

**Can domestic debt contribute to the financing of the
“Millennium Development Goals”? The case of the
West African Economic and Monetary Union (WAEMU)**

Samuel Guerineau, Sylviane Guillaumont Jeanneney

► **To cite this version:**

Samuel Guerineau, Sylviane Guillaumont Jeanneney. Can domestic debt contribute to the financing of the “Millennium Development Goals”? The case of the West African Economic and Monetary Union (WAEMU). 2011. halshs-00557005

HAL Id: halshs-00557005

<https://halshs.archives-ouvertes.fr/halshs-00557005>

Submitted on 18 Jan 2011

HAL is a multi-disciplinary open access archive for the deposit and dissemination of scientific research documents, whether they are published or not. The documents may come from teaching and research institutions in France or abroad, or from public or private research centers.

L'archive ouverte pluridisciplinaire **HAL**, est destinée au dépôt et à la diffusion de documents scientifiques de niveau recherche, publiés ou non, émanant des établissements d'enseignement et de recherche français ou étrangers, des laboratoires publics ou privés.



CENTRE D'ÉTUDES
ET DE RECHERCHES
SUR LE DÉVELOPPEMENT
INTERNATIONAL

Document de travail de la série

Etudes et Documents

E 2007.20

**Can domestic debt contribute to the financing of the
“Millennium Development Goals” ? The case of the West
African Economic and Monetary Union (WAEMU)**

by

Samuel Guerineau and Sylviane Guillaumont Jeanneney*

July 2007
27 p.

* CERDI, CNRS-Université d'Auvergne - 65, boulevard François Mitterrand
63000 Clermont-Ferrand, France
e.mail: S.Guillaumont@u-clermont1.fr

Abstract:

Developing countries are being urged to extent public spending to reach The Millennium Development Goals (MDGs). Following a series of debt cancellations, the public debt of many developing countries has reached low levels, so that external borrowing is a plausible option. However, developing countries can not exclusively rely on external financing. Consequently, is an increase in the domestic debt possible and desirable? This paper investigates this issue in the case of the West African Economic and Monetary Union (WAEMU), of which several countries have benefited from important debt cancellations. We show that an increase in the domestic debt is feasible for some of the WAEMU countries since 1) there exist excess bank liquidity and foreign reserves which involve a low cost for public finance, 2) the main macroeconomic risks (debt distress, crowding out of private investment and real exchange rate appreciation) can be averted and 3) absorptive capacity may be enlarged by giving larger role to regional institutions or local communities.

1. Introduction

The Millennium Development Goals (MDGs) initiative launched in 2000 by the United Nations was aimed at significantly reducing poverty in the developing countries by the year 2015. For this purpose eight objectives were defined by the international community¹, and the governments of the industrialized countries simultaneously commit themselves to increase their official development assistance (ODA). However, five years after this initiative, one could note the gap between the financial needs to attain the Millennium Goals and the expected increase in the international assistance.

How to increase the resources of developing countries in favour of MDGs? This issue has given rise to the concept of fiscal space (Heller 2005a, 2005b, Chambas, 2006). Simultaneously the concern appeared of an increased aid dependency of developing countries. Several negative effects of a too broad recourse to the external assistance were identified in the literature. The first effect is exerted on private saving as external financing is supposed to grasp the better investment opportunities and thus has a detrimental impact on financial system deepening. The second crowding out effect relates to tax resources. Insofar as the governments are accountable to foreign donors rather to the national population, their legitimacy to collect revenue is lessened. Moreover aid may be the source of rent seeking activities or even corruption. Finally aid dependency may lessen domestic institutions which are now considered as an important factor of economic growth. The negative effects of foreign assistance could justify a balance between internal and external resources (Guillaumont and Guillaumont Jeanneney 2006).

An increase of tax resources and a reallocation of public expenditure in favour of MDGs may appear desirable, but in most Low Income Countries this scope of fiscal space would be narrow. A significant reduction of poverty cannot be carried out without economic growth, and a large increase in the tax pressure is likely to be unfavourable to growth. A better effectiveness of public expenditure is necessarily a long term objective. Therefore the matter of public domestic borrowing is becoming relevant.

¹ 1) Eradicate extreme poverty and hunger, 2) achieve universal primary education, 3) promote gender equality and empower women, 4) reduce child mortality, 5) improve maternal health, 6) combat HIV/AIDS, malaria and other diseases, 7) assure environmental sustainability, 8) develop a global partnership for development.

With the heavily indebted poor countries initiative (HIPC initiative), supplemented by the multilateral debt relief initiative (MDRI), many low income countries benefited, during the last years and very recently with regard to the second initiative, of important cancellations of their foreign debts whose volume was thus strongly reduced. While at the same time the international community wonders whether loans to the low income countries may be abandoned in favour of grant only (Cohen *et al.*, 2006), the governments of the developing countries can be tempted to borrow locally. Up to what point is it desirable?

The answer is certainly specific to each country. We will be interested in the countries belonging to West African Economic and Monetary Union (WAEMU), *i.e.* Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Togo and Senegal, which all, except for Côte d'Ivoire, belong to the category of the "least developed countries" (LDCs). First, these countries are still far from achieving the Millennium Development Goals. Second, they belong to the Franc Zone and therefore enjoy a greater monetary stability than the majority of the other low income countries (Guillaumont Jeanneney 2007). After having rehabilitated their banking system, they adopted as soon as the eighties a policy of financial liberalization, so that their banks, monitored on a regional basis, appear as a whole healthy and liquid. In addition WAEMU countries set up a regional financial market which experienced a certain development during the last years. This situation *a priori* seems to allow the governments of these countries to borrow domestically. Finally these eight countries receive already an important international assistance, which could lead them to seek a less aid dependency.

If the governments of WAEMU increase their internal debt in the next years in order to accelerate the achievement of the MDGs, they will incur several kinds of risks. First, it is possible that their debt become non sustainable, all the more that the domestic borrowing cost could be above the foreign one. Second, domestic borrowing might induce macroeconomic imbalances (involving a raise of interest rates and an overvaluation of the real exchange rate) which would not be limited to the borrowing state but would hurt all the WAEMU countries. Third, there is a risk that the increased public expenditures be less effective and weakly contribute to the achievement of the MDGs.

We will successively investigate these potential drawbacks in terms of public finance sustainability, macroeconomic imbalances and domestic expenditure effectiveness and try to define how to minimize them. We will analyse if belonging to an economic and monetary union is an advantage from this point of view.

2. Is an increase in the domestic debt of WAEMU countries a danger for their public finance?

The feasibility and the cost of a domestic indebtedness of WAEMU states, depends on two constraints: the monetary situation of the union and the size of their public debt.

2.1 The monetary situation of the Union, favourable to domestic loans at low cost.

The WAEMU governments already called upon public savings by issuing Treasury bills or bonds on the regional financial market (Regional Securities Exchange Market (BRVM) in Abidjan). The first issue of bonds with a 3 years maturity was carried out by Côte d'Ivoire in 2002. In September 2006, the stock exchange capitalization amounts to CFAF 2144 billion, of which 33% are debt securities. The public securities represent CFAF 277 billion, *i.e.* 13% of market capitalisation and 39% of the stock of debt securities².

