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# IMF Working Paper

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## Local Currency Debt Markets in the West African Economic and Monetary Union

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**IMF Working Paper**

Monetary and Capital Markets Department

**Local Currency Debt Markets in the West African Economic and Monetary Union**

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**Abstract**

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The paper reviews trends and developments in the rapidly growing local currency debt markets in the WAEMU. The main findings are that common institutions, such as a regional central bank and securities exchange have led to high cross-border transactions within the union. However, excess liquidity in the regional banking system has led to limited credit differentiation among issuers and a reliance on supply and demand conditions as a key determinant of yields. The paper also discusses a number of policy issues, including debt management, that are likely to emerge as the markets for government securities continue to develop.

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## I. INTRODUCTION

Local currency-denominated government securities play a key role in the implementation of fiscal and monetary policy. They help in cash and liquidity management, finance fiscal deficits in a non-inflationary manner, and implement monetary policy through open market operations. Government securities are also used for bank recapitalization and to provide a benchmark yield curve for the pricing of financial assets and risk management tools. Despite these benefits and diverse uses, developing the government securities markets remains a challenging task. It also entails a number of policy choices within the context of an overall public debt management strategy and development of local capital markets.

This paper reviews the trends and developments in the rapidly growing government securities markets of the West African Economic and Monetary Union (WAEMU). The key focus is on the primary markets and the determinants of the cost of local-currency denominated public debt.<sup>2</sup> We find that common institutions, such as a regional central bank and securities exchange and uniformity of issuance and distribution procedures have led to high cross-border transactions for government securities within the WAEMU. However, excess liquidity in the regional banking system, the quasi-nonexistence of money markets, and limited secondary markets for government securities have led to limited credit differentiation among issuers. The key determinant of the government yield curve, thus, are the overall supply and demand conditions. The paper also discusses a number of policy challenges and options that are likely to emerge as the markets for government securities continue to develop. In particular, following debt relief, it will be important to improve cash and liquidity forecasting methods, regularly the sustainability of new debt, and develop and implement a medium-term debt strategy. The proper functioning of money markets money markets also assumes significance, especially as excess liquidity diminishes, and will be key for deeper and more liquid government securities markets.

### A. Rapidly Growing Local Currency Debt Markets

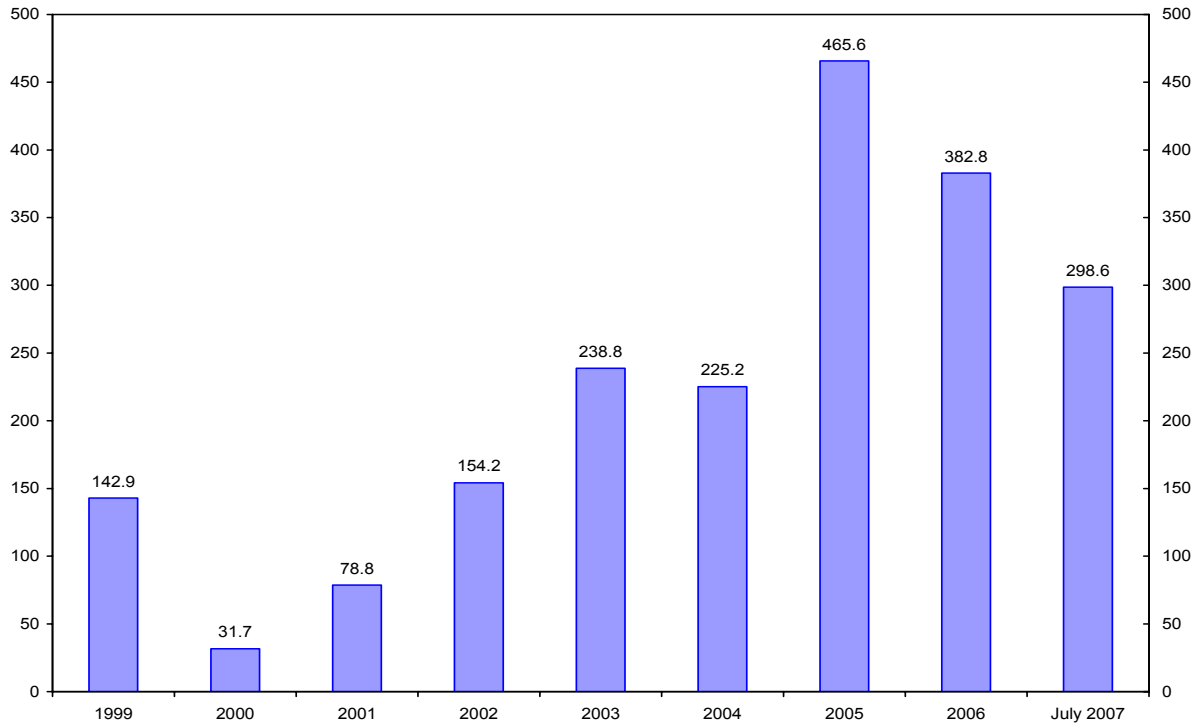
The WAEMU local currency debt market is growing very rapidly (Figure 1). Total gross issuance of publicly traded debt (public, private, and from regional institutions) has grown more than tenfold since 2000 to reach CFAF 382.8 billion, in 2006. As of July 2007, total outstanding debt reached CFAF 905 billion (about US\$2 billion) or 3.5 percent of GDP, which is lower than in South Africa (47 percent) but comparable to Russia (3 percent of GDP).<sup>3</sup> As is typically the case, public debt accounts for most of the local debt market.

