

Monetary transition in Cabo Verde: from the escudo zone to the exchange agreement with Portugal

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Conference EABH, Banco de Portugal, Banque de France

MONEY IN AFRICA

Monetary and financial decolonisation in Africa in the 20th century

Lisbon, Banco de Portugal, 9-10 October 2017

Introduction

Subject: post-independence monetary transitions in Cabo Verde.

Starting Point: since the beginning of the 20th century, with the exception of the period between 1910 and 1930, Cabo Verde has usually lived in a situation of a relative monetary and foreign exchange stability.

Objectives:

- what are the main factors that explain the situation of stability during the colonial period?
- what mechanisms allowed the reconstruction of the monetary and foreign exchange stability after political independence (1st transition) and after the political and economic changes observed after 1991 (2nd transition)?
- what is the nature of the 2nd monetary transition?
- what are the effects of the Exchange Cooperation Agreement (ECA) with Portugal and its contribution to the change of the Cape-Verdean economic model?

1. The colonial period and the escudo zone

Two pillars of foreign exchange stability

- Remittances from emigrants and foreign exchange traded in the island of S. Vicente (the “big business” of the colony) – the *external factor*
- Colonial monetary system – the *institutional factor*
 - * circulation of the Portuguese silver coin (metropolis and the colonies),
 - * circulation of BNU banknotes restricted to the colonies,
 - * obligatory exchange of the BNU banknotes at its headquarters in Lisbon.

The moments of instability were always linked to the bankruptcy of one of the pillars or to the ineffectiveness of its articulation:

- disappearance of the silver coin in 1914 (failure of the *institutional factor*);
- post-war inflation;
- invasion of Angolan banknotes in 1923 (*external factor* under attack).

1929-1975: a long period of stability

The escudo zone and Cape-Verdean stability

The new foundations of the colonial monetary system:

- transition to a (metropolitan) *escudo-standard system*;
- centralisation of the foreign exchange reserves and their management by the *Fundo Cambial* (Foreign Exchange Fund) with the BNU as its agent;
- currency issue based on foreign exchange counterparts.

The changes in the colonial monetary system made possible the existence of:

- a *private* currency managed according to the economic needs of the colony;
- an issue mainly based on foreign exchange counterparts;
- but convertible into the metropolitan currency.

The changes allowed, therefore, to create a more intense relationship between the two pillars, *institutional* and *external*, of monetary and foreign exchange stability.

The escudo zone and Cape-Verdean stability

The escudo zone

The main objective was to build an inter-territorial clearing and payment system that would allow:

- regularity of transfers,
- inter-transferability of currencies
- and the resolution of monetary-exchange imbalances.

The roles of the players in the payment system

- **Fundo Cambial** – began to perform the functions of a central reserve fund and became responsible for payment operations.
- **Banco de Portugal** – central bank of the zone, agent of the inter-territorial payment system and agent of the Monetary Fund of the Escudo Zone.
- **Fundo Monetário da Zona Escudo** – fund that supported the running of the system and assisted in the regularisation of payments through loans.

The escudo zone and Cape-Verdean stability

Table 1: Fundo Cambial currency issue account and Money Supply, 1964-1975 (millions of escudos; %)

	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975
Fundo Cambial	41.2	32.8	65.2	82.6	99.6	96.0	112.1	171.9	175.3	147.1	290.8	383.7
Money Supply	91.8	102.3	126.3	145.8	169.5	178.7	204.5	242.9	276.7	332.2	461.2	586.6
Fundo Cambial / Money Supply (%)	44.9	32.0	51.6	56.6	58.7	53.7	54.8	70.8	63.3	44.3	63.1	65.4

Source: Banco Nacional Ultramarino balance sheets of December; Estêvão (2015).

The escudo zone and Cape-Verdean stability

Table 2: Cabo Verde reserve account credits in the escudo zone payment system, 1963-1973 (%)

	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	Average
Gold and exchange sales to the Banco de Portugal			69.5	32.7	46.0	56.9	56.6	45.4	76.4	10.5	6.8	44.5
Inter-territorial payments	69.6	56.4	21.4	62.3	38.5	38.5	9.6	27.1	21.0	79.2	79.9	45.8
Credit balance of the previous year		13.0	0.2	4.9	15.5	4.7	33.7	27.5	2.6	9.4	10.5	12.2

Source: Banco de Portugal. Sistema de Compensação e de Pagamentos Interterritoriais. Relatório do Agente. Lisboa, several years.