The relatively weak share of public issuing in the total of the call to savings suggests that there is a potential for domestic borrowing. Two characteristics of the monetary situation of the WAEMU reinforce this assumption: the first is the excess liquidity in the consolidated banking system of the Union, the second is the size of the foreign currency reserves held by the common Central Bank (BCEAO). Both characteristics are the two faces of a same phenomenon. But even if domestic borrowing is feasible, the main question remains its cost compared to that of foreign debt.

a) Excess liquidity of the commercial banks of the Union

Excess liquidity is reflected in the fact that BCEAO finance the banks very little. In September 2006 Central Bank refinancing amounts to 0.1% of the credits to the private sector, and that in only three countries, Benin, Burkina Faso and Niger. The rate of required reserves hold by commercial banks with the Central Bank (required for sight deposits, short-term loans, including agricultural loans and bank assets held abroad) is ranging from 3% to 15 % according to the countries. For the Union as a whole, accumulated reserves beyond minimum reserve requirements averaged 124% of the required reserves during the period 2002-2004.

² They are Treasury bills issued in 2006 by Benin, Guinea-Bissau, Senegal and Burkina-Faso with maturities of 6 and 12 months and bonds issued by Burkina-Faso in 2003, Côte d'Ivoire in 2005 and 2006, Senegal in 2003 and 2005 and Togo in 2006, with maturities of 3 or 5 years.

The free reserves decreased since 2004 (49% of the required reserves in September 2006). (cf. Table 1) In spite of this fall, free reserves remain high, particularly since the rate of reserve requirements set by the BCEAO is high because of the size of the voluntary reserves and it could be lowered if necessary³. As a comparison free reserves are equal to 80% of the market capitalisation of public securities.

Table 1: Free reserves of the banks and foreign reserves of the Central Bank (end-year)

| | Free Reserves | Required Reserves | Free Reserves (% Required Reserves) | Gross external assets of BCEAO | |
|------|---------------|-------------------|--|--------------------------------|---------------------|
| | | | | CFAF billion | (months of imports) |
| 2001 | 186 | 216 | 86,1 | 3011 | 6,8 |
| 2002 | 348 | 275 | 126,5 | 3732 | 8,0 |
| 2003 | 371 | 306 | 121,2 | 3735 | 7,8 |
| 2004 | 430 | 348 | 123,6 | 3730 | 7,3 |
| 2005 | 204 | 420 | 48,6 | 3769 | 6,6 |
| 2006 | 220* | 446* | 49,3* | 3966 | 6,7 |

* end of September data

Source: BCEAO, *Monetary and Financial Statistics Bulletin* November 2006.

The excess liquidity of the banks shows their reluctance to take risks by making loans to the private sector. This reluctance is not conducive to a more intensive mobilization of resources to promote growth by public or private enterprises. Nevertheless, the excess liquidity in the banking system of the Union as a whole shows that greater recourse by Governments to domestic borrowing is possible. Still it is necessary that this borrowing does not involve an excessive puncture on the foreign reserves of the Union.

b) Size of the foreign reserves of the BCEAO.

The prohibition on banks from placing their excess liquidity outside the Union is the reason why the excess liquidity in the banking system of the Union takes the form of central currency and results in the high levels of external reserves of the Central Bank (cf. table 1). This accumulation of foreign currencies (88% of its assets in September 2006) reflects the patrimonial behaviour of the BCEAO which draws a high yield from them. Indeed the BCEAO places the main part of its foreign reserves on its “operations account” with the French Treasury which remunerates them by the rate of the marginal lending facility of the

³ Free reserves are almost null in the Eurosystem.

European Central Bank. This rate, which is the ceiling rate for the refinancing of the European banks, is higher by one hundred points than the main refinancing operative minimum bid rate; after having moved between 4.25% and 4.75% in 2000-2001, it was gradually lowered and was maintained at 3% between June 2003 and December 2005, then was gradually raised to reach 4.75 in March 2007; this rate is favourable since it is higher than the 3 months deposits rate in Europe (EURIBOR). It is higher than the rate used by the central bank for the refinancing of the commercial banks as since 2002 the BCEAO has followed the European Central Bank and thus has gradually lowered its pension rate which is 4.25 at the present time. Moreover, the BCEAO, like the other central banks of the Frank Zone, benefits from insurance for the value in SDR of its deposits in “operations account” given by the French Treasury. Thus the depreciation of the euro vis-à-vis the SDR over the period 2000-2002 led the French Treasury to strongly compensate the central banks of the Franc Zone⁴. Admittedly this remuneration should not occur again in the near future. Moreover, according to new agreements made in 2006, the French Treasury does not guarantee any more the value in SDR of the “operations account” deposits above required deposits, which, from 65% of the Central Bank foreign reserves was lowered to 50%, and the favourable interest rate will not apply any more but to the required deposits. Thus the benefit drawn from the holdings of reserves by the BCEAO should decrease in the future.

Paradoxically, the WAEMU banking system places savings abroad⁵, even though the Union is characterized by a need for financing, since its current account is in deficit (CFAF 1.338 billion in 2005, that is to say 5.5% of the Union consolidated GDP). If banks increased their purchases of public securities, that would reduce foreign reserves automatically. The benefit of the central Bank would be reduced and possibly the dividends distributed to the Member States (corresponding with seigniorage), but as those dividends are small⁶ (and badly reported), that would come to reduce only marginally the increase in the financial resources resulting from the issue of public securities. The question is thus to know if the foreign reserves of the Union are excessive and could be reduced without drawbacks.

⁴ This compensation accounted in development aid by the Development aid Committee DAC amounted to 450 euro billions for the two Central Banks of Franc Zone (BCEAO and BEAC). Cf. *France Memorandum to the DAC*.

⁵ This situation, however, is not peculiar to WAEMU. It is also the case in numerous countries mainly in Asia (Lawrence H. Summers, “Reflections on Global Account Imbalance and Emerging Markets Reserves Accumulation”, L.K. Jha Memorial Lecture, Reserve Bank of India, Harvard University. The countries of the franc zone are rather an exception in Africa.

⁶ Before being distributed to the states, the BCEAO benefits may be placed in BCEAO reserves or used to finance buildings, joint projects and regional financial institutions,

Academic studies on the adequate level of a country's external reserves refer to the purpose of foreign reserves held by the Central Bank. When a temporary negative external shock on the balance of payments occurs, the existence of sizeable reserves averts a brutal adjustment of the economy that would lead to a drop in economic activities. However, reserves holdings have an economic cost insofar as they require a balance of payments surplus, which means that the economy is not using all of the resources derived from exports, from the net revenue of factors and from net capital inflows. They also incur a financial cost which must be balanced against the security that they bring if the yield from foreign investments is lower than the return on domestic loans. In point of fact as we have seen above for BCEAO the first one is now higher than the second one (+0.25%).

This problematic which concerns the purpose of the reserves, does not fully apply to WAEMU. Indeed the security which the monetary authorities of other countries are tempted to seek in a broad basket of foreign currency reserves is already achieved by the agreement governing the "operations account" that links the French Public Treasury to the BCEAO and which permits the Bank's foreign reserves to become negative when faced with an adverse external shock. The objective of the Franc Zone agreements is in fact to ensure that African countries do not have to brutally adjust their exchange rates and to suspend the convertibility of their currency in the face of negative shocks, knowing that they would then be required to take some measures in order to gradually improve their balance of payments position (article 51 of the statute of BCEAO)⁷.

If, however, the criteria that are traditionally used to judge "an adequate level" of reserves are applied to the reserves of WAEMU, these last ones would appear to be excessively high. Since the main source of vulnerability of the balance of payments of countries which maintain exchange control in capital movements (which is the case of WAEMU) lies in the trade balance, it is usual to compare the amount of available reserves with imports. In the WAEMU, the gross exchange reserves held by the BCEAO correspond in 2006 to more than six months worth of imports after having amounted until eight months in 2002 (see table 1), while it is generally considered that they should cover three to four months. We recognize,

⁷ It should be added that, according to article 12 of the Treaty establishing WAEMU, the monetary and credit policy of the Union is set by the Council of Ministers "to ensure the safety of the common currency and to provide funding for activities and economic development of the members of the Union".

however, that many countries have higher levels of reserves, especially in the emerging countries of Asia and in Latin America.⁸

It is also common to compare reserves to the money supply because of the risk of an exchange crisis triggered by a rush on bank deposits. While this risk is quite low in WAEMU, the ratio of gross reserves to money supply is 60% in September 2006. It is comparatively higher than in Asia (30% on average) and roughly at the same level as in Latin America (50%)⁹.