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<sup>2</sup> WAEMU members include Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Sénégal, and Togo with a common currency, the CFA franc, and regional institutions, including a common central bank (BCEAO), and securities markets (BRVM).

<sup>3</sup> Estimated for Russia and South Africa are from the BIS. See "Financial Stability and Local Currency Bond Markets," BIS, June 2007.

Figure 1. WAEMU: Total Gross Issuance of Debt Securities, 1999–2007  
(In billions of CFA francs)



The elimination of central bank financing of government has been the main catalyst of the growth of the local debt market. Following a number of initiatives, starting in 1998, central bank financing to national treasuries was gradually phased out. Statutory advances to governments were consolidated with repayment to the central bank starting in 2003. As a result, national treasuries have resorted to market financing of their public deficits as the regional central bank (BCEAO) stopped its statutory advances to governments. The development of the Treasury bills (T-Bills) market also helped reduce the relatively high level of excess liquidity in the system, as commercial banks found a more profitable use for their excess reserves.

Delays in external budget support have also prompted governments to use the regional local debt market for cash management purposes, as funds can be rapidly raised.

T-Bills account for most of the issuance of securities<sup>4</sup> (Tables 1 and 2). Issuance of T-Bills has grown from zero in 2000 to about CFAF 200 billion in 2006. Maturities typically range from 3 months to one year but the most popular instruments are the 3- and 6-month bills. At the same time issuance of government bonds has increased from CFAF 5 billion in 2000 to

<sup>4</sup> The BCEAO, typically does not issue its own securities and rather, relies on a system of differentiated reserve requirement to conduct monetary policy at the regional level.

about CFAF 120 billion in 2006 and CFAF 265 billion as of July 2007. Bond tenors typically range from 3 to 5 years.

**Table 1. WAEMU: Treasury Bills Issuance**  
(In billions of CFA francs)

	2001	2002	2003	2004	2005	2006	July 2007
Benin	0.0	0.0	0.0	0.0	23.4	45.6	
Burkina Faso	0.0	49.9	30.9	41.5	43.3	50.9	26.6
Côte d'Ivoire	0.0	0.0	16.3	15.7	47.5	0.0	
Guinea-Bissau	0.0	0.0	0.0	0.0	6.0	6.7	
Mali	12.0	0.0	15.2	21.0	84.9	20.8	28.1
Niger	0.0	0.0	0.0	0.0	30.0	23.3	14.9
Senegal	42.9	0.0	23.0	45.3	35.5	50.8	
Togo	0.0	0.0	0.0	0.0	0.0	0.0	
WAEMU	54.9	49.9	85.4	123.5	270.6	198.1	69.6

Source: BCEAO

**Table 2. WAEMU: Gross Issuance of Publicly Placed Government Bonds**  
(In billions of CFA francs)

SIP	1999	2000	2001	2002	2003	2004	2005	2006	July 2007
Bonds									
Benin		5.0							96.0
Burkina Faso					25.0				40.0
Côte d'Ivoire	30.2			63.9	40.4		86.1	84.2	51.7
Guinea-Bissau									
Mali									
Niger									
Senegal							45.0		58.7
Togo								36.3	20.0
Total Government Bonds	30.2	5	0.0	63.9	65.4	0.0	131.1	120.5	266.4
BOAD <sup>1</sup>						22.7	25		22.5
BIDC <sup>2</sup>								24.1	
IFC <sup>3</sup>								22	
Total						22.7	156.1	166.6	288.9

Sources: BCEAO, BRVM, and Staff estimates

<sup>1</sup>West African Development Bank

<sup>2</sup>ECOWAS Bank for Investment and Development

<sup>3</sup>International Finance Corporation

## B. Issuers in the WAEMU Local Currency Debt Market

Governments and a few regional development banks are the largest issuers of local currency debt securities in the WAEMU. All member countries have issued government securities and, not surprisingly, the largest economies account for most of the total issuance. As of end-2006, three countries—Côte d'Ivoire, Senegal, and Burkina Faso—account for about two-third of WAEMU GDP and 60 percent of total gross issuance. The market is even more skewed as the addition of Mali brings the share of the four largest issuers to 78 percent of total GDP and 75 percent of total gross issuance. In contrast, Guinea Bissau, Togo, and to some extent Niger and Benin have issued relatively smaller amounts of government securities.

Burkina Faso, Senegal and Mali account for most of the issuance of T-Bills in the region as of end-2006. In contrast, only Togo has not tapped the T-Bills market as of end-2006. Only four member countries have issued government bonds since the advent of the market and apart from a Burkinabe issuance in 2003, all issues have taken place in 2005–06. Bonds issued by Côte d’Ivoire, Senegal, and Togo account for most total issuance.