2. The first monetary transition

Post-independence monetary transition in a complete break with the previous monetary and exchange system:

- creation of the Banco de Cabo Verde, central bank, but also commercial and development bank;
- replacement of the colonial bank;
- creation of a sovereign currency – the Cape-Verdean escudo;
- abandonment of the parity with the Portuguese escudo.

Reconstruction of the *external factor* of the exchange stability

- New economic model (MIRAB type) based on the relationship between two stock-flow pairs :
 - * *Migration-Remittances* – emigrants' stock generated a flow of remittances to their families in Cabo Verde;
 - * *Aid-Employment* – the flow of official development assistance allowed to sustain the employment stock in the domestic economy

The two pairs permitted to manage the running of the economy, to sustain the process of money creation and to manage the availability of reserves.

The first monetary transition

Table 3: Official development assistance and personal remittances, 1982-1992

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Official development assistance (ODA) (%)	36.5	40.6	45.9	46.7	54.6	35.9	31.2	31.0	34.3	31.9	32.6
Personal remittances (%)	18.4	14.8	15.6	15.1	14.0	14.8	15.4	16.6	18.3	18.7	20.7
ODA + Remittances	54.9	55.4	61.5	61.8	68.6	50.7	46.6	47.6	52.6	50.6	53.3

Source: World Bank, World Development Indicators (<http://databank.worldbank.org>); Estêvão (2015).

2. The first monetary transition

Reconstruction of the *institutional factor* of the exchange stability

- foreign exchange inflows were parsimoniously managed by the Banco de Cabo Verde;
- while there was a high degree of control on imports and the provision of foreign currency to economic agents.

The foreign exchange management was therefore based on two fundamental practices that gave substance to the new *institutional factor*:

- preservation of a quasi-fixed exchange rate in relation to the currencies of the main economic partners;
- administrative control of the foreign commercial and financial operations.

2. The first monetary transition

During the colonial period, the peg of the Cape-Verdean escudo to the metropolitan currency guaranteed its convertibility abroad.

Inversely, the institutional and administrative mechanisms of the post-independence **1st monetary transition** created a break with the world economy and determined the **inconvertibility of the national currency**.

However, those same mechanisms made it possible to manage foreign exchange inflows,

- by keeping the exchange rates quasi-fixed with the basket currencies;
- and ensuring a level of reserves that guaranteed the relative stability of the system.

This was a sustainable situation whilst it was possible to maintain the level of foreign exchange inflows, namely through the ODA disbursements and whilst it was possible to guarantee the economic and political management of the country.

The first monetary transition

Table 4: annual variation (%) of the average exchange rates (British pound, Portuguese escudo and US dollar), 1982-1992

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	Average
British pound	3.6	6.6	4.0	4.7	-0.6	0.7	8.6	-0.6	-2.6	1.2	-5.5	1.8
Portuguese escudo	-6.9	-11.9	-11.4	-7.4	0.2	-4.1	-2.5	-1.2	-0.7	0.6	1.3	-4.0
US dollar	19.7	23.0	18.2	8.1	-12.5	-9.9	-0.2	8.1	-10.1	1.9	-5.3	3.7

Source: Banco de Cabo Verde (www.bcv.cv).

The first monetary transition

Table 5: Total reserves in month of imports, 1982-1992

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	Average
Total reserves (US million dollars)	37.8	42.7	45.9	41.0	55.4	56.4	80.7	81.3	74.7	77.0	65.1	75.8
Total reserves (in month of imports)	4.4	4.4	5.0	6.6	6.3	8.2	7.8	6.3	6.0	5.1	4.6	5.9

Source: World Bank, World Development Indicators (<http://databank.worldbank.org>)

3. The second monetary transition and the Exchange Cooperation Agreement (ECA)

1991: change of the political regime and definition of a path of economic liberalisation, which resulted in a refoundation of the institutional framework.