These various ratios seem to indicate at least a comfortable level of exchange reserves of the WAEMU. However this judgement must be moderated by the fact that the reserve holdings were accompanied by an accumulation of external arrears by Côte d'Ivoire, and to a lesser extent by Togo and Guinea-Bissau. In addition reserve holdings would be obviously much less important if the external position of the banks were not regulated.

c) The cost of borrowing

The excess liquidity of the WAEMU banking system and the expectations of exchange rate stability induce relatively low interest rates on the regional financial market. Indeed the interest rates of the Treasury bills issued in 2006 by Benin, Burkina Faso Guinea-Bissau and Senegal are spread out for 2006 between 3,20 % and 6% and the interest rate of the bonds issued by Côte d'Ivoire et Togo in 2005 or 2006 amounts to 6,5%, while Senegal has obtained a rate of 5,5%. Therefore there exists a positive gap compared to the yield of five years public bonds in the European Monetary Union which amounted on average to 2.85% in 2005 and 3.66% in 2006. However the WAEMU rate remain low when they are compared to other developing countries¹⁰ or the rates of international bank loans.

Whatever it is, the cost will be higher than that of concessional loans of bilateral or multilateral donors (and obviously than foreign grants). But borrowing in local currency does not involve any risk of exchange contrary to a debt expressed in dollar or even in euro as a devaluation of the CFA franc is possible. Moreover the governments may consider that

⁸ cf. an IMF study, "Chile: Selected Issues", July 2004

⁹ Moreover, according to the statute of the BCEAO (article 51), the rate of coverage of central money, in other words, the ratio between gross exchange reserves and Central Bank sight instruments, should not fall below 20%. This percentage is evidently not optimal, but nevertheless constitutes a floor that would activate restrictive monetary measures. However, this ratio was 120% in December 2005, a figure that is often cited to justify the higher level of reserves but which has no major significance for our purposes.

¹⁰ For instance, the interest rate on 10-year Treasury bond was around 6% in Brazil, Chile, Colombia and Peru, 7% in India, and above 10% in Uganda on a 3-year Treasury bond.

development assistance is too small or bound by too strict conditions. The main risk is then the non sustainability of the public debt.

2.2 The risk of an unsustainable debt

The increase in debt is a possible solution only if the debt remains sustainable, *i.e.* if the State preserves in the long term the capacity to ensure the service of its debt. This capacity is driven by the evolution of the primary fiscal balance, the real cost of the debt and the rate of the economic growth.

One can express the relation between the ratio of debt on the one hand and the fiscal balance, the real interest rate and the economic growth on the other hand, in the following way:

$$\frac{B_t}{YP_t} = \frac{G^*_t}{YP_t} - \frac{T_t}{YP_t} + \frac{B_{t-1}(1+r)}{Y_{t-1}P_{t-1}(1+\pi+\gamma)}$$

where B represents the stock of debt, Y the domestic product at constant prices, P the general level of prices, G* the current public expenditure except interests of the debt, T the public receipts, π the rate of inflation, r the nominal interest rate, γ the growth rate of the economy and t the period.

The debt ratio (the left member of the equation) depends on the rate of the primary fiscal deficit, of the initial level of the debt and of the ratio $\frac{1+r}{1+\pi+\gamma}$. If the growth rate of the economy γ is higher than the real interest rate ($r-\pi$), the previous ratio is lower than one: a stability of the debt ratio is compatible with a primary deficit. This is the situation of the WAEMU countries since the main part of the external debt is made at concessional rates and that the real interest rates on the domestic debt are weak - as we have seen previously- and thus generally lower than the growth rate of the GDP.

To analyze the sustainability of the debt, it is necessary to forecast the evolution of its various determinants. Economic growth acts on the level of the revenues drawn from taxes (for a given tax rate) and thus on the fiscal balance for a given volume of public expenditure G*/P. Taking into account economic growth, fiscal policy (tax pressure and rate of public expenditure) and debt conditions, it is possible to anticipate the debt level and to compare it to a debt-burden threshold. Such is the approach that the Bretton-Woods Institutions have adopted to analyze the “sustainability of the debt” of the developing countries (Debt

Sustainability Analysis, DSA). They carried out this analysis recently for the WAEMU countries except for Côte d'Ivoire and Togo (cf. table 2). These forecasts have the drawback to relate only to the external debt, for which the data are most easily available. The debt-burden thresholds relate to two indicators, the net present value (NPV) of the public external debt (expressed as a percentage GDP or exports) and the debt service (expressed as a percentage exports or tax revenue). In the DSA, debt-burden thresholds are defined according to the quality of policies and institutions as measured by the Country Policy and Institutional Assessment (CPIA), calculated by the World Bank. According to this indicator the strength of policies and institutions is considered as "medium" for Benin, Mali and Niger, which induces a threshold of the stock of NPV debt equal to 40% of GDP and 150% of exports and a threshold of the debt service equal to 20% of exports and 30% of the tax revenue. The strength of policies and institutions of Burkina-Faso and Senegal being considered as "strong", the ceiling of the NPV debt is raised to 50% of GDP and 200% of exports, and the ceiling of the debt service is changed to 25% of exports and 35% of the tax revenue.

Five countries (Benin, Burkina Faso, Mali, Niger and Senegal) have profited from important cancellations of debt within the framework of initiatives HIPC and MDRI, so that their debt is weak. On the contrary Guinea-Bissau, Côte d'Ivoire and Togo which did not profit yet from debt cancellations have at the present time a level of debt definitely unsustainable. Therefore we will focus on the first five countries (table 2). The profile of their debt is established with assumptions of a growth slightly higher than the growth observed during last years. The assumptions on the fiscal policy vary from one country to another: an increase in the tax pressure is assumed where it is lower than 17%¹¹ and stability is assumed in the other cases, as well as an increase or a reduction in the rate of the public expenditure according to its current level. As for the financing of the deficit, it is assumed to maintain unchanged the share of external grants. As the domestic debt ratio to GDP is supposed constant, the external debt, supposed itself on average very concessional, is the adjustment variable. The net present value (NPV)¹² of the external debt for the five above mentioned countries ranges in 2006 between

¹¹ Which is the standard of the Pact of convergence, stability, growth and solidarity adopted in 1999 by the WAEMU states; see below.

¹² The net present value (NPV) of debt is the discounted value of the projected debt service payments. The choice of the discount rate is critical for the estimates of the NPV. The discounting is made using currency-specific discount rates. In the case of loans from the IBRD (currency pool loans), IDA and IMF, the rate used is the Special Drawing Rights (SDR) rate. In the case of loans from other multilateral institutions, the interest rates charged on non concessional loans is used. Loans from bilateral and commercial sources are discounted by the Commercial Interest Reference Rates (CIRR) agreed by OECD for officially supported export credits. They are on average the most favourable non concessional rate of interest that borrowing countries would be able to

10% and 27.5% of GDP and the debt service lies between 5% and 6.8% of exports. Projections of these indicators over the ten next years indicate a fall for Senegal, a stabilization for Benin and Mali, and a progressive increase for Niger and Burkina-Faso, which does not call into question the respect of the thresholds chosen by the DSA. For all the countries the debt, such as it is predicted until 2015, is assumed far from the maximum sustainable level¹³.