The number of issuers is small and trading is limited. Bonds are listed in the “regional bond segment” of the common securities market, the BRVM (Bourse Regionale des Valeurs Mobilieres). Only 21 bonds issued by WAEMU governments, regional development banks such as the BOAD (Banque Ouest Africaine de Developpement) and the Ecowas Bank for Investment and Development (BIDC-EBID), and very few corporates are listed in the “regional bond” segment.<sup>5</sup>

A new segment for non-WAEMU resident issuers, the “Kola Bond Market” started in 2007 with the listing of a bond issued by the IFC. The IFC issued at-end 2006, a CFAF 22 billion (\$44.6 million equivalent) five-year bond, AAA rated. The bond carries a 4.75 percent coupon rate (priced at the tightest level of BOAD’s prior issues) and was issued at 100 percent of face value. The IFC bond was placed with institutional investors in the eight West WAEMU countries. The issue was broadly distributed throughout the CFA zone and more than 30 percent were raised from non-WAEMU investors. The proceeds will be used to support long-term local currency financing for local companies. The IFC issue had a number of developmental objectives, including (i) to support regional integration and promote development of capital markets in West Africa; (ii) introduce international best practices in bond documentation, syndication, and selling techniques; (iii) reinforce credit differentiation and rationalize market regulations; and (iv) provide investors with an alternative instrument in local currency of AAA quality.

## II. THE INVESTOR BASE OF THE WAEMU LOCAL DEBT/FINANCIAL INTEGRATION

Banks and institutional investors are the largest investors in the T-Bills market. In the context of a relatively large level of excess liquidity, banks have developed an appetite for government securities as they can find a better remuneration for their funds at relatively short-term maturities since reserves at the central banks are not remunerated. In addition, interest earned on such instruments are tax exempt, carry a zero risk weight in the calculation of capital adequacy ratios, are tradable in the eight countries of the WAEMU, and can be, in

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<sup>5</sup> Key impediments to the development of the corporate bond market include the fact that: (i) no bond price is launched before the price is fixed—against standard international best practices of price discovery and book building; (ii) 100 percent guarantees required for all issues except for sovereigns and regional development banks; (iii) only sovereign issues can qualify for zero percent risk weighting—regardless of credit quality; (iv) Corporate bond issues do not reflect the quality of the underlying issuer because of the 100 percent guarantee requirement, (see Oueslati, 2007).



principle, refinanced at the central bank to obtain liquidity. Similarly, regional regulation allows insurance companies to invest in Treasury bills (T-Bills).

In spite of their rapid growth, government securities still represent on average a small share of banking assets (Table 3). Banks' holdings of securities averaged about 7 percent of total assets in 2005.<sup>6</sup> There are, however, some differences among countries with banks in Guinea-Bissau (a post-conflict country with very weak banks) holding 20 percent of their assets in the form of securities and banks in Senegal, Togo, and to some extent Benin holding up to 10 percent of their assets as securities.

Table 3. WAEMU: Banks' Holdings of Securities, 2005

	Holdings of Securities (In percent of total assets)	Total Assets (In billions of CFA francs)	Securities (In billions of CFA francs)
Benin	7.9	726.6	57.6
Burkina Faso	5.4	653.7	35.2
Côte d'Ivoire	4.0	2,025.9	80.7
Guinea-Bissau	20.4	23.3	4.8
Mali	3.5	927.6	32.6
Niger	4.6	236.5	10.9
Senegal	11.1	1,760.7	196.2
Togo	11.0	418.0	46.2
WAEMU	6.8	6,856.9	464.2

Sources: BCEAO and Staff estimates.

The WAEMU Council of Ministers introduced the system of issuance of T-Bills through auctions at the BCEAO in 2001 to promote a regional government securities market. The WAEMU authorities have also received financial and technical assistance from the international community (IDA, MIGA, AfD) starting in 2002 to develop the regional financial market.<sup>7</sup>

Cross-border transactions (within the WAEMU) in the T-Bills market are high especially for countries with smaller banking systems (Figure 2). In 2004–05, nonresident banks within the WAEMU (including the Banque Ouest Africaine de Développement (BOAD)) purchased, on average, half of T-Bills issuance. Cross-border transactions in the

<sup>6</sup> This figure is a slight overestimation as it includes both government and non-government securities.

