Policy brief

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Richard Newfarmer
and Måns Söderbom

International Growth Centre

Rwanda and the East African Monetary Union

In brief

- Policy makers in the East African Community (EAC) are committed to working towards the establishment of the East African Monetary Union (EAMU).
- The formation of a monetary union may be a significant step towards further economic integration and macroeconomic stabilization in East Africa.
- But this note argues that monetary integration undertaken prematurely can also pose serious risks.
- The recent experience of the Eurozone has put in graphic relief these dangers.
- Nonetheless, moving forward with greater policy coordination in the EAC – particularly in monetary and exchange rate policy – as part of the convergence process can produce significant near- term benefits.
- This has the advantage of maintaining national policy flexibility and autonomy, while striving to reduce the wide volatility in real exchange rates within the EAC that at present discourage integration through trade and finance.

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The Economics of Monetary Integration

"Adverse asymmetric shocks within a monetary union pose a serious problem to jobs and production if prices and wages are rigid and capital and labor are immobile"

The key economic question policymakers confront is whether the benefits from eliminating exchange rate fluctuations and reducing foreign exchange transaction costs between member states outweigh the costs of surrendering monetary and exchange rate policy for macroeconomic stabilization of country-specific (asymmetric) shocks.[1] Shocks can affect countries in the currency area differently: for example, a drought can affect the earnings of one country but not another; similarly, political turbulence, a sudden stop of capital inflows, or an abrupt change in investor perceptions on sovereign bonds (such as in Greece) can all constitute adverse shocks that asymmetrically impact countries in a currency union.

In general, adverse asymmetric shocks within a monetary union pose a serious problem to jobs and production if prices and wages are rigid and capital and labor are immobile. For small open economies like Rwanda, the most important price is the value of the Rwandan franc. Even though prices and wages are flexible in Rwanda, the inability to adjust the exchange rate if it were in a currency union would imply that the adjustments to the shock operate primarily through quantities - jobs and output volumes – as distinct from prices. These problems are compounded if labor is relatively immobile because of visa issues since workers will end up in unemployment rather than moving to other member states where labor demand is stronger. Studies of business cycles in the EAC typically find these to be quite dissimilar, although less so now than in the 1990s.[2] Inflation rates in the EAC have been highly variable over time in the last decade. This is partly due to common shocks (e.g. high food prices in 2008). However, country-specific shocks to inflation within the EAC are relatively frequent too. Similar conclusions apply for changes in the money stock.

These observations suggest that asymmetric shocks in the EAC are commonplace. What are the origins of such shocks? While all countries within the EAC are relatively open for international trade, only a small portion is within the Community. Hence to the extent that changes to the terms of trade vary across the EAC countries, these can be an important source of asymmetric shocks. From Rwanda's point of view the considerable volatility in world market prices of tea and coffee is a cause for concern in this respect as these two commodities make up 35 per cent of Rwanda's export (as a comparison coffee is 3 per cent of Kenya's exports). Another potential source of asymmetric shocks is natural resource discovery – such as the discovery of large deposits of oil in Uganda. The resulting export boom in one country would strain the union in various ways, e.g. by resulting in appreciation of the real exchange rate thereby making it harder for the other member states to export.

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Still, monetary union could confer benefits. Since the protocol provides for the East African Central Bank (EACB) to be independent of the governments, have

1. Economists analysed this question in the early literature on Optimal Currency Areas. See Mundell (1961); McKinnon (1963).
2. See Kundan and Ssozi, (2009) and Opolot et al. (2010).

clear objectives, and be accountable only to the purposes of its charter, one would expect a more stable monetary policy in EAMU than in any single EAC country. This would likely reduce the variability of inflation rates. Indeed, some authors argue that the historic record of relatively lax monetary policy in many African countries implies that the delegation of monetary policy to an independent central bank may be very beneficial.[3] Naturally, whether the EACB will be able to deliver on this depends on its mandate and the strength of its political backing from the governments of the country member states. In any case, quantifying the effects of monetary integration on macroeconomic stability is very difficult.

