

**EXECUTIVE
BOARD
MEETING**

SM/22/9
Correction 1

February 10, 2022

To: Members of the Executive Board

From: The Secretary

Subject: **West African Economic and Monetary Union—Staff Report on Common Policies of Member Countries**

Board Action: The attached corrections to SM/22/9 (1/24/22) have been provided by the staff:

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Pages 9, 10, 46, 54

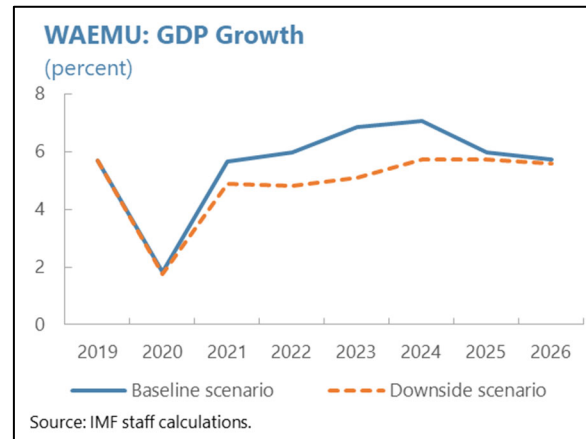
Questions: Mr. Eyraud, AFR (ext. 35684)
Mr. David, AFR (ext. 38427)
Mr. Feler, AFR (ext. 35627)
Mr. Sever, AFR (ext. 37342)

Adverse developments in terms of trade, in particular higher oil prices, are another important risk factor for the outlook, including on the inflation front. At the regional level, further deterioration of security risks, political uncertainties, and delays in hydrocarbon projects could also hurt economic prospects. Slower fiscal adjustment could undermine the credibility of the convergence path and have adverse consequences on FX reserves. Box 1 outlines a downside scenario with a slower recovery.

Box 1. Alternative Scenario with a More Gradual Recovery

Baseline projections reflect expectations of a V-shaped rebound in economic activity in the WAEMU—a scenario supported by recent conjunctural indicators. However, there are substantial downside risks, which could lead to a slower and weaker recovery. This Box presents a downward scenario, which mimics the shape of past recoveries in the region. Given that the recovery in 2022-23 is mostly driven by external demand, a negative scenario could, for instance, materialize as a result of a global shock affecting trade (e.g. sharp oil price increase or trade disruptions due to new pandemic developments) or domestic delays in the gas and oil projects of Niger and Senegal.

The analysis is conducted in two steps. First, the GDP growth path is simulated with a Growth-at-Risk (GaR) model tailored to low-income countries and developed in the context of the current Financial Sector Assessment Program (FSAP).¹ The model estimates the distributional density of historical recovery patterns, and builds the scenario using, more specifically, the last two episodes of 1992 and 2011. Then, in a second step, the analysis quantifies the effect of lower economic growth on fiscal deficits and reserves. To evaluate the impact on the deficit ratio, a revenue to GDP elasticity of 1 is assumed, while nominal spending is kept unchanged relative to the baseline. Regarding reserves, the box replicates the analysis employed in the 2020 [Article IV Staff Report on Common Policies of Member States](#) report, which estimated an econometric relationship between fiscal deficits and reserves.



Simulations show that the growth rate would be, on average, about 1 percentage points lower than under the baseline over the period 2021-26 (Box Figure). In this scenario, the fiscal deficit ratio would increase to about 4 percent of GDP by the end of the forecast horizon, compared to 3 percent of GDP under the baseline. The reserve coverage would decline by about half a month of imports by 2026 compared to the baseline (4.5 months versus 5.0 months).

In terms of policy response, letting automatic stabilizers operate under the downside scenario would make it much more difficult for fiscal deficits to converge back to 3 percent of GDP by 2024. Therefore, staff would recommend offsetting any cyclical revenue shortfall through better expenditure prioritization. On the monetary policy front, maintaining an accommodative monetary stance for longer would seem warranted under this scenario.

¹ GDP growth simulations were prepared by Romain Lafarguette and Zhuohui Chen under the guidance of Romain Veyrune (all MCM).