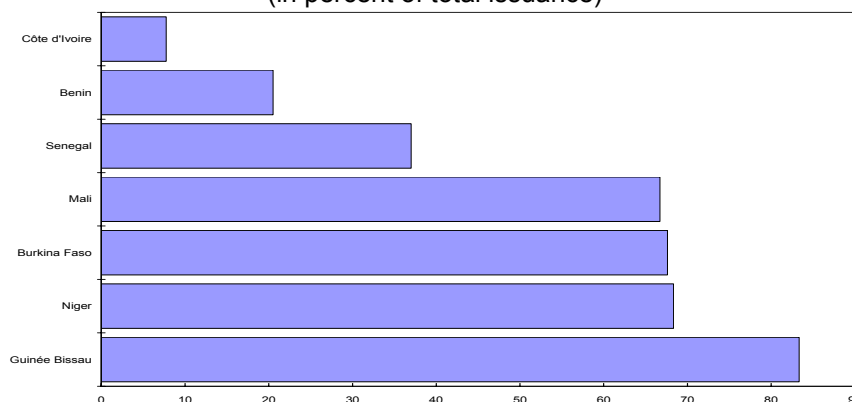
<sup>7</sup> Key elements of the project include (i) increasing the role of the BOAD as a benchmark issuer in the regional market, (ii) raise medium-to long-term funding for public infrastructure projects; (iii) develop risk mitigation instruments to raise private funding for infrastructure projects; (iv) technical assistance to regional bodies in the areas of regulation, training and public education, and tax harmonization. In addition, the CFA franc zone has been identified as a good candidate for the African Development Bank (AfDB) local currency loan program. In addition, the AfDB backed, in 2005, a CFA Franc private sector loan by extending a guarantee to cover the borrower's debt service and repayment obligations to local banks.

T-Bills market are lowest for countries with a larger investor base such as Côte d’Ivoire, Benin, and Senegal. In contrast, nonresident investors within the WAEMU account for most of the investors in countries such as Guinea-Bissau and Niger, with shallower banking systems.

Cross-border investments (within the WAEMU) are also frequent in the government bond market, as illustrated by the latest Togolese issuance. In January 2006, the government of Togo raised CFAF 36.3 billion in the regional bond market. The issued 5-year bond yielding 6.5 percent was oversubscribed as the initial objective was CFAF 30 billion. Nonresident investors within the WAEMU accounted for more than half (54 percent) of the issue, while Togolese residents absorbed the rest of the issue. If the Banque Ouest Africaine de Developpement (BOAD), which is a regional institution headquartered in Togo, is included in this total, the share of non-Togolese investors amounts to about 70 percent.

There are no restrictions for foreign investment in government securities. Nonresident entities (just like resident retail investors) cannot participate in T-Bills auctions but can purchase T-Bills indirectly through resident banks, nonbank financial institutions and accredited financial intermediaries. In contrast, nonresident investors can purchase government bonds listed at the regional securities exchange (BRVM). A recent informal survey<sup>8</sup> of French financial firms (French-owned banks dominate the WAEMU financial sector) conducted by the Banque de France finds that “several African countries have attracted the interest of international investors as a result of debt cancellation and improved fiscal discipline, in addition to very high returns and a sound macroeconomic framework.” However, for investors based in the European union, the CFA peg to the Euro precludes short-term bet on currency appreciation. In addition, the relatively tight spreads between yields in the WAEMU and those in Europe do not appear attractive (see below).

Figure 2. WAEMU: Nonresident Purchases of T-Bills, 2004–05  
(in percent of total issuance)



<sup>8</sup> Cited in “Financial Stability and Local Currency Bond Markets,” CGFS Papers No 28, June 2007, BIS.

### III. DEBT MANAGEMENT STRATEGY IN THE WAEMU

Directives established in 2007 in the WAEMU (and CEMAC<sup>9</sup>) mandate that member countries elaborate a public debt strategy and a public debt financing plan and implement best practices in debt management generally.<sup>10</sup>

The directive mandates the adoption on international best practices in debt management, calls on countries to elaborate external and domestic borrowing strategies to ensure that debt is sustainable, that debt obligations are met when due, and that governments cost and risk objectives are realized.

Once the public debt policy is established, a strategy is expected to be attached annually to budget laws to provide justification for short term borrowing decisions consistent with the debt policy ( for instance, portfolio structure of new borrowing, financing terms, borrowing and guarantee ceilings, and justification for borrowing). The debt profile is also to be forecasted over 15 years.

Transparency and accountability mechanisms are also mandated. The countries are to produce annual debt reports presenting debt strategy objectives and debt profiles, debt sustainability analyses, and results achieved with respect to debt objectives and the use of debt proceeds. The units in charge of debt management are to have clear operating procedures for debt issuance and management and be audited.

A debt coordinating structure chaired by the Ministry of finance is to be set up to monitor the implementation of the debt strategy and coordinate actions of relevant institutions and administrative units involved in the debt management process. This structure, possibly assisted by a technical group, will play the role of a middle office ensuring that debt contracted is in line with guidelines and ensuring information flow. This structure is to be consulted on all debt issuances for its opinion as to conformity with guidelines.

### IV. ISSUANCE MECHANISM

The current system of issuance of T-Bills through auctions at the BCEAO has led to the harmonization of issuance and distribution of government securities. Securities are “negotiable” in all countries of the WAEMU. They are kept in dematerialized form in accounts at the BCEAO. Secondary market transactions are allowed. Prior to the advent of the regional T-Bills market, each national treasuries was issuing securities mainly for cash management and these instruments were not negotiable in other countries of the region.

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<sup>9</sup> Communauté Economique et Monétaire de l’Afrique Centrale.

<sup>10</sup> Règlement 09/2007/CM/UEMOA for the WAEMU and 12/07/UEAC/186/CM/15 for the CEMAC.

