

Terms of trade are defined as the price of a country's exports relative to the price of its imports. Figure 1 illustrates the developments of the terms of trade in Burkina Faso and Mali over the past three decades. A first finding of Figure 1 is the absence of a clear, long-term deteriorating or ameliorating trend in the terms of trade of the countries concerned. With the exception of a short period in the early 1970s, the terms of trade have remained by and large constant in Mali whereas they ameliorated substantially in Burkina Faso after 1979. The latter country experienced a huge, positive terms-of-trade shock between the late 1970s and the mid-1990s. A second finding concerns the relatively large variability

<sup>1</sup> For an illustration of the negative relation between volatility and growth, see e.g. Ramey and Ramey (1995), Aizenman and Marion (1998), Turnovsky and Chattopadhyay (2003), and Blattman et al. (2004). For empirical illustrations focusing on the relation between the volatility in terms of trade, investment and growth in sub-Saharan Africa, see Guillaumont et al. (1999), and Bleaney and Greenaway (2001).

<sup>2</sup> For a recent empirical illustration, see Hnatkovska and Loayza (2004).

of the terms of trade. Note, however, that changes in the terms of trade have been less erratic in Mali than in Burkina Faso. Since the early 1970s, the terms of trade have oscillated between 87 and 122 in Mali whereas they jumped from 50 to 100 in Burkina Faso. A third finding of Figure 1 concerns the period after 1995. The terms of trade deteriorated in both Burkina Faso and Mali after 1995, parallel with the fall in the price of cotton on the world market. The deterioration was more pronounced in Burkina Faso than in Mali, reflecting the fact that Burkina Faso is more dependent upon cotton export than Mali. The terms of trade improved again in 2003 and 2004 following the increase in the price of cotton on the world market. Figure 1 also portrays the evolution of the terms of trade for the whole UEMOA (included Mali and Burkina Faso). It shows that the terms of trade have evolved more like each other (more symmetric) over time.<sup>3</sup> Focusing on the period after the mid-1980s, Figure 1 shows that the terms-of-trade changes between UEMOA and Mali are more similar than between UEMOA and Burkina Faso.

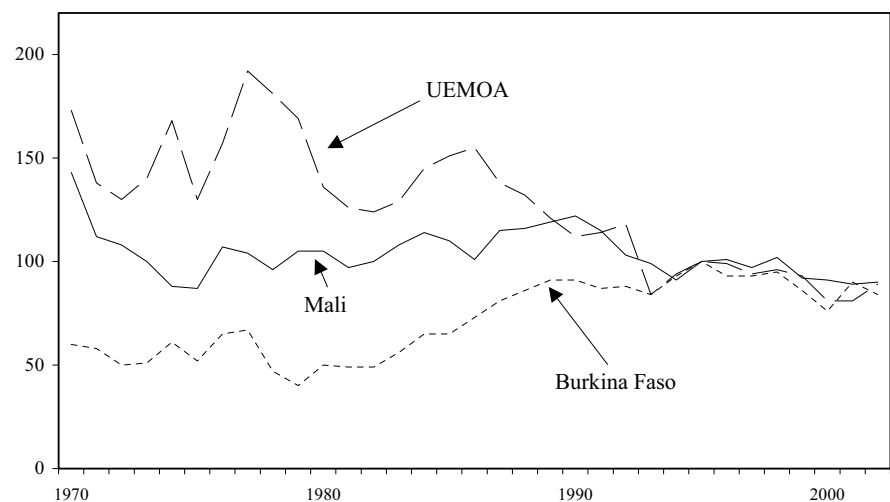
To a large extent fluctuations in a country's terms of trade reflect fluctuations in the prices of the country's export products, most often primary ones, which are traded in a world market where prices are typically volatile. Differences in the development of terms of trade across countries reflect principally differences in their export structure, with various export products and/or export shares for these products. The import structure is generally more similar across countries that belong to the same income *per capita* group. The more concentrated the export structure of a country, the higher the risk that large fluctuations in the price of a dominant export product (or top export products) will result in large fluctuations in the country's terms of trade, and *vice versa*. In turn, the impact of terms-of-trade fluctuations on a country's GDP and income volatility depends upon the country's trade exposure and role of exports in the economy.<sup>4</sup> High volatility in the terms of trade and consequent large income fluctuations are more common in developing than in industrialised countries, whose export structures are much more diversified in terms of the number and the kind of products exported as well as the number of the countries of export destination.<sup>5</sup>

<sup>3</sup> This applies to all the UEMOA countries as well (Guillaumont (2002) Tableau 3, p. 32).

<sup>4</sup> For a recent empirical illustration, see e.g. Jansen (2004), pp. 12–13.

<sup>5</sup> Fluctuations in the terms of trade can be ascribed to goods-price effects and country-price effects. The latter effect refers to the fact that the same product sells for different prices in different countries and thus that changes in the country destination of exports affect the exporting country's terms of trade. The respective roles of goods-price and country-price effects vary according to the kind of products exported and more generally trade specialisation. The larger the share of primary commodities in the country's export is, the larger the role of goods-price effects and the smaller the role of country-price effects as a source of fluctuations of terms of trade will be, and vice versa. For a discussion, see Baxter and Kouparitsas (2000).

**Figure 1: Terms of trade, 1970–2002 (1995=100)**



Source of data: World Bank Africa Database 2004

Both Mali and Burkina Faso exhibit very high levels of export concentration and consequent high volatility in their terms of trade. Table 1 shows that the top three export products accounted for as much as 80% and 90% of total exports from Burkina Faso and Mali, respectively, between 1996 and 2002. Note that export concentration has increased in both countries, more in Burkina Faso than in Mali, over the past decade. The distribution among the top three export commodities (cotton, livestock and gold), that are the same for both countries, differs markedly, however. Gold has replaced cotton as the top export commodity in Mali since 2000 while cotton has remained the dominant export commodity in Burkina Faso (see Table 1). In addition Table 1 shows that the level of export concentration is much less pronounced in UEMOA as a whole than in Burkina Faso and Mali, reflecting the more diversified export structures and the higher degree of industrial development of the other UEMOA-countries. Further, the level of export concentration has remained constant in UEMOA while it has increased slightly in Mali and appreciably in Burkina Faso.

**Table 1: Export concentration and composition.**

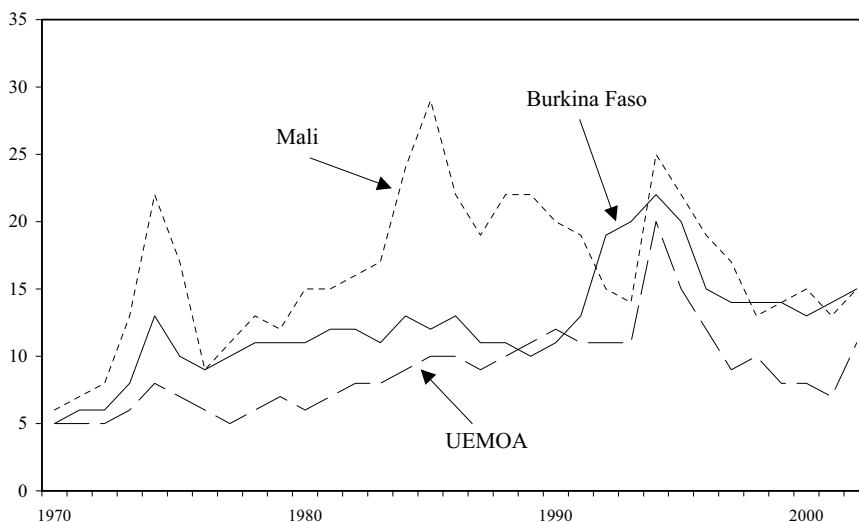
Export of top 3 commodities in% of total exports	1990–1995	1996–2002	2002		
	annual averages		cotton	livestock	gold
Burkina Faso	68%	80%	54%	21%	2%
Mali	88%	90%	22%	4%	65%
UEMOA	42%	43%	-	-	-

Source of data: World Bank

## Pro-cyclical and decreasing official development aid

Another potential source of external instability for Burkina Faso and Mali concerns fluctuations in official development assistance. Both countries are strongly dependent upon official development aid, which accounts for 15% or more of GDP. It is generally admitted that aid has a positive impact on macroeconomic variables, including savings, investment and growth.<sup>6</sup> The magnitude of this impact is, however, believed to vary much from country to country and to be determined by the interaction between aid and policy-oriented and institutional factors, like macroeconomic policy, openness to trade, rule of law and governance.<sup>7</sup> The way aid volatility and uncertainty affect the relationship between aid and macroeconomic variables, like growth, depends upon the quantitative importance of aid for the recipient countries. The larger the official assistance, relative to GDP, the stronger the impact of aid volatility and instability on macroeconomic performance, and *vice versa*.<sup>8</sup> The large role of official aid to Burkina Faso and Mali, when related to the size of the economies, suggests that aid volatility is likely to contribute significantly to GDP and income volatility.