Changes in the banking system and the foreign exchange trade:

- new rules regulating the constitution and functioning of banks;
- the Banco de Cabo Verde takes on the role of a central bank;
- the commercial department of the BCV turns into the Banco Comercial do Atlântico;
- liberalisation of the foreign exchange trade.

The beginning of a privatisations programme that, from the point of view of the banking system, led to :

- the sale of the Banco Comercial do Atlântico (Caixa Geral de Depósitos) ;
- inflow of private capital into the Caixa Económica de Cabo Verde (Montepio Geral) ;
- creation of the Banco Interatlântico (Caixa Geral de Depósitos) .

3. The second monetary transition and the ECA

A new vision of the process of economic development and international economic integration of Cabo Verde summarised through the idea of *dynamic integration in the world economic system*. This integration :

- implied a clear orientation towards the foreign market;
- imposed the need of developing the market, the private sector and human resources;
- depended upon the ability of “taking advantage of the potential opportunities offered by the world economy” and turning them into real opportunities.

One of the most important opportunities offered by the world economy is foreign direct investment. Therefore, it was necessary :

- to create the necessary conditions to **attract FDI**;
- and to find a **strategic partnership for the economic development** of Cabo Verde.

3. The second monetary transition and the ECA

The idea of a peg between the Cape-Verdean escudo and the Portuguese escudo was proposed by Cape-Verdean authorities in March 1995. That **idea came from** :

- the new vision of the Cape-Verdean development process and how important the strategic partnership with Portugal was for that vision ;
- but also the need to re-establish the exchange stability framework that had disappeared with the political and economic transition

The consensus in the negotiations pointed to an exchange agreement:

- based on an unilateral peg of the Cape-Verdean escudo,
- with explicit support from the Portuguese side
- and framed by a monetary arrangement in which exchange parity would be associated with two other components :
 - * a credit facility from the Portuguese Treasury (balance of payments)
 - * and a macroeconomic conditionality (correction of domestic imbalances)

3. The second monetary transition and the ECA

The ECA, signed in Praia in March 1998, established a peg of the Cape-Verdean escudo to the Portuguese escudo by a fixed parity relation, guaranteeing the convertibility of the Cape-Verdean escudo in the following terms :

- a **credit facility** to strengthen the Cape-Verdean foreign exchange reserves;
- adoption by Cabo Verde of the **reference criteria of the European Union**, with the commitment to implement **measures to safeguard exchange parity**;
- creation of a commission (COMACC) to ensure the conditions for the proper functioning of the agreement.

In December 1998, a **decision made by the Council of the European Union authorised Portugal to keep the agreement in force but maintaining its budgetary nature**. Consequently, the Cape-Verdean escudo became pegged to the euro, with a parity of 1 euro = 110.265 escudos, a parity that stays the same almost twenty years on.

3. Effects of the ECA and the changes in the Cape-Verdean economic model

The following tables and graphs allow us to summarise the importance of the ECA for the Cape-Verdean economy over the last 20 years. Three kinds of considerations can be made:

1. The **ECA helped to strengthen economic and financial relations** between Cabo Verde and the countries of the European Union.
 - External trade (**Table 6**) is mainly geared towards European countries. Between 1996 and 2016, exports to Europe made up around 86% of the total, while imports from Europe accounted for around 75% of the total.
 - During that same period, remittances (**Table 7**) from European countries made up about 76% of the total, well above the 19% of the United States of America, a country that, at a certain point, weighted heavily in the flows of transfers of Cape-Verdean emigrants.