WAEMU member governments sell T-bills and bonds to investors in the region through the BCEAO. Resident institutional investors alone can participate in T-Bill auctions and other investors can purchase T-Bills through them. National treasuries sell those securities through the national branches of the regional central bank, the BCEAO, through public auctions which determine the securities' yields. There is no formal coordination of issuance between countries of the Union but issuance procedures are uniform.<sup>11</sup>

Treasury bills' auctions occur typically every quarter or semester. The auction mechanism include:

**Announcement:** The BCEAO's national agency in the issuing country announces the auction in a major newspaper in each of the eight member country, seven days before the bidding date. The auction announcement includes details such as the amount of the issue, the auction date, the maturity date, and the terms and condition of the offering. It also includes macroeconomic data and a description of the auction mechanism.

**Auction:** The BCEAO auctions T-Bills through a multiple rate single allotment (American) auction. Competitive bidding alone is allowed and limited to 60 percent of the issue amount for each bidder and bidders specify the amounts and rates they find acceptable. At the close of an auction, the bidding committee (Comité d'Adjudication) which includes representatives of the BCEAO and the national treasury accepts competitive bids in ascending order in terms of their rates until the quantity of accepted bids reaches the offering amount. The BCEAO will publish information on the level of over- or under-subscription, the total amount of accepted bids, and the weighted average of accepted rates.

**Participants:** Institutional investors alone, including resident banks, nonbank financial institutions, regional financial institutions (e.g., BCEAO and BOAD), and accredited financial intermediaries (Société de Gestion et d'Intermédiation, SGI), can participate in T-Bills auctions. Participants are also required to have an account at the BCEAO. Foreign and retail investors can purchase T-Bills through institutional investors. Although there is no system of primary dealers at the moment, the legal framework allows the BCEAO to set up one should it choose to do so.

**Issuance:** On issue day, the BCEAO delivers securities to successful bidders and charges their accounts for payment of the securities. T-Bills are issued at a discount from face value and are paid their par value at maturity.

Although government bonds can also be auctioned by the BCEAO, issuance has so far been in the regional securities exchange (Bourse Regionale de Valeurs Mobilieres, BRVM). The

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<sup>11</sup> The U.S. Treasury has provided technical assistance to the BCEAO in the areas of public debt management and government securities market development since 1999.

regional authorities have attributed this development to market participants' confusion about differences in the bidding process. While bidders specify rates for T-Bills which are issued at a discount, the BCEAO requires them to specify prices for Government bonds.<sup>12</sup> Government bonds are therefore typically issued in the BRVM where issuers set the price at which they are willing to sell a quantity of bonds. Holland (2006) notes that this type of fixed-price "tap" may be particularly appropriate in circumstances where price discovery is poor and market participants are relatively uninformed or unsophisticated. She also notes that this mechanism can be a viable way of generating some price information where no prices are observable in the secondary market and no other securities exist to serve as a reference. However, the challenge for the issuer is how to determine the appropriate price. If the price is set too low, then demand will exceed supply and the cost of financing will be higher than it needs to be. If the price is set too high, then the government will fail to raise the required amount of financing.

Secondary Markets are thin as trading in government securities is very limited. T-Bills are dematerialized and the BCEAO is willing to settle trades among market participants with accounts in its books. However, commercial banks consider T-Bills mainly as alternative investments to unremunerated excess reserves at the central bank. As a result of the buy-and-hold nature of investors, there is little trading of T-Bills.

#### **V. COST OF DEBT AND RISK ASSESSMENT?**

The ability and willingness of national governments to repay should be the key determinant of risk for WAEMU investors.<sup>13</sup> Indeed, the common currency implies no foreign exchange risk for WAEMU investors and risk weights for the calculation of the capital adequacy ratio are nil for all government securities. Tax convention appear to be the same for all countries. As a result, risk premia on government securities should mainly be driven by investors' assessment of default risk. We use a number of indicators to assess how market participants assess such a risk. These include:

- (i) sovereign credit ratings as a proxy for default risk and assess whether countries with better ratings pay a lower risk premium for their debt instruments;
- (ii) differences in rates paid by WAEMU governments with those in the European Union (EU) as the CFAF is pegged to the euro;
- (iii) whether countries with higher levels of indebtedness as measured by the Debt-to-GDP pay a higher risk premium; and

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<sup>12</sup> The BCEAO conducts workshops to familiarize market participants with the concepts of bond yields and market required rates of return.

<sup>13</sup> Since monetary policy is at the regional level, governments issued debt for financing.

(iv) technical factors, in particular liquidity conditions, as proxied by the level of excess reserves in the banking sector.<sup>14</sup>

T-Bill rates differ by issuer and have increased in 2006. Typically, Guinea-Bissau—a post-conflict country—has the highest T-Bills rate while countries with the lowest rate vary. In 2005, T-bill rates were as low as 3.490 percent for Benin and as high as 5.06 percent for Guinea-Bissau. T-Bill rates increased in 2006 with a low of 3.900 for Burkina Faso and a high of 5.450 for Guinea-Bissau.