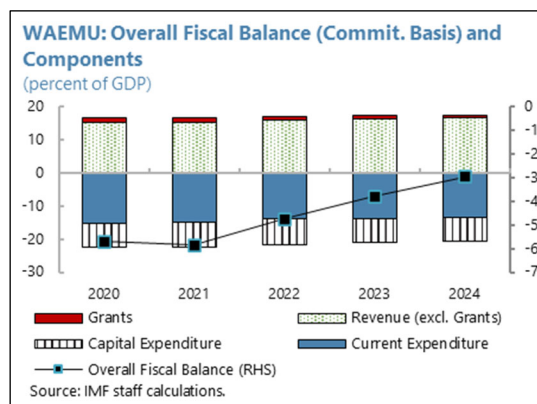
Authorities' Views

14. The regional authorities broadly agreed with IMF staff on the economic outlook and risks. Projections were broadly aligned, although the BCEAO and WAEMU Commission forecast more favorable medium-term growth (about half a percentage point higher than projected by staff over 2022-25), assuming full recovery of sectors affected by the crisis and a strong effect of public infrastructure projects on the economy. On the fiscal side, the authorities expect, like staff, that member states will converge to the 3 percent of GDP deficit target by 2024. Regarding the regional balance of payments, the BCEAO foresees higher capital inflows than staff, reflecting more favorable assumptions concerning foreign direct investments (FDIs) ahead of the planned realization of hydrocarbon projects in Senegal and Niger. This, together with a projected substantial reduction in the current account deficit from 2023 (linked to higher oil exports), implies a stronger reserve coverage, which would stabilize around 6 months of imports by 2023 (compared to close to 5 months in staff projections).

POLICY DISCUSSIONS

A. Recalibrating the Medium-Term Fiscal Strategy After the Crisis

15. Staff supports the authorities' decision to converge towards the regional fiscal deficit of 3 percent of GDP by 2024. In June 2021, the head of states of the ECOWAS (15 members, including all WAEMU countries) committed to converging towards the fiscal deficit anchor over the years 2024-26.¹² This is one year later than recommended in last year's [Article IV](#) report, but staff assesses the more gradual adjustment path, incorporated in baseline projections, to be compatible with external viability and fiscal sustainability.¹³ The WAEMU's foreign exchange position is, in fact, stronger than expected at the time of last year's consultation and the regional financial market has shown some resilience in absorbing increased sovereign issuances.



16. The credibility of the medium-term fiscal trajectory would be strengthened by re-establishing the WAEMU Convergence Pact which was suspended in 2020. Although a convergence plan has been adopted at the ECOWAS level, the WAEMU set of fiscal rules has not yet been reinstated. The WAEMU Commission is expected to make a proposal to the Council of

¹² According to Article 6 of the Macroeconomic Convergence and Stability Pact among ECOWAS member states: "The deadline for macroeconomic convergence shall be 31 December 2026. By the aforementioned date, a majority of Member States shall, in a sustainable manner, have complied with all primary criteria over the last three (3) years (2024-2026)." The 3 percent of GDP deficit ceiling is one of the primary convergence criteria.

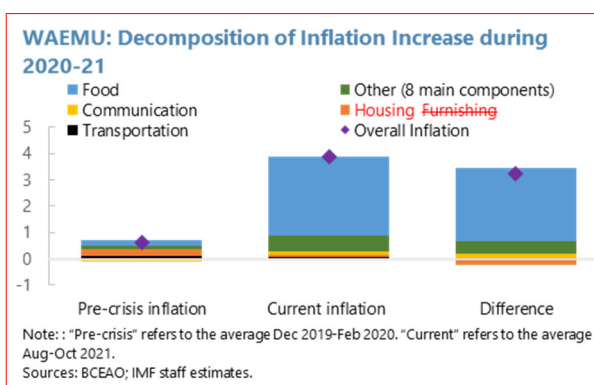
¹³ Even with successful consolidation and strong growth, the public debt-to-GDP ratio would remain about 5 percentage points higher in 2026 compared with pre-Covid level of 45.5 percent in 2019.

