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The Franc Zone: Can the Operations Account Mechanism Survive the Push for Financial Deepening?

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Abstract:

This paper identifies the key historical factors that have shaped the development of the financial sector in the Franc Zone. At the heart of the Franc Zone is the Operations Account mechanism held at the French Treasury. It is this that differentiates the nature of financial integration in the Franc Zone from other low income countries. There are however reasons to doubt that the Operations Account mechanism, designed to sustain convertibility through overall trade balances, could be effective with a build-up of cross-border debt in the private or public sectors of member countries.

Key words: Franc Zone, currency union, external debt, domestic debt, financial sector development, optimal currency area

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Introduction

The growth of the financial sector during the era of financial liberalisation is associated with the process of financialisation, a process that has been extensively studied in recent years. Financialisation is characterized by general tendencies associated with the growth in importance of financial markets, financial institutions and financial motives for domestic and international economies (Epstein, 2005). This paper contributes to the growing literature on financialisation in developing countries (see Bonizzi (2013) for a review), and specifically low income countries, by exploring the particularities of financial sector development in the Franc Zone.

The Franc Zone consists of a common currency area between two sub regions in Sub Saharan Africa and France. Each sub region has a multilateral central bank, with the West African sub region's central bank located in Senegal, and the Central African sub region's located in Cameroon.[1] The currency area emerged out of colonial monetary arrangements when France consolidated many of its colonies' currencies and initiated the new currency, the CFA franc.

This paper identifies several key historical and institutional factors that have shaped the development of the financial sector in the Franc Zone. At the heart of the Franc Zone is the Operations Account mechanism held at the French Treasury. It is this that differentiates the nature of financial integration in the Franc Zone from other low income countries. Current literature on and policy practice in the Franc Zone contain a series of underlying tensions. From the stifling debt crisis during the 1970 and 1980s, the Franc Zone now neatly fits within the expanding financial development literature and policy practice which extolls the benefits

[1] The West African zone consists of Benin, Burkina Faso, Cote D'Ivoire, Guinea Bissau, Mali, Niger, Togo and Senegal and the Central African region consists of Cameroon, Central African Republic, Chad, Republic of Congo, Equatorial Guinea, and Gabon. The Comoros Islands are also part of the Franc Zone.

of finance with few reservations. During this period, the presentation of government borrowing has undergone a transformation: from negative due to crowding out arguments to more favourable views arising from the provision of good collateral supposed to promote domestic financial deepening. This paper concludes however, that the internal mechanism of the Franc Zone, the Operations Account, may prove too strict to accommodate the generalized credit boom which is currently underway.

I. The Operation Accounts at the French Treasury

Four main pillars constitute the core of the Franc Zone. The first pillar of the Franc Zone is that CFA francs are freely convertible into euros at a fixed exchange rate, which prior to 2002 were convertible into French francs. The parity has remained unchanged from 1948 with the exception of the historic devaluation in 1994. The second pillar is that the convertibility between CFA francs and hard currency is guaranteed by France and this is done through the Operations Account held at the French treasury. The third pillar is that in exchange for the convertibility guarantee, the countries of the Franc Zone must maintain the majority of their foreign exchange reserves at the two sub regional central banks of the Franc Zone. The fourth pillar is the requirement of capital mobility throughout the Franc Zone and between the Franc Zone and France (Allechi and Niamkey, 1994; Boughton, 1991).

This set of arrangements has severe macroeconomic implications for the members. Members supply the Operations Account with foreign exchange generated through trade surpluses. The reserve pooling arrangement implies that countries can credit and debit the Operations Account by drawing on and supplying each other with reserves. Countries needing foreign exchange debit the Operation Account whilst those supplying non-CFA currencies credit the account (Engberg, 1973). Members' balance of payments imbalances are financed through the Operations Account, either using the pooled reserves of other members that are obligatorily kept there or if these do not prove sufficient, through the guarantee by the French Treasury to supply necessary foreign exchange via an overdraft facility in the Operations Account. Therefore, the French Treasury steps in when the overall balance of the Operations Account is in deficit. The degree of fiscal intervention by France is regulated by the overall

payment balance across each sub region, rather than imbalances in individual countries. Intervention by the French Treasury is unnecessary if the net overall balance is positive even if there are diverging balance of payments needs between the countries. For example, in the 1980s Benin, Cote D'Ivoire and Senegal drew down the operations of other countries with surpluses in the Operations Account, such as Burkina Faso, Niger and Togo (Allechi and Niamkey, 1994).

