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INTERNATIONAL MONETARY FUND

CENTRAL AFRICAN ECONOMIC AND MONETARY COMMUNITY (CEMAC)

SELECTED ISSUES

December 1, 2017

Approved By
African Department

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IMPLEMENTING THE NEW CEMAC REGIONAL CONVERGENCE FRAMEWORK[1]

A. Introduction

1. **The CEMAC Regional convergence framework aims at ensuring that national policies are consistent with a smooth functioning of CEMAC's economic and monetary union.** Established in 1999, a few years after the 1994 devaluation, as part of the Convergence and Stability Pact, it aims at addressing the coordination challenges posed by CEMAC's common monetary policies and decentralized fiscal policies. As is also the case in the Eurozone, the convergence framework aims at preventing national fiscal policies from producing negative spillovers on other countries and on the conduct of monetary policies, such as: monetary tightening to contain inflation fueled by fiscal expansion in a particular country; higher area-wide interest rates due to crowding out; contagion effects; and bailout costs. In the case of the CEMAC, whose currency is pegged to the euro, it also aims at preventing the occurrence of excessive deficits, whose financing would be incompatible with the maintenance of an adequate level of international reserves. The convergence framework calls for the monitoring of a number economic indicators: the four convergence criteria—on the fiscal deficit, inflation, public debt, and the accumulation of domestic and external payment arrears—and several other, secondary, indicators allowing for a broader understanding of economic developments (including growth, monetary, fiscal, external and financial data). Since 2007, the CEMAC commission is the regional institution in charge of monitoring and enforcing the convergence framework.

2. **In 2016, CEMAC's heads of states adopted a number of revisions, proposed by the CEMAC commission, to the regional convergence framework.** These changes, first considered prior to the sharp drop in oil, were aimed at strengthening regional convergence through: (i) the revision of the fiscal balance criterion, which now covers the non-oil overall balance and a three-year average of oil revenue (see below); (ii) the introduction of a debt break, aimed at limiting debt accumulation over the medium term; (iii) the revision of the inflation criterion to a three-year average; and (iv) the introduction of additional secondary indicators.

3. **This paper focuses on the revision of the fiscal balance criterion.[2]** Section II examines the recent fiscal track record under the previous criterion, takes stock of the recent reforms, and assesses whether the new criterion constitutes an adequate target for fiscal policy in CEMAC countries. Section III explores ways to strengthen the enforcement of the convergence framework.

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[1] Prepared by Edouard Martin and Mathilde Perinet (AFR).

[2] For a discussion of the debt limit criterion, please see Zdzienicka (2014) and Guérineau et al. (2015).

B. The New Fiscal Balance Criterion: A Macroeconomic Perspective

4. In the CEMAC convergence framework, the overall fiscal balance plays the role of intermediate target toward ensuring the member-states' public debt sustainability. Meeting this objective while maintaining simplicity indeed suggests a two-pillar approach to the design of a fiscal framework, with a single fiscal anchor and a single operational rule that acts as the lever that moves the anchor.[3] As the final objective of the framework is to preserve fiscal sustainability, a natural anchor is the debt ratio, which creates an upper limit to repeated (cumulative) fiscal slippages. The operational target should be under the direct control of governments (contrary to public debt, which might be affected by valuation effects and extra-budgetary public borrowing), while also having a close link to debt dynamics. If other options (e.g. an expenditure rule, a revenue rule, a structural balance rule, or a public-sector balance rule) could play this role, the CEMAC's convergence framework relies on a fiscal balance rule.

Shortcomings of previous fiscal balance rule

5. The previous fiscal balance criterion had significant weaknesses, both in terms of design and implementation:

- It set a nil-floor on the basic fiscal balance (i.e. the overall budget balance, excluding grants and foreign-financed investment). By definition (i.e. by excluding foreign-financed investment), this rule was neither a strong indicator to assess the fiscal stance nor an adequate intermediate target to ensure long-term fiscal sustainability. It was pro-cyclical, as it allowed governments to increase their spending by the full amount of any increase in oil revenue. On the contrary, it called for an immediate adjustment of the non-oil fiscal balance to any shortfall in revenue, with no mechanism to smooth this adjustment over time. Also, this rule was only distantly related to debt dynamics as it did not put a cap on external borrowing to finance capital expenditures (and did not take into account extra-budgetary public borrowing).[4] This became an increasing problem as foreign-financed spending increased from an average of 1¼percent of GDP during 2001–10 to an average of 2½ percent of GDP in 2011–16.

- Enforcement was also weak, as the rule was followed only in about 40 percent of the cases over the last 10 years, and was observed by none of the six member-states in 2016 (Figure 1).

[3] See Andrle and al., 2017.

[4] Moreover, it is not a clear that capital expenditures raise productivity and potential growth more than other expenditure items, such as outlays on health and education. Also, excluding capital expenditures entails risks of creative accounting.

Figure 1. CEMAC: Basic Fiscal Balance (Old Criterion)
(In percent of GDP)

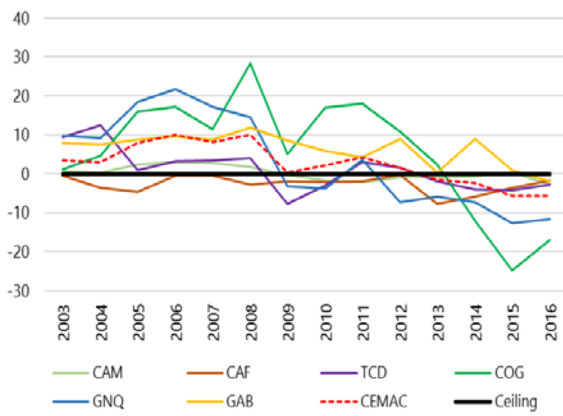
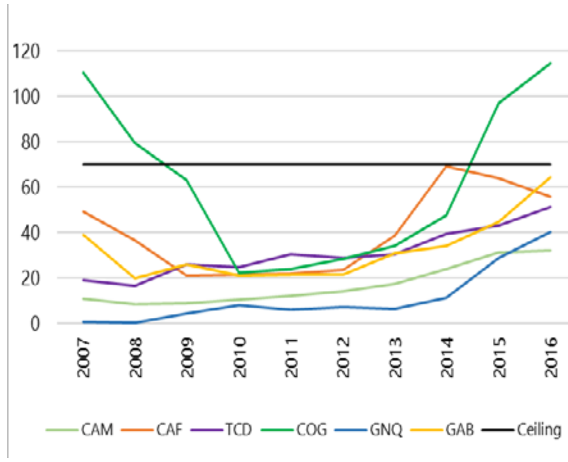


Figure 2. CEMAC: Public Debt, 2007–16
(In percent of GDP)



Source: IMF Staff calculations.

6. Owing in part to these weaknesses, the fiscal convergence framework has not been sufficient to prevent a sharp deterioration in public accounts over the last few years (Figure 2). Public debt increased substantially over the last three years, from 22.0 percent of GDP at end-2013 to 50.4 percent of GDP at end-2016, when it exceeded 100 percent of GDP in Congo and 50 percent of GDP in three other countries (CAR, Chad, and Gabon). This increase was much larger than the increase envisaged at the time of the 2014 regional consultation, when the debt-to-GDP ratio was projected to increase by only 4 percentage points over that period (Table 1). Compared with these projections, the higher debt-to-GDP ratio reflects mainly three factors: (i) the lower-than-expected basic fiscal balance, as the decline in oil revenue was only partly offset by lower domestically financed spending; (ii) a higher-than-expected interest rate-growth differential, reflecting both higher interest payments and lower growth; and (iii) non-budgetary factors not captured by the basic fiscal balance. It is worth noting that the latter did not include higher foreign-financed expenditures, as these turned out lower than projected.