Differentiation among issuers of T-Bills which was limited in 2005 has increased in 2006. The difference between the highest (Guinea-Bissau, 5.060 percent) and lowest rates (Benin, 3.490 percent) averaged 157 basis point (bp). If instead, Guinea-Bissau was excluded, then this difference decreased to 38.5 bp (with Côte d'Ivoire having the second highest rate). In contrast, in 2006, the difference between the highest (Guinea-Bissau, 5.450 percent) and lowest rate (Burkina Faso, 3.900 percent) was relatively unchanged at 155 basis point (bp). However, if Guinea-Bissau was excluded, this difference increased to 110 bp.

Sovereign ratings alone cannot also explain the differences in T-Bill and government bond rates (Table 4). Four member countries have been rated by S&P but their ratings have not changed since their inception. While Senegal has the highest rating (B+) all other rated countries (Benin, Burkina Faso, and Mali) are equally rated (B). In contrast, Côte d'Ivoire, Guinea-Bissau, and Togo are not rated. The interest rate paid by different governments is, however, not increasing with the deterioration in rating. As an illustration, spreads with Senegalese T-Bills range from -99bp to 56bp and are 100bp for Government bonds. WAEMU sovereign bond yields appear low even if bonds issued by an international organization such as the IFC are used as a benchmark. For instance, the B+ rated 5-year Senegalese bonds are 75 bps higher than the AAA-rated CFA-franc IFC bonds with a similar maturity.

As an illustration, T-Bill rates paid by similarly rated EU governments trade in a narrow range (Table 5). The EU countries considered (Belgium, France, Germany, Italy, and Spain) all have the highest rating (A-1+) for local currency short-term debt. The maximum difference between T-Bills rate was at about 4 basis point (as of mid-January, 2007). Abstracting from foreign exchange and convertibility risk considerations, WAEMU T-bills rates appear low when compared with EU rates. For instance, average Senegalese T-bills rates (B+ rating) are about 130 bps higher than French 6-months T-Bill rates (A-1+ rating).<sup>15</sup>

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<sup>14</sup> Given data limitations, our findings reflect supply and demand factors at a particular point in time.

<sup>15</sup> The CFA franc is pegged to the euro but experienced a 50 percent devaluation against the French franc in 1994.

Table 4. WAEMU: Sovereign Ratings and Spreads

	Standard and Poor's Rating	Bond Yield (In percent)	Bond Spread (In basis points) <sup>1</sup>	Bond Maturity (In years)	Treasury Bill Rate (In percent)	Treasury Bill Spread (In basis points) <sup>1</sup>	Treasury Bill Spread (In basis points) <sup>2</sup>
Benin	B				4.34	-56	-15
Burkina Faso	B				4.48	-41	0
Côte d'Ivoire	Not Rated	7.00	100	3			
Guinée Bissau	Not Rated				5.45	56	97
Mali	B				3.90	-99	-58
Niger	Not Rated				5.01	12	53
Senegal	B+	5.50	0	5	4.89	0	41
Togo	Not Rated	6.50	100	5			

<sup>1/</sup> Spread over Senegalese securities

<sup>2/</sup> Spread over Burkinabé securities

Sources: BCEAO, Standard and Poor's, and Staff estimates.

Table 5. European Local Currency Short-Term Rating and T-Bill Rates  
(January 19, 2007)

	Standard and Poor's Rating	1 Month Treasury Bill Rate (In percent)	3 Month Treasury Bill Rate (In percent)	6 Month Treasury Bill Rate (In percent)	1 Year Treasury Bill Rate (In percent)
France	A-1+	3.50	3.60	3.70	3.91
Germany	A-1+	3.49	3.59	3.69	3.89
Italy	A-1+	3.53	3.63	3.72	3.93
Belgium	A-1+	3.52	3.62	3.72	3.92
Spain	A-1+	3.50	3.59	3.68	3.91