3. Effects of the ECA and the changes in the Cape-Verdean economic model

Table 6: Geographical distribution of trade, 1996-2016

	1996	1998	2000	2002	2004	2006	2008	2010	2012	2014	2016	Average
Exports												
Portugal	77.0	88.9	80.1	88.4	78.3	49.8	40.6	22.7	16.0	14.7	17.0	52.1
Spain	11.1	7.3	3.5	0.8	0.3	27.3	37.2	72.6	76.3	63.9	64.2	33.1
Europe Union	90.5	97.0	86.2	91.1	79.0	77.7	78.3	96.2	92.5	79.4	81.6	86.3
Other countries	9.5	3.0	13.8	8.9	21.0	22.3	21.7	3.8	7.5	20.6	18.4	13.7
Imports												
Spain	3.8	2.4	2.5	3.8	3.8	5.6	7.3	10.6	7.2	7.6	11.1	6.0
Netherlands	7.6	6.8	13.0	18.1	13.7	11.2	17.0	16.8	15.0	15.6	7.3	12.9
Portugal	40.9	46.9	52.4	55.3	42.5	50.2	50.3	51.4	48.2	44.3	49.6	48.4
Europe Union	65.4	69.2	75.7	86.8	67.5	78.2	82.2	85.4	75.5	72.1	73.1	75.5
Other countries	38.4	33.3	26.9	17.1	36.3	27.4	25.0	25.2	31.6	27.9	26.9	28.7

Source: Banco de Cabo Verde (www.bcv.cv) and author's own calculations.

3. Effects of the ECA and the changes in the Cape-Verdean economic model

Table 7: Remittances by countries of origin (% of total)

	1996	1998	2000	2002	2004	2006	2008	2010	2012	2014	2016	Average
France	12.4	11.5	13.4	22.4	23.5	22.9	22.0	23.0	23.6	21.3	18.0	19.4
Italy	9.1	7.7	7.9	4.8	7.7	7.1	6.9	6.3	6.2	6.0	6.8	7.0
Netherlands	14.7	15.9	14.7	11.0	9.0	8.9	11.4	8.1	9.3	10.2	5.7	10.8
Portugal	24.2	26.2	20.4	25.3	28.8	28.6	30.0	30.7	32.1	32.4	31.8	28.2
Europe Union	67.5	67.9	63.8	66.9	75.6	76.6	80.1	77.4	79.0	77.6	81.0	75.5
USA	19.3	22.7	30.0	27.4	18.1	19.4	14.5	16.6	14.4	14.6	11.8	19.0
Other countries	20.3	16.0	13.7	9.1	13.0	13.1	15.3	15.4	14.4	15.6	25.9	15.6

Source: Banco de Cabo Verde (www.bcv.cv) and author's own calculations.

3. Effects of the ECA and the changes in the Cape-Verdean economic model

- Foreign direct investment (**Table 8**) from Europe accounted for 78% of the total reaching, in some years, even higher figures.

The intensity of economic and financial relations with Europe was a key argument to justify the importance of the monetary agreement. However, the deepening of those relations is also a consequence of the agreement that was reached and how well it has worked for the past 20 years.

2. The **ECA had a significant effect on the stability of the economy**, namely on price stability and on international reserves.

- The agreement was a good mechanism to influence price stability. **Figure 1** shows not only a strong downward trend in inflation, but also the reduction in price volatility, particularly in the second half of the period under analysis.