Table 1. CEMAC: Increase in Public Debt, 2014–16

(In percentage points of GDP)

	2014 proj.	Actual	Difference
Increase	3.8	28.4	24.6
Overall fiscal deficit	4.3	21.9	17.6
Interest-rate growth differential	0.5	5.2	4.7
Real interest rate	4.2	6.2	1.9
Real GDP growth	-3.7	-1.0	2.8
Primary deficit	3.8	16.7	12.9
Primary spending	82.8	78.0	-4.7
Revenue	-79.2	-60.4	18.8
Oil revenue	-26.4	-25.7	0.7
Nonoil revenue	-52.8	-34.7	18.1
Other factors	-0.5	6.4	7.0
Memorandum items:			
Contributions of			
Basic fiscal balance	-0.5	13.6	14.0
Foreign financed capital expenditures	9.8	7.7	-2.0

Source: National Authorities; and IMF Staff Estimates.

7. **These fiscal slippages, along with an accommodative monetary policy, also contributed to the depletion of BEAC's international reserves.** In 2015, as governments faced increasing financing needs and liquidity pressures, BEAC reversed its policy of gradually phasing out its credit to governments and re-instated statutory advances at their statutory level (i.e., 20 percent of the previous year fiscal revenue), contributing to tilting heavily the budget financing mix toward domestic financing. These accommodative policies contributed to a substantial widening of the current account deficit, which, together with lower net capital flows and external borrowing, led to as sharp drop in reserves, from Euro12.8 billion at end-2014 to Euro 4.7 billion at end-2016.

The new fiscal balance rule

To address these weaknesses, the authorities have adopted a new fiscal balance criterion, which represents a significant improvement in terms of design. The new criterion, which became effective with the 2017 budget, sets a floor of -1.5 percent of GDP on the reference fiscal balance, defined as the overall fiscal balance minus: 20 percent of oil revenue; and 80 percent of the difference between oil revenue and their average relative to GDP over the previous three years. This rule has distinct qualities in terms of design:

- **Simplicity.** As the rule only requires the measurement of the overall fiscal balance and of government oil revenue, it can be monitored accurately and easily. While slightly more complicated than a simple overall balance rule (as the one used in the Eurozone), it is also simple enough to be understood by a large public.

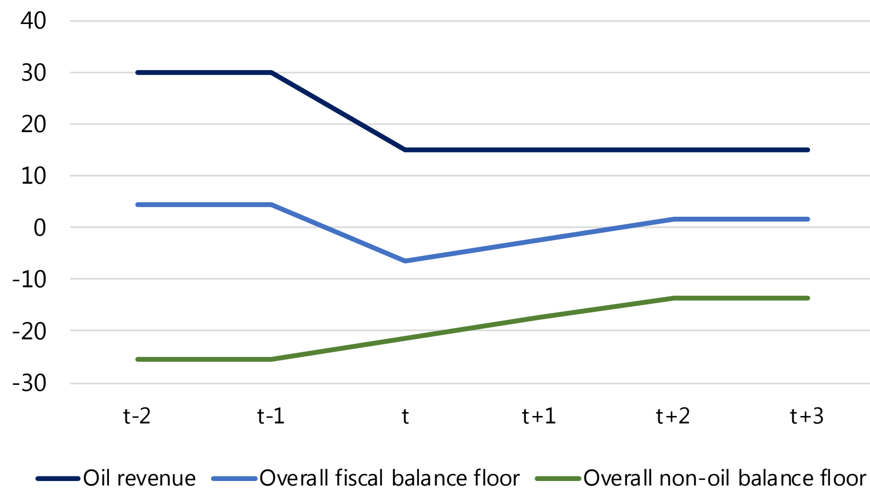
- **Country Specificity.** As was the case with the previous criterion, countries with higher oil revenue will be allowed to have a higher non-oil balance. Contrary to the previous criterion, however, the oil producing countries will be asked to generate higher overall fiscal balances, and thereby to save some of their oil revenue for future generations. For instance, the Central

African Republic (CAR), which does not produce oil, will be asked to limit its overall deficit (and its overall non-oil deficit) to 1.5 percent of GDP, while the Republic of Congo, with oil revenue expected to average 7.6 percent of GDP in 2015–17 and to amount to 12.6 percent of GDP in 2018, should generate an overall fiscal surplus of at least 5 percent of GDP in 2018 (and an overall non-oil deficit not exceeding 7.6 percent of GDP).

- **Counter-Cyclicality.** The reference fiscal balance can also be defined as the overall non-oil balance plus 80 percent of the average oil revenue-to-GDP ratio over the three previous years. It is therefore fully disconnected from the current year's oil revenue, and thereby does not allow governments to increase spending immediately when oil revenue increase, even temporarily, during the year, as was the case under the previous rule. An increase in spending will only be allowed the following year, and only if the increase lasts enough to result in an increase in the average three-year oil revenue-to-GDP ratio. On the contrary, in the case of a permanent drop in oil revenue (Figure 3), the authorities will be able to adjust their non-oil fiscal balance over a three-year period to bring the reference fiscal balance to its new steady-state level.

Figure 3. CEMAC: Response to a Fall in Oil Revenues [1]

(In percent of GDP)



[1] Assumes that a country's oil revenue declines from 30 percent to 15 percent of GDP at year

- **Debt dynamics.** The new rule allows for a better control of debt dynamics as it takes into account all forms of budgetary spending and debt accumulation (including the external financing of capital expenditures, which were excluded from the basic fiscal balance). One should recognize, however, that, as was already the case with the previous rule, the new rule does not cover extra-budgetary public borrowing.

Short-term considerations

8. A number of countries (incl. Cameroon and Equatorial Guinea) are not expected to comply with the rule in the next few years. This appears appropriate as long as they implement fiscal consolidation programs that will ensure their fiscal sustainability and allow them to conform with the rule over the medium term. Expecting these countries to meet the target in the short term would be unrealistic and could be counterproductive, as additional fiscal tightening could have possible severe consequences on growth. This points to the need for a flexible medium-term perspective in the implementation of the rule in the aftermath of the 2014 drop in oil prices, with possibly an application of the escape clause for countries facing exceptional circumstances on the condition that they adopt and implement ambitious fiscal consolidation efforts (see also section III).

9. A contrario, some (highly indebted) countries (e.g. Congo) will need to significantly overperform the fiscal criterion if they want to bring public debt to safer levels over the medium term. These two points are illustrated by the following graph, which compares the current public debt projections for Cameroon and Congo with the paths that would result from simply sticking to the reference fiscal balance floor.[5] In the case of Congo, just sticking to the floor would result in a significantly more gradual debt reduction, with debt still exceeding 90 percent in 2022 (Figure 5). It is worth noting that, while limited, this reduction would be substantially larger than if Congo was sticking to the old fiscal balance floor, in which case little progress would be made over the next 5 years in reducing debt.

Figure 4. Cameroon: Public Debt, 2015–22

(In percent of GDP)

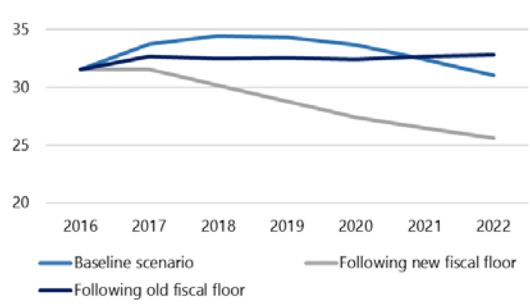
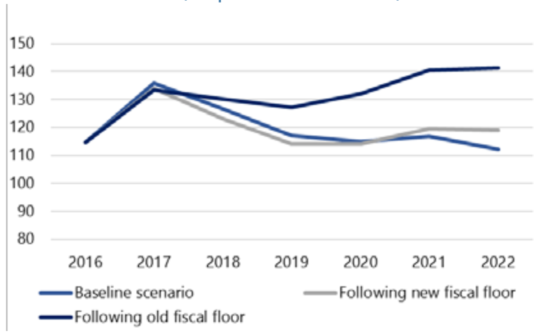


Figure 5. Congo: Public Debt, 2015–22

(In percent of GDP)



Source: IMF Staff Calculations.

