RESEARCH NOTE NO.6. – 2013 (RN/6/13)

Kenya Bankers Association Centre for Research on Financial Markets and Policy®

December 18, , 2013

The East African Monetary Union – An Opportunity for Reflection

> *"Any lessons that can be picked from the Euro-zone especially since the global financial crisis that begun in 2008 will without doubt be invaluable, and it is obvious that the EAC is drawing lessons. The one lesson that we believe has not informed the EAC process – and we take a view that it ought to – is why Britain stayed out of the Euro. Not drawing on this wide experience in its entirety would mean that the five EAC will be confronted with the alternatives of either entering the monetary union or not[1] and then have the option to choose their poison! - for either alternative may not be appealing."*

Highlights

- The signing of the Protocol for the Establishment of the East African Community Monetary Union on 30th November 2013 marked an important milestone in the integration agenda of the East African Community (EAC) partners.
- The logic behind the willingness to forgo the right to conduct monetary policy to a supranational institution – in this case the East African Central Bank (EACB) as envisaged in the Protocol – is that it will be more than adequately compensated by the envisaged gains.
- While the process so far has been supported by analytical work that underpins the choice of the convergence criteria variables, we argue that the said analytics have not informed the magnitude of the variables. This is an implicit indication that the magnitudes of the convergence parameters are admittedly more of a negotiated outcome than a determination of analytical rigour.
- The commitment of the five EAC partners to taking the integration agenda forward is obvious. The timetable for attaining the monetary Union as set out in the Protocol gives a chance for further reflection on the adequacy of the convergence criteria, the appropriateness of the implicit benchmark in the European Union's Euro-zone, and whether the correct and comprehensive lessons are being drawn from the Euro experience – especially with regard to the fiasco that has become of the Euro-zone, and the basis of those that chose to remain out of the Euro.
- This *Research Note* concludes that unless these aspects are given due consideration during the ten year transition period that the Protocol has provided, then five EAC will be confronted with the obvious alternatives of either entering the monetary union or not and then have the option to choose their poison!- for either alternative may not be appealing.

Introduction

The signing of the Protocol for the Establishment of the East African Community Monetary Union (subsequently the Protocol) on 30th November 2013 marked an important milestone in the integration agenda of the East African Community (EAC) Partners. As the penultimate level of integration[1], a monetary union presents an opportunity for the EAC's five partner states to demonstrate that individually they are willing to shed some sovereign aspects of economic management, specifically the right to issue currency and conduct monetary policy to address any arising domestic challenges where such policy conduct is appropriate.

The logic behind the willingness to forgo the right to conduct monetary policy to a supranational institution – in this case the East African Central Bank (EACB) as envisaged in the Protocol – is that it will be more than adequately compensated by the anticipated gains. A careful look at the Protocol reveals the desire by the EAC partner to get it right. Undoubtedly, the process so far has been supported by analytical work[2] that underpins the choice of the convergence criteria variables, although this *Research Note* seeks to argue that the said analytics have not informed the magnitude of the variables.

In this *Research Note*, we are alive to the fact that any stage of economic integration generally, and therefore even in the case of the EAC, is as much about politics as it is about economics. That is why we observe that the conclusion of the Protocol has been followed by long-drawn negotiations and, interestingly, the magnitudes of the convergence parameters are admittedly more of a negotiated outcome than anything else.

It is in this regard that we see the ten-year transition period spelled out in the Protocol's timetable to be critical in steering the process from being negotiation-driven to being intellectually-driven. That way, further rigorous analytical work[3] will be able to support the proposed institutions – those responsible for financial services; statistics; and surveillance, compliance and enforcement – lead to the realization of the benefits of the monetary union or avoid the risks of a monetary union gone wrong.

In undertaking the further work the European Union's experience with the Euro – evidently the EAC's chosen benchmark – will provide a good guide. Any lessons that can be picked from the Eurozone especially since the global financial crisis that begun in 2008 will without doubt be invaluable, and it is obvious that the EAC is drawing lessons. The one lesson that we believe has not informed the EAC process – and we take a view that it ought to – is why Britain stayed out of the Euro. Not drawing on this wide experience in its entirety, this *Research Note* will argue, would mean that the five EAC will be confronted with the alternatives of either entering the monetary union or not[4] and then have the option to choose their poison!

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[1] The EAC integration journey seeks to ultimately lead to a political federation.

