

FESSUD

FINANCIALISATION, ECONOMY, SOCIETY AND SUSTAINABLE DEVELOPMENT

Working Paper Series

No 158

Financial sector development in the context of the
Franc Zone

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Abstract: This paper looks at the common currency area of the Franc Zone in the context of the discussion on financial sector development. We aim to lay out the key historical and institutional factors that have shaped the development of the financial sector in the Franc Zone, a trend which has accelerated since the financial crisis in 2007. In light of the peculiarities of the Franc Zone, which hinge upon its modus operandi, the Operations Account mechanism, we highlight specific constraints and potential future difficulties that could arise from the officially encouraged process of financialisation currently underway.

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

Date of publication as FESSUD Working Paper: March 2016

Journal of Economic Literature classification: H6, F3, F4

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This project has received funding from the European Union's Seventh Framework Programme for research, technological development and demonstration under grant agreement no 266800



Acknowledgments: The research leading to these results has received funding from the European Union Seventh Framework Programme (FP7/2007-2013) under grant agreement n° 266800.

We also acknowledge the valuable comments on this paper provided by Alice Sindzingre.

Website: www.fessud.eu

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I. Introduction

As part of Work Package 6 exploring the new financial relationship between the EU and developing countries, this paper looks at the common currency area in the Franc Zone in the context of the discussion on financial sector development. We aim to lay out the key historical and institutional factors that have shaped the development of the financial sector in the Franc Zone, a trend which has accelerated since the financial crisis in 2007. In light of the peculiarities of the Franc Zone, which centre around the Operations Account mechanism, we highlight specific constraints and potential future difficulties that could arise from the encouraged process of financialisation currently underway.

Alongside other papers in this Work Package concerned with the development of the financial sector in developing countries (such as Tyson and McKinley (2014)) this paper looks in detail at the Franc Zone, the common currency in West and Central Africa. At the heart of the Franc Zone is the Operations Account mechanism run by France's Treasury. With the switch of the peg from the franc to the euro in 1999, France, at the heart of the euro zone, has continued to run a central banking function through this mechanism, to 14 countries in West Africa. In exchange for keeping the arrangement essentially intact whilst European monetary integration has proceeded, the Franc Zone currency arrangement entered into European Union surveillance mechanisms, and crucially, became more integrated in overall EU development policy.

The paper begins with an overview of the key issues in the literature on financial integration in the Franc Zone which has tended to be placed within the framework of the Optimum Currency Area literature (Section I). Section II examines the key mechanism that governs the Franc Zone, the Operations Account. In our view, it is this that differentiates the nature of financial integration in the Franc Zone from other low income countries, even though several of the concerns around the rapid financial development are common to other low income countries. In Section III we identify three periods in the history of the Franc Zone

distinguished by the financial reforms undertaken in the Zone. The reforms were initiated by the IMF and World Bank during the period of adjustment programmes. A subsequent reform occurred through the explicit adoption of the EU's model of integration.

Our research identifies a significant theoretical and analytical issue at the heart of the literature on and policy practice in the Franc Zone. There has been a change in attitude towards government borrowing both in theory as well as policy practice. We trace a transition within the literature that started from discussing stagnation and debt burdened crises that began in the late 1970s and were generalized by the 1980s, to the current framework where the Franc Zone's economic development fits neatly into the expanding financial development literature and is discussed as consisting of "lucrative debt markets" for global investors searching for yields. The literature on how government borrowing is perceived has in some ways changed. A key element of the integration process is the development of a government securities market as a necessary precursor to deepening the private capital market. Marketable government debt has historically facilitated the emergence of private debt markets. In the remainder part of the paper (Section V) we outline how this process has been undertaken in the Franc Zone. Overall, we conclude that there has been a shift in rhetoric about government financing - from negative due to crowding out arguments to more favourable views because the provision of good collateral is supposed to promote domestic financial deepening. Our paper concludes however, that the internal mechanism of the Franc Zone, the Operations Account, may prove too strict to accommodate the generalized credit boom which is currently underway.

II. Justifications for the Franc Zone

The African Franc Zone consists of a common currency area between two sub regions in Sub Saharan Africa, each with a central bank. The West African sub region consists of Benin, Burkina Faso, Guinea Bissau, Ivory Coast, Mali, Niger, Senegal and Togo. The

Central African region consists of Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea, and Gabon, and the Comoros Islands are also part of the Franc Zone arrangement. In this section of the paper we present an overview of the English-speaking literature which has tried to provide economic rationales and theoretical justifications for the Zone and have followed trends in the literature on developing economies. In particular we examine the Optimal Currency Area (OCA) literature alongside other explanations for the Franc Zone's emergence, durability and appeal.

The operation of the Franc zone emerges out of colonial monetary arrangements that France had set up during the 1930s and 1940s. At the end of the Second World War its African colonies' currencies were consolidated and from independence onwards the new currency was baptised as 'Communauté Financière Africaine'. The principles guiding the nascent Franc Zone's organisation were a rather crude form of a gold standard.

Over the last half-century or so, since the independence of those colonies was achieved, assessments of the functioning of the Zone have tended to be in terms Optimum Currency Area (OCA) theory. The standard reference of this literature is by Mundell (1961) and was developed by subsequent contributions by McKinnon (1963), and Fleming (1971) which identify key conditions that would enhance the operation of a currency union. According to this literature, relinquishing monetary and exchange rate policy reduces the policy instruments available to governments for dealing with changing economic circumstances. In order to mitigate the varied difficulties that countries may face, the OCA literature looks at certain features that would lessen these difficulties and thus create more of an optimal currency area. The justification for countries to join a currency area under OCA theory is based around describing the necessary conditions, such as symmetry of shocks, high factor mobility and high intra-regional trade, that would allow the benefits of membership to exceed the costs.

The majority of the literature on the Franc Zone has the OCA literature as its starting point, yet most of the literature that seeks to explain the durability of the Franc Zone concludes that the Franc Zone is not an Optimal Currency Area (Boughton 1991; Hallet 2008; Fouda and Stasavage 2000 and Strauss-Kahn, 2003). Wage and price flexibility is presented as the key adjustment mechanism through which countries can respond to changing external conditions given the inability of the exchange rate to adapt to changing external circumstances (Mougani, 2014). Such a requirement assumes private, public and producer prices are able to respond through absolute reductions in order to meet decreases in external revenues such as export earnings. The onset of the first structural adjustment programmes in the region and the experience from the commodity price collapse and response to price and wage cuts, as for example in Cote D'Ivoire from 1980, indicated for example, that price and wage deflation were not routes for any equilibrium to be restored.