Data on domestic debt are unfortunately much scarcer than those concerning the external one. A recent study of the IMF and the World Bank proposes a statistical analysis of the level of the domestic debt for a sample of 66 low income countries over the period 1998-2004, but does not provide exhaustive country-level data (IMF and World Bank, 2006). Over this period, on average the domestic debt amounts to 21.3% of the total debt and for 2/3 of the countries it represents less than 25% of the total debt. For the three countries of the WAEMU for which we could obtain the data, the internal debt accounts for a weak fraction of the total debt, approximately 7% for Senegal and less than 5% for Mali and Benin. We remind that Côte d'Ivoire still has payment arrears on the domestic debt in 2006.

Even if one raises from 5 to 7 points of percentage the debt ratio to GDP (since domestic debt imply the charge of a market interest rate, NPV and face value of the debt are similar) the levels anticipated for 2015 are lower than the debt-burden threshold defined by the Bretton-Woods Institutions. Compared to the level of 2015, there remains a margin of indebtedness of about 36% of GDP for Senegal, 30% for Burkina, 21% for Niger, 25% for Benin and 11% for Mali . Of course, since the cost of internal borrowing is higher than external one, the rise of the debt-burden indicator would be faster by using internal debt. For instance an additional debt from IDA of 100 will incur an increase in the NPV of debt of only 33 (against a 100

obtain in each currency market. (cf. IDA and IMF, 2006, *Heavily Indebted Poor Countries (HIPC) Initiative – List of Ring-Fenced Countries that Meet the Income and Indebtness Criteria at end 2004*, April 11, p.19.

¹³ Moreover the diagnosis of debt sustainability proposes (except for Burkina-Faso) an analysis of the sensitivity of the trajectory of the indicators to shocks (product or exports drops, depreciation of the exchange rate, loan cost rise etc.). These sensitivity tests indicate that Niger and Mali remain vulnerable to exogenous shocks (rise of the interest rates and fall of exports) whereas the vulnerability of Senegal and Benin seems more moderate. It is possible also that Niger would not be able to increase its tax pressure and Mali to reduce its expenditure as it is expected. The estimated dynamics of the debt in Burkina-Faso also suggests a rather strong vulnerability of this country, in particular with an unfavourable evolution of exports, since the NPV debt would represent nearly 150% of exports since 2010.

increase with internal debt)¹⁴. In other words, the increase in the debt indicator is three times as fast by using internal debt. This additional cost may be acceptable for a share of the debt if this provides some insurance on exchange rate risks and reduces aid dependence.

Table 2: External debt sustainability Indicators (2002-2015)

| (expressed in %) | | Threshold | before HIPC 2002-2004 | after HIPC 2005 | after MDRI 2006 | Margin | 2010 | 2015 |
|---------------------|----------------------|-----------|-----------------------------|--------------------|--------------------|--------|-------|-------|
| Benin | NPV debt/GDP | 40% | | | 11 | 29 | 12 | 15 |
| PPTTE:2003 | NPV debt/exports | 150% | | | 86 | 25 | 80 | 81 |
| IADM: 2006 | Debt service/exports | 20% | 18 | 12 | 5 | | 5 | 4 |
| Burkina Faso | NPV debt/GDP | 50% | 17,5 | 18,3 | 10,5 | 39 | 16,6 | 19,6 |
| PPTTE:2003 | NPV debt/exports | 200% | 164,6 | 186,1 | 96 | 30 | 144,4 | 151,1 |
| IADM: 2006 | Debt service/exports | 25% | 8,3 | 7,8 | 5,1 | | 5,1 | 6,5 |
| Mali | NPV debt/GDP | 40% | | 27,2 | 27,5 | 12 | 28,3 | 29,3 |
| PPTTE:2003 | NPV debt/exports | 150% | | 105,2 | 95,6 | 11 | 102,8 | 126,3 |
| IADM: 2006 | Debt service/exports | 20% | 6,3 | 7,4 | 6,8 | | 6 | 4,7 |
| Niger | NPV debt/GDP | 40% | | 21,9 | 7,9 | 32 | 13,7 | 19,1 |
| PPTTE: 2004 | NPV debt/exports | 150% | | 136,4 | 45,6 | 21 | 70,9 | 98,5 |
| IADM: 2006 | Debt service/exports | 20% | | 9,3 | 2,2 | | 2,5 | 2,8 |
| Senegal | NPV debt/GDP | 50% | 35,5 | 28,2 | 27 | 23 | 23,3 | 13,8 |
| PPTTE: 2004 | NPV debt/exports | 200% | 124,7 | 113,6 | 103,1 | | 92,4 | 73,5 |
| IADM: 2006 | Debt service/exports | 25% | 10,2 | 5,6 | 6 | | 5,2 | 3,4 |

Sources: IMF, Debt Sustainability Analysis (DSA), drawn from:

IMF, 2006, *IMF Country Reports*: Burkina-Faso (n°06/359, October); (Guinea-Bissau (n°06/312, August); Mali, (n°06/73, March); Senegal (n°06/12, March et n°06/274, July)
IMF, 2007, *IMF Country Reports*: Benin (n°07/06, January); Niger (n°07/13, January).

In conclusion, the analysis of the sustainability of the external debt of the WAEMU countries and the level of their domestic debt confirm that five countries (Benin, Burkina-Faso, Mali, Niger and Senegal) have a potential of domestic borrowing. Thus they could increase their public expenditure in favour the MDGs or reduce their aid dependency without excessively increasing the cost for public finance. However the margin is probably more dubious for the countries most vulnerable to the external shocks (Burkina-Faso, Mali and Niger). For Côte d'Ivoire, Guinea-Bissau and Togo, a new domestic debt is clearly contra-indicated since these countries have accumulated arrears of payment and do not meet the conditions allowing cancellations of the debt within the framework of HIPC and MDRI initiatives. Admittedly

¹⁴ The NPV value is calculated with the current IDA terms (as of July 2006), *i.e.* 40 years maturity and 0,75% interest rate, but also 10 years of grace period, 2%-a year of principal repayment during the next 10 years and 4%-a-year of principal repayment during the last 20 years.

Côte d'Ivoire and Togo succeeded in borrowing recently on the regional market with good financial conditions, but in the future such a financing appears quite uncertain.

Even if the present situation of public finance allows domestic borrowing, are there actually any macroeconomic dangers?

3 May an increase in the domestic debt of WAEMU countries induce macroeconomic imbalances?

Theoretically an increase of budgetary deficit thanks to domestic loans meets the risk of crowding private investment and exports through a rise of interest rate and an overvaluation of real exchange rate.

3.1 The risk of private investment crowding out

The expansion of the fiscal space in favor of the Millennium Development Goals through domestic borrowing run the risk of discouraging private investment and therefore slowing growth while at the same time the reduction of poverty depends on the rate of the growth. Indeed by increasing its domestic borrowing a government contributes to raise interest rates. In the near future, this risk seems low in WAEMU for three main reasons. 1) The situation of excess- liquidity where are the WAEMU banks shows that they do not find a safe and profitable use of their whole resources; consequently public borrowing will not come to cut down the private savings devoted to firms. In a certain sense WEAMU countries are in a Keynesian liquidity trap. 2) Issuing of public securities will contribute to financial diversification and thus is likely to encourage the households to save more and especially to invest their savings in the regional financial market instead of investing them in goods or abroad. 3) In the framework of MDGs, public investments are complementary to private investments to a certain extent, as it finances infrastructures and human capital which raises the profitability of private capital¹⁵.