**Figure 2: Official Development Assistance (in% of GDP), 1970–2002.**



Source of data: World Bank Africa Database 2004

In order to highlight the impact of aid volatility on macroeconomic performance and to assess the effectiveness of aid, it is also essential to take into consideration the timing of aid and its responsiveness to the problems arising from other external shocks, like deteriorating terms of trade or political conflicts. A priori, there are few reasons to believe that official assistance, which in most cases is poorly co-ordinated and prima-

<sup>6</sup> See e.g. the survey by Hansen and Tarp (2000).

<sup>7</sup> For a recent assessment, see e.g. Burnside and Dollar (2004).

<sup>8</sup> There are surprisingly very few studies dealing with the impact of aid volatility on macroeconomic variables. An exception is Lensink and Morrissey (1999) who show that aid instability has a detrimental effect on investment and growth of developing countries.



rily driven by donors' considerations, is counter-cyclical; that it increases in times of economic downturn and decreases in times of economic upturn in the recipient country.<sup>9</sup>

Changes in official development assistance to Mali and Burkina Faso over the past three decades are portrayed in Figure 2. There is evidence of a long-term increase in development assistance that went from some 5% of GDP in the late 1960s to some 15% of GDP in the early 2000s. Official assistance has fluctuated over time, more in Mali than in Burkina Faso, and more during the past decade than during the 1980s.<sup>10</sup> The peak observed in the mid-1990s can be ascribed to the devaluation of the CFA franc by 50% in 1994. Thereafter, official development aid diminished in both countries, partly as a result of rapid economic growth that brought down the aid-to-GDP ratio. Official assistance also decreased in *absolute real terms* by 15–20% between 1995 and 2000. This decrease ran parallel with the deterioration of terms of trade, which illustrates the pro-cyclical character of official assistance to Burkina Faso and Mali. By the same token, the increase in official aid before the mid-1990s ran parallel with the amelioration of the terms of trade of Burkina Faso and Mali (see Figure 1). The decrease in official aid to UEMOA as a whole was more pronounced than for these two countries during the same period, with official aid in real terms dropping by some 30% between 1995 and 2000. Official assistance to UEMOA increased again in 2002.

### **Socio-political crisis in Côte d'Ivoire**

Burkina Faso and Mali were recently hit by another external shock, the political crisis in Côte d'Ivoire. The crisis, that was started by a military coup in late 1999 and reached its peak in September 2002 with the quasi partition of the country, has affected neighbouring countries' economies through three potential channels, trade, foreign direct investment and remittances.<sup>11</sup> The first channel refers to the fact that Côte d'Ivoire has been historically the main transit route for exports from and imports to landlocked Burkina Faso and Mali, and Port Autonome d'Abidjan their main seaport for trade with countries outside Africa. The political crisis led both countries to change their transportation routes and to ship more goods through other countries, especially Benin, Togo and Ghana, which should have increased their freight and other transaction costs. For the products sold on the world markets where Burkina Faso and Mali are price takers without the possibility of altering prices, this has resulted in less export revenue and more expensive import prices. For those exporters and importers that have maintained shipping through Côte d'Ivoire, the multiplication of police and military checkpoints in the northern part of the country has had a similar effect on trade costs. For both Burkina Faso and Mali, the higher shipping costs have adversely affected trade and further limited their possibilities of diversifying exports, in particular

<sup>9</sup> There are many examples of pro-cyclical aid. One is given by the difficulty in providing counterpart funds to aid projects in times of economic downturn, which is a reason for postponing aid. Eventually improved economic conditions lead to the availability of counterpart funds and aid disbursement.

<sup>10</sup> In real terms official aid to Burkina Faso fluctuated between 318 and 432 millions US\$ (constant 2000 US\$) between 1990 and 2001 with the peak reached in 1993, while aid to Mali fluctuated between 322 and 444 millions US\$ during the same period with the peak reached in 1991.

<sup>11</sup> Doré et al. (2003).

towards products with a high import content. There is no doubt that this development has been detrimental to economic activity and growth in both countries.<sup>12</sup>

**Table 2: Foreign Direct Investment in Burkina Faso and Mali (annual average)**

	1991–1996	1997–2000	2001–2002
FDI inflows in millions US\$			
Burkina Faso	9	15	9
Mali	29	61	112
Sub-Saharan Africa	2 992	7 006	10 374
FDI inflows in% of gross fixed capital formation			
Burkina Faso	1.7	2.3	1.3
Mali	4.8	12	16.9
Sub-Saharan Africa	6.1	12.6	18.9
Inward FDI stocks in% of GDP			
Burkina Faso	1.4 (1990)	3.4 (1995)	6.1
Mali	1.6 (1990)	6.6 (1995)	21.1
Sub-Saharan Africa	11.9 (1990)	16.6 (1995)	37.5

Source: UNCTAD (2003), pp. 249–250, 269–270, and 280–281.

A second potential channel of influence works through reduced foreign direct investment (FDI). Political instability may have deterred foreign firms' plans to establish in the region, including Burkina Faso and Mali. Table 2 shows the volume and evolution of FDI in Burkina Faso, Mali and Sub-Saharan Africa during the past decade. Comparing the development of FDI in Burkina Faso with that of Mali and Sub-Saharan Africa as a whole suggests that the adverse effect of the political crisis in Côte d'Ivoire on FDI is concentrated to Burkina Faso. The crisis does not seem to have affected inflows of FDI to Mali, which have increased significantly during the last decade attracted by the gold boom and the economic opportunities it provides. Note, however, that the role of FDI in Burkina Faso in terms of capital formation and GDP is very limited when compared to other sub-Saharan African countries. This implies that the drop that could be noticed in the volume of FDI in this country in the early 2000s presumably had a limited effect on investment and growth.

The third potential channel of transmission works through private workers' remittances. These play an important economic role in Burkina Faso but a less important one in Mali. Between 1970 and 1998, worker remittances amounted on average to 6.4% of GDP in Burkina Faso and 3.7% in Mali.<sup>13</sup> In addition, the country source of remittances varies,

<sup>12</sup> For a quantitative assessment, see Doré et al. (2003).

<sup>13</sup> Chami et al. (2003), p. 29.

with a much larger share of Burkina Faso's remittances coming from Côte d'Ivoire (some 40% of total remittances in the mid-1990s). The political crisis in Côte d'Ivoire resulted in a noticeable drop in workers' remittances to Burkina Faso in the early 2000s. Remittances from Côte d'Ivoire decreased by 68% between 1996 and 2003.<sup>14</sup> This drastic decline in remittances contributed not only to a rise in poverty in Burkina Faso<sup>15</sup> but also to an increase of child labour.<sup>16</sup> The limited role of remittances in Mali (as a share of GDP) and the fact that the lion's share of remittances originates from other countries, in particular France, suggest that the detrimental impact of the political crisis in Côte d'Ivoire through declined remittances has been less of a problem for this country.

### **Summary: turbulent post-devaluation period**

Turbulent years followed the devaluation of the CFA franc in January 1994. It is likely that the external shocks that hit Burkina Faso and Mali during this period counteracted to a significant extent the positive effects of the currency devaluation on macroeconomic development in these two countries. The deterioration of terms of trade after 1995, the pro-cyclical official aid in a period of economic downturn, and the prolonged socio-political crisis in Côte d'Ivoire limited the room for manoeuvre of macroeconomic policy and presumably had a negative impact on growth. Our analysis suggests that Burkina Faso was more severely hit than Mali. The deterioration of the terms of trade after 1995 was more apparent in Burkina Faso, due to the higher dependency of this country upon cotton export and the gold boom in Mali. Both Burkina Faso and Mali have experienced pro-cyclical aid policy, which means that aid policy might have reinforced the negative effect on growth of the deterioration of the terms of trade. On the other hand, the socio-political crisis in Côte d'Ivoire hit Burkina Faso more severely than Mali, through a sharp decline in workers' remittances and a noticeable drop in foreign direct investment.