The structural characteristics of the economies and the degree to which they respond in similar ways to external shocks are important factors that can minimise the relative price shifts among countries. When domestic nominal price and wage flexibility is limited, OCA theory identifies factor mobility as an important adjustment mechanism, with labour migration responding to changes in relative wage changes. In theory, relative price shifts would be mitigated the higher the degree of factor mobility between countries (Boughton 1991). Although in the Franc Zone there is in some cases high labour mobility it is not clear this responds to movements from areas of high unemployment to low.

The OCA literature understands the desirability and viability of a common currency area as occurring between homogenous and integrated countries, which face similar external difficulties. According to this view, a currency area is more optimal, the more symmetrical their responses are to external shocks. The way that countries in a currency union respond to external changes is determined by the degree of diversity in export and import structures between the countries and the trend of the terms of trade. Within the Franc Zone there is a small degree of intra-regional trade and the diversity of export structures has increased,

with the West Africa area relying more on the export of coffee and cocoa and the Central African area relying more on minerals and oil exports. The prices of these commodities may move in different ways which in combination with the changing exchange rate the exports are priced in lead to changes in competitiveness between the countries in the Franc Zone (Boughton 1991). Furthermore, at times divergent inflation rates within the currency union reinforced an increased loss of competitiveness for the high inflation countries.

The OCA literature is often the starting point to explain the puzzling fact of the Franc Zone's remarkable continuity. However, even when justification for the Franc Zone does not follow traditional OCA criteria, ardent supporters of the Franc Zone look at the benefits of Franc Zone membership from a different perspective. The first is to establish whether members of the Franc Zone have grown faster than Sub Saharan African countries who are non-members. Several empirical studies compare the macroeconomic performance of Franc Zone countries with non-members in Sub Saharan Africa. The main overwhelming benefit is the significance of a more stable inflation rate and the lack of exchange rate crisis. Studies such as Elu and Price (2010) provide evidence that participation in the Franc Zone has contributed to higher growth rates than other Sub Saharan African countries. Debrun, Masson, and Pattillo (2003) draw on the Franc Zone experience to provide empirical support for the desirability of the creation of a broader West African currency union. Anyanwu (2003) finds empirical evidence to support that the monetary union in West Africa has been especially beneficial for economic growth. Balogun (2008) constructs a formal model to show that currency unions are worth replicating in Sub Saharan Africa. Strauss-Kahn (2003) highlights the benefit accruing from relinquishing monetary policy autonomy lies in reducing the transaction costs in external trade and the enhanced price stability arising from anchoring with a country which has a lower inflation rate. Couharde et al. (2013) evidence that the Franc Zone may not be Optimal, but it is sustainable. They estimate document a convergence process in real exchange rates towards their equilibrium paths as an explanation for the sustainability of the Zone. Devarajan and de Melo (1987), and

Guillaumont, Guillaumont, and Plane (1988) find that the growth performance is better for those who are part of the Zone.

However, significant evidence is mounted to the contrary as well. Assane and Pourgerami (1994) cannot replicate the beneficial results mentioned above. The study by Devarajan and Rodrik (1991) shows that the Franc Zone performance was worse than that of comparable countries, with overvaluation of the exchange rate as the main constraint. Newman et al. (1990) and Savvides (1996) also find that being a member of the Franc Zone had a negative impact on the growth paths of the economies.

Another key element of the literature assessing the merits and costs of the Franc Zone surrounds the issue of competitiveness loss arising from the fixed parity. This loss of competitiveness that may result when the exchange rate tool is given up has been highlighted as a key problem for the Franc Zone countries, especially given their attempt to undergo some sort of structural transformation. A fixed parity undermines the competitiveness of member countries if the CFA franc is considered to be overvalued, which by many was considered to be the case for a long time (see Dearden (1999))

The devaluation of 1994 which is examined in more depth in Section IV and the subsequent pegging from the Franc to the euro raised new concerns about what the exchange rate dynamics would be between the Franc Zone and its nominal anchor. It is entirely coincidental if the monetary policy pursued by the European Central Bank is suitable to the members of the Franc Zone. With a growing importance of the Franc Zone's trade with countries outside of Europe, there is an increased importance to the Euro / Dollar and Euro / Yen exchange rate and its effect on Franc Zone countries. Given the divergent structures of trade and external liabilities and different currencies these are priced in, exchange rate movements affect different countries in different ways. For example, for those countries which trade significantly with Europe, a strong euro increases problems of competitiveness in the France Zone (Fouda and Stasavage, 2000). The real effective exchange rate (REER)

has appreciated because of the increasing trade with Asia (in dollars) and due to the appreciation of the Euro / Dollar exchange rate (Djoufelkit, 2007). To the contrary, a weak euro would improve international competitiveness but weaken external debt situations (Dearden 1999).

The brief literature survey indicates that the traditional explanations for the emergence and durability of the Franc Zone do not sufficiently capture the complex arrangement and varied experiences of countries therein. Apart from the close political relationship between France and its former colonies, various economic benefits from membership have been adduced over time. The original economic justification for the zone was the provision of currency that would not be vulnerable to inflation and would allow free movements of capital within the zone. Most authors who go down the OCA route conclude that the Franc Zone cannot be assessed in OCA terms. This literature however reveals confusion about the causality and circularity regarding regional economic integration and the benefits that may result. Does the presence or absence of OCA characteristics have sufficient explanatory power to explain the emergence and justification of the currency union arrangements? This is doubtful without taking into account the specific historical and political circumstances that allowed such arrangements to emerge and continue. Given that the Franc Zone cannot be understood in these terms, the literature seeks alternate justifications and explanations. Several authors (for example Assoua (2013) and Couharde et al. (2013)) point out how limited OCA theory is when applied to the Franc Zone, as it cannot account for non-monetary and non-financial justifications, such as political factors, for the Zone's existence.

The reasons for the Franc Zone's creation and durability are more adequately explained on political rather than economic grounds. Several authors conclude that it takes more political will than economic rationality to sustain a monetary union (Lamine 2006; Bordo and Jonung 2003) and who find the most adequate explanation of the Franc Zone's sustainability by identifying a series of political considerations, such as the close collaboration between the African and French elites (Stasavage 2003). Fouda and

Stasavage (2000) conclude that although the maintenance of the Franc Zone cannot be supported on OCA considerations, the benefits of remaining in the Franc Zone could accrue from policy credibility and fiscal discipline. Despite this claim, the authors highlight several ways in which the currency union was not able to constrain fiscal policy and thus call for significant institutional re-organisation in order to achieve greater policy credibility.