Nevertheless, this risk of investment crowding out cannot be completely excluded if domestic borrowing was important and long-lasting. Thus it would be useful to accompany this borrowing by a policy aiming at three targets: promoting the expansion of private savings, and

¹⁵ See for instance Gupta *et al.* (2003) and Sachs *et al.* (2004).

more particularly savings earmarked in investment in financial assets and finally in public assets. The rate of private savings is largely determined by structural factors (economic, demographic and socio-political), not easily modifiable in the short run (in particular development level and distribution of income) and by the stability of the political context, on which safety of private property rights depends. The policies which support economic growth and the stability of the economic and political context are not specific to the financing of public expenditure; this is why we focus here on the measures concerning the banking participation by households and the channelling of savings towards the States.

Households' banking participation depends on the accessibility of the banking services, of the remuneration of the deposits and the risks associated with these deposits. Thanks to the monetary stability in the union and to the regional monitoring of the banks, confidence of households in the banking system is high and, since the liberalization of credit and deposit conditions, the banks offer positive real interest rates. In medium term, the main issue is a better accessibility of households to the banking services. This improvement could be based on the extension of the range of the financial services, in particular the supply of bank accounts better suited to the poor households than the traditional accounts (Claessens, 2005) and the supply of services facilitating the transfers of the migrant workers. It would be also useful to improve the geographic coverage of banking services in the rural zones, for example by using already existing networks such as the postal network or the networks of retail trade. The support on existing networks permits to limit the overheads associated with these banking services and thus not to exclude the poorest households. Progress of the elimination of illiteracy waited within the framework the MDGs should increase the capacity of the poorest households to manage a banking account.

Naturally it is not sufficient to increase financial savings. It is also necessary to channel it to the States. Channelling of capital to the public sector must be based both on the strengthening of confidence in the financial stability of the States and on the modernization of the financial techniques used in Government borrowing. In the area of debt management, the main aim is to diversify the paper issued. For example, it would be useful to issue indexed bonds (on a price index or the trading price of the euro), as many developed countries (for example the United States of America or France) do. Such an arrangement could overcome the reluctance on the part of those, especially non-residents, who fear becoming victims of a devaluation of the CFA franc. Later on, it would undoubtedly be interesting to develop the capacity of the local communities to mobilize borrowed resources (cf. *infra*).

3.2 The risk of Dutch disease and export crowding out

It is well known that an abrupt surge of external resources, due for example to an improvement of the terms of trade, a discovery of natural resources, foreign direct investments or foreign assistance, can be at the origin of a “Dutch disease”¹⁶. The reasoning is simple: if the surge of external resources is not completely absorbed by additional imports, it involves an increase in the demand of non tradable goods. If there is not unemployed output capacity in this sector, the demand increase induces a rise of the relative price of these goods, in other words an appreciation of the real exchange rate and a loss of competitiveness. This real appreciation is evidenced in particular by the rise in the real remuneration of skilled work because this last one is a scarce production factor in developing countries; it is thus likely to affect the industrial sector or services using a modern technology and particularly demanding of skilled work (Rajan and Subramanian 2005).

An increase in the public domestic debt can exert a similar effect when it is carried out on a regional financial market (rather than national) or if it is carried out in an over-liquid economy so that the withdrawal of domestic saving does not involve a reduction of the private expenditure able to slow down the rise of non tradable prices, which is the assumption made previously for the WAEMU countries. In these last ones, if the increase in public expenditure relates to importable goods, it will be without influence on the price level of these goods, since the currency is convertible; it will involve only a reduction in the external reserves which are in excess. On the other hand, if the additional public expenditure relates to non tradable goods, it is likely to induce a rise in their price, an appreciation of the rate of real exchange and a loss of competitiveness of the economy as the nominal exchange rate is fixed and defined at the level of the Union.

Two answers to this concern, relating to the evolution of the rate of real exchange of the WAEMU since the devaluation of CFA Franc in 1994 and to the possibility of directing the additional expenditure towards productivity gains. The 50% devaluation of CFA Franc have induced a large real depreciation of the currency because of the good control of inflation due to the relative autonomy of the BCEAO and to the commitment of the States in favour of

¹⁶ Analyses of « Dutch disease » are numerous (see for instance Collier and Gunning, 1999).

monetary stability within the framework of the Franc Zone agreements. In 2005 the benefit of competitiveness given by the devaluation had not been lost, in spite of the nominal appreciation of the euro with respect to the dollar, even if the situation differs from one country to another. Table 3 presents the evolution since 1980 of three indices of real effective exchange rate which differ by the weighting granted to foreign countries partners. The first index refers to a weighting according to the origin of the imports and thus reflects the impact of the exchange rate on the competitiveness of the local producers on the domestic markets. For countries mainly exporting primary products a weighting according to the geographical destination of exports would not be relevant since these products in fact are sold on international markets. To appreciate the impact of the rate of exchange on the competitiveness of the WAEMU countries on external markets, it is preferable to consider the export competitors. Thus the two following indices use a double weighting according to the categories of exported products and main world exporters of these products, by distinguishing the primary products on the one hand and the manufactured goods on the other hand (cf. notes to table 3).

The three indices of real exchange rate give similar results. In 2005 three countries among the five countries for which it seems to us there is a reasonable opportunity to resort to domestic debt, that is to say Burkina, Mali and Senegal, have a real effective exchange rate which significantly remains lower than the pre-devaluation level (from 25 to 30%). On the other hand the real exchange rate of Niger and Benin is only lower from 10 to 15% than the 1993 level. Côte d'Ivoire kept a 20% margin compared to the pre-devaluation level.

However, only the evolution of the real exchange rate is insufficient to refute the existence of an overvaluation. It may be indeed that the fundamental determinants of the equilibrium rate have changed since the reference period. Y Abdih and C.G. Tsangarides, (2006) presented an econometric analysis of the equilibrium real exchange rate of the WAEMU which shed light on this issue. Although the weighting, reduced to five competitors, is different from ours, the evolution of the real exchange rate is rather similar¹⁷. The authors proceed classically in two steps. 1) They estimate the real exchange rate in function of its fundamentals, which are terms of trade, government consumption as a share of GDP, the degree of control of the foreign

¹⁷ Y Abdih and C.G. Tsangarides use the real effective exchange rates calculated by IMF. As for CERDI indices the calculation uses the consumer price indices. But the weighting is relative to the import and export main partners and limited to five developed countries. The variables relative to the WAEMU are an average of Member States' variables weighted by their GDP. The real effective exchange rate of WAEMU in 2005 is 11% lower than the pre-devaluation level, which reflects the large weight of Côte d'Ivoire in the calculation.

trade (measured by openness, *i.e.* the ratio of foreign trade to GDP), the real GDP per capita relative to trading partners to capture the Balassa-Samuelson effect and the ratio of investment

Table 3 : Real effective exchange rates of WAEMU countries (1980- 2005)