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<sup>14</sup> Lachaud (2004a), p. 28.

<sup>15</sup> Ibid.

<sup>16</sup> Lachaud (2004b).

# 3. Savings, Investment and Growth

The impact of trade shocks on economic growth depends upon the nature, the direction (positive or negative) and the magnitude of the shock. It also depends on the degree of dependence of the economy on the sector(s) hit by the shock. It depends finally on the initial domestic policy regime and the policy response to the shock. A critical factor when it comes to economic policy concerns the kind of exchange rate regime adopted by the country. External shocks, like terms-of-trade shocks, have an impact on the economy through different channels, incomes, savings and investments. In addition, they have an impact on the economy in a more indirect way through macro-economic policy, in particular fiscal policy. For example, a drop in export revenue caused by a fall in the prices of the main export crops or products results eventually in less tax revenue and less opportunity for public investment. The fact that countries like Burkina Faso and Mali have no access (or very little access) to international capital markets for use in smoothing shocks over time makes these countries more vulnerable to external shocks, which are potentially damaging for economic development.<sup>17</sup>

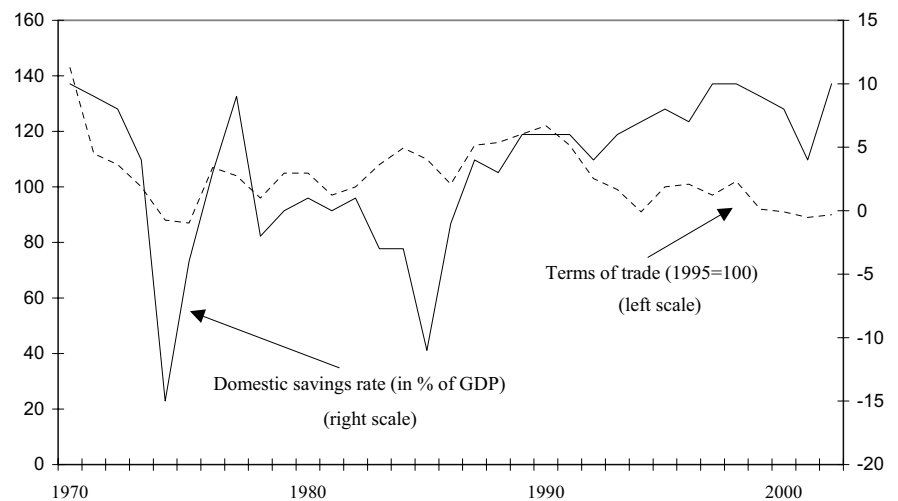
## **Savings responses**

The savings response to a trade shock depends upon whether the shock is considered transitory or permanent. Agricultural shocks, like a price decrease for an export crop, are more likely to be interpreted as temporary because they can easily be traced back to climatic shocks or other sorts of supply shocks.<sup>18</sup> Transitory shocks tend to result in a higher savings response than permanent shocks, which modify the consumption pattern of households and government. Two other factors shape the savings response. The first is whether the income gains (or losses) generated by the trade shock accrue to the private sector or to the public sector. The second is whether the shock is negative (a price decrease for an export crop) or positive (a price increase).

<sup>17</sup> Ranking of countries according to their access to capital markets shows that Burkina Faso and Mali (like most other CFA-countries) ranked very poor. On a 0–5 scale, the score 5 being obtained by most OECD countries, Burkina Faso and Mali obtained 0.13 and 0.0, respectively. The average for sub-Saharan Africa is 0.22. Braga de Macedo et al. (2001), Table 1.4, p. 25.

<sup>18</sup> Collier and Gunning (1999), p. 12.

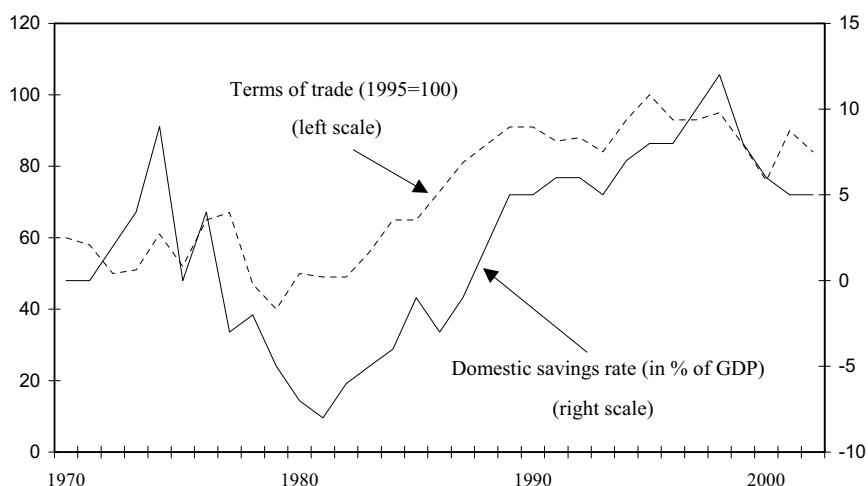
**Figure 3: Terms of trade and domestic savings in Mali, 1970–2002.**



Source of data: World Bank Africa Database 2004

Figures 3 and 4 illustrate the co-movement of the savings rates and terms of trade in Mali and Burkina Faso. From Figure 3 we can see that, in Mali, the savings rates by and large follow changes in terms of trade. Exceptions are, however, the years 1974 and 1985 when the savings rate dropped drastically as a result of the severe droughts that hit the country. Another exception is the 1990s when the savings rate continued to rise rather steadily while the terms of trade deteriorated. A reason for this may have been the gold boom in Mali. Another reason may have been a structural change in economic policy during the 1990s with improved incentives for savings and investment. The domestic savings rate in Mali increased significantly between the early 1980s and 1998, going from 0–1% to 10% of GDP. This reflects the improvement in the terms of trade, but also presumably the increase in official development assistance to Mali and changes in economic policy (fiscal policy, financial liberalisation, etc.). The worsening of Mali's terms of trade after 1990 was not accompanied by a savings rate decline of the same order of magnitude. The domestic savings rate remained under 10% of GDP in the late 1990s and early 2000s.

**Figure 4: Terms of trade and domestic savings in Burkina Faso, 1970–2002.**



Source of data: World Bank Africa Database 2004

Figure 4 provides details of the development of domestic savings in Burkina Faso between 1970 to 2002. The series shows a clear upward trend between the early 1980s and 1998, which mirrors with a lag the sharp increase in the terms of trade of the country brought about by the increase in the price of cotton on the world market. The worsening of the terms of trade for Burkina Faso after the mid-1990s contributed to a decline of the savings rate in the late 1990s. The drop was limited, however, suggesting that the impact on savings of positive and negative terms-of-trade shocks is not symmetric.

**Table 3: Private and Public Savings (annual averages, millions of current US\$)**

	Burkina Faso			Mali		
	1990–93	1994–98	1999–2002	1990–93	1994–98	1999–2002
Gross private savings	77	84	48	54	134	273
Gross public savings	80	112	216	99	83	42