With the crisis in Europe all this literature has been fundamentally and irreversibly shaken. New concerns have arisen about how the Euro Zone's crisis affects the developing countries which peg to the euro. More significantly, the European crisis brings to the fore much broader concerns, such as the costs of maintaining a currency union. This has largely delegitimised the rosy picture of integration that dotted the literature on financial and regional integration. In the words of the African Development Bank: "the Euro zone crisis has threatened to disorganise the European monetary integration model that Africa sought to imitate" (Mougani 2014: xvii).

A key element missing from this literature is cross-border debt. The discussion of the Franc Zone as an Optimal Currency Area, or in relation to its economic growth or politics, omits the key factor that initiated the process of reform and restructuring in the Franc Zone in the 1980s, namely the foreign debt of the countries in the zone. It is this lacuna in the literature that our paper addresses.

III. The Operation Accounts at the French Treasury

The Franc Zone arrangement is frequently described as being constituted by four main principles at its core. First is the convertibility of CFA francs into French francs at a fixed exchange rate. The parity remained unchanged since 1948 with the exception of the devaluation in 1994. The second pillar is that France guarantees this convertibility between CFA francs and French francs (until 2002, and since then convertibility into Euro) through

the 'Operations Account' that will be discussed in depth in this Section. Thirdly, in exchange for the convertibility guarantee, Franc Zone countries must maintain the majority of their foreign exchange reserves at the central banks of the Zone. Fourthly, capital mobility throughout the Franc Zone and between the Franc Zone and France is needed (Boughton 1991; Allechi and Niamkey 1994).

This set of arrangements has severe macroeconomic implications for the members. Members' balance of payments imbalances are financed through the Operations Account, either using the pooled reserves of other members that are obligatorily kept there or through the guarantee by the French Treasury to supply necessary foreign exchange via an overdraft facility in the Operations account.

There is an observable constraint on the growth of the monetary base although the system itself does not force an equal inflation rate onto each country (Boughton 1991). This mechanism was inspired by the Bretton Woods accords of the Post War era and the gold-exchange standard these set up. The Franc Zone poses a credit constraint on the member countries which can be likened to the legislative restrictions and credit controls of the Bretton Woods era, that were accompanied by a restriction on the amount of dollars in circulation limited by the gold reserves kept by central banks. In the Franc Zone credit expansion is limited through the legislative rules which place limits on the two central banks credit and reserve policy. Target balances in the Operation Account are maintained through legislation on the credit creation of the two central banks. For example, the regional central banks restrict the availability of credit by raising the cost of rediscounting and by limiting the amount of credit available to governments, although this has now changed.

Although the Franc Zone is inspired by gold exchange standard mechanisms there are some key differences. The CFA Franc could not be bought and sold on the market, but rather only be converted into French Francs (Allechi and Niamkey 1994). Thus the sale and

purchase of CFA francs appear on the Operation Account in the French Treasury as debits or credits, whereby those needing foreign exchange debit the Operation Account whilst those supplying non-CFA currencies credit the account (Engberg 1973). The French Treasury steps in when the overall balance of the Operations Account is in deficit. The degree of fiscal intervention by France is regulated by the overall payment balance across each sub region, rather than imbalances in individual countries.

The reserve pooling arrangement implies that countries can credit and debit the Operations Account by drawing on and supplying each other with reserves. French Treasury intervention is unnecessary if the net overall balance is positive even if there are diverging balance of payments needs between the countries. For example, in the 1980s Benin, Cote D'Ivoire and Senegal drew down the operations of other countries with surpluses in the Operations Account, such as Burkina Faso, Niger and Togo (Allechi and Niamkey 1994). Fiscal interventions by France are therefore only required if and when the overall balance of the Operation Account is in deficit, for at other times, the reserve pooling system means that according to whether a country is in deficit or surplus it will draw on or provide reserves to other countries in the Zone.

The heterogeneous nature of the Franc Zone and specifically, the asymmetric responses to external shocks is the characteristic that makes the Zone less than Optimal following the OCA literature. Franc Zone countries have distinct and diverse export structures, which respond in unsynchronized ways to changing global conditions. The contradiction in this arrangement is that the reserve pooling mechanism's functions reduce the need to rely on France's overdraft precisely because of these asymmetries. Limitations placed on the Operations Account constrict the ability of countries to draw down the "unlimited" overdraft facility provided by France, by in effect, making it quite a limited facility, as countries most frequently draw on each other's reserves rather than relying on France. Furthermore, the disciplining mechanism on countries with imbalances would be applied politically by France. For example, as commercial bank lending is limited by, among others, the amount

of reserves it must keep at the central bank, similar to such a mechanism are the limitations imposed on the overdraft facilities of the Operations Account in the French Treasury. These include minimum reserve ratios between the foreign exchange reserves in French francs and the deposit liabilities and restrictions on the monetary financing permitted by each central bank of governments' deficits.

In times where the Operation Account is in extended deficit, automatic measures are built in, such as making it more costly to run deficits, enforced by increasing the discount rate, a rate that the French Treasury charges for net imbalances.

Apart from the statutory regulation between the two central banks and France, political involvement in regulating overall credit policy has been instrumental in the monetary arrangements of the Franc Zone. The governance of the two central banks has included greater African participation since independence; however, French officials maintain high representation in the Boards and veto power.

One strand in the literature that emerges assesses the disciplinary capacity of a strict monetary regime on the fiscal balance of participating members. The ability of an exchange rate mechanism per se to act as a disciplinary mechanism on governments, as well as the means with which it could do so, is contested in the literature. One dominant stream maintains that a monetary union and an exchange rate peg are mechanisms that assist fiscal discipline of governments. Such discipline has traditionally been held to prevent 'crowding out' or the use of scarce 'savings' for government consumption rather than private investment. If private savings are being used by (lent to) the government instead of being intermediated through private banks, the relative interest rate will rise, reducing further the loanable funds to the private sector. The higher borrowing costs that result from increased government deficits "crowds" out firms and households.

An exchange rate peg with full convertibility is supposed to act as a disciplinary mechanism for expansionary fiscal policies since direct monetary financing could force the peg to be abandoned. This view emphasizes the exhaustion of reserves and possibly politically costly abandonment of the peg that could result. The level of foreign currency reserves that back the pegged currency act as a constraint on the fiscal deficit. One IMF historian (Boughton 1991) remarks there is little doubt CFA has imposed fiscal discipline. Before the 1980s crises the merits of the Franc Zone were frequently ascribed to the disciplinary capabilities enforced by the currency union.