(1990 = 100)

| Pays | TCER | 1980 | 1985 | 1990 | 1993 | 1994 | 2000 | 2005 |
|---------------|------------------|-------|-------|-------|-------|------|------|------|
| Benin | Imports | 117,0 | 94,6 | 100,0 | 98,4 | 72,6 | 82,0 | 91,6 |
| | Primary products | 169,5 | 83,2 | 100,0 | 104,2 | 73,7 | 73,3 | 93,6 |
| | Industry | 140,3 | 85,5 | 100,0 | 100,9 | 71,3 | 77,3 | 93,9 |
| Burkina Faso | Imports | 124,5 | 114,4 | 100,0 | 90,9 | 65,4 | 64,8 | 72,5 |
| | Primary products | 133,9 | 87,1 | 100,0 | 95,5 | 60,9 | 53,6 | 68,1 |
| | Industry | 122,5 | 96,7 | 100,0 | 94,6 | 59,7 | 57,2 | 69,5 |
| Côte d'Ivoire | Imports | 110,9 | 87,1 | 100,0 | 100,3 | 62,8 | 70,5 | 79,5 |
| | Primary products | 80,4 | 59,5 | 100,0 | 101,4 | 65,8 | 77,2 | 90,9 |
| | Industry | 111,4 | 76,1 | 100,0 | 97,3 | 61,7 | 65,1 | 78,8 |
| Guinea-Bissau | Importations | 147,8 | 118,2 | 100,0 | 84,8 | 80,2 | 87,3 | |
| Mali | Imports | 85,2 | 97,6 | 100,0 | 86,9 | 64,3 | 65,6 | 69,3 |
| | Primary products | 139,6 | 97,2 | 100,0 | 85,4 | 52,5 | 47,7 | 58,9 |
| | Industry | 130,3 | 107,6 | 100,0 | 93,3 | 57,9 | 55,5 | 63,9 |
| Niger | Imports | 127,9 | 113,1 | 100,0 | 79,4 | 62,3 | 59,9 | 68,1 |
| | Primary products | 150,4 | 115,3 | 100,0 | 83,5 | 54,7 | 58,0 | 62,7 |
| | Industry | 128,8 | 108,1 | 100,0 | 80,2 | 56,4 | 55,0 | 66,6 |
| Senegal | Imports | 106,8 | 109,9 | 100,0 | 89,1 | 59,3 | 60,9 | 63,2 |
| | Primary products | 90,4 | 88,5 | 100,0 | 88,6 | 58,8 | 53,1 | 63,5 |
| | Industry | 98,5 | 93,0 | 100,0 | 85,8 | 56,3 | 50,4 | 58,6 |
| Togo | Imports | 129,7 | 110,9 | 100,0 | 93,4 | 70,4 | 81,1 | 85,3 |
| | Primary products | 105,5 | 78,7 | 100,0 | 94,1 | 66,9 | 68,7 | 85,2 |
| | Industry | 118,6 | 90,7 | 100,0 | 88,9 | 64,5 | 70,4 | 82,0 |

Source : CERDI Data base

NB : Real exchange rates are a geometrical average of bilateral real exchange rates of WAEMU countries vis-à-vis their main trade partners (source Comtrade PCTAS-CTCI-REV3, 4 digits). These rates are calculated with the consumption price indices; a rise of the rate means an appreciation. The three categories of exchange rates differ in the choice and the weighting of partners. The "Imports" index is based on the geographical distribution of imports except petroleum (ten main partners in 1999-2003) The two following indices "primary products" and "industry" weight the bilateral indices by the ten main competitors of WAEMU countries in foreign markets for their main primary or manufactured exports (between two and twenty-four products average 1999-2003).

to GDP¹⁸. The estimate relates to the period 1970-2005 and uses the Johansen maximum likelihood procedure to test for the existence of a long-run co-integrating relationship between the exchange rate and its fundamentals. The coefficients of the explanatory variables are significant with the expected signs. During the recent period 2000-2005, the improvement of

¹⁸ The authors also include foreign direct investment to GDP as a proxy for capital inflows/ controls in the explanatory variables set, but the coefficient is not significant.

the terms of trade and the increase in the government consumption contributed to the real appreciation while the increase in the rate of investment and in openness and the reduction of the relative growth of per capita product are associated with a real depreciation. 2) In a second step, the authors extract the permanent components of the fundamentals from the series¹⁹ and combining these results with long-run relationship between real exchange rate and its fundamentals, they may calculate the equilibrium exchange rate and for each year as the difference between the observed rate and the equilibrium rate. It appears that in 2005 the WAEMU observed real exchange rate is slightly higher than the equilibrium rate, but the difference is not statistically significant.

Undoubtedly, in order to present an analysis free from any subjectivity, the authors do not give their opinion on the desirable level of the long-run fundamentals of the equilibrium real exchange rate. It is however a limit of their analysis insofar as an acceleration of growth and a more vigorous action in favour of the reduction of poverty could imply a larger openness and higher investment rate (that a broader recourse to domestic debt aims at supporting), which would justify a depreciation of the real exchange rate.

Even if one estimates that the current level of the real exchange rate of the WAEMU is not worrying, vigilance for the future is useful all the more that it is difficult in a monetary union to devalue the currency in order to correct an imbalance. Indeed a modification of the parity of the common currency requires a unanimous decision of the Heads of State, while at the same time all the economies of the union would not gain uniformly with such a decision. The judgement about the undesirable character of the real appreciation will crucially depend on the impact of the expenditure financed by the domestic loan on productivity. Indeed, if the additional public expenditure increases the production capacity of the sector of the non tradable goods, it contributes to slow down the rise of their prices. If it improves factor productivity in the sector of tradable goods, it contributes to compensate for the effect of the real appreciation on the competitiveness of the economy. This is why it is important that governments take care to maintain a balance between the public expenditure aiming at increasing output and factor productivity (spending in infrastructures of communication, training of the workers, spreading of new technologies for example) and expenditure assigned to the social sectors. The recurring expenses or investments in the education and the health of

¹⁹ The authors apply two different methods of screening: the Hodrick-Prescott filter and the Gonzalo-Granger decomposition.

children have a long-run effect on labour productivity while in the short run increased hiring in these social tends to raise the cost of skilled work.

It is also undoubtedly advisable to avoid abrupt modifications in the public expenditure which is likely to involve real exchange rate instability. When this last one is not anticipated by economic agents, it results in re-allocations of resources between sectors, expensive and unjustified in the long run; even anticipated, real exchange rate instability can lead to business bankruptcy in the presence of credit market imperfections. The unfavourable consequences of the instability of the rate of real exchange on the development of the foreign trade and in a more general way on economic growth are now well established (Guillaumont *et al.* 1999, Bleaney and Greenaway 2001). Domestic borrowing may give some leeway to national authorities to offset an unforeseen reduction in tax resources (due to an exogenous shock) or in aid flows and thus to smooth public expenditure (Heller 2005b). Still it is necessary that the governments build up a reserve either in the form of deposits in central bank or in the form of a potential for domestic borrowing.

3.3 How may a regional control cope with the risks of macroeconomic imbalances?

In a monetary union there are two reasons of promoting a regional control of fiscal policy of each government, the risk of non sustainability of the public debt (Beetsma and Bovenberg, 1999) and the macroeconomic consequences of budget deficits which justify a coordinated *policy mix* (Debrun, 2000, Villieu 2003). For the WAEMU countries the second issue is the more relevant, as for five counties the debt level is low and broadly under the maximum standard (70% of GDP), agreed by the WAEMU States in the pact of Convergence, Stability, Growth and Solidarity (known further as Pact of convergence), adopted in 1999.

In WAEMU governments' domestic borrowing actually comes up to three constraints: the first one related to the initial rules of the Monetary Union which is the counterpart of its belonging to Franc Zone; the second constraint results from the transformation of the monetary union in an economic one in 1994 and the objective of a balanced budget adopted in the Pact of convergence; the third constraint is due to the IMF agreements.

Initially the advances which the BCEAO can grant to the African governments were limited by its statutes (Art 14 to 16): the cumulated advances cannot exceed 20% of the budget

revenue of the past year. Moreover, after the transformation of the monetary union into an economic and monetary union, the governments took the commitment to reduce the overdrafts of the current account of the public Treasuries with the central bank to zero from 1998 to 2001; but in front of the difficulty encountered by all the government, except in Benin, to fill this engagement, the Council of Ministers decided in September 2002 the consolidation of the statutory advances at the level reached at 31 December 2002 and their repayment over the next ten years, the interest rate of the advances inside the ceiling being of 3% and lower than the rate of refinancing of the banks. In 2005 Côte d'Ivoire and Niger could not respect their engagement what shows that these States at least are subjected to a liquidity constraint²⁰. The only instrument through which a Member State could channel private savings is therefore the issuance of Government paper to which banks may subscribe.