Source of data: World Bank Africa Database 2004

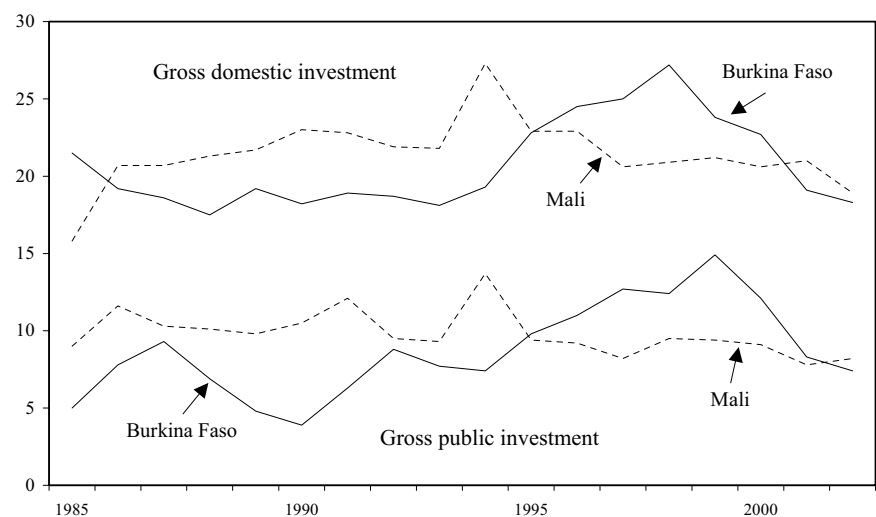
For the whole period it seems like savings in Burkina Faso were more dependent upon the evolution of the terms of trade than in Mali, where the savings rate was to some extent de-linked from the fluctuations in the terms of trade over the last decade. Once the initial effect of the gold boom on savings is over, it is likely that the evolution of savings in Mali will again mirror the country's terms of trade. The domestic savings rates of both Mali and Burkina Faso have increased steadily during the 1980s and 1990s to reach some 10% of GDP in the late 1990s. They eventually decreased, more markedly in Burkina Faso than in Mali. Savings in both countries remain low by international standards.<sup>19</sup> Splitting up domestic

savings into public and private savings provides additional insights. It shows first that public savings account for a large share of aggregate savings in both countries, in Burkina Faso significantly more than in Mali. It also shows that the windfall gains, which could be ascribed to the improvement in the terms of trade and to the devaluation of CFA franc in January 1994, accrued more to the public sector in Burkina Faso but more to the private sector in Mali. The savings responses to the 1990's external shocks thus differed significantly in both countries, which might have had implications for the impact of savings on investment and eventually growth.

### Public investment boom in Burkina Faso

A priori high savings responses to terms-of-trade shocks are likely to produce limited (if any) consumption effects but significant investment effects. Figure 5 shows no increase in aggregated domestic investment parallel with the increase in savings brought about by the improvement in the terms of trade. An exception is the period between 1994 and 1998 in Burkina Faso when the investment ratio jumped from some 19 to 27% of GDP. In addition to the improvement in the country's terms of trade, a factor that may have contributed to this development was the huge devaluation of the CFA franc in January 1994, which increased the profitability of the trade-exposed sectors. The aggregate investment ratio declined eventually in the late 1990s and early 2000s, parallel with the worsening of the country's terms of trade.

**Figure 5: Investment in Burkina Faso and Mali (in% of GDP), 1985–2002.**



Source of data: World Bank Africa Database 2004

In Mali and Burkina Faso, public investment plays a considerable role, accounting for about half of total investment. This is by far more than is expected of the role of the state in the economy of these countries in

<sup>19</sup> In 2000–2002, gross domestic savings amounted on average to 17% and 21% of GDP in Sub-Saharan Africa and all Africa, respectively.

terms of production and employment. The government also decides on the sector destination of public investment and the kind of investment (infrastructure, equipment, foreign assets, etc.). These choices are critical for the growth impact of public investment.<sup>20</sup> The relative roles of public and private investment have remained roughly constant in Mali while public investment has increased its relative role in Burkina Faso. The significant increase in domestic investment in Burkina Faso during the second half of the 1990s reflects essentially an increase in public investment, which in turn reflects the rapid increase in public savings in this country (Table 3). On the other hand, the rapid increase in private savings in Mali during the same period (Table 3) did not result in an increase in private investment (the difference between public investment and domestic investment in Figure 5). The upsurge in foreign direct investment in Mali during the second half of the 1990s (Table 2) suggests that domestically financed private investment relative to GDP decreased after the mid-1990s as well. It seems like economic policy in Mali failed to create sufficiently strong incentives to transform private savings into *domestic* private investments.<sup>21</sup>

### Relatively modest and uneven growth

High, prolonged economic growth is hardly achievable without investment and capital accumulation. To be sustainable, high growth also requires improvement in total factor (capital, land and labour) productivity, which creates strong incentives for firms and people to invest in physical and human capital. In order to promote and amplify productivity gains it is in turn necessary to invest in machines, equipment, infrastructure, education and training. All this means that growth is not sustainable if only (or mostly) based on capital accumulation. Neither is growth sustainable in the absence of investments (and savings). The growth process is dynamic and of cumulative and circular character, which explains the difficulties met by empirical studies that attempt to assess the causal links between savings, investment and growth.<sup>22</sup>

**Table 4: Real growth in% (annual average), 1985–2002**

	Burkina Faso			Mali		
	1985–93	1994–97	1998–2002	1985–93	1994–97	1998–2002
GDP	4.3	4.6	3.7	1.7	4.3	6.1
Agriculture	4.7	3.5	3.8	5.2	4.2	4.3
Industry	2.6	8.9	2.3	4.1	7.9	11.7
Service	5.2	3.5	4.3	1.1	2.5	4.1
GDP <i>per capita</i>	1.9	2.0	1.2	-1	1.8	3.6

Source of data: World Bank Africa Database 2004

<sup>20</sup> It is generally admitted that investment in infrastructure is less effective in generating growth than machinery and equipment investment. See e.g. de Long and Summers (1991). It is also admitted that public investment is biased in favour of infrastructure investment.

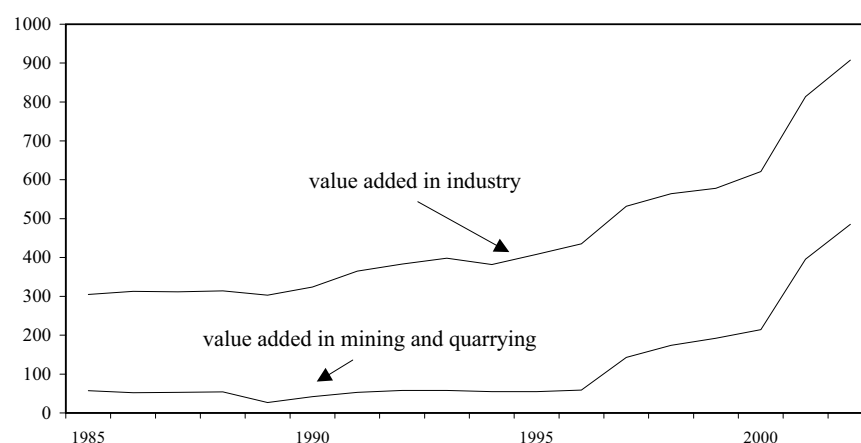
<sup>21</sup> An illustration of this may be the underdeveloped and poorly secured property rights that encourage the gains of terms-of-trade booms to be transferred abroad for safekeeping.

<sup>22</sup> An illustration of this is a cross-country study by Attanasio et al. (1999), which finds a positive effect of (lagged) savings on investment, a negative effect of investment on growth, and a positive effect of growth on both savings and investment.



The growth performances of Burkina Faso and Mali are illustrated in Table 4. A first finding of Table 4 concerns the relatively modest growth achieved by Mali and Burkina Faso between 1985 and 2002, on average 3.5% and 3.7% respectively. Economic growth was slightly superior to the rate of population growth, which means that only a minor increase in average income *per capita* was noticed in both countries over the two decades. A second finding is that the improvement in the terms of trade in the mid-1990s and the devaluation of the CFA franc led to a temporary acceleration of economic growth in Burkina Faso. The impact on growth was achieved through two plausible channels, directly and immediately through a price increase for export products, and indirectly and with a lag through increased savings, investments and output. Mali also experienced increased growth in the mid-1990s. Growth further accelerated thereafter, fuelled by the gold boom in the country. Gold production has increased enormously since 1997. Today it accounts for 6–7% of GDP while it only accounted for 2% of GDP during the first half of the 1990s.<sup>23</sup> The rapid industrial growth in Mali between 1998 and 2002, some 12% on annual average, can be ascribed to this gold boom (see Figure 6). A third finding of Table 4 is that the deterioration in the countries' terms of trade and the various shocks that hit these countries in the late 1990s and early 2000s slowed down the rate of economic growth apparently more in Burkina Faso than in Mali. This is not surprising since Burkina Faso was hit more severely than Mali by the external shocks (see above). The negative impact of the worsening of the terms of trade on Mali's growth was more than outweighed by the gold boom.

**Figure 6: Value added in industry in Mali**  
(constant 1995 US\$, millions), 1985–2002.



Source: World Bank Africa Database 2004.