This view is contested however on theoretical and practical grounds. Tornell and Velasco (1995) provide a theoretical critique of this argument by pointing out how countries under flexible exchange rate may face alternative disciplinary mechanisms on fiscal behaviour. In the 1980s Franc Zone countries saw their export earnings collapse with the prices of primary commodities declining. Access to the expanding international dollar markets grew and most of the Franc Zone countries became embroiled in a severe debt crisis. This led to the devaluation of 1994. Hadjimichael and Galy (1997) argue that the Operation Account rules were not sufficient to instill fiscal discipline. Stasavage (1997:132) presents mounting evidence for even the strongest proponents of the Franc Zone to agree that fiscal discipline was not promoted through the currency and monetary arrangements of the Franc Zone in the 1980s and early 1990s. He argues that in the CFA Zone the traditional view that a hard peg would encourage fiscal discipline was not the case because of institutional flaws in the design of the union and political interests on behalf of French and African elites. By presenting a detailed composition of the methods of fiscal financing and the means available to circumvent the institutional constraints of the Zone, we see how the composition of public debt develops in the Zone.

The available sources of fiscal financing to Franc Zone governments were direct financing of treasuries via the two central banks which were limited in financing up to of 20% of government's past fiscal receipts. Government deficits were also funded from abroad; up to

the mid-1980s access to heavy commercial external borrowing (Eurobonds) was prevalent but as this dried up it left official IFI loans and donor aid funds as the main source of external financing. The de facto practice of accumulating arrears with domestic suppliers and creditors also created the image of improved fiscal positions by leaving pensions and payment public sector employees unpaid (Stasavage, 1997). A fourth key financing mechanism was indirect financing of budget deficits via domestic commercial banks which were often government owned. These loans presented a circumvention of the fiscal borrowing rule of the Central Banks of the Franc Zone and these loans were refinanced through the regional central banks at subsidised rates (Honohan 1993). This practise was key in the worsening conditions of the late 1980s and was part and parcel of the banking crises that developed in almost every CFA country at that time.

Though the Franc Zone's central banks did not directly influence the way each country built up arrears or borrowed from abroad, they were part of the refinancing policy that permitted the commercial banks to over lend to the governments. French officials have strong authority over the decisions of the two central banks. As detailed by Julienne (1988) in (Stasavage 1997: 60) the choice and operation of the Franc Zone central banks are highly politicised both by their choice of location, nationality of governor and de facto importance of French officials in decision making. The crises in most Franc Zone countries built up the pressure for the historic devaluation of 1994.

“In each country where a restructuring of the financial sector was undertaken, debts owed by failed banks to BCEAO and BEAC were absorbed by governments as ‘consolidated credits’, and governments in turn were allowed to refinance these consolidated credits with each central bank at a heavily subsidised rate ... weakening the income position of the two central banks and leading to a situation where a few states are now garnering a vastly disproportionate share of central bank seignorage” (Stasavage 1997: 137).

To summarise, the original mechanism of the Franc Zone was budgetary in nature, supported by the French Treasury. The Operations Account has been described as resembling a “discount window” at the French Treasury for the two central banks (Engberg 1973: 539). What this implies is that the French Treasury performs a central banking function to the two sub regions to cover the region’s reserve deficit. Had this arrangement been based in the French Central Bank, financing of the overdraft would represent reserve creation of the Banque de France, whereas, currently, the overdraft is financed through the budget or by borrowing (Engberg 1973).

IV. Structural changes that promoted financial sector development

IV.I Conditionality programmes from the International Financial Institutions

The situation in the France Zone deteriorated dramatically in the early 1980s, most frequently attributed to the dramatic decrease in the terms of trade following the commodity price collapses and the sharp appreciation of the French franc under President Mitterrand’s *Franc Fort* policy. The severe debt crisis that much of the developing world experienced, including the Franc Zone, had implications for restructuring that promoted financial sector development.

Over the course of three decades the entire region has gone through structural adjustment programmes and several rounds of debt restructurings, through the IFIs and the private Paris Club. The persistence in many countries of a precarious debt situation despite numerous debt restructuring programmes confirm many arguments advanced by critics of these highly conditional multilateral debt relief programmes. Assessing these lies beyond the scope of this paper, however they represented major influences in the developments in the Franc Zone. The conditionalities attached to the programmes included financial sector liberalisation and reforms that encourage economic integration. For example, specific reforms to further financial integration and encourage competition within the domestic

banking sector have been implemented as part of these broader programmes (as an example see Cameroon's PRSP IMF (2006)).

IV.II Exporting the EU model to the Franc Zone

A deteriorating balance of payments built pressure to go forward with currency devaluation in 1994, altering the parity between the CFA franc and the French franc for the first time since 1948. This prompted deep institutional changes within the Franc Zone which model it explicitly along the lines developed in the EMU. From this perspective we see a more active attempt to model the Franc Zone as an OCA to extract more of the alleged economic benefits.

The devaluation of the CFA Franc in 1994 spurred a series of institutional and policy changes across the Franc Zone. Where the problem was identified as being insufficient integration across the Franc Zone, it was argued that more of the economic benefits of a currency and monetary union would be harnessed if only the Zone was better integrated (Hallet 2008). Specifically, it was recognised that governments in the Franc Zone needed more effective debt markets to avoid recourse to the French Treasury or the International Monetary Fund. At the same time an expansion of regional cross-border trade in Africa was needed to reduce financial and economic dependence on France. The result was the extension of the monetary union to other kinds of economic co-operation and financial integration. The previous institutional arrangements were replaced by the Central African Economic and Monetary Union (CEMAC) and the West African Economic and Monetary Union (WAEMU). These institutions greatly expanded on previous monetary arrangements extending to broader economic, legal and regulatory reforms.

From 1994 onwards, the model of integration copied the framework of the EU. Several elements of EU rules were "exported", thus the new arrangements in the Franc Zone were an explicit transfer of norms and institutional similarities and objectives of the EU, whose

constraints and feasibility of such replication have been detailed in Claeys and Sindzingre (2003). The limitations of the viability of such a replication stem both from the nature of the EU model and the characteristics of the Franc Zone. Furthermore, the on-going crisis and re-organisation of the EU is affecting the desirability of the model.