10. While less than the previous one, the new criterion remains sensitive to oil price fluctuations (Figures 6 and 7). If, as aforementioned, the reference fiscal balance is disconnected from the current year's oil revenue, over time, it will gradually adjust to permanent changes in oil prices. It is worth noting, however, that: (i) even over the medium term, it is less sensitive to oil price

[5] This illustration does not assume any impact (i.e. a fiscal multiplier) of fiscal consolidation on growth.

fluctuations than the basic fiscal balance; and (ii) other fiscal balances (such as the structural balance and the PIH balance) would also be sensitive over time to permanent oil price shocks.

Figure 6. Congo: Sensitivity of Basic Fiscal Balance to Oil Prices, 2018–22

(In percent of GDP)

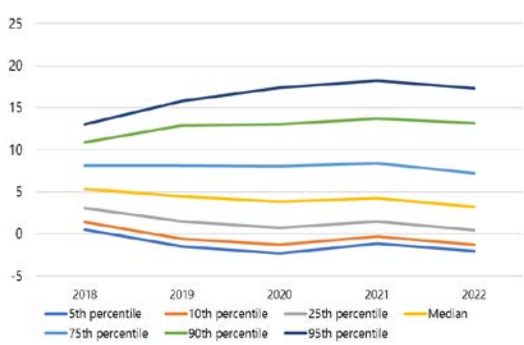
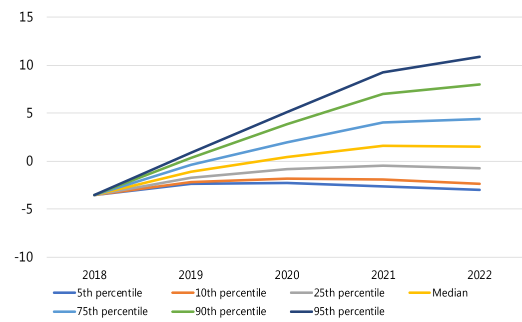


Figure 7. Congo: Sensitivity of the Reference Fiscal Balance to Oil Prices, 2018–22

(In percent of GDP)



Sources: IMF Staff Calculations.

Medium-term considerations

11. Looking over a longer time horizon, the new fiscal balance criterion appears consistent with the stabilization of debt at a safe level in most countries. For all countries, observing the rule would be more than sufficient to ensure the stabilization of public debt at its current level[6], and would allow debt to converge to 50 percent of GDP over the next 10 years (Table 2). With the exception of Congo, it would also be consistent with bringing debt to 50 percent over a 5-year period. If in the case of Congo, as discussed earlier, just sticking to the fiscal balance rule would not be ambitious enough over the medium term, bringing its debt to 50 percent of GDP over the next 5 years would not be realistic either.

[6] The level at which a country's public debt would remain stable if its fiscal balance was equal to its ceiling varies from -6.5 percent of GDP for Congo to 23 percent of GDP for the Central African Republic. If initially higher, public debt would gradually decline toward these levels.

Table 2. CEMAC: Overall Balance Indicators

(In percent of GDP)

	End-2016 Debt	Debt-stabilizing overall balance 1/	Overall balance to reduce debt to 50 percent over 1/ 10 years	5 years	Long-term overall balance floor 2/
Central African Republic	56.0	-3.7	-2.9	-2.4	-1.5
Cameroon	31.6	-2.1	-4.6	-6.3	-1.2
Republic of Congo	114.6	-7.6	1.0	7.1	0.4
Gabon	64.2	-4.3	-2.4	-1.0	-0.5
Equatorial Guinea	40.1	-2.7	-4.0	-4.9	0.3
Chad	51.1	-3.4	-3.2	-3.1	-0.6
CEMAC	50.4	-3.3	-3.3	-3.3	-0.7

Sources: IMF Staff Estimates.
1/ Assumes growth of 4.5 percent and inflation of 2.5 percent.
2/ Estimated at -1.5 plus 20 percent of the projected average of oil revenue over 2017–26.

12. The new rule would, however, not provide for an accumulation of financial assets for future generation consistent with permanent income hypothesis (PIH) and fiscal sustainability framework (FSF) models. For countries with resource exhaustibility issues—including most countries in the CEMAC, apart from the Central African Republic—a non-resource primary balance rule can help assess fiscal sustainability. The non-resource primary balance benchmark can be set in different ways. Under a PIH framework, the government expenditure path is set constant over time, equal to the return on the present value of the future stream of resource revenues and the net return on accumulated financial assets. Although this set up is used as a benchmark that ensures fiscal sustainability, it faces weaknesses: first, it does not allow the country to spend the revenues accumulated from resources to finance investment scaling up or development projects; second, it considers that the marginal utility of one unit of consumption is the same across generations, neglecting the fact that future generations may be richer than the current ones. The modified PIH framework (MPIH) aims at addressing this issue by allowing for an investment scaling-up in the short run, compensated with a fiscal adjustment to offset the short-run spending and maintain long-run fiscal sustainability but without accounting for the impact of investment on growth. The last fiscal benchmark—the FSF —incorporates the impact of investment scaling-up on growth to derive a fiscally sustainable path. Simulations of long-run non-resource primary balances suggest that if the countries were to follow the new fiscal rule, their implicit non-resource primary deficits would be larger than these three fiscal benchmarks. (Figure 8).

Table 3. CEMAC: Non-Resource Primary Balances

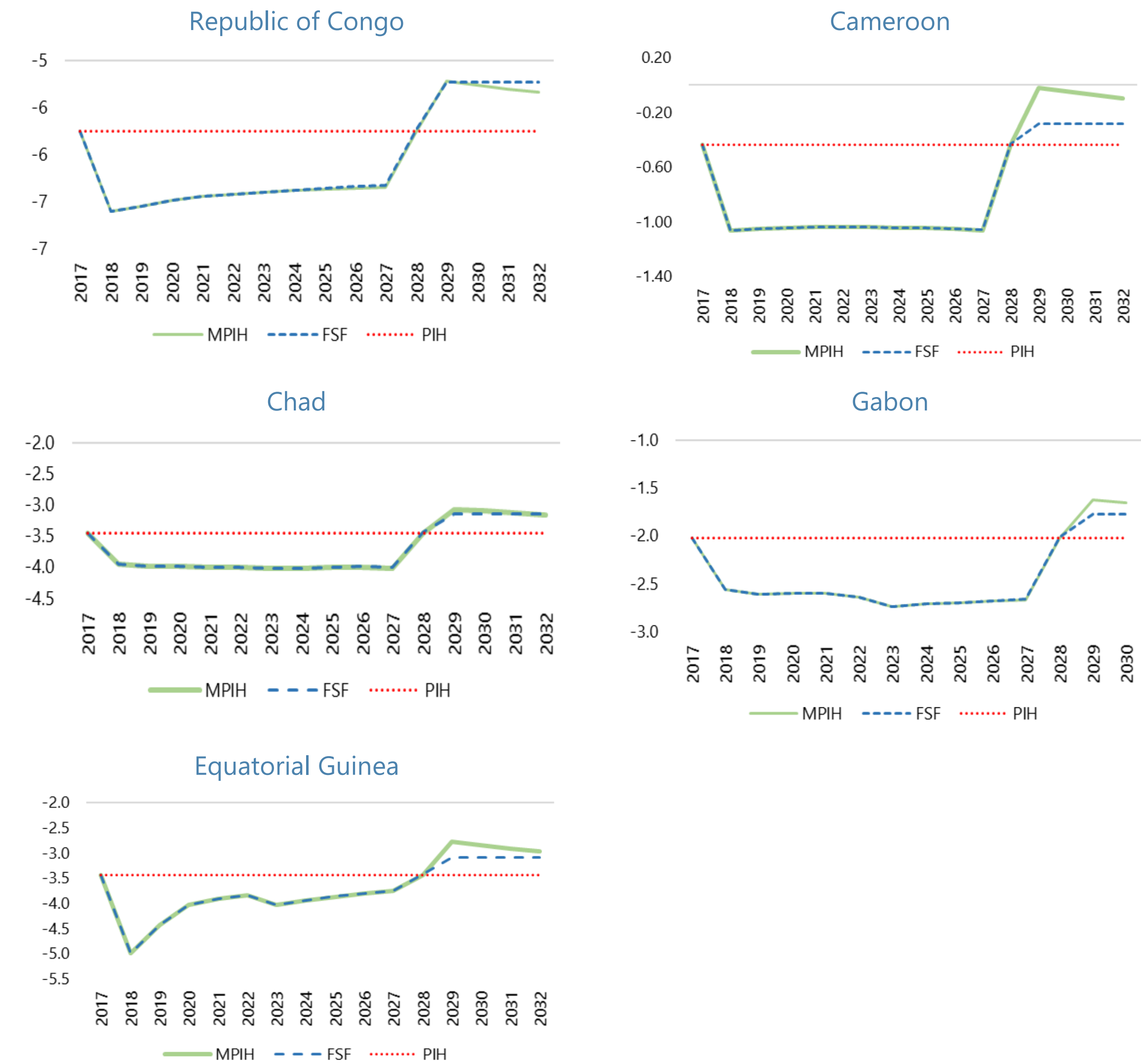
(In percent of non-resource GDP)