[2] Duverall, D. (2011), "*East African Community: Preconditions for an Effective Monetary Union*" University of Gothenburg School of Business, Economics and Law, Working Papers in Economics, No 520, December, presents an argument that an EAC monetary union is politically risk albeit with potentially high economic benefits. Other analytical work that has informed this process include Davoodi, H. R. [ed.], (2012), "*The East African Community after Ten Years: Deepening Integration*", EAC Secretariat; and Davoodi, H.R., S. Dixit and G. Pinter, (2013), "*Monetary Transmission Mechanism in the East African Community: An Empirical Investigation*", IMF Working Paper WP/13/39, February.

[3] There is a popular, but arguably misinformed, view that once the Protocol was concluded the window for analytics is slammed shut and that of procedural implementation is exclusively open.

[4] The Protocol allows any three of the five EAC partners that have met the convergence criteria for three consecutive years – as well as meeting the conditions – to enter into a monetary union, implying therefore that members have the option of staying out of the union even when they have met the criteria of joining.

Negotiating our Way into Convergence?

The ultimate intentions of the Protocol is to lead the EAC integration to a monetary union that, together with the other integration pillars of a customs union and common market will result in the region's sustainable development. At the core of such development is non-inflationary growth backed by an integrated financial system that is able to efficiently allocate resources.

At the core of this grand objective is a convergence that at least three economies must meet at least three years before the monetary union that entails a single currency and a common monetary policy conducted by the EACB comes to effect; the three economies can then form the monetary union and others can join when they meet the criteria[5]. The convergence criteria is as follows:

- A ceiling of core inflation of 5 percent; and a ceiling of headline at 7 percent;
- A ceiling of fiscal deficit excluding grants of 6 percent of GDP; and a ceiling of fiscal deficit including grants of 3 percent of GDP;
- A tax [revenue] to GDP ratio of 25 percent; and a ceiling of 50 percent of GDP in net present terms;
- A [foreign currency] reserve cover [equivalent] of 4.5 months cover.

If the essence of the convergence criteria is to anchor sustainable non-inflationary growth, then it is logical to expect that the five EAC economies seek to have their business/economic cycles synchronized. The real output growth of the EAC partners over the past decade has shown no particular pattern; the *spaghetti* growth trend (**Figure 1**) can only illustrate the fact that seeking to target a harmonized growth rate would be a challenging affair. But that is no reason as to why real growth rate is controversially missing from the convergence parameters.

This *Research Note* advisedly considers the omission of the real growth as one of the convergence parameters as controversial, not least because at the pinnacle of the monetary union is the conduct of a common monetary policy that is expected to influence growth[6] that is not expected to have some form of convergence – not necessarily in terms of the absolute rate but in terms of the trend within a given threshold.

Admittedly, it is equally controversial that the fact that the convergence parameters are explicit on the nominal value of foreign exchange reserves (an equivalent of 4.5 months of import cover) – the end product – without any indication of the sustainability of the underlying dynamics with regard to the external environment – as could be manifested by the level current account balance as a ratio of GDP. It is a possibility that an economy could meet this targets merely through market participation by the monetary authority especially if the given economy is a beneficially of some balance of payment support programme.