The institutional replication involved setting up in the Franc Zone up two regional Commissions, Council of Ministers, and Heads of State meetings as well as common Treaty Law. For a detailed description of each sub region's new institutions (see Lamine 2006). The 1994 devaluation followed by the third stage of European Monetary Integration following shortly after, set in motion regional processes of economic integration by setting up convergence criteria and ensuring these are met by setting up corollary multilateral surveillance arrangements. The convergence criteria focus on fiscal consolidation which differentiate between primary criteria (budget balances, debt levels, inflations, and payment arrears) and secondary criteria (wage bills, tax revenues etc). The multilateral surveillance framework in the WAEMU was set up in 1999 and in CEMAC in 2001. The framework of multilateral surveillance is constituted in a Treaty along the lines of the EU's Growth and Stability Pact, called Convergence, Stability, Growth and Solidarity Pact. The responsible authorities for the implementation of these surveillance mechanisms are the regional Commissions and countries deviating from the convergence criteria define a "corrective" programme with the regional Commission (Banque de France, 2014). The annual or biannual meetings of Franc Zone Finance Ministers, Governors of the central banks and relevant authorities in presence of the French Finance Minister have repeatedly focused on improving convergence of macroeconomic policies and improving multilateral surveillance across countries (see Franc Zone Finance Ministers press releases since 2011 at Banque de France).

Other institutional changes include setting up a customs Union in WAEMU in effect since 2000, introduction of a common external tariff and removal of duties on intraregional trade, adopting common business law through an initiative to harmonise business in Africa,

setting up a Court of Justice in each Zone and falling more rigidly within the IMF's Article VIII demand that all transaction restrictions on current payments are removed (See IMF, AA VIII.2)

At the time of the adoption of the euro a new wave of literature emerged which sought to assess the impact that the switch of the peg from Franc to euro would have on the member countries of the Franc Zone. As the European states headed towards the third stage of integration and the introduction of a single currency, a protracted discussion began about how the Franc Zone arrangement ought to be interpreted and treated under Maastricht Rules. France initially argued that given the budgetary nature of the arrangement it should be treated as a domestic affair and that it is compatible with Maastricht criteria (Care, 1997). However, given the exchange rate mechanism implicit in these arrangements, and thus their monetary nature, the switch of the Franc Zone's peg to the euro mechanism was formalised within an EU Council Decision of November 23rd 1998, through the reasoning that exchange rate systems linked to the euro ought to come under European Council oversight. (This is further discussed in Hadjimichael and Galy 1997 and Lamine 2006).

The switch to the euro was relatively smooth; certain oversight functions were moved to the EU level, such as decisions to change the parity with the euro requiring EU permission, as well as a strict understanding that there is no obligation for the ECB to support the peg or the convertibility. So long as the arrangement remains budgetary and with the French Treasury it does not in theory oblige the ECB to support the peg (Allen and Hagan 2005).

IV.III The Franc Zone and the New EU Development Policy

So far we have identified two processes that led to significant overhauls of the financial system in the Franc Zone arising out of the various IFI-led structural adjustment programmes and the EU-led adjustment that occurred after devaluation. A third and more

recent trend further advances the financial sector development of the Franc Zone. EU Development Policy which has whole heartedly embraced the financial sector development paradigm explicitly refers to countries of the Franc Zone, by integrating them into their policy and funding programmes. Examples include the European Development Fund (EDF) which funds the promotion of regional integration in the Franc Zone. In Central Africa, the EU is working with CEMAC and its member states to promote economic and financial integration via its Regional Indicative Programme for Central Africa 2014 – 2020. A similar Indicative Programme has been set up for West Africa, encompassing both WAEMU and the broader regional body ECOWAS, in order to promote “regional economic integration and support for trade and private sector”. Such funds have been used to establish a common market and to promote private sector competition (See European Commission, International Cooperation and Development, West Africa).

Furthermore, the EDF funds both the West African sub grouping in the Franc Zone, the WAEMU and the broader West African regional body the WAEMU belongs to, ECOWAS, to further regional integration and objectives established under the common Economic Partnership Agreement (EPA). EPAs are trade agreements between the EU and involve the ACP regional grouping. Under this programme, the EU has committed to €6.5 billion in the West Africa's Economic Partnership Agreement Development Program (PAPED) for the period 2015-2020, see for example European Commission (2015).

V. Recent trends in financial deepening in the Franc Zone

The traditional literature on the relationship between finance and development focuses on how more finance can bring about more development. The main mechanism that brings this about is the loanable funds model of financial markets channeling savings to investment and this bringing about development (see King and Levine, 1983, and Levine 1997). A key trend that is identified in the Financialisation in Developing countries

literature (see (Bonizzi 2013)) is the structural transformations that occur to the financial sector, with a transition to market based regimes being a key characteristic of financialisation in developing countries. Although this is well documented in Middle Income Countries, there are less studied in Low Income Countries.

As a product of the three distinct but parallel processes described in the preceding section, financial sector reform was pushed forward with setting up new institutions, such as regional Bourses, and the regional banking commissions which were responsible for much of the financial sector restructuring in the post devaluation period. Central to the political push for regional economic integration has been a set of policies to 'deepen' the financial systems of countries in the Franc Zone as indicated by decisions of the monetary and fiscal authorities to promote government debt markets in their areas (Cabrillac and Rocher 2009).

The expansion of the local debt market was prompted by a number of developments, including changes in the rules of how governments finance themselves. Of particular importance to the development of domestic debt markets is the restriction of direct monetary financing by the regional central banks (Banque De France 2006). The international financial community encouraged the WAEMU and CEMAC to move towards central bank independence thus limiting or phasing out the direct advances made by central banks to governments. Under the previous rules the Central Banks of the Franc Zone could provide borrowing for member governments of up to 20% of their current budget. New rules prohibit member state's fiscal deficits from being financed by the central banks thus prompting governments to turn to issuing securities, and encourage the development of local currency debt markets.

The development of the domestic debt market in Franc Zone countries came after the development of the domestic debt market in non-Franc Zone countries which had begun from the 1980s (Christensen 2004: 4). As domestic debt markets develop in the early 2000s

a discussion emerged on the choice between external and domestic debt that countries face in financing budget deficits. Due to the highly concessional external borrowing available to Sub Saharan African countries, domestic government borrowing has generally been more expensive. Beaugrand, Loko, and Mlachila (2002) argue that “highly concessional external debt is usually superior to domestic debt in terms of financial costs and risks, even in face of probable devaluations”. Despite the higher costs associated with domestic debt, the surrounding strong promotion of market based financing means that domestic debt market development is a key element in the financial deepening agenda.