However the Pact of convergence prevents the governments from issuing bills or bonds except for managing their existing debt. Indeed, according to the main "first criterion" of the pact of convergence the "base budgetary balance" must be zero or positive. Curiously enough, this balance is calculated as the difference between the budgetary income and total expenditure (including interest on debt) with the exception of investment expenditures financed from foreign resources, which formally excludes the funding of public investments from domestic savings and thus, to some extent, encourages governments to have recourse to external financing. But in 2006 only Benin and Mali are adhering to the criterion, *i.e.* two of the eight States and there is no true sanction to the violation of the criterion²¹.

Finally domestic borrowing is bounded by the commitments entered into with the International Monetary Fund. In July 2006 four "Poverty Reduction and Growth Facilities" were in force, granted respectively to Benin, Burkina Faso, Mali and Niger; Togo is without agreement while the agreements of Côte d'Ivoire and Guinea Bissau are suspended. As for Senegal, whose agreement 2003-2005 is closed, it has confirmed in February 2006 to the IMF that it was working towards the implementation of the new economic policy support programme (not financed by the Fund) which nevertheless includes conditionalities and reviews at regular intervals. Poverty Reduction and Growth Facilities generally include conditions relative to a positive base budgetary balance, calculated differently from the one

²⁰ Moreover, Côte d'Ivoire, Niger and also Togo and Guinea Bissau accumulated arrears of payments, contrary to the rules of the Pact of Convergence.

²¹ If the Convergence Pact is to retain any credibility, it would be better to improve the criterion than to accept its routine violation

used in the Convergence Pact, by not taking into account expenditures such as capital expenditures financed from external resources and also the temporary cost of structural reforms, and expenditures financed from HIPC (Highly Indebted Poor Countries Initiative) resources. Conversely countries benefiting from this last initiative and being in the transitory phase between the decision and the completion points (here only Guinea-Bissau) are not authorized to receive new loans on non-concessional terms from foreign lenders, while loans from financial institutions of the Union are exempt from this prohibition.

The tangle of the rules which surround the domestic indebtedness of WAEMU governments certainly complicates their task and, more important the rules don't allow a good "policy mix" As in Europe the application of the Convergence Pact comes up against two problems²⁹. The first is a slowing down of growth due to an excessive budget constraint, while per capita income growth in the Union as a whole is too low to achieve the Millennium Development Goals. The second is that of asymmetric shocks suffered by countries of the union and resulting in unequal performances, which make the very principle of nominal convergence debatable. The European pact was modified in March 2005 in order to give some flexibility in its implementation, by taking into broader account 1) cost of structural reforms that have positive effects on growth, 2) the expenditure of research and innovation or of European solidarity on the grounds that because of the future income from the investment its cost should be distributed over time, 3) situations of bad conjuncture.

Let us suggest some solutions In the WAEMU context. A first one would be to no longer include in expenditures for calculating the budget balance the share of investment from domestic resources beyond the 20% of tax revenues, since one of the Pact of convergence "second rank" criteria to observe is to allocate 20% of tax revenues to investment. Another modification would be to exclude from investment expenditures financed from domestic resources those devoted to regional projects. It could, for example, concern investment expenses made under the NEPAD (New Economic Partnership for African Development)²².

There are also business situations where a budget deficit is desirable. Recall again that the countries making up the WAEMU are economies exporting mainly agricultural products and

²⁹ Cf. Report of the Council of Economic Analysis, *Reforming the Growth and Stability Pact*, La Documentation Française, 2004.

²² The New Economic Partnership for African Development was launched by five African State leaders (South Africa, Algeria, Egypt, Nigeria and Senegal) in order to promote a integrated socio-economic framework for Africa development.

are, as a consequence, subject to exogenous shocks - often asymmetric - which render them extremely unstable (BCEAO, 2001; Fielding and Shields, 2001). In the presence of common exchange and monetary policies, the budgetary policy is the sole instrument which can respond to the specific conjunctures in each country. It is desirable that the national budgets can at least play the role of automatic stabiliser. A transitional deterioration of the terms of trade should lead normally to a deficit and an improvement to a surplus (Ary Tanimoun and Plane, 2005, Guillaumont Jeanneney, 2007).

In order that the States are encouraged to pursue a counter-cyclical policy, it would be desirable that the Pact of Convergence define, for the periods of improvement of the terms of trade, a target of fiscal surplus.²³ This fiscal surplus would allow governments to reduce their debt and would give them some margin to borrow when a deterioration of terms of trade occurs. Moreover a certain dose of budgetary federalism might allow the strengthening of national counter-cyclical policies.

4. How to prevent a misuse of additional public resources?

The issue of public expenditure effectiveness is at the heart of the fiscal space concept (Heller, 2005a). There is a concern about the absorptive capacity of domestic finance as well as foreign aid supposed to have decreasing returns (Guillaumont and Guillaumont Jeanneney, 2006, Bourguignon and Sundberg, 2007). In order to moderate this risk, one may reduce the role of central States to the benefit of regional institutions or local communities.

4.1 The regionalism

The regional way to finance MDGs by domestic loans has the advantage of neither implying reform of the Pact of convergence nor negotiation with the IMF. The WAEMU Commission (which is the Union executive) could borrow on the regional financial market to promote and carry out projects of regional interest. This solution should be acceptable for the whole of the countries. Indeed it would correspond to the principle of solidarity between the Member States which the pooling of the reserves expresses. Moreover it would meet the priority given

²³ The BCEAO, modulating the conditions of its purchases of public securities (Treasury bills or other bonds), should also contribute to the implementation of this counter-cyclical policy..

to regional investments, as underlined by the Regional Economic Program adopted by the Council of Ministers from May 2004 and it would perfectly fit the objectives of the New Economic Partnership for African Development (NEPAD).

The right to borrow is actually recognised to WAEMU by article 54 of the modified Treaty of the Union. The president of the Commission has received in November 2005 an agreement from the Regional Council of Public Saving and Financial Markets which underlined the deepening benefit that the regional financial market might draw from the issue of bonds by the Commission. The Union has own resources which should make safe the refunding of its loans: for the moment these resources are a fraction of the product of the common external tariff. The Treaty of the Economic and Monetary Union (art.55) provides that, in the medium term, new taxes (in particular a value added tax) could supply the budget of the Union. The resources of the Union are mainly used to compensate the Member States for the budgetary losses resulting from the drop of customs duties and to supply a “structural investments fund” which could guarantee debt servicing of the WAEMU. However these resources would need themselves to be protected (undoubtedly by a direct tax perception by the Commission as envisaged in the Treaty) in order to prevent some States in financial difficulty from omitting to pay back them to the Union, as it was the case of Côte d’Ivoire these last years.

From the same point of view, the African Western Bank of Development (BOAD) borrows on the regional market since many years in order to finance infrastructure projects of regional interest. Its role could increase, but its customers evolve from the public sector to the private one what is a healthy tendency.

Finally, being under the control of all member States, the quality of public expenditures might be higher than at the national level.