A fourth finding of Table 4 concerns the large variations in the sector distribution of growth. The accelerated growth during the second half of the 1990s benefited for the most part the industrial sector. Since the improvement in the terms of trade reflected the increase in the price of cotton on the world market, this suggests that the windfall gains more than proportionally accrued to the ginning sector than to the agricultural

sector and cotton growers.<sup>24</sup> Industrial growth continued at an impressive rate in Mali in the late 1990s and early 2000s as a consequence of the gold boom. Table 4 also shows that agricultural growth slowed down markedly in both countries after the mid-1980s. This development has had severe consequences for the evolution of the scope and depth of poverty because the bulk of the poor live in rural areas. An implication of the uneven distribution of growth across sectors is that the growth of GDP *per capita* in Table 4 is unevenly distributed across individuals and has benefited (if at all) the rural population and the many poor among them to a limited extent. That growth in Burkina Faso has not been pro-poor is supported by the official figures, which show that the scope and depth of poverty actually increased between 1994 and 2003.<sup>25</sup> A similar conclusion emerges from a study concerned with Mali.<sup>26</sup>

### Summary: wasted opportunities?

The main economic challenge faced by Mali and Burkina Faso concerns their relatively modest long-term economic growth. Growth in both countries is not sufficient to secure a significant and steady increase in income *per capita*. As is the case in other Sub-Saharan countries, income distribution in Mali and Burkina Faso has remained very uneven, and from time to time even become still more uneven.<sup>27</sup> The result has been a decrease in income *per capita* for large population groups and an augmentation of the risks of poverty for a growing share of the population. The improvement in the terms of trade from the late 1980s until 1998, associated with the devaluation of the CFA franc in January 1994, permitted an increase in savings and a recurrence of growth during the second half of the 1990s. This acceleration of growth was temporary in Burkina Faso, however. Deteriorated terms of trade, diminished official development assistance flows and the instability caused by the socio-political crisis in Côte d'Ivoire contributed to the worsening of growth performance in Burkina Faso. In Mali, the gold boom originated a rapid industrial and GDP growth in the early 2000s. It seems like both countries failed in the mid-1990s to translate the windfall income gains from improved terms of trade and the devaluation of the CFA franc into productive investments that promote the diversification of the economy and make economic growth more sustainable. The relatively poor and deteriorating growth performance of the agricultural sector over time remains the main obstacle to significant reduction in the scope and depth of poverty, which remains predominantly a rural phenomenon in both countries.

<sup>23</sup> On gold mining in Mali, see IMF (2000), pp. 8–18, and IMF (2004), p. 23. The impact of gold mining on the labour market is limited since less than 2000 are employed in gold exploration and production. The gold sector accounted for 7–8% of total government revenue in the early 2000s.

<sup>24</sup> For Mali, see Bourdet (2002), pp. 51–53.

<sup>25</sup> Between 1994 and 2003, the percentage of individuals in the population whose household expenditures per capita fall below the poverty line increased from 44.5% to 46.4% (from 45% to 46.4% between 1998 and 2003). The increase was more pronounced for urban than for rural households. Rural-urban migration may explain this result. On the incidence, depth and evolution of poverty in Burkina Faso, see Ministère de l'Économie et du Développement (2003) and Lachaud (2003).

<sup>26</sup> Marouani and Raffinot (2003). As pointed out by the authors, the results for Mali should be interpreted with care because the poverty estimates (based on the 1994 household survey) are of poor quality (Ibid., pp. 17–23). On the incidence, depth and distribution of poverty across space in Mali, see also IMF (2003), pp. 12–17, and Annexe 2, and Nteziyaremye et al. (2001), pp. 31–40.

<sup>27</sup> For an analysis of the change in income distribution in Africa, see Artadi and Sala-i-Martin (2003), pp. 3–5.

# 4. Exchange Rate Policy Matters

Mali and Burkina Faso share the same currency and belong to a monetary union whose exchange rate is pegged to the Euro (to the French Franc before 1<sup>st</sup> January 1999). The question that now arises is whether membership in the CFA-zone affected the growth performance of Mali and Burkina Faso when the price of cotton on the world market dropped and the terms of trade deteriorated in the late 1990s and early 2000s. This raises the issue of whether and to what extent the impact of real external shocks on economic growth depends upon the exchange rate regime, fixed or floating. A related question concerns the competitiveness of exchange rates in low-income countries like Mali and Burkina Faso.

What are the channels and mechanisms through which external shocks affect real economic activity under alternative exchange rate regimes?<sup>28</sup> Under a flexible exchange rate regime, a fall in the price of an export crop that accounts for a substantial share of total export results in a significant drop in export revenue (in foreign currency), a decrease in the demand for the domestic currency on the foreign exchange market, and subsequently a depreciation of the nominal exchange rate. This depreciation improves the competitiveness of the country's exports and of the home products competing with imports, which should give a boost to the demand for both kinds of products on world and domestic markets, respectively. Improved competitiveness eventually stimulates activity in export and import-competing industries, which will tend to offset the initial negative impact of the deterioration of the terms of trade on output and growth.

On the other hand, under a fixed exchange rate regime, the fall in the price of an export crop has an adverse effect on the income of exporters, which contracts output and employment in the export sector concerned and in the rest of the economy through the multiplier effect. The drop in export revenue nominated in foreign currency and the subsequent decrease in the supply of foreign currency on the foreign exchange market also oblige authorities to intervene in this market in order to maintain the peg. This will be ideally done through a restrictive monetary policy that drains money out of the domestic economy, which will have an additional adverse effect on output and employment in the economy.

<sup>28</sup> For a discussion of the relation between terms-of-trade instability and exchange rate regimes, see Broda (2001) and Edwards and Levy Yeyati (2003). For recent theoretical and empirical surveys on the choice and consequences of exchange rate regimes, see Corden (2002), Ghosh et al. (2002), and Levy Yeyati and Sturzenegger (2003).

The above reasoning suggests that the inability to use the exchange rate as an instrument of adjustment in fixed exchange rate regimes has real economic costs in terms of contracted output and slower growth. There are few empirical studies that have attempted to assess this role of the exchange rate regime when economies are hit by terms-of-trade disturbances. A recent study confirms that the kind of exchange rate regime matters very much when the economy is hit by a negative shock.

<sup>29</sup> The study includes 75 developing countries and shows that negative terms-of-trade shocks have large and significant adverse effects on GDP in countries with fixed exchange rate regimes, but result in only small GDP losses in countries with flexible exchange rate regimes. It also shows that about a third of the real GDP fluctuations in developing countries with fixed exchange rate regimes can be ascribed to terms-of-trade shocks as compared to less than 10% for developing countries with flexible regimes.<sup>30</sup> The estimates for African developing countries are slightly different, 25 and 15% respectively. These estimates give an indication of the impact of terms-of-trade shocks on real GDP in the *long run*, which is necessary since the impact stretches over several years. Short-run estimates are significantly lower, some 21% and 2% for the whole sample of developing countries (75 countries) respectively some 14% and 4% for African developing countries. These results are confirmed by another study that shows that a deterioration of the terms of trade under a fixed exchange rate regime by 10% translates into a contraction of GDP *per capita* twice that under a flexible exchange rate regime, 0.80 and 0.43 of one percentage point, respectively.<sup>31</sup>

That the exchange rate regime matters is illustrated by Table 5, which covers the 1999–2001 period when the terms of trade deteriorated in the UEMOA, including Mali and Burkina Faso (see Figure 1).<sup>32</sup> Table 5 shows that UEMOA exhibited poorer growth performance and diversification (as illustrated by industry and service sector growth) than other groups of African countries. The limited difference between UEMOA and the other African groupings can be due to the fact that the figures of Table 5 only captures the *short-run* impact of terms-of-trade disturbances, which is significantly lower than the *long-term* (full) impact of terms-of-trade shocks on real growth (see the reasoning above).

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<sup>29</sup> Broda (2004).

<sup>30</sup> Ibid., Table 4.

<sup>31</sup> Edwards and Levy Yeyati (2003), p. 12. The study includes 183 countries over the period 1974–2000.

<sup>32</sup> Note that the terms of trade improved somewhat in the non-UEMOA groups of countries, which may have contributed to the growth discrepancy between the UEMOA and other African groupings.