As outlined in preceding Section the reform packages that were adopted as necessary preconditions for countries to receive debt relief during the debt crises they faced included financial integration measures (see for example (IMF 2006)). Financial integration was also promoted under the institutional reorganisation developed to mimic the EMU model of integration. In what appears to be a disassociation from the history of negative experiences with debt crises, the recent scholarship has emerged to enthusiastically apply all the assumed benefits of market based financing to the Franc Zone countries.

What are the benefits of countries moving away from official bilateral and multilateral, mostly concessional lending and towards a market based, diversified funding sources? One frequently stated reason is that the creation of a liquid government securities market will facilitate monetary policy implementation. Another frequently stated reason is the benefits ascribed to foreign borrowing, whereby foreign savings can be effectively utilised to fund domestic investment in capital scarce countries. Importing (private) capital from abroad allows developing countries access to funds to finance domestic investment, which will in turn provide the necessary resources to service their debt in the future.

Low income countries have had limited if any access to international capital markets. The development of developing country domestic debt markets has been institutionally promoted by the International Monetary Fund and the World Bank. For the IFIs, the

development of the domestic debt market has become a stepping stone in the overall financial development of low income countries. The IMF used to place limits on the borrowing a Low Income Country under an IMF programme could access at non concessional rates. These limits have been now made looser and this allows for a greater proportion of non-concessional borrowing even for LICs under IMF programmes (Allen and Hagan 2005). Domestic debt market development would reduce reliance on bank lending and broaden investment opportunities, enhance capital allocation by directing savings towards investments, and enhance risk management by distributing risk among varied investors (for a deeper exposition of these arguments see Adelegan and Radzewicz-Bak 2009; Gulde 2008).

As the literature emanating from the IMF in particular lay out, domestic debt market development is seen as a key aspect of developing the overall financial system. Besides the aforementioned benefits proffered as accruing to the governments once they develop market based financing the other key stated benefit is the relationship this has to furthering private debt markets. "Achieving rapid growth in private debt markets is generally the second key objective of a government securities issuance strategy" (Cabrillac and Rocher 2009: 15).

The reason is that the developments of the government securities market alongside the institutional changes that facilitate it are seen as a prerequisite for the subsequent development of a private debt market. A key part of this process is the benchmark created from the government securities market from which private securities can be priced. The enthusiasm for expanding government securities markets can thus be linked as a means to develop private capital markets. "Yields on government securities can serve as a pricing benchmark for long-term private debt issued by banks or enterprises" (Abbas and Christensen 2010: 214) which has also been argued would enhance corporate bond market development and put pressure for competition on the banking sector (Fabella and Madhur 2003).

Although it was popular in the past to argue against the expansion of local government debt, with the most commonly sighted explanation being that domestic government debt crowds out private sector credit, and has negative consequences for private investment, we can observe a decisive shift in the literature, with conflicting views of old literature and new, as it tries to contend with the latest enthusiasm for securitised government debt and market based financial integration.

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

Within this strand of the literature a new series of problems that developing countries face and thus need to be changed have been identified as crucial in order to "make finance work for development". They point to shallow financial markets, narrow investor base, missing or small stock markets and weak legal structures. However, the most serious challenge posed to the financial sector development agenda is the increasing attention drawn to the potential for yet another serious debt crisis in the region (See UNCTAD (2015) for an analysis of this discussion). This is a serious tension in the literature that on the one hand encourages such developments and on the other warns against rising debt levels.

The efforts of the private sector and the donor community into developing domestic bond markets have been considerable (Moyo 2008; Dahou, Omar, and Pfister 2009). However, the IFIs, main donors and government efforts at furthering financial deepening have often been disparate and uncoordinated. To address this problem, they were brought together through

the African Development Bank. The IFIs, the private sector and the major donors now collaborate under the *Making Finance Work for Africa Framework*. The African Financial Markets Initiative hosted in the African Development Bank has the sole goal of developing and deepening domestic financial markets in Africa (see African Development Bank 2015).

Although this trend is not specific to the Franc Zone, it has specific characteristics and consequences for the Zone. In 2006 for example, the WAEMU region set up a new credit rating system to encourage bond issuance (Moyo 2008). Institutional barriers are targeted and transaction costs are attempted to be reduced. A mortgage market and securitization programme is underway, spearheaded by the regional Bourse, the BVRM and the custodian agent of the regional central bank, the DCBR. Although the risks are recognised, the process is continuing rapidly. Certain countries in the Franc Zone have seen a rapid credit growth in the past decade. Recent research shows (Griffith-Jones and Karwowski 2014) that for a few of the Franc Zone countries, credit growth was close or far above 100% of their GDP.

VI. Conclusion

The debt restructuring programmes of the last three decades reduced overall debt burdens and in certain cases improved debt sustainability indicators. This improvement, the structural changes brought about as conditionality for debt relief, the EU's development agenda and the application of the 'financial development' literature has created a new policy agenda for the Franc Zone in which the development and promotion of foreign debt is once more considered as a condition of economic development in general. The changes underway have set countries up for a new cycle of borrowing, despite the tensions and warnings being issued by the very proponents of these policies (See UNCTAD, 2015).