3. Effects of the ECA and the changes in the Cape-Verdean economic model

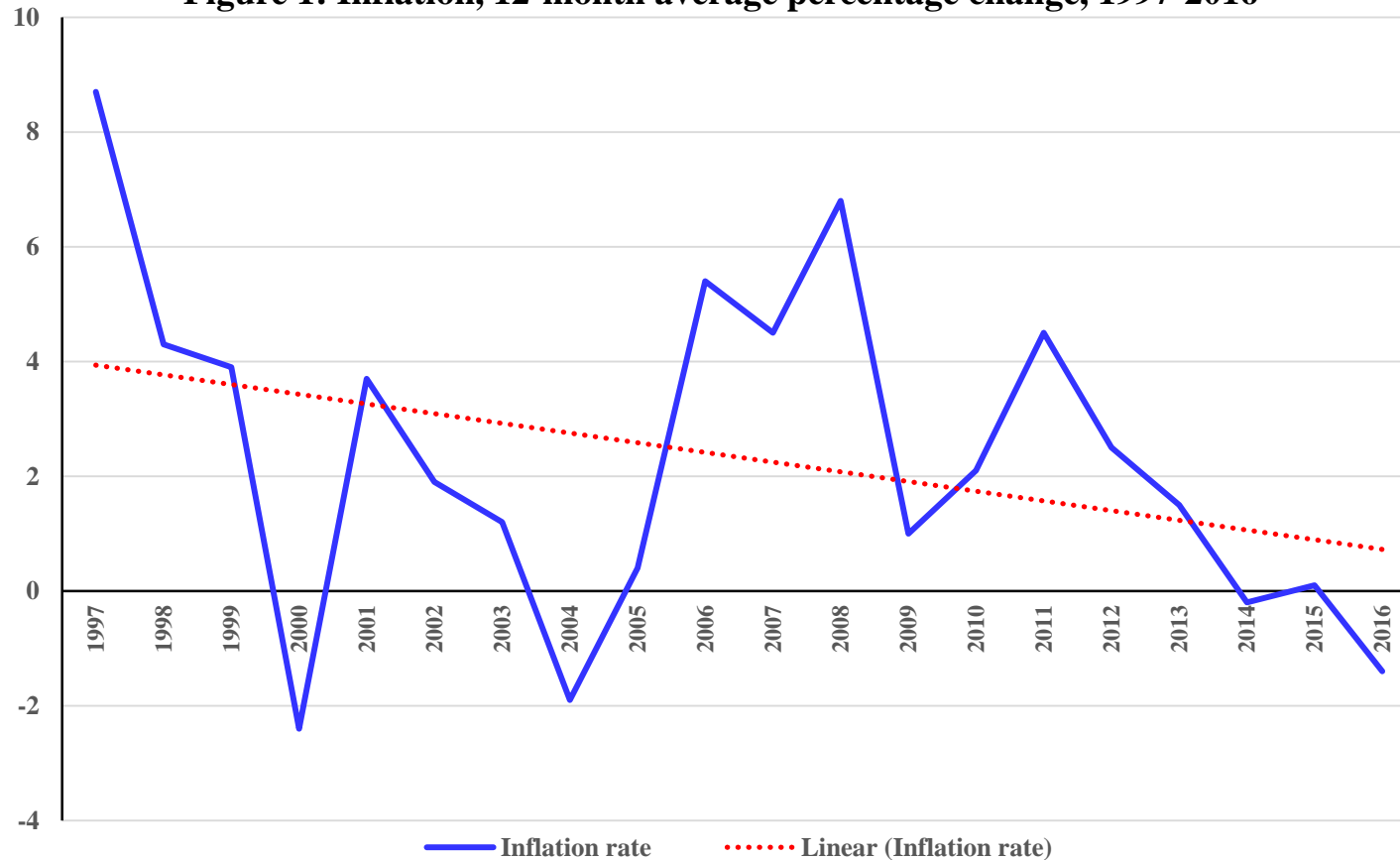
Table 8: Foreign direct investment by countries of origin, 1999-2015 (% of total)

	1999	2001	2003	2005	2007	2009	2011	2013	2015
Ireland	0.0	0.0	0.0	0.0	2.6	7.9	1.9	0.7	0.5
Italy	6.7	29.5	1.3	14.1	16.1	4.7	1.9	1.0	0.0
Portugal	90.2	30.7	37.6	64.1	11.9	6.8	8.2	16.9	13.1
Spain	0.0	13.5	0.1	8.8	20.3	18.9	54.5	3.4	3.0
UK	0.0	9.0	15.0	0.5	14.4	29.2	17.7	47.7	61.2
Europe	96.9	82.8	54.0	87.5	65.3	67.4	84.3	69.8	77.9
Others	3.1	17.2	46.0	12.5	34.7	32.6	15.7	30.2	22.1