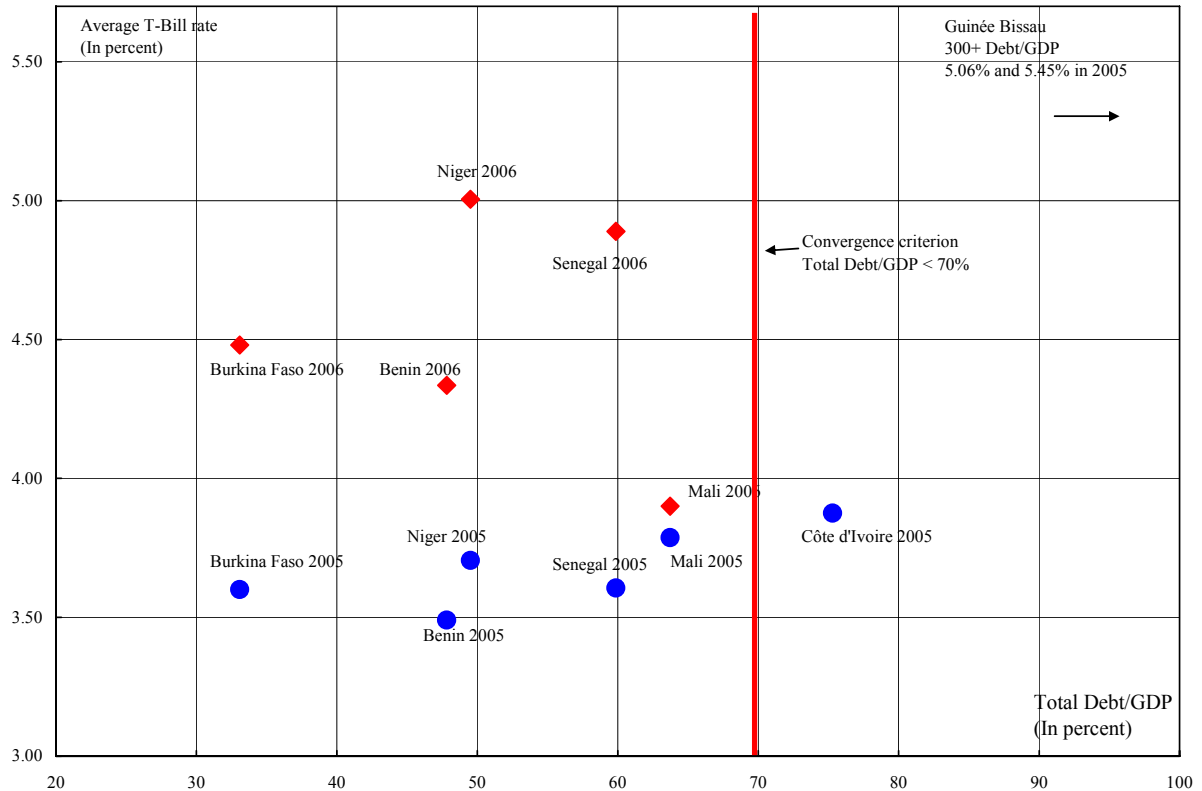
Source: Banque de France

Apart from Guinea-Bissau, the level of indebtedness does not fully account for the increased differentiation in T-bills rates (Figure 3). Guinea-Bissau has the highest Debt-to-GDP ratio (in excess of 300 percent and in contrast to a convergence criterion of 70 percent) and has a history of delays in its payment (which rating agencies would classify as “technical defaults”).<sup>16</sup> Not surprisingly, Guinea-Bissau pays the highest T-Bill rate in the WAEMU. However, T-Bill rates are not increasing with the levels of indebtedness. Some countries have paid higher rates in 2006 than issuers with comparable debt-to-GDP ratio (such as Senegal vs. Mali or Niger vs. Benin). At times, some countries like Burkina Faso in 2006 have paid rates comparable to more indebted countries like Benin.

In the new and developing WAEMU T-Bills market, supply and demand conditions appear to override sovereign rating considerations in explaining the differences in rates paid by countries. On the supply side, a few countries are the largest and more frequent issuers of T-Bills in the region (Senegal, Mali, and Burkina Faso over the 2005–06 period). In addition, regional authorities have noted the difficulties for national treasuries to publish and respect issuance calendars, the irregular frequency of some issuance, bunching of issues, communication problems with market participants, and seasonal effects in liquidity.

<sup>16</sup> Following delays in external budget support, Guinée Bissau was four months late in paying its T-Bill maturing April 16, 2006 and was not able to repay CFAF 6.74 billion of a 6-month T-Bill maturing on February 11, 2007.