Restrictions are in place in order to safeguard the unlimited guarantee that France provides to the Zone. These limitations placed on the Operations Account constrict the ability of countries to draw down the 'unlimited' overdraft facility provided by France, by in effect, making it quite a limited facility. Automatic measures make it more costly to run extended deficits in the Operations Account. For example, the regional central banks restrict the availability of credit by raising the cost of rediscounting and by limiting the amount of credit available to governments. Limitations are imposed on the overdraft facilities of the Operations Account in the French Treasury. These include minimum reserve ratios between the foreign exchange reserves in French francs and restrictions on the monetary financing of governments' deficits by each central bank. Disciplining mechanisms on members with imbalances are invariably also applied politically by France. Apart from the statutory regulation between the two central banks and France, political involvement in regulating overall credit policy has been instrumental in the monetary arrangements of the Franc Zone. The governance of the two central banks has included greater African participation since independence, but French officials maintain high representation in the Boards and veto power.

Beyond the aforementioned institutional constraints, the fiscal contribution by France into the Operation Account is structurally limited by the heterogeneous nature of the Franc Zone itself and specifically the asymmetric responses to external shocks. The main consequence of reserve pooling has been to reduce the need to rely on France's overdraft precisely because Franc Zone countries have distinct and diverse export structures, which respond in unsynchronized ways to changing global conditions. The consequence of this is that countries most frequently draw on each other's reserves rather than relying on France.

This is worth placing in the context of the literature whose examinations of the Franc Zone rest on providing economic rationales and theoretical justifications for its continuity by

contextualizing the Franc Zone through the optimal currency area lens (Mundell (1961), McKinnon (1963), and Fleming (1971)). Aside from the characteristics that, according to this theory, allow the benefits of membership of a currency area to exceed the costs, such as wage and price flexibility (Mougani, 2014) and high factor mobility (Boughton, 1991), the similarity in response to external shocks are frequently-mentioned desirable traits that can minimise the relative price shifts among countries. This theory suggests that highly integrated countries are more likely to reap benefits from a common currency. Contrary to the optimal currency area literature however, there is a small degree of intra-regional trade in the Franc Zone and considerable diversity in export structures. The West Africa sub region has traditionally relied on the export of coffee and cocoa and the Central African sub region has relied on minerals and oil exports. The prices of these commodities may move in different directions, which in combination with the changing exchange rate that the exports are priced in, lead to changes in competitiveness between the countries in the Franc Zone (Boughton, 1991). In light of the Operations Account mechanism, it is the presence of features which make the Franc Zone non-Optimal in this respect that have allowed for its durability. Although a majority of the English-speaking literature on the Franc Zone has optimal currency area theory as its starting point, the majority of studies conclude the Franc Zone cannot be interpreted in these terms (Boughton, 1991; Fouda and Stasavage, 2000; Hallet, 2008). Conversely, there is a broad consensus that the durability of the Franc Zone is better explained on political grounds (Assoua (2013), Couharde, Coulibaly, Guerreiro, and Mignon (2013), Bordo and Jonung (2003) Lamine (2006), Stasavage (2003) and Fouda and Stasavage (2000)).

To summarise, the original mechanism of the Franc Zone was budgetary in nature, supported by the French Treasury. The Operations Account has been described as resembling a "discount window" at the French Treasury for the two central banks (Engberg, 1973). What this implies is that the French Treasury performs a central banking function to the two sub regions to cover the region's reserve deficit. Had this arrangement been based in the French central bank, financing the overdraft would represent reserve creation by the Bank of France, whereas, currently, the overdraft is financed through the budget or by borrowing (Engberg, 1973).

Financial sector development

This section discusses historical and institutional changes that have been instrumental in shaping and restructuring the Franc Zone's financial sector. The main drivers that contributed to financial sector transformation in the Franc Zone were the conditionality programmes implemented by the International Financial Institutions (IFIs) and the institutional re-organisation following the devaluation in 1994. This section reviews this trajectory emphasizing the recent remodeling of the Franc Zone along EU lines.