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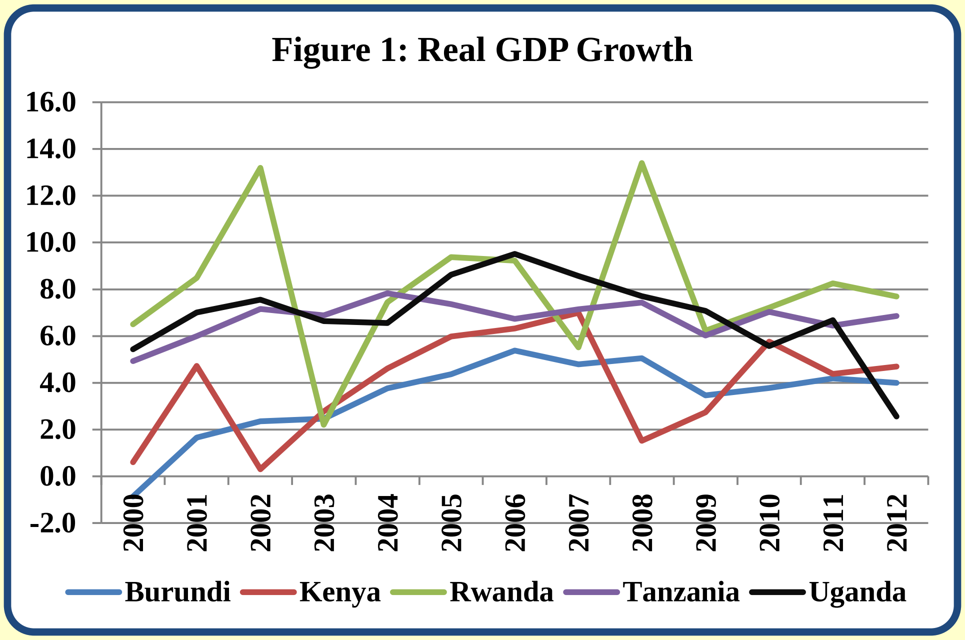
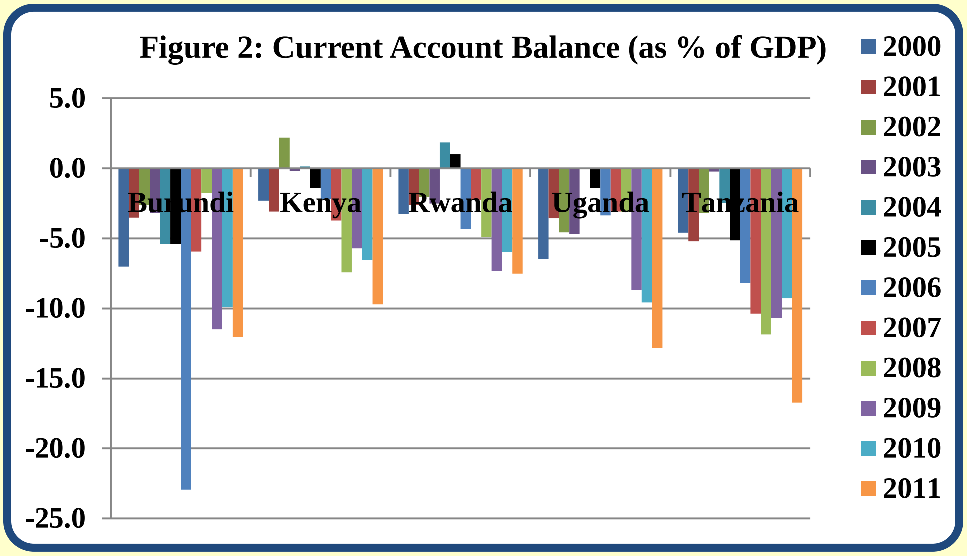
[5] The EAC treaty provides for the principle of variable geometry whereby some community members can move faster than others on some matters.

[6] The monetary policy – growth is a well-argued nexus that stretches back to the seminal paper, Fischer, Stanley, (1977), "Long-Term Contracts, Rational Expectations and the Optimal Money Supply Rule", *The Journal of Political Economy*, Vol. 85. No.1, pp. 191 – 205, February.



Source: IMF World Economic Outlook Database; October 2013

But then the opportunity for such market activism will not be there once the economies go into a monetary union and the conduct of monetary policy is surrendered to an independent supranational central bank – in this case the EACB. That is why the convergence parameter on the foreign exchange reserves should, of necessity, be grounded on the sustainability of the external position of the respective economies, more so given the evident diversities that prevail amongst the five economies with regard to their external balances positions (**Figure 2**).



Source: IMF World Economic Outlook Database; October 2013

It is obvious that with then monetary policy now ceded, the countries in the monetary union will seek to have fiscal policy as their macroeconomic lever to influence growth. But this has to be in line with the parameters of the Protocol. It is now common practice that the fiscal budgets of the five EAC partners to be presented on the same day. This is an act beyond symbolism. The essence of fiscal coordination as a key determinant of the success of the monetary union needs to be evaluated on the platform of what fiscal policy is – decisions that the government makes about spending and taxes. This may sound strange to a non-critical eye that imagines a monetary union as a referendum on the advantages and disadvantages of having a single currency, therefore falling in the realm of monetary policy and not fiscal policy.

Given our earlier observation regarding the need to have real output growth as an important parameter in the journey to a monetary union, we could surmise that the consideration of the demand-side parameters in the convergence criteria – which we surmise are meant to entrench stability – need to be matched by supply-side considerations. Supply disturbances are particularly important given that their effect on the real economy could shift the economy's potential output. If the disturbances are highly correlated, then it is plausible to assume that they would need the same kind of monetary policy response, hence a monetary union. Otherwise, a monetary union would be a costly affair.