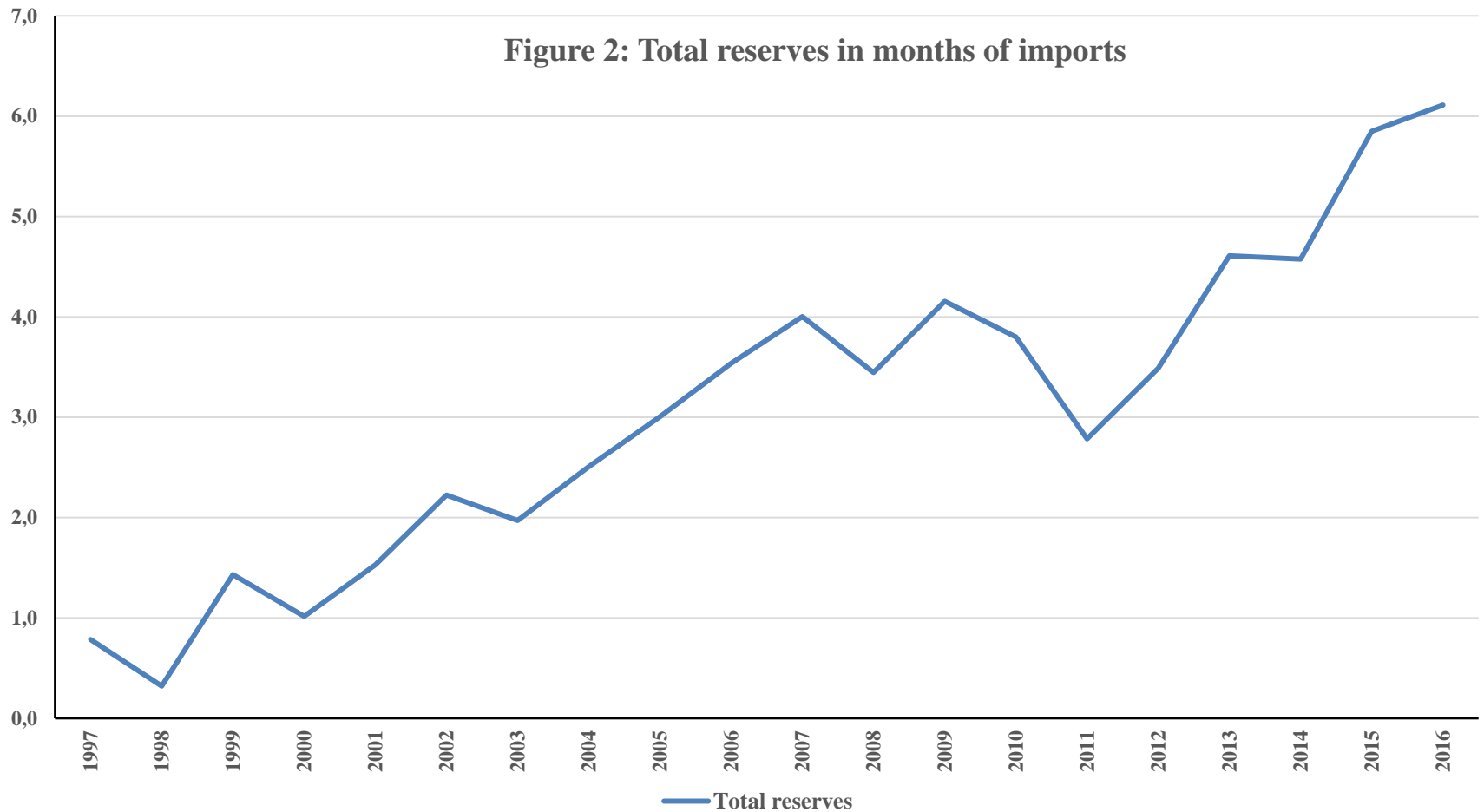
Source: Banco de Cabo Verde (www.bcv.cv) and author's own calculations.