In the 1980s Franc Zone countries saw their export earnings collapse with the prices of primary commodities declining. The sharp appreciation of the French franc under President Mitterand's *Franc Fort* policy led to a deteriorating terms of trade. Access to the expanding international dollar markets grew and the majority of Franc Zone countries were embroiled in a severe debt crisis. The entire region went through structural adjustment programmes and several rounds of debt restructurings, both through the IFIs and the private Paris Club. A key component of the conditionalities attached to these programmes included financial sector liberalization and specific reforms to encourage competition within the domestic banking sector. This practice has continued with recent conditionality programmes (as an example see Cameroon's PRSP (IMF, 2006)).

The discussion on government borrowing and indebtedness became central during the crippling debt crisis. Up to that point few doubted that the main merits of the Franc Zone for its members were the disciplinary capacity enforced by the currency union. Indeed fiscal discipline and price stability were frequently cited as the main merits of the Franc Zone (Boughton, 1991). The rationale was that an exchange rate peg with full convertibility would act as a disciplinary mechanism for expansionary fiscal policies since direct monetary financing could force the peg to be abandoned. Yet this is not a universally held view, neither in theory nor practice. Hadjimichael and Galy (1997) argue that the Operation Account rules were not sufficient to instill fiscal discipline. Stasavage (1997) presents mounting evidence for even the strongest proponents of the Franc Zone to agree that fiscal discipline was not promoted through the currency and monetary arrangements of the Franc Zone in the 1980s and early 1990s.The reasons he gives are the institutional flaws in the design of the union and political interests on behalf of French and African elites. The institutional constraints of the Zone were circumvented in a number of ways. Under the Operation Account rules direct financing of treasuries via the two central banks was limited to 20% of government's past

fiscal receipts. However indirect financing of budget deficits via domestic commercial banks which were often government owned circumvented the fiscal borrowing rule of the Franc Zone's central banks. These loans could then be refinanced though the regional central banks at subsidised rates (Honohan, 1993). This practice was central to the worsening conditions of the late 1980s and was part and parcel of the banking crises that developed in almost every Franc Zone country at that time. According to Stasavage (1997), the governments absorbed the debts of failed banks, which were then refinanced by the central banks. The consequence of this practice meant that the central banks' positions were weakened. Government deficits were also funded from abroad and once access to external commercial borrowing dried up, official multilateral loans and donor aid funds were the main or sole source of external financing. The de facto practice of accumulating arrears with domestic suppliers and creditors also created the image of improved fiscal positions by leaving pensions and payment public sector employees unpaid (Stasavage, 1997). As in Stasavage (1997) these choices were highly politicised by the de facto importance of French officials in decision making.

A deteriorating balance of payments built pressure to proceed with currency devaluation in 1994, altering the parity between the CFA franc and the French franc for the first time since 1948. This prompted deep institutional and policy changes within the Franc Zone. The result was the extension of the monetary union to include broader elements of economic and financial integration, such as economic, legal and regulatory reforms. The previous institutional arrangements were replaced by new ones, and the Central African Economic and Monetary Union (CEMAC) and West African Economic and Monetary Union (WAEMU) were created. The changes that occurred after the devaluation were modelled explicitly on the EU's integration model, thus representing an explicit transfer of norms and institutional similarities to the EU (Claeys and Sindzingre, 2003).

As the European Monetary Union members headed towards the third stage of integration and the introduction of a single currency, a protracted discussion began about how the Franc Zone arrangement ought to be interpreted and treated under Maastricht Rules. At the time of the euro's adoption a new wave of literature emerged which sought to assess the impact that the switch of the peg from French franc to euro would have on the Franc Zone. France initially argued that given the budgetary nature of the arrangement it should be treated as a domestic affair as it was entirely compatible with Maastricht criteria (Care, 1997). However, it was agreed that exchange rate arrangements linked to the euro ought to come under European

Council oversight, so the switch of the Franc Zone's peg to the euro mechanism was formalised with an EU Council Decision of November 1998 (See Hadjimichael and Galy (1997) and Lamine (2006)). The Operation Account mechanism was to remain intact under the strict understanding that the European Central Bank remains under no obligation to support the peg or the convertibility (Allen and Hagan, 2005). Certain oversight functions were moved to the EU level, with any decisions to change the parity with the euro now requiring EU approval.

The institutional replication along EU lines followed the devaluation. Two regional Commissions, Council of Ministers, and Heads of State meetings have been created and common Treaty Law has been established (Lamine, 2006). Economic integration is directed through convergence criteria for the Franc Zone countries, which focus on fiscal consolidation relating to budget balances, debt levels, wage bills and tax revenues. Attempts to meet the criteria occur through corollary multilateral surveillance arrangements, constituted in a Treaty along the lines of the EU's Growth and Stability Pact. The responsible authorities for the implementation of these surveillance mechanisms are the regional Commissions and similar to the euro area, countries deviating from the convergence criteria define a 'corrective' programme with the regional Commission (Banque de France, 2014).