	New fiscal rule	Permanent Income Hypothesis	Modified Permanent Income Hypothesis	Fiscal Sustainability Framework
CAM	-2.0	-0.4	0.0	-0.3
TCD	-4.6	-3.5	-3.1	-3.2
COG	-11.1	-5.8	-5.3	-5.2
GNQ	-8.9	-3.4	-2.8	-3.1
GAB	-3.1	-2.0	-1.6	-1.8

Source: IMF Staff estimates.

Figure 8. CEMAC: Non-Resource Primary Balance

(In percent of non-resource GDP)



Sources: IMF Staff calculations.

Notes: PIH stands for 'Permanent Income Hypothesis', MPIH stands for 'Modified Permanent Income Hypothesis', 'FSF stands for 'Fiscal Sustainability Framework' and 'Fiscal rule' represents the long-run non-primary primary balance that would hold if the new fiscal rule were to be respected.

The non-resource primary balance is equivalent to the non-oil primary balance except for Equatorial Guinea which has both oil and gas.

For this simulation, the public investment path is assumed as 10 percent higher than the capital expenditure baseline projection, over a 10-year period starting in 2018.

13. Overall, the new fiscal balance criterion constitutes a significant improvement, but it may need to be implemented carefully, and eventually recalibrated, in the future. While remaining simple, the new rule is more country-specific, better takes into account each country oil revenues, and is more closely related to debt dynamics, making it a more appropriate intermediate target for debt sustainability. Also, it allows for a smoother response to external shocks. However, the authorities may want to address two issues:

- In the aftermath of the 2014 drop in oil prices, it may not be realistic, and may even be counterproductive to expect all countries to follow the rule strictly in the short term. When implementing the enforcement mechanism and assessing the need for sanctions, the authorities should therefore assess the member-states' policy response to the nonobservance and whether it is likely to remedy it over the medium term. If so, they may consider applying the escape clause.

- In the long run, while being consistent with debt sustainability, the new rule does not provide for the accumulation of financial assets for the next generation. A more ambitious target may therefore need to be envisaged once the current fiscal consolidation programs have run their course, at least for the countries with substantial oil revenue.

C. Enforcement Considerations

The current enforcement mechanism

14. The convergence framework's enforcement mechanism is defined in the convention governing the region's monetary and economic union. The convention stipulates that:

- The CEMAC Commission is, in concertation with the BEAC, in charge of the implementation and enforcement of the convergence framework. The chairman of the Commission chairs a regional unit ("Cellule communautaire"), who is in charge of writing regular reports on the status of convergence, including on whether the convergence criteria have been met. These reports are submitted to the Council of Ministers after review by a Surveillance Council.[7,8]

- If one member-state does not meet the convergence criteria, or did not follow the policy guidelines and/or adjustment that had been agreed upon during previous meetings, the Council of Ministers can adopt, based on a proposal of the chairman of the Commission, an injunction to the contravening member-state. The latter has then 45 days to design, in concertation with the Chairman of the Commission, an adjustment plan.

- The Chairman of the Commission then assesses whether the adjustment plan conforms to the Council of Ministries' injunction.

[7] The latest convergence report, covering performance at end-2016 was published in September 2017.

[8] "Collège de Surveillance", also chaired by the chairman of the Commission, and where each country is represented.

- o If so, the member state will benefit from the support of the Commission in the implementation of, and the mobilization of external financing for, its plan.

- o If not, the Chairman of the Commission will report to the Council of Ministers and may propose sanctions. The Council then decide whether to impose sanctions (or other measures that would contribute to the enforcement of the convergence framework), and if so, the nature of these sanctions.

The Council of Ministers can exempt a country facing exceptional circumstances from observing the convergence criteria ('escape clause').

15. In 2009, a preventive arm was added to the framework. The national units, which are in charge in each of the member states of the gathering and consistency check of data relevant to multilateral surveillance, are now also requested to prepare triennial convergence programs. These plans, which are updated annually, are reviewed by the Commission, which then submit them for adoption to the Council of ministers.

16. In practice, the enforcement mechanism has hardly been implemented. In line with the convention, the "Cellule communautaire" has prepared annual reports on the status of convergence (the latest report, covering 2016, was published in September 2017), which were submitted to the ministers of finance of the member-states after review by the Council of Surveillance. In some cases, however, these reports have not been discussed by the Council of Ministers. Moreover, while there have been many instances of the primary convergence criteria not being met by member-states, there has so far been no instance of the Council of Ministers issuing an injunction requesting that a contravening member state prepares an adjustment program. With the regard to the preventive arm, while some triennial convergence programs were initially submitted by some member-states, none has been submitted over the last few years.

17. Weak enforcement may in some instances have reflected the shortcomings of the previous fiscal balance criterion. In particular, it might have been unrealistic (and not economically sound) to expect countries to adjust fully over one year to an external shock of the magnitude of the 2014 fall in oil prices. Notwithstanding these shortcomings, the authorities could have followed the prescribed procedures, with the Commission making recommendations and the Council of Ministers deciding formally on the need to adopt sanctions or not.

18. Weak enforcement may also have reflected a lack of political will and a separation of roles between the monitoring entity (i.e. the Commission, which is in charge of the monitoring but can only make recommendations on the adequate response to non-observance of criteria) and the decision maker (i.e. the Council of Ministers, which makes the ultimate judgement on whether sanctions should be imposed). Finance ministers may give more weight to political considerations and be lenient and reluctant to impose sanctions that could be politically costly for other member-states, knowing that they themselves may be in a similar situation in the future.[9] This problem is all the more acute as the

[9] This phenomenon is referred as 'sinners judging sinners' incentive problem (see Eyraud et al. (2017)).

number of non-compliant countries rises (as was the case last year when none of the countries met the fiscal balance criteria), in which case decisions on non-compliant countries may be taken by other non-complaint countries. It is also exacerbated by the fact that sanctions and escape clauses are only broadly defined in the convergence framework, which leaves ample space for discretionary decisions by the Council of Ministers.

19. In practice, the main regulatory consequence for member-states of not meeting the convergence criteria stem from the COBAC's regulations on risk weights and BEAC's regulations on collateral eligibility for refinancing. [10] According to these regulations, when assessing the capital needs of commercial banks or their division of risks, the risk weights applied on their claims on member-states depends on the member-states' observance of the convergence criteria. More specifically, the risk weight associated to banks' claims on a given member-state government is increased by: 20 percentage points if the member-state has not met the fiscal balance criterion; 10 percentage points if it has not met the debt criterion; 5 percentage points if it has not met the inflation criterion; and 65 percentage points if it has not met the arrears criterion. With regard to refinancing by BEAC, and additional discount of 10 percent is supposed to be applied to debt instruments uses as collateral that were issued by member-states contravening to the criterion on the accumulation of budgetary arrears.[11]

20. These regulations are, however, of a prudential or collateral management nature and cannot make up for the lack of a proper convergence enforcement system. COBAC's regulations aim at ensuring that commercial banks adequately take into account the risks when they invest in government papers by increasing the associated costs. BEAC's regulations aim at protecting BEAC's balance sheet against potential losses on government paper it takes as collateral. As a by-product, by potentially limiting the commercial banks' appetite for government paper, these measures may increase the member-state's financing costs and thereby incentivize them to meet the convergence criteria. This is not their main goal, however, and each of these instruments should not be assigned a second objective, lest it impede (e.g. by altering its calibration) its capacity to meet its first one.