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Analysis must then compare the benefits of macro stabilization against the costs of less discretion to deal with asymmetric costs. Most studies on the conditions for monetary integration in Africa conclude that the economies are too different for there to be substantial economic net benefits associated with a monetary union. A recent study using macroeconomic models calibrated to African data suggests a monetary union within the EAC would yield positive but small net benefits for the EAC as a whole.[4] This study further identifies positive but modest net gains for Rwanda, primarily as a result of macroeconomic stabilization. That said, costs associated with asymmetric terms of trade shocks could be quite high for the country suffering the shocks because national governments could not respond with monetary policy. Needless to say, uncertainty precludes a definitive answer, but the cost- benefit ratio depends on the magnitude of the country-specific shock and the responsiveness of the new monetary authority in interpreting its mandate.

That there will be convergence in inflation rates and other nominal variables following the formation of a monetary union seems very likely. The question is whether this is in the interest of the individual member states. In the case of Europe, Paul Krugman argues that the reluctance of the ECB to reduce interest rates in order to raise inflation in the EU will make it much harder for countries like Spain, Italy and Greece to recover from the current crisis.

Economic Pre-Conditions and Convergence Criteria

Drawing on the theory of OCA and purporting to reduce the risk and consequences of asymmetric shocks, the EU has established a set of economic convergence criteria that have to be fulfilled before a state can become a member of the EMU. The EAC has adopted a similar strategy. The Stage II (2011-2015) convergence criteria established by the EAC are as follows:

- The budget deficit not to exceed 5 per cent of GDP excluding grants (2 per cent including grants).
- The annual average inflation rate not to exceed 5 per cent.
- External reserves to cover six months of imports.

3. Honohan and Lane (2000).
4. Debrun et al. (2011).

- Interest rates to be market-based.
- Sustained real GDP growth by at least 7 percent.
- Sustained pursuit of debt sustainability.
- Domestic savings-to-GDP ratio of at least 20 percent
- Sustainable level of current account deficit excluding grants.

"Moreover, it is odd to have a requirement for budget deficits with and without grants, since the amount of foreign aid received by government affects the difference"

Clearly these convergence criteria have a number of weaknesses. In particular, there is a lack of definitions of several of the concepts (eg, what price index should be used? what is the definition of domestic saving? what is a sustainable level?). A report published by the European Central Bank (ECB) points out that harmonization in the measurement and definitions of these variables across countries is urgently needed for the convergence criteria to become comparable and operational.[5] Experiences in the EU suggest such a process can be difficult, costly and outdrawn. For example, the construction of a new consumer price index with prices of comparable goods, the Harmonized Index of Consumer Prices (HIPC), took several years. It is also noteworthy that some of the outcomes above are hard or impossible for national governments to control (e.g. real GDP growth and domestic savings). Moreover, it is odd to have a requirement for budget deficits with and without grants, since the amount of foreign aid received by government affects the difference. During 2003-2008, Rwanda's budget deficit varied between 9.8 per cent and 13.1 per cent, excluding grants, in spite of being below 3 per cent, including grants, every single year. According to IMF, Rwanda is expected receive grants of about 10 per cent of GDP until 2015.[6] It is thus in Rwanda's interest to change this criterion, removing or downgrading the deficit that excludes grants. Other weaknesses can also be identified.[7]

Political and Institutional Pre-Conditions

Paul De Grauwe, a leading expert on monetary integration, argues strongly that it is necessary to have a well- functioning supranational institutional structure in place in order to establish and run a monetary union.[8] Within the EU, institutions such as the European Commission, the European Court of Justice, ECOFIN and the European Parliament, have been vital for the formation of European Central Bank, and some of these institutions have grown out of several decades of collaboration. Building the necessary institutions is a complicated and difficult process, and a huge amount of political negotiations and technical work will be needed before the EAMU can be launched. The EMU had 40 years of practice in intergovernmental collaboration before launching the monetary union.