Figure 3. T-Bills Rates and Indebtedness



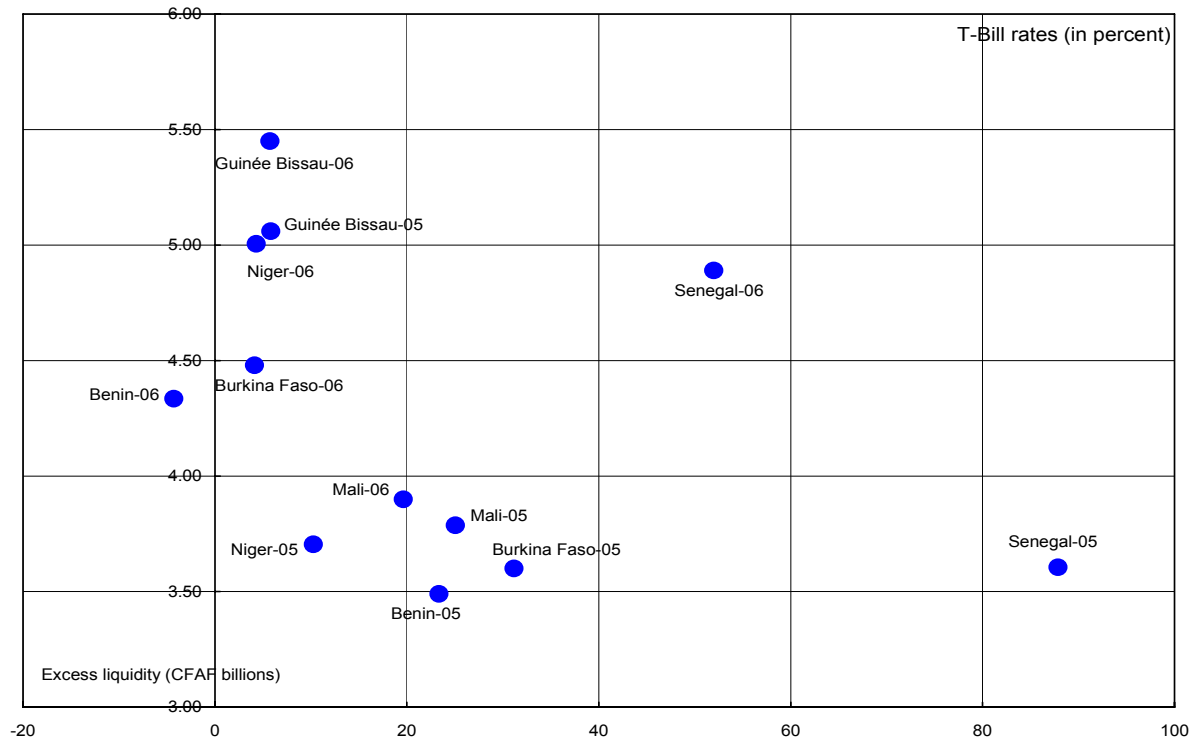
On the demand side, liquidity conditions in both individual countries and the region appear to be an important determinant of T-Bills rates in the WAEMU (Figure 4). Over the 2005–06 period, T-Bills rates are broadly higher for countries with lower excess liquidity, an indicator of liquidity conditions. As banks' deposits with the central bank are unremunerated and there are very few alternative assets available, banks' demand for government securities depend on the pace of credit growth and the availability and returns of government securities.

## VI. POLICY ISSUES AND CONCLUSIONS

The rapid growth of the government securities market in the WAEMU has a number of potential benefits for the development of the money and capital markets. Governments have been able to finance their deficits in local currency. Excess liquidity has fallen as banks have reduced their levels of unremunerated reserves at the central bank to invest in T-Bills. The market is also accelerating financial integration as intra-WAEMU cross-border transactions have increased.



Figure 4. T-Bills Rates and Excess Liquidity



A review of the government securities market indicates that for investors, supply and demand conditions are more important than rating or indebtedness levels. This is not surprising in a nascent government securities markets with relatively high levels of excess liquidity in the banking sector. At the same time, from the governments perspective, cost considerations may be subordinated to the objective of raising the required amount of financing in a timely and flexible fashion. However, as the local debt market develop, execution considerations must not dominate the objective of minimizing the cost of funding subject to reasonable level of risk. It will be also important to improve market efficiency, including through the provision of timely and relevant information to market participants.

Going forward, risks to financial stability have to be managed properly, including through adequate debt sustainability analysis and the development of debt management strategy by national authorities. The HIPC and MDRI initiatives have reduced the debt burden of most countries and international donors typically place constraints on external non-concessional loans for program countries. While the share of external debt is falling countries are resorting increasingly to domestic debt. Maintaining debt sustainability remains, therefore, a key priority, especially in the WAEMU where fiscal indicators have deteriorated in 2006.

Even if debt is sustainable, improving budgetary planning and projections will also help avoid the build-up of arrears to publicly owned companies and the private sector or delays in repaying investors. There may be a need to minimize iddle balances or manage the delayed payment of large aid flows.

At the country level, policy measures should also include sound debt management practices. National authorities should ensure that the cost of debt is minimized while risks are being managed. Good practice in debt management would also help market development as, for instance, governments issue and respect issuance calendars and disclose timely and adequate information to investors. In particular, coordination of issuance policies in the regional market for government securities can help reduce national governments' cost of funding. Sound debt strategies will also help manage "rollover risk" in the T-Bills markets, which can arise when investors are reluctant to rollover maturing debt. In this respect, implementations of the recently adopted directives in the WAEMU (and CEMAC) have recently adopted a debt management strategy can help sustain the rapid development of the regional public debt market.

It will also be important to address market development issues. In the case of the WAEMU, the development of efficient money markets will become important as excess liquidity abates. The WAEMU interbank market remains thin and activity is limited to intra-group transactions. Obstacles to the development of the interbank market include the absence of a legal framework, appropriate collateral (as most transactions are not collateralized), a network to match supply and demand, and a counterparty risk assessment framework. A well functioning payment system is a key determinant of integrated money markets and great progress has been achieved in the WAEMU (see Sy (2006)).

The conduct of monetary policy in the Union will have to be adapted as financial markets become more integrated. In the WAEMU, differentiated reserve requirements have been used extensively as other sterilization instruments have proved to be less effective in a context of excess liquidity and thin interbank money markets. As liquidity conditions have been tightening recently, however, the BCEAO has conducted reverse repo operations, including T-Bills as collateral..

Finally, financial stability issues, may have to be addressed to manage rollover risk and the impact of foreign investors, should their involvement in the local currency debt markets increase. These include managing rollover risk and possible adverse pressure on the exchange rate.

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