Strengthening enforcement

21. Strengthening the enforcement of the convergence framework will play an important role in ensuring the fiscal and external sustainability of member-states. As explained in introduction, excessive fiscal deficits, along with an accommodative monetary policy, contributed to the accumulation of unsustainable debt levels in some member-states and to a sharp fall in international reserves. Strengthening enforcement will help prevent such large imbalances to develop and hence contribute to strengthening the sustainability of the monetary union.

[10] COBAC's regulation R-2010/01 on the coverage of commercial banks' risks et decision du comité de politique monétaire n° 2013-05.

[11] As of end-October 2017, this additional discount had still to be implemented.

22. Two main, non-exclusive, directions could be followed to improve compliance. The first approach relies on strengthening the existing convergence framework by addressing the discussed weaknesses. The second approach relies on alternative mechanisms to promote fiscal discipline, including stronger market oversight and discipline.

First approach—strengthening the existing framework towards deeper integration

23. A number of measures could be taken to strengthen the existing framework while ensuring better enforcement. These include:

- **Strengthening the national units' capacity to monitor economic developments.** This would require a more exhaustive and timely sharing of data by the member states, notably on infra-annual fiscal developments. It would also be important, possibly with the technical assistance of development partners, to strengthen the national units' capacity to process these data and to monitor and analyze economic developments and economic policies. The national units should notably start anew preparing triennial convergence programs, which will contribute to enhancing the information provided to the upper echelons of the surveillance framework while providing benchmarks against which to assess economic and structural performance.

- **Reflecting the fiscal convergence framework in national legislations.** National fiscal frameworks have a key role to play in strengthening the overall fiscal architecture. Reliance on national fiscal rules and fiscal councils is a central part of the efforts to foster compliance with supranational requirements.

- **Entrusting monitoring to independent institutions.** This could be done by establishing an independent fiscal council, which would be in charge in charge of monitoring economic and policy developments in the region and to assess whether convergence criteria are met and policy commitments implemented.[12] A fiscal council's independence and strong media influence can have a significant electoral and reputational impact for policymakers by fostering accountability and transparency.[13] Under the existing framework, an alternative would be to give less leeway to Council of Ministers (e.g .by adopting the "reverse qualified majority" procedure following the Eurozone's example, by which the Commission's recommendations are approved by the Council unless a qualified majority of, or possibly all, Ministers vote against it).[14]

- **Providing for, and better defining, escape clauses.** The system should remain flexible and not entirely rule-based, so as to leave some room for discretionary judgement based on sound

[12] A fiscal council is 'a permanent agency with a statutory or executive mandate to assess publicly and independently from partisan influence government's fiscal policies, plans and performance against macroeconomic objective related to the long-term sustainability of public finances, short-and medium-term macroeconomic stability, and other official objectives' (IMF, 2013).

[13] For further discussion, see Nassar (2016).

[14] As Commission Directors are appointed by member-states, there is a risk, however, that, if given more weight in the sanction decision process, the Commission may also be subject to pressures from member-states.

economic judgement. As emphasized in Section II, the mechanism could allow for some short-term deviations if the authorities adopt measures that will pay off in the medium term.

- **Better defining the consequences of non-compliance.** While sanctions are envisaged under the convergence framework, their exact nature is not specified. They could include:

    - Financial penalties. This might be difficult to levy in difficult times, however, lest they accentuate government arrear problems;

    - Cuts in BDEAC financing (or in CEMAC's commission spending, if its budget were to increase). This would have the advantage to free resources for the compliant countries, which would thereby be rewarded for their observance of the fiscal criteria.

24. Insights on potential ways of reforming the current architecture may be found in the recent reforms in the European Union framework for fiscal policies, which aim at addressing the system's weaknesses revealed during the sovereign debt crisis (see Box 1). In particular, the new EU framework, which is composed of three main reformed blocks, has a strong forward-looking approach seen in its preventive arm, aiming at helping the achievement of medium-term fiscal target. In addition, it also includes a corrective arm with clearly defined potential sanctions, while allowing flexibility in the respect of the rules, taking into account exceptional and/or temporary circumstances a country may face.

Second approach—promoting market oversight and discipline

25. Under this approach, incentives to comply with fiscal framework rules would be provided through financial markets, by increasing borrowing costs for non-compliers. This approach, which should be viewed as complementary to the first one, may take more time to implement in view of the current shallowness of the financial markets. Some measures could, however, be already taken so that market oversight grows over time. These include:

- **Promoting fiscal transparency**, including on governments' liabilities and capacity to repay. In particular, the Commission report could provide a more detailed assessment of the fiscal situation of individual countries and of their medium-term outlook, building on the triennial convergence reports. As aforementioned, the establishment of a fiscal council could also contribute to enhanced transparency.

- **Expanding the investor base.** Government's domestic debt is currently essentially held to maturity by the banking sector, which does not sell it on to its clients. The BEAC could enforce more strictly the regulations calling for the banks to do so, which could contribute to expanding the government paper's investors base to households, companies, and institutional investors. Doing so would increase the number of stakeholders in fiscal transparency and good fiscal policies.

26. Pending the implementation of such reforms, the BEAC could play this role in part. It could in particular develop a capacity to assess country risk according to the fiscal position/outlook and apply a discount on its refinancing accordingly (possibly through differentiated haircuts). This will be all the more important as, as part of the modernization of the monetary policy implementation framework, the refinancing ceilings would eventually disappear after the new liquidity management framework is implemented in early 2018. This would mitigate some risks of unduly borrowing by member-states which would not implement appropriate policies. As discussed in section II, this approach should, however, be primarily guided by monetary objectives (i.e. safeguarding the BEAC's balance sheet against defaults) than fiscal sustainability consideration and could substitute only temporary to genuine market discipline and stronger enforcement of the convergence framework by the Commission/Council of Ministers.

Box 1. CEMAC: The European Union's Framework for Fiscal Policies

The EU fiscal framework was initially established in 1997 by the Stability and Growth Pact (SGP), in order to build a set of rules to ensure the compliance of member states with the deficit and debt limits stated in the Maastricht Treaty in 1992. Following the sovereign debt crisis, the fiscal framework has been reformed to reinforce the coordination and the surveillance of Member states' fiscal policies, placing greater emphasis on structural balances, public debt stocks, and the prevention of unsustainable fiscal positions, as well as increasing the automaticity of sanctions. Between 2011 and 2013, three sets of reforms entered into effect: the Economic Governance Package ('Six-Pack'); the intergovernmental Treaty on Stability, Coordination, and Governance (including the 'Fiscal Compact'); and the 'Two-Pack' assessing the national draft budgetary plans of euro area countries.

The reformed SGP's main objective remains the promotion of sustainable fiscal policies by member-states. It comprises a *preventive* and a *corrective arm*:

- **The preventive aims at ensuring the respect by member-states of the medium-term budgetary objective (a structural budget balance)** which should not be lower than -1 percent of GDP. To this purpose, each member-state must submit each year a Stability and Convergence Programme (SCP), specifying the MTO and the necessary adjustment path towards it. The Commission has the possibility to address an *early warning* (taking the form of policy recommendations on necessary adjustments) to a member-state in case of deviations from the adjustment path. In the case of euro area countries, if the member-state fails to implement these recommendations, *financial sanctions* can be imposed in the form of an interest-bearing deposit of 0.2 percent of the previous year' GDP.
- **The corrective arm aims at avoiding excessive deficits and at correcting them if needed.** Also called the excessive deficit procedure (EDP), it is triggered by the non-respect of the deficit criterion ([overall deficit] higher than 3 percent of GDP) or the debt criterion (stock of debt higher than 60 percent of GDP). When assessing whether the deficit is excessive, exceptional or temporary factors that may have contributed to the non-respect of the criterion are taken into account. In case of an excessive deficit (of possible occurrence of it), the EU Council makes recommendations for corrective actions, which must be reported by the member-state within up to six months. In the event of insufficient corrective action taken in the specified timeframe, the member-state may be given notice by the Council to take appropriate measures. Failing appropriate action, for euro area countries, sanctions may be imposed in the form of fines, reaching a maximum of 0.5 percent of GDP.