**Table 5: Real growth in% (annual average), 1999–2001**

	UEMOA	CFA	ECOWAS	Non-CFA Africa	All Africa
GDP	2.2	2.4	2.8	2.9	3.1
Agriculture	2.7	3.3	3.7	3.7	2.3
Industry	2	2.8	2.3	2.3	3.2
Service	1.8	1.4	2.1	3.2	3.4
GDP <i>per capita</i>	- 0.3	- 0.1	0.3	0.7	1

Notes: CFA consists of 15 countries; Non-CFA Africa consists of 33 sub-Saharan countries; All Africa consists of 53 countries.  
Source of data: Computed from World Bank Africa Database 2004

The poor growth performance of UEMOA-countries, and the CFA-countries as a whole, resulted in a fall in their GDP *per capita* during the period examined (Table 5). In the meantime, GDP *per capita* increased in non-CFA countries. The decrease in GDP *per capita* in the UEMOA (and other CFA-countries) made it difficult to reduce poverty, which could only be done through income redistribution during the 1999–2001 period. It is likely that the strong appreciation (by some 20%) of the Euro relative to the US Dollar since the early 2002 and the fixed parity between the CFA franc and the Euro have led *ceteris paribus* to a misalignment (overvaluation) of the CFA franc, which has also contributed to the relatively poor growth performance of the UEMOA and other CFA-countries in the past two years.

# 5. Monetary Integration in West Africa: the ECOWAS Challenge

How and to what extent terms-of-trade instability affects economic growth thus depends to a significant extent upon exchange rate policy. The considerable terms-of-trade fluctuations experienced by the great majority of developing countries, in particular primary product exporters, suggest therefore that the choice of exchange rate arrangement plays a critical role for longer-term growth. A question that arises is how the proposed enlarged monetary union for West Africa, including all but one of the members of the Economic Community of West African States (ECOWAS), is likely to affect macroeconomic development and growth in Burkina Faso and Mali.

In April 2000, six of the seven non-CFA members of ECOWAS expressed their intention, through the Accra Declaration, to establish a second monetary union in West Africa by 2003 and to work towards the creation of a unified, enlarged monetary union, including both CFA and non-CFA countries by 2004.<sup>33</sup> The countries involved in the making of the enlarged unified monetary union are six non-UEMOA members of ECOWAS, namely The Gambia, Ghana, Guinea, Liberia, Nigeria and Sierra Leone, and the UEMOA countries (Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal and Togo). Liberia has so far declined to participate in the monetary union project because of the civil war in the country. Cape Verde was the only non-CFA ECOWAS member not to sign the Accra Declaration.<sup>34</sup>

The planned monetary union of non-CFA ECOWAS countries has been named the West African Monetary Zone (WAMZ). The implicated countries have set up a new institution, the West African Monetary Institute (WAMI), with headquarters in Accra in Ghana, in order to monitor the transition process towards WAMZ. The initial plan agreed in 2000 was unrealistic and therefore modified in November 2002. The start of the monetary union among the non-UEMOA members of the ECOWAS has been postponed to July 2005. The date for the establishment of the unified, enlarged ECOWAS monetary union has also been

<sup>33</sup> The best introduction to the process of monetary integration in West Africa is Masson and Patillo (2001a). See also Ouédraogo (2003).

<sup>34</sup> The current Cape Verdean government led by the PAICV (Partido Africano da Independencia de Cabo Verde) is more committed to co-operation with West Africa than its predecessor, and this may change the position of the country if the planned monetary union materialises.

postponed. It is to be decided in 2005, on the basis of the “performance of the economies of the second monetary union (among non-UEMOA members) and the level of convergence of the economies of the sub-region as a whole”.

The plan for an enlarged monetary union in West Africa raises several questions about the transition path that has been chosen to achieve monetary integration in the second monetary union (WAMZ). One issue is the advantages and disadvantages of the new monetary arrangement for individual countries, in particular Burkina Faso and Mali, as well as for the monetary union as a whole. Another concerns the transition towards the enlarged monetary union including all the ECOWAS countries, with the exception of Cape Verde, and the choice of the external exchange rate policy, a peg or a flexible exchange rate.

### **Unstable and uncertain transition**

The process towards the second monetary union (WAMZ) goes through macroeconomic convergence of the participating countries.<sup>35</sup> The Accra Declaration in 2000 set up a number of convergence criteria, inspired by the experiences of the UEMOA and the European Union, that the participating countries have to strive for and eventually fulfil (?) before the introduction of the common currency. These criteria are essentially of macroeconomic character and divided into two sub-groups, primary and secondary criteria. There are four primary criteria concerned with inflation, the size and financing of budget deficit and gross reserves (see Table 6 for the thresholds). The secondary criteria are government revenue and expenditure (current and investment), real interest rate and exchange rate stability (Table 6). As suggested by the names, primary criteria are considered more important than secondary criteria.

The West African Monetary Institute (WAMI) is in charge of the surveillance of the convergence process and the making of recommendations for policy measures for individual countries in order to come closer to and eventually meet the convergence criteria. WAMI has three other main tasks. First, it is responsible for the setting up of a common central bank for the non-UEMOA countries. Second, it is in charge of the elaboration of a legal and institutional framework necessary for the working of the monetary union and the conduct of a common monetary policy. Finally, it will have to determinate the value of the common currency and the conversion rates between the national currencies and the common currency.

<sup>35</sup> Information on the implementation and progress of the second monetary union is available on the web site of the West African Monetary Institute (WAMI) ([www.mani-umao.org](http://www.mani-umao.org)).

**Table 6: WAMZ countries' compliance with the convergence criteria.**

	Number of countries (out of five) meeting criterion	
	2000	2003 (June)
<i>Primary criteria</i>		
Budget deficit (excl. grants)/GDP: 4% or less (5% or less in 2000–2001)	2	3
Inflation rate (end period): less than 10%	3	2
Central bank financing of budget deficit/previous year tax revenue: 10% or less	2	5
Gross reserves (in months of imports): 3 or more	2	3
<i>Secondary criteria</i>		
Tax revenue/GDP: 20% or more	1	0
Wage bill/tax revenue: 35% or less	2	3
Domestically financed public investment/tax revenue: 20% or more	2	0
Real interest rate: >0	4	0
Nominal exchange rate depreciation: +/- 15%	2	4

Note: Only The Gambia, Ghana, Guinea, Nigeria and Sierra Leone are considered in Table 6. Liberia is not included.

Source: Based on West African Monetary Institute (2003), pp. 13–14.

The transition process towards a common currency in the second monetary union (WAMZ) faces several problems that may endanger its establishment or at least its date of launch. A first problem concerns the poor records of the participating countries in meeting the convergence criteria (see Table 6). Although some improvement could be noticed between 2000, the year the project was initiated, and 2003 as regards the primary criteria, the picture that emerges from Table 6 is that the participants are rather far from the thresholds of the convergence criteria. This concerns particularly the secondary criteria with none of the five participating countries complying with three out of five secondary criteria. Most worrying is the criterion concerned with monetary stability, which probably reflects the lack of an anchor country among the participating countries. A second problem is the uncertainty surrounding compliance with the convergence criteria (used as qualifiers?) before the adoption of a common currency. A third problem is related to the undetermined role of the WAMI as an embryo of a central bank. Note that these shortcomings are not based on an evaluation of the structural factors put forward by the theory of optimal currency area (like the probability of asymmetric shocks, labour mobility, wage flexibility, export diversification or the degree of fiscal federalism) to sort out countries most prone to form a successful monetary union.<sup>36</sup>

<sup>36</sup> On the theory of optimum currency area and its critique, see e.g. De Grauwe (2000), chapters 1 and 2.

