Chapter 2
Inflation and Economic Performance in the CFA Franc Zone:
Transmission Channels and Threshold Effects

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ABSTRACT

This chapter examines the relationship between inflation and economic performance in the CFA franc zone over the period 1991-2009 and studies the mechanism through which inflation affects long-term economic growth. Using a threshold model, the evidence strongly supports the view that the relationship between inflation and economic growth is nonlinear with a unique threshold. The most striking difference between West Africa Economic and Monetary Union (WAEMU) zone and Central African Economic and Monetary Community (CEMAC) zone is that the coefficients of inflation are all significantly negative for all inflation regimes, while for WAEMU zone, the coefficient of inflation is positive for the low and high inflation regimes. Further investigation suggests that for the WAEMU countries, but not for the CEMAC countries, the level of investment is the channel through which inflation nonlinearly affects economic growth. One of the main contributions of this chapter is to enable the policymakers, specifically central bankers in each zone, to concentrate on those policies that keep the target of inflation, which may be helpful for the achievement of sustainable economic growth. Low inflation is also helpful for minimizing the uncertainties in the financial market, which in turn boost the investment in the country.

1. INTRODUCTION

One of the major objectives of macroeconomic policies is to achieve high and sustainable economic growth rates along with low, stable, and predictable inflation rates and is, therefore, fundamental for policymakers. If these two variables are interrelated, then policymakers would like to control them depending on the structure of such relationship in order to reach policy targets. Because of its importance, the inflation-growth relationship has attracted much attention from economists in academia and the world of central banking.

Several theoretical and empirical studies explored this issue. If one agrees that inflation has three causes (money, cost, and demand), the channels through which it affects economic growth are subject to controversy and the impact of inflation on economic activity can be: (1) none; (2) positive; and (3) negative. Sidrauski (1967) established the first result, showing that money is neutral and superneutral[1] in an optimal control framework, claiming that an increase in the inflation rate does not affect economic growth. Tobin (1965), who assumed money is as substitute to capital, established the positive impact of inflation on growth; his result is being known as the Tobin effect. The negative impact of inflation on growth is associated mainly with cash-in-advance models (e.g., Stockman, 1981) which consider money as complementary to capital. Thus, effect of inflation economic growth has not yet been conclusively established in macroeconomic models. For example, inflation imposes negative externalities on the economy when it interferes with economic efficiency if it results in uncertainty about the future profitability of investment projects. The associated increase in risk leads to more conservative investment strategies than would otherwise be the case. Higher inflation may also reduce a country's international competitiveness, by making its exports relatively more expensive, thus impacting on the balance of payments. Moreover, inflation can interact with the tax system to distort borrowing and lending decisions. Also, a high rate of inflation negatively affects real economic growth and thus causes adverse consequences for economic performance at the aggregate level. However, the nature of the relationship between inflation and economic growth and the channels through which inflation affects real economic activities is still a debatable issue (Li, 2006).

Recent literature emphasizes the existence of a nonlinear relationship between the two variables and its results support the hypothesis that low and stable inflation promotes economic growth while higher inflations rates have a significant negative effect on growth (Bruno and Easterly, 1996; Ghosh and Phillips, 1998; Khan and Senhadji, 2001; Kamgnia Dia et al., 2009; Combey and Nubukpo, 2010; Egbendewe-Mondzozo, 2010; Ary Tanimoune and Fiodendji, 2011).

This strand of literature highlights various channels through which inflation can affect economic growth and investment is an important channel. The nonlinear investment, inflation and economic growth nexus can be explained by using financial market development. A predictable increase in the rate of inflation can slow down financial market development and nonlinearity between inflation and finance is well documented (Boyd et al., 1998; Huybens and Smith, 1997; Boyd et al. 2001; Khan et al, 2001). Investment is the most important channel through which the financial market affects economic growth (Li, 2006). Inflation can be viewed as a tax on real balances that reduces real returns to savings which, in turn, causes an informational friction in the financial system. These informational frictions result in credit rationing, thus limiting the availability of investment capital. Finally, the reduction in investment adversely impacts economic growth. Choi et al. (1996) explain the nonlinear effects of inflation on economic growth, arguing that credit market frictions are potentially insignificant and that, therefore, in low inflation may not result in credit rationing. In such a case, higher inflation

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