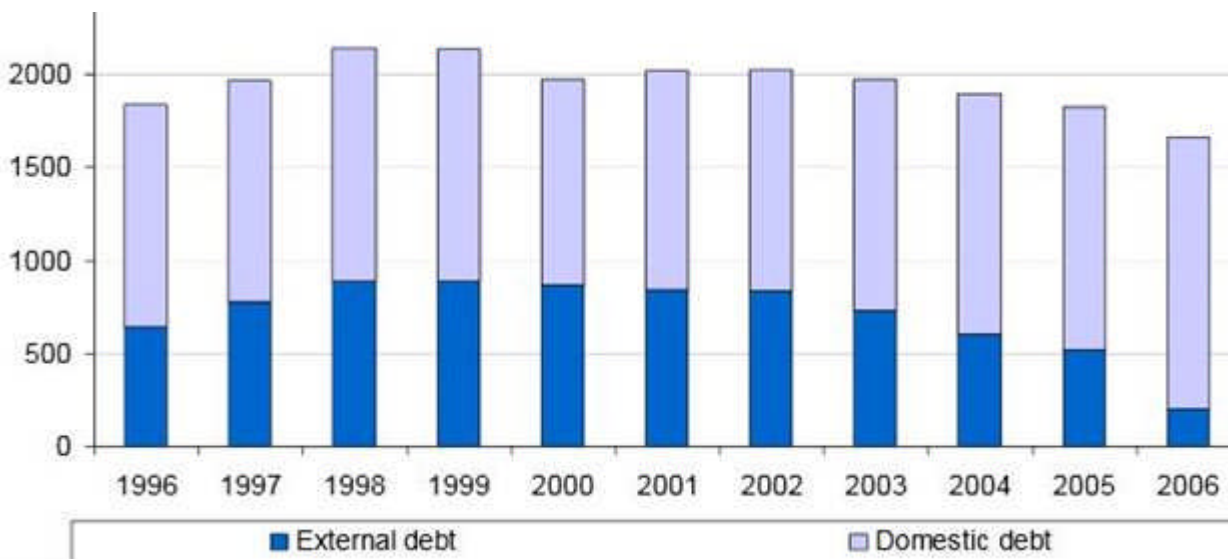
Where the problem of the 1980s was interpreted as a problem of foreign currency borrowing, the solution that developed was to expand debt markets in domestic currency. The contribution of domestic debt markets to debt sustainability lies in the greater ease with which governments and companies may manage cash flows and borrowing in their own currency. On the one hand, a fixed exchange rate system like that of the Franc Zone facilitates the refinancing of foreign currency debt into domestic currency debt. The main flaw in the Franc Zone is in the institutional mechanism that maintains the fixed exchange rate system. As we showed in Section II, the mechanism at the heart of the Franc Zone, is the Operations Accounts at the French Treasury. A rise in domestic incomes associated with the growth in private sector investment in any country of the Zone would increase the import bill and widen that country's trade deficit. The Operations Account mechanism would frustrate this kind of private sector economic development. This could lead to even larger call on operating accounts if central banks (or governments) are obliged to act as lenders of last resort in the event of a credit bubble. The only condition under which this will not happen is if export markets expand, or export commodity prices rise. However, this is unlikely with slow economic growth in the major economies of the world, which in turn is depressing the prices of the commodity exports of the Zone. The fixed exchange rate with the Euro, the currency of the region from which most of the Franc Zone imports are obtained, gives the Franc zone a virtuous record on consumer price inflation, certainly in relation to neighbouring African countries. However, it concentrates currency risks in the export sector, where commodity exports are priced in US dollars.

The Franc Zone highlights not only the inadequacy of viewing exchange rate policy from the point of view of trade or inflation. The discussion on the Franc Zone has been almost entirely on the costs and benefits of a currency, in terms of trade competitiveness and fiscal rectitude, to the neglect of the impact of the currency arrangements on the debt structures that build up over time. The exception here is Dearden (1999). There are strong reasons to doubt that the Operations Account mechanism of the Zone, designed to sustain

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

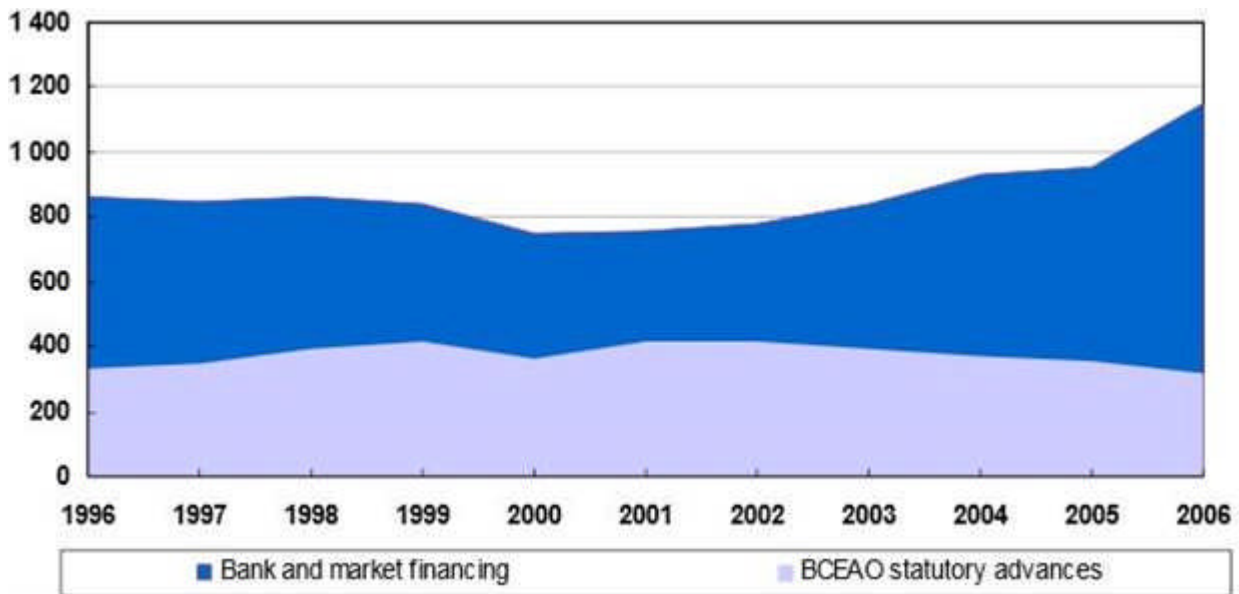
VII. Annex: Data

Figure 1 : Changes in WAEMU Government Financing 1996 – 2006, in billions of CFA Francs.