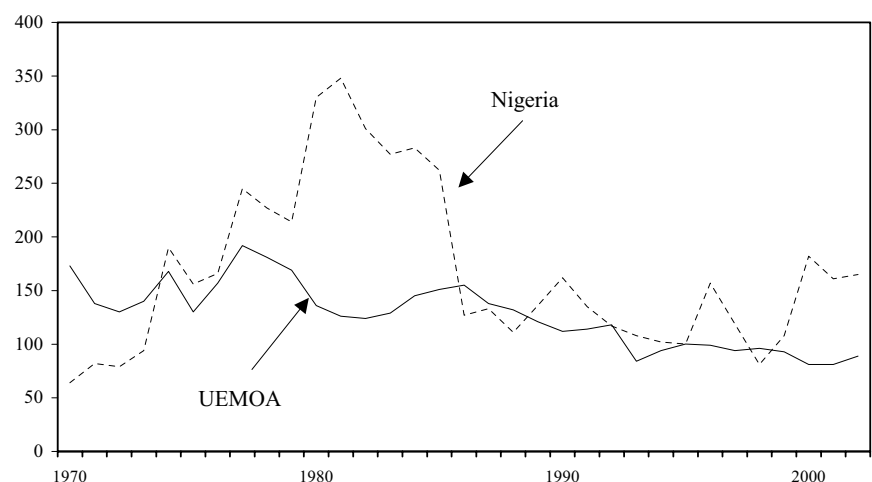


### Limited benefits and large potential costs of the enlarged monetary union

The benefits and costs of joining a monetary union vary from country to country according to the volume of trade between participating countries and the structural factors pointed out by the theory of optimum currency area (see above). They vary equally over time because the volume of trade changes and the structural factors change in parallel with the process of economic development (increased export diversification, more labour mobility, etc.).

The benefits of joining the monetary union are mostly trade-related. The more the countries, which aim at participating in a monetary union, trade with each other the larger are the potential gains of integration. These gains, that derive from the elimination of transaction costs and exchange rate instability, should further international specialisation, a better exploitation of the production resources and eventually higher growth. A look at the trade between UEMOA and other ECOWAS countries shows that the volume of trade between them is rather limited. UEMOA countries' trade with other ECOWAS countries accounts for about 5% of their total foreign trade (to be compared to some 10% for intra-UEMOA trade).<sup>37</sup> The importance of trade between some individual UEMOA countries, like Mali and Burkina Faso, and non-CFA ECOWAS countries is still smaller, accounting for only 1–2% of their foreign trade. These figures may underestimate the true trade volume because they do not include unrecorded, informal trade, which is considered to be large between the countries of the region. Informal trade is large among UEMOA countries and between these countries and the other ECOWAS countries. It is likely to be limited, however, in trade with the rest of the world.

**Figure 7: Terms of trade in UEMOA and Nigeria (1995=100), 1970–2002.**



Source of data: World Bank Africa Database 2004

<sup>37</sup> Masson and Patillo (2001a), p. 20. Subtracting primary commodities intended for world markets increases the share of intra-UEMOA trade significantly. For example, intra-UEMOA export accounts for some 20% of total UEMOA export in such a case (Guillaumont (2002), p. 16).

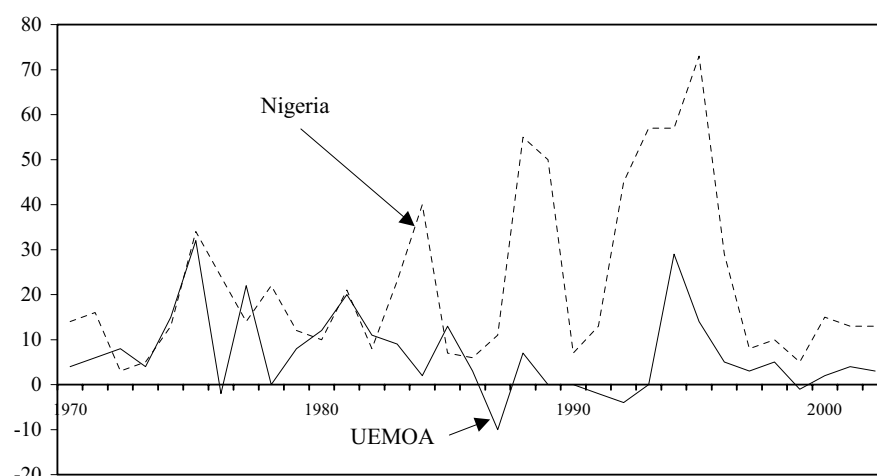
The costs of joining a monetary union derive from the fact that the countries that belong to a monetary union lose an instrument of economic policy, exchange rate policy. This instrument can be very useful if the participating countries are exposed to different shocks that require adjustment in the exchange rate to minimise the impact of the asymmetric shock on growth and employment. The most important source of shocks for the ECOWAS countries is terms-of-trade instability. Figure 7 shows considerable differences in the development of terms of trade of UEMOA and Nigeria, by far the dominant economy in the planned enlarged monetary union.<sup>38</sup> The considerable amplitude in the swings of Nigeria's terms of trade is caused by changes in the world price of oil. Different specialisation patterns and composition of the countries' exports explain the divergent changes in the terms of trade of UEMOA as a whole and Nigeria, respectively.<sup>39</sup> One of the main, undisputed lessons of monetary integration literature is that the more asymmetric the shocks facing the countries, the greater the cost of a fixed exchange rate system. This being so, the large discrepancies in terms-of-trade changes between Nigeria and UEMOA countries will increase significantly the costs of the proposed monetary union for member countries. The implication is also that the enlarged monetary union might not be sustainable in the longer term.

The adverse impact of asymmetric shocks on growth and employment can be mitigated in a monetary union if there is sufficient mobility of labour; labour moving out of the country hit by the shock. Labour mobility is formally possible within ECOWAS but there remain informal obstacles to the free movement of labour, as illustrated by the socio-political crisis in Côte d'Ivoire, the country with the highest proportion of foreign workers in West Africa. It is also likely that labour mobility is higher within the UEMOA than between the UEMOA and the other ECOWAS countries, not least because of linguistic and cultural differences. All this suggests that the mitigating effect of labour mobility in case of asymmetric shock should be considered limited in the enlarged monetary union. Other mitigating forces put forward by the theory of optimum currency area, like the degree of centralisation of fiscal policy, at the ECOWAS level, and of wage flexibility are likely to play a minor role in the enlarged monetary union, at least in the medium term.

<sup>38</sup> Nigeria accounts for some 70% and half of the GDP of the WAMZ and the ECOWAS, respectively.

<sup>39</sup> Figure 7 portrays terms-of-trade changes for the UEMOA as a whole. Terms-of-trade changes among UEMOA countries are rather highly correlated, and more correlated than terms-of-trade changes among the other ECOWAS countries, and between UEMOA and other ECOWAS countries (Masson and Patillo (2001a), p. 20, and Debrun et al. (2002), pp. 9–10). See also Figure 1, which shows that terms of trade (1995 = 100) fluctuated between 40 and 100 and 80 and 150 in Burkina Faso and Mali, respectively, while they fluctuated between 50 and 350 in Nigeria (Figure 7).

**Figure 8: Inflation in Nigeria and UEMOA (% change), 1970–2002.**



Source of data: World Bank Africa Database 2004

The UEMOA countries have a long tradition of monetary stability that can be ascribed to the strict monetary policy conducted by the common central bank BCEAO (Banque Centrale des États d'Afrique de l'Ouest) and the disciplinary effect of the CFA franc link to the French franc and the Euro since January 1999. A full ECOWAS monetary union will include countries that historically have poor records in terms of monetary stability. For countries like Nigeria and Ghana, joining the enlarged monetary union can improve credibility in their monetary policy and result in significant gains. On the other hand, for the UEMOA countries, the enlarged monetary union can be a step backward and a significant cost in case the monetary policy that is conducted at the ECOWAS level fails to deliver price stability. Figure 8 shows the considerable differences between the rates of inflation in UEMOA and Nigeria. These differences have increased markedly since the mid-1980s. If the monetary policy of the central bank to be created to conduct monetary policy in the enlarged monetary union is influenced to some extent by the monetary history of Nigeria, this will incur significant costs for the UEMOA countries.<sup>40</sup>

### To peg or not to peg?

The transition process towards the enlarged, ECOWAS-wide monetary union raises a number of critical issues that have not been considered in the Accra Declaration and subsequent meetings between the governments and authorities of the participating countries. It is still not clear whether the central bank in charge of the conduct of monetary policy in the second monetary union (WAMZ) will merge with the BCEAO or whether the two will work in parallel for a transitory period (how extended?). Neither the new central bank, if one is created for the whole ECOWAS-region, nor its location and institutional and organisational structure, is yet clear.

<sup>40</sup> A study by Debrun et al. (2002) shows that a monetary union with Nigeria is not in the interest of the other ECOWAS countries, in particular the UEMOA countries, if it is not accompanied by effective measures to discipline Nigeria's fiscal policy.

