Journal of International Money and Finance 53 (2015) 36–74

Contents lists available at ScienceDirect

Journal of International Money and Finance

journal homepage: www.elsevier.com/locate/jimf

The importance of the exchange rate regime in limiting current account imbalances in sub-Saharan African countries

Blaise Gnimassoun *

EconomiX – CNRS, University of Paris Ouest – Nanterre La Défense, 200 avenue de la République, 92001 Nanterre Cedex, France

ARTICLE INFO

Article history:
Available online 9 January 2015

JEL classification:
F32
F33
C11

Keywords:
Current account imbalances
Exchange rate regime
Bayesian model averaging
Sub-Saharan Africa

ABSTRACT

One of the major current concerns of economic policy in developing countries is the choice of the appropriate exchange rate regime to consolidate and accelerate the pace of economic growth. This paper aims to investigate whether the choice of a country's exchange rate regime may affect current account imbalances for sub-Saharan African economies. To this end, we first use Bayesian model averaging (BMA) supplemented by the General-to-Specific (GETS) method to address concerns about model uncertainty and identify the key determinants (fundamentals) of external balances. Then, estimating current account imbalances over the period 1980–2012, we show that flexible exchange rate regimes are more effective in preventing such disequilibria. Consequently, candidates for membership of monetary unions should discuss widely the possible adjustment mechanisms before forming such unions; one potential measure is the sharing of external risks at the regional level.

* Tel.: +33 (0)46 65 50 88; fax: +33 (0)1 40 97 41 98.
E-mail address: blaise.gnimassoun@u-paris10.fr.

http://dx.doi.org/10.1016/j.jimonfin.2014.12.012

1. Introduction

The choice of exchange rate regime and its impact on macroeconomic performance is undoubtedly one of the most controversial topics in macroeconomic policy (Levy-Yeyati and Sturzenegger, 2003). If the debate on the relative merits and demerits of alternative exchange rate regimes is longstanding, it remains topical for developing countries, especially for sub-Saharan African countries that are seeking an appropriate regime to consolidate and strengthen their economic impetus (Yagci, 2001; Masson, 2008; Bird and Rowlands, 2009; Qureshi and Tsangarides, 2012). Several internal and external factors justify the attention paid to this issue: the economic performances achieved in sub-Saharan Africa during the 2000s, as well as the unexplored potential economic growth, the gradual opening of some countries to international financial flows, the increasing global imbalances and their implications, the need to strengthen regional trade, etc. While the average economic growth of sub-Saharan Africa stagnated in the 1980s and 1990s (2.6% and 2.2% respectively), it has doubled in the 2000s to stand at 5.5%, with predictions that remain strong according to the International Monetary Fund (IMF).[1] With the aim of enhancing this economic trend in the long term and stimulating sub-regional markets, the enthusiasm for monetary unions is increasingly apparent in sub-Saharan Africa.[2]

Several reasons could justify the formation of monetary unions or the choice of a fixed exchange rate regime for developing countries,[3] namely the intensification of regional trade, the level of which remains low given the high specialization of these countries in commodity exports, the credibility of economic policy – mainly fiscal policy – the management of which is usually much more rigorous in countries with fixed exchange rate regimes, and the legibility of monetary policy that is favourable to foreign capital and investment. Contrasting with these arguments, it is well known that the adoption of such schemes involves the abandonment of the exchange rate as an instrument for adjusting external imbalances.[4] Regarding the case of the euro area, there is some evidence that external imbalances have increased since the introduction of the common currency (see for instance, Berger and Nitsch, 2010; Holmes et al., 2010; Proaño et al., 2012; Körner and Zemanek, 2013). The adjustment of these imbalances, which is still ongoing, has been particularly painful in economic terms (falling wages, rising unemployment, labour market reforms, popular protests) partly because member countries can no longer individually use the exchange rate as an adjustment instrument. In a context in which some sub-Saharan African countries are tempted by other monetary policies, especially other exchange rate policies, the question of the link between the exchange rate regime and external imbalances is thus particularly acute.

While the increase in global imbalances during the 2000s has renewed interest in the literature on sustainability and the adjustment of current accounts, little attention has been paid to the link between current account imbalances and the exchange rate regime.[5] In addition, to the best of our knowledge, no study has addressed the case of developing countries. The focus on industrialized countries is justified in part by the fact that their external imbalances also represent a challenge to the stability of the global economy. However, the case of developing economies – sub-Saharan African countries in

[1] See World Economic Outlook (WEO), April 2014.

[2] In addition to the monetary union project for West Africa, five East African countries (Burundi, Kenya, Rwanda, Tanzania and Uganda) signed a protocol agreement on 30 November 2013 establishing a monetary union. The West African project aims to merge the West African Monetary Zone (WAMZ), consisting of Gambia, Ghana, Guinea, Nigeria and Sierra Leone, with the West African Monetary Union (WAMU), including Benin, Burkina Faso, Guinea Bissau, Ivory Coast, Mali, Niger, Senegal and Togo. The WAMZ is a monetary union undergoing training, whereas the WAMU is an existing monetary union with the CFA franc as its currency. The economic bloc of the Southern African Development Community (SADC), consisting of Angola, Botswana, the Republic of Congo, Lesotho, Malawi, Mauritius, Mozambique, Namibia, Swaziland, South Africa, Tanzania, Zambia and Zimbabwe, also plans to form a monetary union. Some coordination of monetary and exchange rate policies already takes place between South Africa, Lesotho and Swaziland, although the relationship is closer to that of a currency board.

[3] See, for example, Guillaume and Stasavage (2000), Chang and Velasco (2000), Frankel (2012), Qureshi and Tsangarides (2012).

[4] Throughout this paper, the terms “current account imbalances” and “external imbalances” are used interchangeably.

[5] Most of these studies focus on current account reversal (Clarida et al., 2007; Freund, 2005; Freund and Warnock, 2007) or the link between the latter and the exchange rate regime (Chinn and Wei, 2013; Ghosh et al., 2013; Pancaro, 2013).