Annex IV. Inflation Dynamics During the Pandemic¹

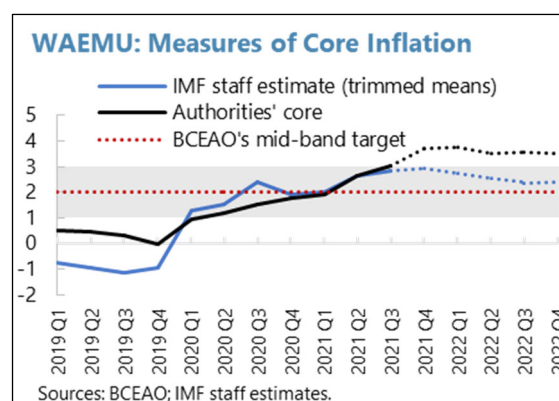
This annex analyzes the recent increase in inflation in the region to identify its causes and assess its persistence. The three approaches presented below do not provide a clear and consistent message about the risk of second-round effects. Given the high uncertainty around the diagnostic, it will be essential to closely monitor developments in the coming months to determine whether inflation will return within the BCEAO's target band without the need for policy tightening.

1. Headline inflation started increasing at the beginning of 2020 after recording negative rates throughout 2019. Inflation has exceeded the BCEAO central target of 2 percent since mid-2020, breached the ceiling of the 1-3 range in April 2021, and has remained above 3 percent in subsequent months. A fundamental question for monetary policy is whether the recent inflation spike is likely to continue in the future. This Annex relies on three approaches to throw light on this issue.

2. First approach: decomposition of headline inflation. Inflation is more likely to persist if price pressures broaden and are not limited to a few items of the consumption basket. In this regard, the rise in headline inflation during the crisis has been essentially driven by higher food prices, reflecting domestic supply problems and higher import costs. The contribution of food to inflation has increased from 0.20 percent before the crisis (December 2019-February 2020) to 3.0 percent on average over August-October 2021. Other components of the basket have had marginal effects on inflation dynamics.



3. Second approach: analysis of core inflation. Another way to approach the question is to examine the evolution of inflation when volatile and transitory shocks are filtered out. The argument is that the inflation is bound to remain elevated, and the central bank is more likely to respond if the increase in volatile components is transmitted to more stable ones. Two measures of core inflation are used: (1) the authorities' "core" indicator, published on the BCEAO website, which excludes food and energy prices from headline inflation; and (2) an alternative measure produced by IMF staff using a "trimmed mean" approach that filters out disturbances (the components at the high and low ends of the distribution are excluded from headline inflation in each period, and the remaining



¹ Prepared by Cecilia Melo Fernandes (MCM). This annex was prepared in early December 2021.

the IMF African Department to share and discuss with WAEMU regional institutions relevant analyses and guidance notes prepared by Fund Staff on PFM and on monetary and financial stability policies in response to the Covid crisis. For instance, webinars were organized by FAD and AFW for WAEMU government and regional institutions' officials on all PFM aspects linked to Covid operations. Similarly, AFW provided TA aimed at helping the BCEAO better anticipate and manage the potential deterioration of banks' asset quality following the unwinding of prudential forbearance measures introduced in response to the pandemic. Notwithstanding Covid-related constraints, some CD projects initiated prior to the pandemic were successfully pursued, particularly in the PFM area, with the completion of three regional guidance manuals on employment ceiling budgeting, government's opening balance sheet, and budget and accounting internal control respectively.

5. Furthermore, the virtual interactions with regional institutions since the beginning of the pandemic have allowed a better integration of CD and surveillance activities of the IMF.

Experts from AFW and relevant Fund TA departments were able to contribute directly to the regular dialogue of the WAEMU team (from the African department) with regional institutions, in the context of ad-hoc virtual meetings, staff visits and [Article IV annual](#) consultation missions. Similarly, members of the WAEMU team have been able to participate into many virtual meetings between MCM and regional institutions in the context of the ongoing FSAP. Finally, in the context of the 2021 WAEMU regional consultation, a member of the WAEMU team and an expert from the MCM department collaborated closely with relevant regional institutions to undertake a pilot in-depth assessment of the development of the WAEMU's local currency sovereign security market.

Provider	Description	Recipient	Objectives	Outputs/Outcomes
MCM / AFW	Enhance Bank Prudential and Accounting Standards and Enhance Banking Supervision	SGCBU (2020) Jan.	Enhance risk-based bank prudential supervision.	Inspectors developed capacity in various areas of on-site and document control, including AML-FT.
		SGCBU (2021) Apr.	Enhance supervision of regional affiliates of external banking groups.	Improved capacity for the preparation and conduct of colleges with supervisors from non-WAEMU jurisdictions.
		SGCBU (2021) Sep.	Enhance credit risk evaluation and control.	Acquisition of methods to identify analysis and control points, including with regard to general credit policy, governance, risk classification and management, monitoring procedures and rules for downgrading to default.