Another critical issue that has not yet been touched upon concerns the external exchange rate policy. UEOMA and other ECOWAS countries have different external exchange rate policy regimes, exchange rate pegged to the Euro and flexible exchange rate (with limited intervention of the national central banks to smooth fluctuations), respectively. As yet it is not clear whether a flexible exchange rate regime will be chosen in the second monetary union (WAMZ). What kind of exchange rate regime will be chosen when the two monetary unions merge is not clear either. Soft pegs, that is fixed but adjustable exchange rates, have lost much of their attractiveness in recent years following the enormous increase in capital mobility and the disruptive exchange rate crises in several emerging economies.<sup>41</sup> Actually, there remain two main (polar) alternatives, a fixed exchange rate or inflation targeting with a flexible exchange rate. The first alternative raises additional questions of which currency the new common currency should be pegged to (Euro, dollar or a currency basket reflecting either trade or primary exports).<sup>42</sup> The current CFA regime, with a peg to the Euro guaranteed by the French Treasury, is very unlikely to continue for three reasons.<sup>43</sup> The first is the reluctance of France to grant a French Treasury guarantee to the enlarged monetary union. The second is the reluctance of the other EU countries to accept the extension of the guarantee to more countries (the consent of the European Council is necessary to extend the French Treasury's guarantee to additional countries).<sup>44</sup> The third is the reluctance of some non-UEMOA countries, like Nigeria, to accept the role of France as guarantor of convertibility and to representation on the board of the central bank (BCEAO). This being the case, the choice of a peg to an external currency or a basket of currencies will have to be guaranteed by the newly created central bank of the enlarged monetary union. The choice in such a case could fall on a fixed-but-adjustable exchange rate regime. A regime that permits smoother adjustment of the exchange rate to external shocks could be motivated by the fact that capital mobility is still low among West African countries.<sup>45</sup> On the other hand, in case the participating countries opt for a flexible exchange rate regime, the monetary authorities will have to adopt a target for domestic inflation as an anchor for monetary policy. They will also have to set up institutions and rules that secure the independence of the common central bank to deliver monetary stability and to design an effective multilateral surveillance mechanism to discipline fiscal policies in the member countries.

<sup>41</sup> See Tavas (2003) and Ghosh (2002), chapter 4.

<sup>42</sup> The choice between a single-currency or a multi-currency peg should be based on the structure of foreign trade and the relative role of the Euro, the dollar and other major currencies. It should also be based on the administrative and technical capacity of the central bank because a multi-currency peg is more difficult to monitor than a single-currency peg (Corden (2002), pp. 78).

<sup>43</sup> Masson and Patillo (2001a), pp. 26–29.

<sup>44</sup> The consent of the European Council is also formally required for modification of the convertibility guarantee and the peg system.

<sup>45</sup> It is worth pointing out that fixed-but-adjustable exchange rate regimes are not compatible with high capital mobility, as illustrated by the Asian exchange rate crises. On this, see Obstfeld and Rogoff (1995).

### **Summary: unfinished and premature project**

Real integration stagnated among the ECOWAS countries, in particular between the UEMOA and other ECOWAS countries, in the late 1990s and the early 2000. This led the heads of government of the member countries to launch an ambitious project of monetary integration in Accra in 2000.<sup>46</sup> Monetary integration was expected to promote economic and political co-operation among West African countries in a time of civil wars and socio-political instability, and to encourage trade integration and a better exploitation of the production resources of the region. The project has two main components. The first is a monetary union of the non-CFA countries belonging to ECOWAS. Until now the convergence programme that was designed to pave the way for this monetary union has failed to bring the participating countries close to the benchmarks set up in the initial programme. The second component, the merging of the two sub-regional monetary unions (CFA zone and WAMZ) is still embryonic with severe question marks on the nature and timing of the transition process from two to one central bank, the institutions and rules governing the future central bank, and the choice of an anchor for monetary policy.

As it stands today the project is unfinished with many important issues and potential problems in the dark. It is also premature in view of the specialisation, level of development and macroeconomic stance of the economies concerned. The uneven distribution of costs and benefits across the participating countries and group of countries (UEMOA versus other ECOWAS countries), and the opposition that this is likely to give rise to among participating countries, also contribute to questioning the economic pertinence of the project and its chance of coming into force in the near and medium-term future.<sup>47</sup>

<sup>46</sup> A factor that might have contributed to the project was the launch of the EMU through a kind of demonstration effect. For a well-balanced discussion of the impact of EMU on monetary integration in Africa, see Honohan and Lane (2001).

<sup>47</sup> An illustration of the opposition to the project is given by the interventions of the participants in the seminar on the conduct of monetary policy organised by the BCEAO in 2002. See BCEAO (2002), vol. II.

# 6. Concluding Remarks

The specialisation of Burkina Faso and Mali, with a few primary commodities accounting for the dominant share of exports, make them very prone to terms-of-trade instability. GDP fluctuations in both countries reflect, to a significant extent, this instability, which has been fed by counter-cyclical foreign official assistance and the socio-political crisis in Côte d'Ivoire. In both Burkina Faso and Mali the improvement in the terms of trade during the 1990s, combined with the huge devaluation of the CFA franc, contributed to an increase in savings. In Burkina Faso increased savings resulted in increased investment, mainly public, and an acceleration of growth during the second half of the 1990s. In Mali, the increase in private savings and foreign direct investment (essentially in the mining sector) did not contribute to increased investment. This raises a number of questions on the policy stance and on the structure of incentives to transform private savings into productive investment in this country. On the other hand, the gold boom has contributed to sustaining growth in Mali.

Both Burkina Faso and Mali were struck by a worsening in the terms of trade in the late 1990s and the early 2000s. This and the fact that both countries belong to the CFA monetary union, whose currency is pegged to the Euro, contributed *ceteris paribus* to a slow-down of their GDP growth. In Mali, the slow-down was more than outweighed by the gold boom. The negative impact of external shocks is only one critical consideration when discussing the choice of exchange rate regime, which should be weighed against the benefits of monetary integration in the form of lower transaction costs and monetary stability. Another potential problem with the peg to the Euro concerns the risks of misalignment (overvaluation and loss of competitiveness) of the CFA franc following the Euro, the value of which reflects monetary policy in the Euro Zone. A precedent is the misalignment of the CFA franc prior to its devaluation in January 1994, which to a large extent was due to the strict monetary policy conducted in France and the French government's policy of keeping the franc high relative to the currencies of other industrial countries ("*politique du franc fort*"). There is a real risk that history will repeat itself when growth increases again in Europe and the European Central Bank (ECB) is on the verge of tightening monetary policy. If the

objective of policy is to maximise the rate of GDP growth so as to reduce poverty, it is necessary to evaluate the present CFA franc external peg in a longer-term growth perspective.

The optimal choice for the CFA countries is an exchange-rate regime that absorbs external shock but at the same time delivers monetary stability. For countries hit regularly by real shocks, like terms-of-trade shocks, a flexible exchange rate regime is preferable *under the condition that the monetary authorities succeed in delivering monetary stability and low inflation*. Actually, it is the best way to insulate the economy from real disturbances that strike either this economy or the anchor economy (the Euro zone). The current CFA system has contributed greatly to monetary stability through the combination of external peg, convertibility guaranteed by the French Treasury and rather strict monetary policy. The planned reform of the statute of the BCEAO will strengthen its independence, which is a precondition for monetary stability whatever the choice of external exchange rate regime. On the other hand, the CFA system incurs real costs in terms of lower growth when the participating economies are hit by negative external shocks or in case of exchange-rate misalignment. The proposed enlarged currency union is going to actualise the choice of an exchange rate regime for the participating countries, since it is very likely to lead to the abandonment of the French guarantee for the peg. The project of an enlarged West African monetary union is rather shaky in its present form, which suggests that its probability of coming into force within the next decade should be considered rather low. In the mean time, there remain the risks of misalignment and loss of competitiveness for Burkina Faso, Mali and the other CFA countries. Instead of waiting for the hypothetical materialisation of the ECOWAS-wide monetary union, it may be wise to start a reflection on the reform of the external peg of the CFA-zone, with, as a priority, the acceleration of growth, which is a prerequisite for poverty reduction.

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