3. Effects of the ECA and the changes in the Cape-Verdean economic model

Figure 1: Inflation, 12-month average percentage change, 1997-2016



3. Effects of the ECA and the changes in the Cape-Verdean economic model



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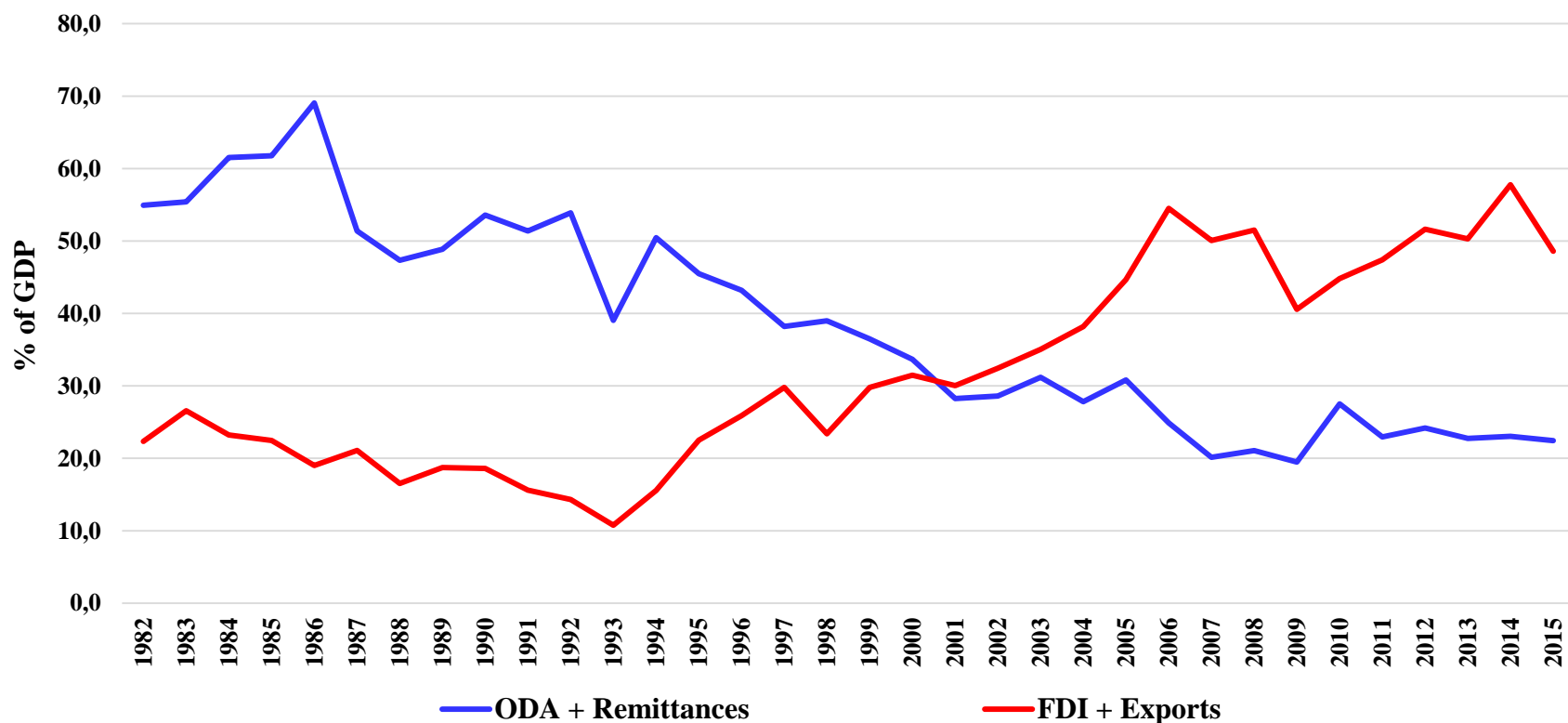
- On the other hand, **Figure 2** shows that international reserves have grown steadily; the situation today is much more comfortable (5 to 6 months of imports) than in the late 1990s, when reserves often represented less than a month of imports.

3. Globally, **the ECA has influenced**, in a very significant way, **the climate of economic change in Cabo Verde** since the early 2000s:

- that climate has allowed the country to move from a situation where it depended essentially on flows of transfers (private and public) to a situation where the economy is increasingly based on market relations and flows.

3. Effects of the ECA and the changes in the Cape-Verdean economic model

Figure 3: 'ODA-Remittances' and 'FDI-Exports' flows, 1982-2015



3. Effects of the ECA and the changes in the Cape-Verdean economic model

- **Figure 3** shows this clearly: up to around 2000, the sum of the official assistance and remittances flows had a much greater weight in the Cape-Verdean economy than the sum of foreign investment flows (insignificant until around 1993) and export revenues.
- Since then the economy has been increasingly dependent on these flows, which reflects a very important change in how it works. Now, the Cape-Verdean economy is a real market economy and its performance depends more and more on the ability to attract foreign investment and to increase the competitiveness of the exports.