Signed by euro area countries plus Denmark, Bulgaria, and Romania in 2012, the 'Fiscal Compact' mandates the incorporation of a balanced budget *golden rule* (structural deficit not higher than 0.5 percent of GDP, or 1 percent if the member-state's public debt is lower than 60 percent of GDP) **in national laws, preferably at the constitutional level**. Signatory countries had to transpose the rule within one year, or could otherwise face a 0.1-percent of GDP sanction by the European Court of Justice. The rule is subject to national enforcement, with significant deviations automatically triggering a correction mechanism.

Implemented in 2013, the 'Two-pack' is a two-fold set of regulations strengthening governance. The first regulation aims at strengthening the monitoring and assessment of draft budgetary plans of euro area countries. The second one in specifically addressed to euro area Member States in situation of serious difficulties, providing for a set of rules for enhanced surveillance.

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THE STAKES OF THE SOVEREIGN-BANKS NEXUS IN THE CEMAC

A. Introduction

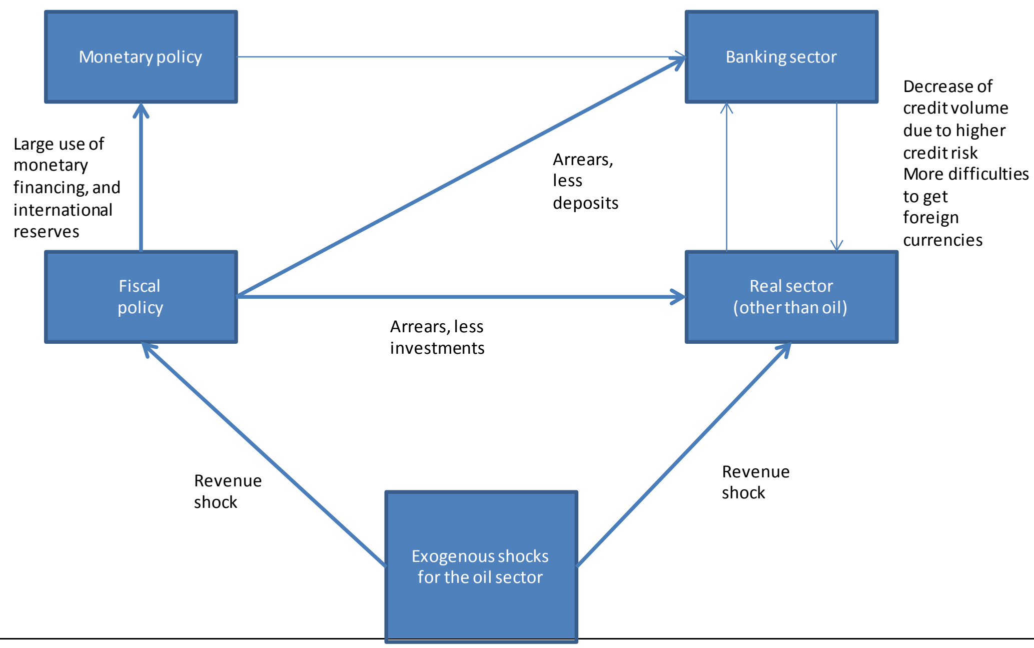
1. **In many economies, strong links between sovereign and banks exist, which can amplify vulnerabilities in each sector.** The recent financial crisis in Western countries, mainly the United States and Europe, illustrated well the negative spillovers such links can have. This interconnectedness often required direct involvement of governments to manage banking crisis, and similarly some sovereign crisis put at risk domestic banks. Such links between sovereigns and banks cannot and should not be fully severed, in particular since sovereigns largely rely on banks for their financing, and banks on government bonds to have safe and liquid assets, as well as to get easy refinancing from central banks. However, this Selected Issues Paper (SIP) aims at highlighting the risks a too strong sovereign-banks nexus could pose to financial stability and how it could be addressed in the CEMAC through ongoing reforms.

B. Main Causes of the Strong Sovereign-Banks Nexus in CEMAC

2. **Banks and sovereigns are linked by multiple interacting channels in most economies.** Three main channels can be highlighted: (i) the sovereign-exposure channel (banks hold large amounts of sovereign debt); (ii) the safety net channel (banks are protected by government guarantees) and; (iii) the macroeconomic channel (banks' and governments' health affect and are affected by economic activity). Additionally, indirect channels, including banking supervision and implementation of monetary policy reinforce the latter. Evidence suggests that all direct and indirect channels are relevant in the CEMAC. In the case of the CEMAC, the macroeconomic channel remains certainly the first source of concern, in particular since it is harder to address, but the banks' exposure to sovereign and the two indirect channels are also particularly critical.

3. **The nexus between sovereigns and banks is strong in the CEMAC and has been highlighted as the main transmission channel of macro-financial risks in past Article IV staff reports.** The main interacting channel contributing to this strong link is a macroeconomic channel, which relates to the economic structure of the CEMAC. The oil sector is indeed the main driver of economic activity in most CEMAC countries, which represented 30 percent of the regional GDP and generated 59 percent of regional fiscal revenues in the last decade. Therefore, any reduction in the oil sector activity and income will immediately impact both the sovereign fiscal position as well as banking activities. The current crisis in the CEMAC illustrates well this situation. Because of a large decline in budget oil revenue at a time when large public investment programs were launched, all CEMAC oil-producing countries recorded large fiscal imbalances, accumulated arrears vis-à-vis their suppliers and had to reduce their investments, eventually impacting negatively the soundness of the banking sector.

Figure 1. CEMAC Macrofinancial Linkages



4. A second important channel is the high reliance of CEMAC member States on their domestic banks for their financing. Almost all domestic government securities are purchased and held by banks. Different reasons explain this situation. First, savings by (non-bank) companies and households are small and do not provide a credible and sufficient alternative to banks for government domestic financing. In particular, insurance companies, with a total asset size of about XAF600 billion, and pension funds remain underdeveloped. Second, most banks have always considered that holding sovereign securities (T-bills and T-bonds) represented an easy and cheap way to generate income. Sovereign securities can be easily refinanced at the central bank without large haircuts, and ceilings on sovereign securities which can be used as collateral for bank refinancing were not binding until recently. These securities also enjoy a preferential treatment in terms of banking supervision compared to other financial assets, in terms of risk weighting and liquidity requirements. While these two preferential treatments (at the central bank[1].and at the supervisory body) may seem reasonable, it clearly encourages banks to keep sovereign securities instead of trying to sell them back to potential final investors.

5. Besides these two main channels, others more specific in the context of the CEMAC must be highlighted. These include: (i) links related to banking sector management, (ii) implementation of monetary policy, and (iii) approach to address the risk of free-riding by a member State in a context of a monetary union.

[1] At BEAC refinancing operations, government securities have lower haircuts than private securities, and the rules to make them accepted as collateral are not as strict as those applying to other securities.

Figure 2. CEMAC: Commercial Banks' Credit to the Government
(In percent of total commercial banks' assets)

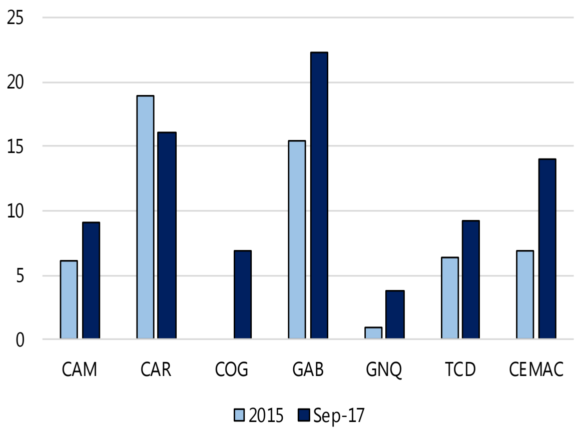
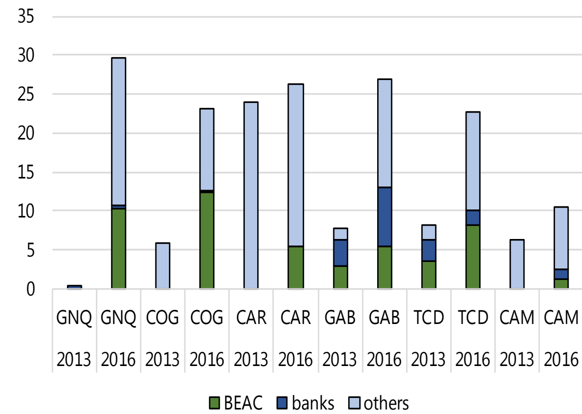


Figure 3. CEMAC: Domestic Debt
(In percent of GDP)



Sources: BEAC and IMF Staff Calculations.