A broad set of institutional changes have taken place; a customs Union has been set up, common external tariff introduced and duties on intraregional trade removed, common business law has been adopted, and a Court of Justice in each Zone has been set up. Financial sector reform was pushed forward through setting up new institutions, such as regional Bourses and the regional banking commissions, which were responsible for much of the financial sector restructuring in the post devaluation period. Central to this push for further economic integration has been a set of policies to 'deepen' the financial systems of countries in the Franc Zone (Cabrillac and Rocher, 2009). At the time these changes were taking place, it was argued that the economic benefits of a currency and monetary union would be better harnessed if only the Zone was better integrated (Hallet, 2008). Specifically, it was recognised that the governments in the Franc Zone needed more effective debt markets to avoid recourse to the French Treasury or the International Monetary Fund. The development of the financial sector was promoted in order to reduce the financial and economic dependence on France.

Recent trends in financial deepening

The global financial crisis was frequently attributed as an impetus in the development of Sub Saharan debt markets on several accounts. Global investors' hunt for has encouraged higher investment into African markets yields (Adelegan and Radzewicz-Bak, 2009). Regular aid funds were reduced as donors cut back on their spending, which necessitated a search for alternatives, particularly through developing domestic markets. Long term domestic financing was presented as a solution to financing development by enhancing diversification.

With regards to scholarship, there has been a decisive shift within the literature as it tries to contend with the latest enthusiasm for securitised government debt and market based financial integration. Following the contours of the development finance literature (see Bonizzi 2013 for a critique) one finds a plethora of studies that discuss the benefits that could come from the expansion of the finance in the Franc Zone (Adelegan and Radzewicz-Bak, 2009; Gulde, 2008). Arguments in favour of local security markets propose that reliance on bank lending would be reduced and investment opportunities broadened. The benefits of countries moving away from official bilateral and multilateral, mostly concessional lending and towards a market based financing, according to this viewpoint, is that capital allocation would be enhanced, and the creation of a liquid government securities market would help monetary policy implementation.

The practical efforts of the private sector and the donor community to develop domestic bond markets have been considerable (Dahou, Omar, and Pfister, 2009; Moyo, 2008). However, the efforts at furthering financial deepening have often been disparate and uncoordinated. To address this problem, the African Development Bank hosts the collaborations between the IFIs, the private sector and the major donors; the creation of the African Financial Markets Initiative has the sole goal of developing and deepening domestic financial markets in Africa.

Low income countries have had limited, if any, access to international capital markets. Due to the highly concessional external borrowing available to Sub Saharan African countries, local borrowing has generally been more expensive. Beaugrand, Loko, and Mlachila (2002: 3) argue that "highly concessional external debt is usually superior to domestic debt in terms of financial costs and risks, even in face of probable devaluations". Despite the higher costs associated with domestic debt, the promotion of market based financing has placed

developing the domestic debt market at the heart of the financial deepening agenda. Local security markets have been institutionally promoted by the International Monetary Fund and the World Bank as part of a stepping stone in the overall process of financial development of low income countries. For example, the IMF has placed limits on the borrowing low income countries under IMF programmes can access at non concessional rates. These limits have now been made looser allowing for a greater proportion of non-concessional borrowing for Low Income Countries under IMF programmes (Allen and Hagan, 2005).

The arguments in favour of developing local government securities markets are not solely in terms of better financing for governments, but rather, are also for the purpose of enhancing private sector security markets. "Achieving rapid growth in private debt markets is generally the second key objective of a government securities issuance strategy" (Cabrillac and Rocher, 2009: 10). The development of the government securities market, alongside the institutional changes that facilitate it, are seen as prerequisites for the subsequent development of a private debt market. A key part of this process is the benchmark created from the government securities market from which private securities can be priced. "Yields on government securities can serve as a pricing benchmark for long-term private debt issued by banks or enterprises" (Abbas and Christensen, 2010: 6). It is argued this would enhance corporate bond market development and put pressure for competition on the banking sector (Fabella and Madhur, 2003).