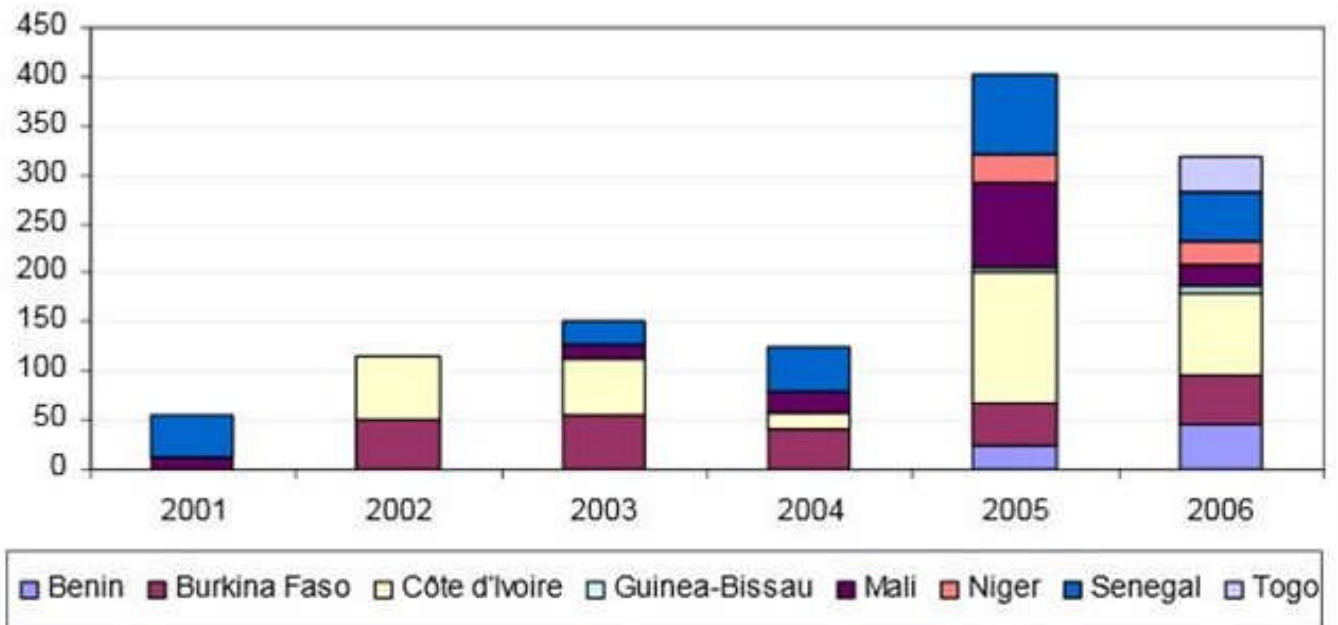
Source: Banque de France (2006) **Note:** Government net borrowing requirement, external debt excluding debt cancellation

Figure 2: Changes in WAEMU Government Financing (Government net borrowing requirement), 1996 – 2006, in billions of CFA Franc



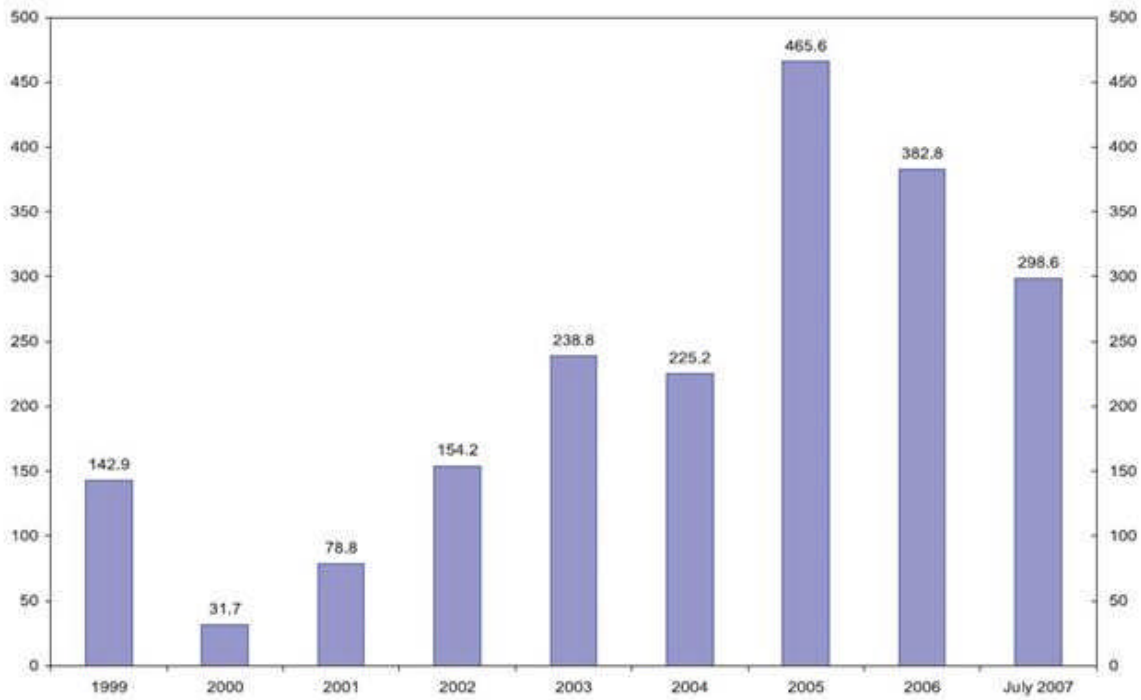
Source: Banque De France (2006)

Figure 3: Government Debt Securities Issuance 2001 – 2006, in billions of CFA Francs



Source: Banque De France (2006)

Figure 4: WAEMU, total gross issuance of debt securities, 1997- 2007 (in billions of CFA francs)



Source: Sy (2007)

Figure 5: Credit Growth Expansion in the Franc Zone 2000 – 2010

Credit Growth 2000-2010 (p.c. GDP)	
Benin	99.1%
Burkina Faso	52.8%
Burundi	15.6%
Cameroon	44.2%
CAR	68.2%
Chad	47%
Cote d' Ivoire	13.8%
Mali	286.7%
Niger	174.4%
Senegal	48.5%

Source: Griffith-Jones and Karwowski (2014)

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Financialisation, Economy, Society and Sustainable Development (FESSUD) is a 10 million euro project largely funded by a near 8 million euro grant from the European Commission under Framework Programme 7 (contract number : 266800). The University of Leeds is the lead co-ordinator for the research project with a budget of over 2 million euros.

THE ABSTRACT OF THE PROJECT IS:

The research programme will integrate diverse levels, methods and disciplinary traditions with the aim of developing a comprehensive policy agenda for changing the role of the financial system to help achieve a future which is sustainable in environmental, social and economic terms. The programme involves an integrated and balanced consortium involving partners from 14 countries that has unsurpassed experience of deploying diverse perspectives both within economics and across disciplines inclusive of economics. The programme is distinctively pluralistic, and aims to forge alliances across the social sciences, so as to understand how finance can better serve economic, social and environmental needs. The central issues addressed are the ways in which the growth and performance of economies in the last 30 years have been dependent on the characteristics of the processes of financialisation; how has financialisation impacted on the achievement of specific economic, social, and environmental objectives?; the nature of the relationship between financialisation and the sustainability of the financial system, economic development and the environment?; the lessons to be drawn from the crisis about the nature and impacts of financialisation? ; what are the requisites of a financial system able to support a process of sustainable development, broadly conceived?'

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Published in Leeds, U.K. on behalf of the FESSUD project.