It is on account of the supply disturbances that the fiscal policy crucially enters the equation. The economies subjected to supply disturbances will obviously not sit on their hands and watch but will exercise their sovereign mandate of restoring a desirable economic order by way of expenditure and tax measures. That is why as we have argued, fiscal policy will be the only macroeconomic policy lever that is at the discretion of each sovereign economy under the monetary union. As the experience of the Euro zone has shown us, sovereign fiscal positions in a monetary union need to be taken while bearing in mind the situation in the other economies in the block.

It is tempting to argue that the essence of having an agreed level of fiscal deficit – among other convergence parameters such as levels of debt, foreign currency reserves and inflation positions – is to address fiscal policy related challenges in monetary union. This is the especially the case given that the EAC monetary union will not be accompanied by a fiscal union. Necessary as that may be, though, it is far from sufficient unless there is some analysis of the unbundled budgets of the respective economy in the bloc to determine how the proposed expenditure is to be financed. In the East African case, there are glaring disparities in the budget financing mechanisms with some economies routinely having more than a quarter of their budgets externally financed.

Ultimately, the ten-year transition period spelled out in the Protocol's timetable needs to be seen as a window to address the limitations we highlight above so that we have a process that is steered being negotiation-driven to being analytically-driven.

The Optimal Currency Area – Why bother when you can "Just Do It"?

In order to have a balanced inference of the implications of the monetary union that is more realistic that the two extremes of the excitement underpinned by optimism on the one hand and the fatal pessimism on the other, there has to be some form of cost-benefit analysis undertaken.
The key advantages underlying the EAC ambition for a single currency are lower transaction costs and the elimination of exchange rate volatility amongst the partners. The overwhelming conviction is that these advantages will be more than compensatory for the disadvantages of loss of an independent monetary policy and the use of exchange rate as an economic policy instrument. But then it will take an economic jolt for one to determine the extent of the advantages surpass the disadvantages.

If the shocks are symmetrical amongst the economies in the monetary union – meaning the disturbances are similar and correlated – then a monetary union will be able to counter them and the economies adjust to desirable positions.

The opposite is when the shocks are asymmetrical and unrelated, a scenario where the cost of adopting a monetary union is much higher given that each economy would need a different monetary policy response. It is reasonable to assume that at the core of the Protocol are areas of co-operation aimed at addressing asymmetrical shocks. Granted, asymmetric shocks cannot be avoided. If such shocks are small, them the loss of an independent monetary policy may not be too costly. But if they are not, then the task is to ensure that the economy in question is able to adjust quickly and smoothly to return to stability.

How do you ensure that there is quick and smooth adjustment? Take a scenario where two EAC partners are hit by adverse shocks with unemployment rising in one and falling in another. More flexibility in both labour and wages will facilitate ease of adjustment. I can only assume that this aspect has been taken care of under the EAC common market that allows for free labour movement within the block. We use the word assume deliberately because there have so far been glitches on the labour movement under the common market so far.

Beyond labour flexibility, and arguably most critical, is the earlier observed need to build mechanisms of differentiating between demand and supply disturbances. Divergent demand shocks arising from different monetary policies would not arise under a monetary union regime. However the relationship between supply disturbances needs special scrutiny given that they hinge on the underlying structure of the given economies that seek to be in a monetary union.

Supply disturbances are particularly important given that their effect on the real economy could shift the economy's potential output. If the disturbances are highly correlated, then it is plausible to assume that they would need the same kind of monetary policy response, hence a monetary union. Otherwise, a monetary union would be a costly affair. That is why under ideal circumstances when there is no hitch insofar as meeting all the pre-conditions a monetary union is concerned – in other world the regional block being an "optimal currency area (OCA)[7]" – then economies such as the five EAC members could go ahead and have a monetary union.

Several studies indicate that the Euro zone – which we observe to be the EAC's apparent benchmark – was never an optimal currency area[8]. But it went ahead with the experiment. It is worthy nothing that recent analyses[9] indicate that by October 2012, all the Eurozone economies were in violation of their own convergence criteria. It is noteworthy too that the Maastricht criteria, an equivalent of the Protocol's convergence, is pretty close in terms of the parameters (and not necessarily their magnitude). The four-point Maastricht criteria is as follows:

- Price stability (inflation rate not more than 1.5 percentage points above the rate of the three best performing member states);
- Sound public finances (public deficit should not exceed 3% of GDP);
- Sustainable public finances (government debt should not exceed 60% of GDP);
- Durability of convergence (long-term interest rate should not be more than 2 percentage points above the rate of the three best performing members in terms of price stability) and exchange rate stability.