6. Sovereigns have often been directly engaged in banking activities. The are still several public banks, representing 10-15 percent of CEMAC banking activity. Also, some politicians used to be members of banks' boards of directors (this is less the case now, since the COBAC has prohibited such possibility), or some banks may have been encouraged to support sovereigns' refinancing. Finally, in the absence of a strong enough deposit guarantee fund, CEMAC governments were always expected to be directly involved in the resolution of troubled banks.

7. Monetary financing (in place up to end-2017) has led to have a common refinancing rate for banks and sovereigns. In most countries, the central bank policy rate only indirectly influences the financing rate of sovereigns, through the monetary policy transmission channel. In the case of CEMAC, the impact of the policy rate on the sovereign financing rate has been direct for years, since member States used to get financing from the BEAC directly at its policy rate (the BEAC has refinanced up to 20 percent of a member State's fiscal resources). This situation may have generated conflicting interests for the conduct of monetary policy.

8. Finally, and this is more specific to the CEMAC as a monetary union, the most effective means to induce fiscal discipline of member State have relied on the banking channel. While the regional surveillance framework aims at imposing limits on public debt and fiscal positions of member states to support the monetary arrangement and the region external sustainability, its enforcement has been weak (see other SIP). At the same time, the BEAC charter makes provision for the BEAC Governor to request from the authorities concerned, together with the CEMAC Ministerial Committee, to design and implement adjustment measures when a country's situation shows an insufficient balance in its operations account at the central bank (Article 11.2 of the Charter). The enforcement of this provision is leveraging on the banks by reducing their ability to refinance a non-compliant member State. This is achieved through rules related to central bank refinancing operations and those related to banks' prudential ratios.

- *Open market refinancing operations*: the size of open market refinancing operations per country and the size of eligible government securities for these operations[2] are automatically reduced in case the outstanding of the *Compte d'opérations* of a member State is insufficient related to its domestic fiduciary circulation. Following this rule, two CEMAC member States saw the size of open market refinancing operations for their banks reduced by 20 percent in May 2017. Moreover, with regards to the collateral haircut framework, in case a member State has arrears, the haircut applying to its securities should in principle be increased by 10 percentage points.[3]

- *Prudential ratios*: the risk weighting of a member State depends solely on its compliance against the regional convergence criteria. The weights can be very large in case of non-compliance (like 65 percentage points in case of arrears).[4] Such large risk weights make investments in government bonds of such member State almost unattractive, as they lead to very large deterioration of two key prudential ratios: solvency ratio and concentration ratio.

C. Main Negative Spillovers due to the Sovereign-Banks Nexus in the CEMAC

9. With the recent contraction in oil income and the decline in public spending, the banking situation has substantially deteriorated in the CEMAC. Banks' deposits decreased, leading to specific liquidity issues, eventually forcing a couple of banks to ask for refinancing at a penalty rate at the BEAC, in a context of underdeveloped interbank markets. The increase in government arrears in all CEMAC countries and the scaling down of public investment projects have contributed to a large increase in banks' NPLs, as many companies relying on government contracts started facing difficulties to repay their bank loans: the NPL ratio jumped from 9.1 percent as share of total loans at end-2014 to 14.0 percent at end-July 2017. Higher NPLs have affected the profitability of the banking sector and its ability to provide credit to the private sector, since the banks' solvency ratio has significantly declined. Eventually, banks could not provide a countercyclical solution to the current crisis originated from the oil price shock and transmitted by sovereigns.

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[2] The size of the eligible government securities per country for BEAC refinancing operations cannot exceed 15 percent of this member State's fiscal resources.

[3] However, this rule has not been implemented so far.

[4] If a member State complies against CEMAC convergence criteria is risk weighting is 0 percent. In accordance with COBAC regulation R-2010/01, the CEMAC member State assets are weighted between 0 and 100%. The 4 convergence criteria are taken into account as follows: accumulation of arrears (65%), negative budget balance (20%), stock of debt above 70% of GDP (10%), and rate of inflation. greater than 3% (5%).

10. The historical attractiveness of government debt for banks contributed to limited credit to private sector. Since long, banks have favored credit to sovereigns or economic agents related to sovereigns, such as government's suppliers, civil servants, or credit guaranteed by governments, because of their preferential treatment in the banking supervision framework. The credit to other sectors, in particular to small and medium enterprises has always remained limited, even when bank liquidity was abundant, preventing the CEMAC from engaging in better financial inclusion.

11. Governments appear to have slowed down the resolution of problems banks in some cases. While several non-systemic banks in the CEMAC now have negative capital, almost no such banks were resolved in the last decade (these banks represent about 5 percent of CEMAC banking assets). Governments may have been reluctant to sort out such issues, since it could become financially or politically costly. This has kept alive some banks with weak business models. While these banks are non-systemic, long delays in their resolution would likely increase the related fiscal cost.

12. Because of the direct or indirect involvement of sovereigns in banking activities, the banking risk is generally not well perceived by depositors. Currently, the general expectation by banks' depositors is that sovereigns would ultimately bail out banks. As a result, the banking risk is not appropriately discriminated and not well reflected in the banks' conditions offered to their clients.

13. The high dependency of the sovereigns vis-à-vis banks for their refinancing has made almost impossible for banks to readjust their business model when needed. Such readjustments, even if potentially desirable from a banking point of view, could indeed lead to deeper sovereign crisis. This was for example the case in Chad, where a strategy had to be put in place to address short-term liquidity pressures among some domestic banks while alleviating the bank-sovereign nexus. This strategy is based on two pillars: (i) firm plans to put public finances on a healthier footing to reestablish banks' confidence to roll-over large amounts of government securities; and (ii) a credible framework for liquidity assistance from the central bank to commercial banks that is consistent with existing regulations and regional stability objectives.

14. Following the 2017 upward revision of CEMAC member States' risk weighting,[5] most banks are facing difficulties to comply against all prudential ratios. The necessary adjustments by the banks to enable a full compliance against these prudential ratios would require very large changes in their sovereigns' portfolios. In practice, most banks are not making such adjustments, resulting in possible breaches of prudential ratios. The regional banking commission has recently clarified conditions under which banks could be granted a temporary waiver on a case-by-case basis for the implementation of the new sovereign risk weighting. Such solutions, even if no other may have been viable, raise however specific concerns in terms of the credibility of some banking supervisory rules.

[5] Since most CEMAC member States were in breach against most convergence criteria.

15. Some monetary policy decisions were likely influenced by the potential impacts on sovereigns' ability to refinance. For example, the decision to cut BEAC policy rate in July 2015 was certainly more driven by the will to reduce the financing cost of the sovereigns, rather than strict monetary policy considerations. The refinancing cost of the banks (open market operations by the BEAC represented about XFA250 billion in mid-2015) and the credit developments could hardly justify such decision at the time. Similarly, the reduction by half of the reserve requirement rates in November 2016 was not really required for the banks, but was rather a way to increase further excess liquidity and encourage banks to finance CEMAC governments.