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Compared to the EU, the intergovernmental institutions within the EAC have a short history. Moreover, the key institutions for monetary integration within the EAC – eg, Council of Ministers, East African Legislative Assembly, East African Court

5. ECB (2010).
6. IMF (2011).
7. See Section 4 in Durevall (2011) for details.
8. De Grauwe (2010).

of Justice – have a less far-reaching mandate than their counterpart institutions in the EU. For example, a major difference between the EU and EAC is that EAC's supranational institutions do not have legal rights to force national governments to implement integration measures. Strengthening the institutions that would manage the monetary union in EAC would seem extremely important in order to minimize the risk of failure. To facilitate the process and make sure EACB will be able to act as an independent central bank, supranational institutions that impose legal constraints on policymakers need to be formed. Moreover, legitimacy of the supranational institutions should be ensured.

"Bank failures, a new credit crunch, and a sharp contraction in output and employment would be likely outcomes if the Euro were to collapse"

The Cost of Failure

The economic cost of a monetary union breakup can be substantial, as is evident from the current crisis in the EMU. Bank failures, a new credit crunch, and a sharp contraction in output and employment would be likely outcomes if the Euro were to collapse. Nonetheless, the economic costs do not need to be very high if the breakup is due to political disintegration or a desire by an individual government to use seigniorage to finance budget deficits, which have been the case in several breakups in the past.[9] Thus, the economic costs depend on the cause of the breakup. There will also be substantial political costs, as leaders have invested time and money, and their reputation, in establishing the monetary union.

Conclusion: Focus on Benefits from the Convergence Agenda

Monetary integration in the EAC may well have long-term benefits in the form of lower transaction costs, increased trade, greater macroeconomic and monetary stability. However, the exposure of the region to shocks that affect countries differently raises the risks of adopting a common currency prematurely. This is particularly true if, as the European Central Bank warns, so few of the necessary pre-conditions are met.[10]

"Bank failures, a new credit crunch, and a sharp contraction in output and employment would be likely outcomes if the Euro were to collapse"

That said, even if political authorities were to take the decision to postpone full monetary integration indefinitely – and there are strong arguments for doing so – deepening collaboration within the EAC on elements of the convergence agenda can have considerable pay-offs. One area is improving macroeconomic coordination, particularly in monetary and exchange rate policies. If greater communication among monetary authorities were to facilitate common monetary decision rules (for example, on inflation targeting) and these efforts were to reduce price level volatility within the EAC, it would help expand trade by allowing firms to set up distribution networks that would otherwise be disrupted by today's volatility in real exchange rates. Similarly, deepening collaboration on reducing restrictions on trade in goods and services – through facilitation, reducing NTBs, and adopting

9. See Bordo and Jonung (1999); Cheikbossian, (2001, 2002); Rose (2006).
10. ECB (2010).

common regulation and standards – would promote regional integration and contribute to regional price stability. Finally, adopting procedures to allow for greater labor mobility – particularly in professional services – can help put in place the fundamentals of regional price stability and deep integration.

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About the authors

Richard Newfarmer was most recently the World Bank's Special Representative to the United Nations and World Trade Organization, based in Geneva, where he worked with country delegations and Geneva-based international organizations on issues of trade (WTO, UNCTAD and ITC), labour (the ILO), climate change (the WMO and WFP), and health (WHO, Global Fund, UNAIDs). Most recently, he has focused on aid for trade. He has also lectured at the World Trade Institute, University of St. Gallen, and the Graduate Institute, among others. Previously, he was Economic Advisor in the International Trade Department and in the Prospects Group of the World Bank, and worked extensively on trade, investment and globalization issues. He co-edited "Breaking into New Markets: Emerging Lessons for Export Diversification" and previously edited "Trade, Doha and Development: A Window into the Issues". He led the teams that produced "Global Economic Prospects 2007: Managing the Next Wave of Globalization" and was the lead author of four previous "Global Economic Prospects" reports — on regional trade, the WTO negotiations, and investment and competition policy. Besides authoring numerous country studies at the World Bank, Mr. Newfarmer has written on FDI, with publications in the Journal of World Trade, Cambridge Journal of Economics, Journal of Development Economics and Foreign Policy, among others. Mr. Newfarmer holds a PhD and two MAs from the University of Wisconsin, and BA from the University of California.

Måns Söderbom is Professor of Economics at the University of Gothenburg. He specialises in development economics and applied econometrics. Most of his work focuses on the decisions and performance of firms.

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International Growth Centre,
London School of Economic and Political Science,
Houghton Street,
London WC2A 2AE

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