The specific experience of the Franc Zone amongst these broader developments is as follows. The development of the domestic debt market in the Franc Zone countries has lagged behind the development of the domestic debt market in non-Franc Zone Sub Saharan African countries which had begun from the 1980s (Christensen 2004: 4). The recent promotion of government debt markets has been accompanied by changes in the Franc Zone rules about how governments finance themselves. In particular, domestic debt market development is linked to increased restriction of direct monetary financing by the regional central banks (Banque De France, 2006). The international financial community encouraged the WAEMU and CEMAC to move towards central bank independence thus limiting or phasing out the direct advances made by central banks to governments. This is evidenced in Figure 1 which indicates a steady increased reliance in market and bank based funding for governments in the West African sub region and the steady decrease in reliance on central bank financing.

<FIGURE 7.1 HERE>

Under the previous rules the Central Banks of the Franc Zone could provide borrowing for member governments of up to 20% of their budget. New rules further limit member state's fiscal deficits from being financed by the central banks thus prompting governments to turn to issuing securities, and encourage the development of local currency debt markets. As indicated in Figure 2 domestic debt became an increasing component of government financing as opposed to external debt.

<FIGURE 7.2 HERE>

Other changes in the Franc Zone include a new credit rating system set up in 2006 to encourage bond issuance in the WAEMU region (Moyo, 2008). Institutional barriers were targeted and attempts were made to reduce transaction costs. A mortgage market and securitization programme begun, spearheaded by the regional Bourse and the custodian agent of the regional central bank.

The issuance of debt securities has rapidly increased in the 2000s as shown in Figure 3 and 4.

<FIGURE 7.3 HERE>
<FIGURE 7.4 HERE>

Certain countries in the Franc Zone have seen a rapid credit growth in the past decade. Recent research by Griffith-Jones and Karwowski (2014) shows that for a few of the Franc Zone countries, credit growth was close or far above 100% of their GDP. This is shown in Table 1.

<TABLE 7.1 HERE>

The changes described above have set up the members of the Franc Zone for a new cycle of borrowing. Where the problem of the 1980s was interpreted as a problem of foreign currency borrowing, the solution that developed was to expand debt markets in domestic currency. The

contribution of domestic debt markets to debt sustainability lies in the greater ease with which governments and companies may manage cash flows and borrowing in their own currency. However, the most serious challenge posed to the financial sector development agenda is the increasing attention drawn to the potential for yet another serious debt crisis in the region (see UNCTAD, 2015). This highlights the serious tension as although the risks are recognised, the process is continuing rapidly.

Conclusion

This paper has shown how the analytical and theoretical trajectory in the Franc Zone has been shaped on the one hand by the structural changes brought about by the conditionality attached to IFI programmes and the explicit modelling along EU lines, whilst on the other hand, the gradual application of the financial development literature has created a new policy agenda for the Franc Zone. The constraints of the replication of the EU model in the Franc Zone have been detailed in Claeys and Sindzingre (2003). To these concerns the on-going crisis of the EU can be added, which profoundly affects the feasibility as well as desirability of the model.

The institutional mechanism in the Franc Zone's centre, the Operations Accounts at the French Treasury, may come up against problems in light the promoted credit boom. This is associated to the rise in domestic incomes that growth in private sector investment could lead to, which would increase the import bill and widen trade deficits. The Operations Account mechanism would frustrate this kind of private sector economic development. Furthermore, large calls on these accounts could materialize if national authorities (central banks or governments) are obliged to act as lenders of last resort in the event of a credit bubble. The main condition that falls under normal Franc Zone operations under which this will not happen is if export markets expand, or export commodity prices rise. However, this is unlikely with slow economic growth in the major economies of the world.

The discussion about the Franc Zone has been almost entirely about the costs and benefits of a common currency, in terms of trade competitiveness and fiscal rectitude, to the neglect of the impact of the currency arrangements on the debt structures that build up over time. There are strong reasons to doubt that the Operations Account mechanism of the Zone, designed to

sustain convertibility through overall trade equilibrium in the Zone, could be effective with a build-up of cross-border debt in the private or public sectors of member countries.

The way financialisation is experienced under a variety of monetary institutional settings is a under researched area, particularly in developing countries. Such research is important to assess the impact that general trends of increased market access and security issuance currently under way in sub Saharan Africa has on the Franc Zone. It is also necessary, in order to distinguish the features that are particular to the Franc Zone countries. Given the recent warnings (UNCTAD, 2015) regarding potential vulnerabilities in the build-up of debt positions, this paper has attempted to highlight some areas of concern.

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