D. Considerations to Reduce the Sovereign-Banks Nexus in the CEMAC

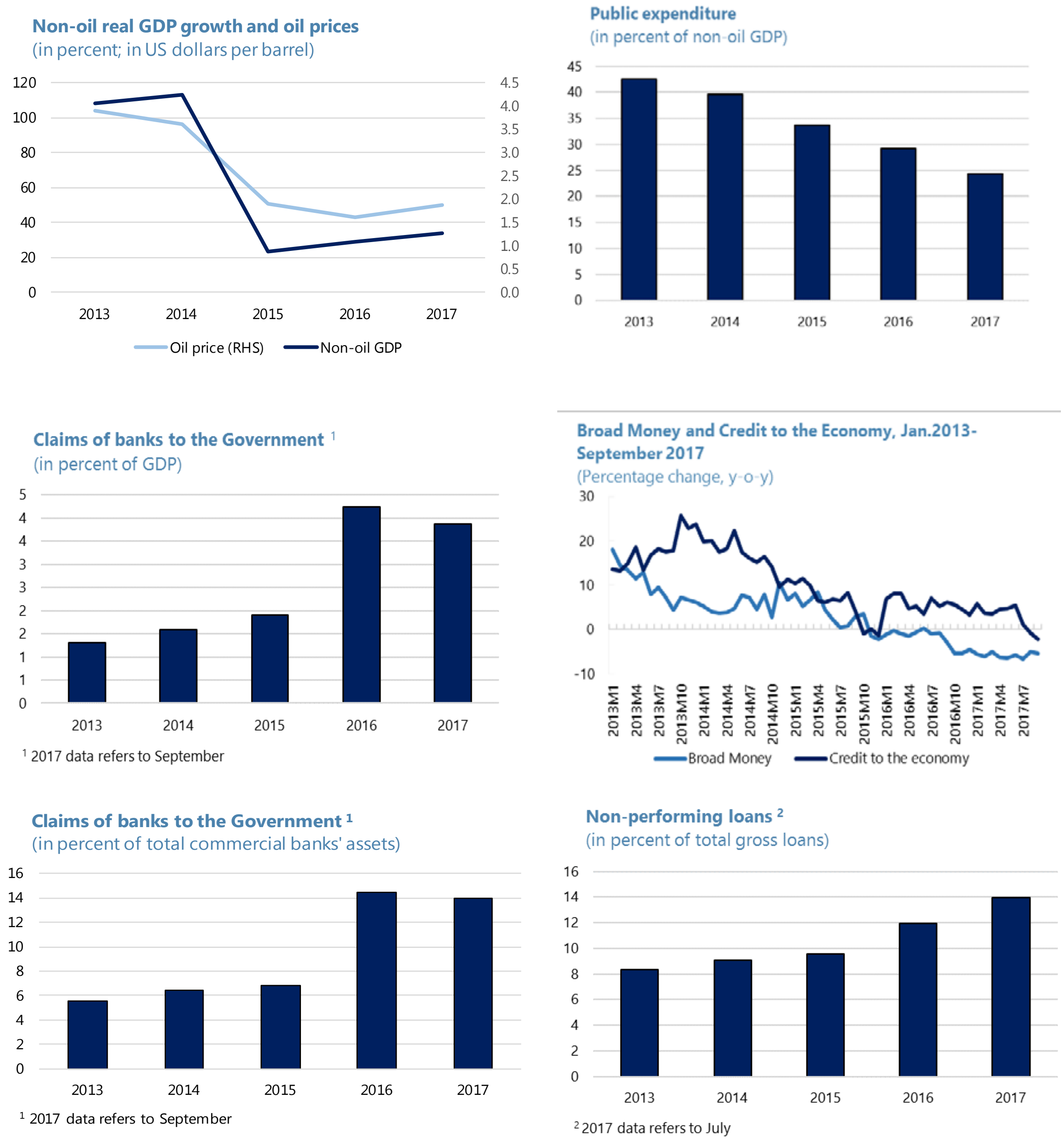
16. Considering the spillovers of the sovereign-banks nexus, it seems appropriate to now review it, and potentially try to change the way sovereigns and banks interact. While it would certainly not be feasible nor advisable to entirely delink sovereigns from banks, CEMAC institutions should however reassess the relevance of some of these links, with the objective to reduce risks of negative spillovers, and strengthen financial stability.

17. Following recent reforms, some links between banks and sovereigns have been removed already:

- *End of monetary financing:* this should allow to severe the direct link between banks' refinancing rate and sovereigns'. The contemplated end of monetary programming and (gradual) removal of ceilings on government securities that can be used as collateral for refinancing should also allow for a more flexible and independent monetary policy implementation.

- *Reinforcement of the banking resolution framework:* first, the CEMAC supervisory body has fully reviewed its banking resolution framework (regulation 02/14). However, it has not been tested yet and CEMAC countries governments may still prefer to rescue banks, depending on the costs. A full application of the resolution framework is still needed to severe the link between the sovereign and banks in distress. Also, the regional deposit guarantee fund should be fully operational soon, both in terms of its own resources (about XFA130 billion at end-October 2017) and compensation rules for depositors.

Figure 4. CEMAC: Oil Price Shock and Sovereign-Bank Nexus



Sources: BEAC; country authorities; and IMF Staff estimates.
[1] 2017 data refers to September.
[2] 2017 data refers to July.

18. Additional reforms that are ongoing or planned should also contribute to further delink sovereigns from banks, and eventually reduce the risks of negative feedback loops between sovereigns and banks. These reforms include:

- *End of the calculation of the size of open market refinancing operations per country and with respect to the member States'* Compte d'opérations: with the implementation of the new liquidity management framework planned for early 2018, the size of refinancing operations will be determined at the regional level and based on autonomous factors to ensure no excess liquidity.

- *End of the ceiling on the size of eligible government securities for refinancing operations*: a strict and granular haircut system for all eligible securities as collateral for open market operations should replace the current collateral management framework, and allow for an appropriate market discrimination among government securities based on the credit risk, instead of an arbitrary ceiling.

19. Beyond these ongoing efforts, more could be done to reduce the links between sovereigns and banks:

- *Broadening CEMAC investors' base for government securities*, in particular by better encouraging insurance companies and pension funds, but also private investors, to purchase such securities. Governments should directly target these investors that still have unused liquidities simply deposited at banks. This also requires developing private markets, and better financial information (the central bank is working on this). The recent decision to merge the two CEMAC stock exchanges in the region into one single stock exchange in Douala, Cameroon, with a single regional regulator in Libreville, Gabon is an opportunity to develop capital markets.

- *In depth review of the risk weighting rules for CEMAC domestic sovereigns*: in many other countries outside the CEMAC risk weighting is set at zero percent. The BIS has not provided guidance that could well apply to the CEMAC case, where positive risk weighting appears needed to encourage banks to consider sovereign risk in their strategy to invest in government securities. New rules could usefully be based on the level of credit risk, rather than the level of compliance of a sovereign against the regional surveillance framework rules. A default of a sovereign could trigger the non-eligibility of its securities for refinancing operations at the BEAC. Also, the COBAC should consider to amend its rules to incentivize commercial banks to favor the diversification of sovereign instruments from different CEMAC countries.

- *Improve arrears and debt management in CEMAC countries:* CEMAC States are major economic actors, and governments' arrears toward firms eventually translate into arrears by firms toward banks. Robust and credible government arrears repayment plans will be paramount to strengthen banks position in the short term. Over the medium term, reinforcing CEMAC governments' capacity to manage their debt, and to avoid the accumulation of arrears, will reduce the risk of spill-over of deteriorated government financial situation on banks.

- *Reinforce independence and management of public banks:* 13 public banks (out of 52) account for 10–15 percent of the banking activity in the CEMAC region, and are much more fragile that their private peers. Their weaknesses have increased on various counts (solvency, liquidity, profits and arrears). This calls for renewed efforts to strengthen public banks' governance, in particular to favor the independent management of public banks by skilled professionals.

20. Finally, structural reforms at the national and regional levels to diversify CEMAC economies would go a long way in reducing the main macroeconomic channel of the banks-sovereign nexus. These will be key to reduce the CEMAC economies' dependence on oil revenues and provide a more stable and sustainable basis for economic development, which would benefit both banks and government finances.