4.2 The decentralisation

The WAEMU governments have initiated, as in many developing countries, a movement of decentralization which aims at entrusting to the communes the responsibility for the local infrastructures and the management of most social services. One hopes that the proximity of local managers will better fit the population’s needs. But a good exercise of this responsibility, essential to the reduction of poverty, comes up against two constraints, the insufficiency of the financial resources of the majority of the communes and their low

technical and administrative capability. This is why the international creditors, in particular the World Bank, set up programmes which offer at the same time a financing and a technical aid to the communes (capacity building). The Senegalese “commune support programme” (1998-2005), implemented by the World Bank and to which various bilateral donors were associated, is a good illustration of the interest carried by the international community to decentralization.

An increased recourse to domestic debt to finance the MDGs on a local basis raises two questions. On the one hand, must borrowing be reserved to central States? The risk is that the transfers of funds to the communes are not up to the new functions transferred to them, which is the current situation in WAEMU countries. On the other hand, could urban communes borrow directly to banks? Within the framework of the above mentioned programme, the Senegal’s urban communes had the possibility of borrowing from a Municipal Development Agency in order to supplement the subsidies that the latter gave to them. The majority of communes have honoured their commitments. But that does not mean that the urban communes (and still less the rural ones) are ready to borrow from the banks and that banks would be prepared to grant them loans. The excellent loan repayment rates are explained both by the mix of subsidies to loans and by the technical support available to communes for evaluating their financial situation and for concluding “municipal contract” with the Agency and thus selecting their own investments. The improvement of the management of the communes and the increase in their own resources thanks to local taxation are the conditions of banking loans.

.4. Conclusion

The attainment of MDGs requires the mobilization of an important financing in next years; it is undoubtedly neither possible nor desirable that this financing be exclusively external. The question thus arises about the possibility and interest for the developing countries to increase the public domestic borrowing. This issue is examined within the context of the West African Economic and Monetary Union.

Our conclusion is that the monetary situation and the public finances of the Union would allow a widening of fiscal space by public domestic borrowing, either on a regional basis by the Commission, or by the five Member States (Benin, Burkina Faso, Mali, Niger and

Senegal) which respect the criteria of the Pact of Convergence relating to public debt and payment arrears.

The WAEMU situation illustrates the complexity of the sharing of the roles between the public actors of the development (regional union, national States, local communities). Our analysis has shown the potential risks of macroeconomic imbalances (rise of interest rates and overvaluation of real exchange rates) involved by domestic borrowing. It is why public expenditure pattern must preserve a balance between productive sectors and social sectors. If regional monitoring of fiscal policy and indebtedness remains essential, its modalities defined by the Pact of convergence, stability, growth and solidarity should be modified to allow more flexibility, realism and finally effectiveness. The advantages of the membership to an economic and monetary union seem to surpass its drawbacks.

References

- Abdih Y. and C.G. Tsangarides, 2006, "FEER for the CFA franc", *IMF Working paper*, WP/06/236.
- Ary Tanimoune, N., and P. Plane, 2005, "Performance et convergence des politiques économiques en zone franc", *Revue française d'économie*, Vol. XX, juillet, p.235-268.
- BCEAO, 2001, "Evaluation de l'impact des chocs exogènes récents sur les économies de l'UMOA", BCEAO, *Notes d'information et statistiques*, 512, mars.
- BCEAO, 2006, *Monetary and Financial Statistics Bulletin*, November.
- Beetsma R. and A. Bovenberg, 1999, "Does Monetary Unification Lead to Excessive Debt Accumulation?", *Journal of Public Economics*, Vol.74, p.299-325.
- Bleaney M. et D. Greenaway, 2001, "The impact of terms of trade and real exchange Rate Volatility on Investment and Growth in Sub-Saharan Africa", *Journal of Development Economics*, vol.65, n°2, p.491-500.
- Bourguignon F. and M. Sundberg, 2007, "Absorptive Capacity and Achieving the MDGs" in G. Mavrotas and A. Shorrocks (Eds), *Advancing Development. Core Themes in Global Economics*, Palgrave, in association with UNU WIDER, p. 640-663.
- Chambas G. 2006, (with Brun J-F., Combes J-L., Dulbecco P., Gastambide A., Guérineau S., Guillaumont S. and G. Rota Graziosi), *Evaluation of Fiscal Space in Developing Countries*. Concept Paper. PNUD
- Claessens S., 2005, "Access to Financial services A Review of the Issues and Public Policy Objectives", *World Bank PRWP*, 3589, May.
- Cohen D., Jacquet P. and H. Reisen, 2006, "Au-delà de la controverse prêts ou dons : comment utiliser la dette pour le développement ? ", *Revue d'économie du développement*, n°2-3, septembre, p.131-158.
- Collier P. and J.W. Gunning (eds), 1999, *Trade shocks in Developing Countries*, Clarendon Press, Oxford.

- Conseil d'Analyse économique (CAE), 2004, *Report of the Council of Economic Analysis, Reforming the Growth and Stability Pact*, La Documentation Française.
- Debrun X., 2000, "Fiscal Rules in a Monetary Union: A Short Run Analysis", *Open Economic Review*, Vol. 11, p. 323-358.
- Fielding D. and K. Shields, 2001, "Modeling Macroeconomic Shocks in the CFA Frank Zone", *Journal of Development Economics*, vol.66, n°1, october, p.199-224.
- Guillaumont Jeanneney S., 2007, "Independence of the Central Bank of West African States : An Expected Reform ? ", *Revue d'économie du développement*, forthcoming. .
- Guillaumont P. and S.Guillaumont Jeanneney, 2006, "Big Push versus Absorptive Capacity: How to reconcile the Two Approaches", UNU WIDER Conference « Aid: Principles, Policies and performance », Helsinki, 16-17 June 2006, Forthcoming.
- Guillaumont P.Guillaumont Jeanneney S. et F. Brun, 1999, "How Instability Lowers African Growth ? ", *Journal of African Economies*, vol.8, n°1, March, p.87-107.
- Gupta S., B. Clements, A. Pivovarsky et E. Tiongson, 2003, "Foreign Aid and Revenue Response: Does the Composition of Aid Matter?", *IMF Working Paper*, n° 03/176.
- Heller P., 2005a, "Understanding Fiscal Space", *IMF Discussion Paper*, O5/4
- Heller P., 2005b, "Pity the Finance Minister. Issues in Managing a substantial scaling Up of Aid Flows", *World Economics*, Vol.6, n° 4, p.69-110.
- IDA and IMF, 2006, *Heavily Indebted Poor Countries (HIPC) Initiative – List of Ring-Fenced Countries that Meet the Income and Indebtness Criteria at end 2004*, April 11, p.19.
- IMF and World Bank, 2006, *Applying the Debt Sustainability Framework for Low-Income Countries Post Debt Relief*, 6 novembre. Appendix 1 Domestic debt in LICs and Links to External Debt Distress.
- IMF, 2004, IMF Country Report, Chile: Selected Issues, n°04/292, September.
- IMF, 2006, IMF Country Reports: Burkina-Faso (n°06/359, octobre) ; (Guinea-Bissau (n°06/312, août) ; Mali , (n°06/73, March) ; Sénégal (n°06/12, March et n°06/274, July)
- IMF, 2007, IMF Country Reports: Bénin (n°07/06, January) ; Niger (n°07/13, January) .
- Rajan R.G. and A. Subramanian (2005b) "Aid and Growth: What Does the Cross-Country Evidence Really Show?", *IMF Working Paper*, WP/05/127.
- Sachs J.D., J.W. McArthur, G. Schmidt-Traub, M. Kruk, C. Bahadur, M. Faye et G. McCord, 2004, "Ending Africa's Poverty Trap", *Brookings Papers on Economic Activity*, vol. 1, 117-238.
- Villieu P., 2003, "Pacte de stabilité, crédibilité du policy mix et coordination des politiques budgétaires en union monétaire", *Revue économique*, Vol.54, n°1, p.25-46.