With the observation that the Euro-zone economies have not been able to sustain their attainment of some level of convergence, it is worthy reflecting as to whether they provide the best benchmark for the EAC monetary union. In any case, if meeting the Maastricht criteria is challenging, then expecting the same economies to consider aspects of OCA is far-fetched. This implies therefore that the decision of the European Union members that formed the Euro-zone was

[7]The Pioneering seiminal work of Mundell, Robert. (1961), "A Theory of Optimum Currency Areas", *The American Economic Review*, Vol. 51, No. 4, pp. 657 – 665, and the subsequent rich literature gives a clear picture when a monetary union works without hitches.

[8] Among other studies that come to such conclusion is Furrutter, M. (2012), *"The Eurozone: An Optimal Currency Area?"* IFIER Papers, February.

[9]See for instance a study by Investment bankers, Nordea, [http://research.nordeamarkets.com/en/2012/10/18/all-eur-countries-in-violation-of-their-own-convergence-criteria/]. According to this study, of all the Eurozone economies, it is only the so-called peripheral economies of Finland, Luxembourg and Estonia come closest to meeting the criteria at the time of assessment.

driven by the strategy that Economist Barry Eichengreen calls the Nike strategy – Just do it!; the rider here is that a monetary union is as much a political process as it is economic.

Does it matter that Euro Members went Nike? The answer seems to lie in the reasoning behind Britain staying out of the Euro, an aspect that has conspicuously missed out of the debate on the EAC monetary union so far but whose litigation may be important at this stage. The British economy was on a strong footing to be among the first economies to qualify to join the Euro based on the Maastricht criteria – and equivalent of our the convergence criteria in the Protocol on the Establishment of the East African Monetary. Instead its British's Treasury decided spend the initial years of the seven-year transition period – an equivalent of the ten years under the Protocol – to respond to five tests set out by the Chancellor of the Exchequer. These tests, which speak directly to the question of an optimal currency area, are:

- The convergence test – are business cycles and economic structures compatible so that we and others could live comfortably with euro interest rates on a permanent basis?;
- The flexibility test –if problems emerge is there sufficient flexibility to deal with them?
- The investment test – would joining Euro create better conditions for firms making long-term decisions to invest in Britain?;
- The *City* test – what impact would entry into Euro have on the competitive position of the UK's financial services industry, particularly the *City's* wholesale markets?; and
- The jobs test – will joining Euro promote higher growth, stability and a lasting increase in jobs?

Its assessment, based on 18 papers that the British Treasury published, was that "neither flexibility nor convergence are sufficient at present to make joining Euro in the near future desirable". This was evidently an informed position. In any case, the core argument of the test was that the five tests had a crucial advantage of dealing with the real economy and the macroeconomic implication of the required adjustments in markets at the microeconomic level the Maastricht criteria that dealt with exclusively nominal variables.

While all the analytical work informed the British's decision as regards its joining of the Euro is concerned, two of them are arguably instructive to the EAC move towards a monetary union post the signing of the protocol. One of them[10] argues that there are transition costs that may have a bearing to the meeting of the convergence criteria and therefore should not be ignored. The other[11], which essentially assesses whether the US is an OCA, highlights the importance of having a fiscal union if the monetary union is to function optimally.

Conclusion

The arguments we present above give a critical glimpse to the Protocol for the Establishment of the East African Community Monetary Union. It is obvious that the five EAC partners are committed to taking the integration agenda forward, and the timetable for the monetary Union as set out in the Protocol gives a chance for further reflection on the adequacy of the convergence criteria, the appropriateness of the implicit benchmark in the European Union's Euro-zone, and whether the correct and comprehensive lessons are being drawn from the Euro experience – especially with regard to the fiasco that has become of the Euro and the basis of those that chose to remain out of the Euro. We observe that unless these aspects are given due consideration during the ten year transition period that the Protocol has provided, then five EAC will be confronted with the obvious alternatives of either entering the monetary union or not and then have the option to choose their poison!- for either alternative may not be appealing.

[10] Peter Westaway, (2003), "*Modelling the transition to EMU: EMU Study*", HM Treasury.
[11] HM Treasury, (2003) *"The United States as a monetary union: EMU Study"*HM Treasury.

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