South Sudan, the EAC and the East African Monetary Union
Lecture Notes - Christopher Adam, 16 June 2016

The History of the East African Community

The East African Community (EAC) regional bloc builds has monetary and political economy considerations for all the member states involved. The current EAC draws on experiences from Europe and therefore the EAC member states can also learn from the crisis in Europe.

The roots of the preceding organization can be traced back to the East African Commission that dates back to the British High Commission in East Africa, which formed a bloc between Kenya, Uganda and Tanganyika (Tanzania). The first EAC was then established between these countries in 1967. It was ultimately dissolved in 1977 due to conflict between Tanzania and Uganda. However, another very important reason was the perception that the gains from integration were poorly distributed and to a large extent accrued just to Kenya. The current EAC was re-formed in 2002, by Kenya, Uganda and Tanzania and then later, in 2009, Rwanda and Burundi joined as well. South Sudan became the newest member state in 2016.

The functional aspiration of the EAC, up to a certain degree, reflects the European experience: a single market for goods (customs union -2010), a single market for capital and labour (common market - 2015) and a monetary union (currently set for 2024). There is also the overall aspiration for full political federation.

Levels of Regional Integration

There are various stages of regional integration that range from a single country with most-favoured-nation status to a full political union. At the current stage of the EAC, the interest lies in the moving from a fledgling customs union and common market to a more integrated single market and then to a deeper form of economic integration, which would involve a substantial pooling of sovereignty. In particular, the move to a monetary union would imply the delegation of monetary policy, a common exchange rate and thus a single monetary policy for the region. The final step is the full political union where these policies get subsumed.

The arguments for moving towards a more integrated union, is that there is significant growth potential for all states involved. This arises due to increases in productivity and the levels of consumption, amongst other factors. However, it can also come with forces that lead to economic divergence, which is a trade-off. The major challenge for any successful regional grouping is to ensure that growth is inclusive at a country level (i.e. the gains from trade spread equitably) and also across countries (i.e. inclusive growth patterns for all the countries involved). Any successful economic union of this type requires the national structures that can mitigate the potential negative consequences that may arise. For the latter stages of regional integration, here will also be an increasing requirement to relinquish some sovereignty and authority.

In this context there are two forms of legitimacy that are relevant:

- <u>Output legitimacy:</u> the support for supranational institutions as a result of the overall assessment of the relevance and quality of those institutions.

- Input legitimacy: the support for supranational institutions as a result of the legitimacy of the underlying process (e.g. democratic) as inputs to those institutions.

There is always a balance between output and input legitimacy. When things are going well, citizens tend to focus on the output legitimacy. However, often the input illegitimacy is criticised when things are not going so well (e.g. see the current Brexit debate). This underlying tension is fundamentally a governance issue.

The Economics of Regional Integration - Potential Gains But Important Role for Governance

The biggest case for regional integration is scale, on the basis of increased economic activity, and improved competition, resulting in improved efficiency. The beneficiaries of this, to a large extent are the consumers as they are able to enjoy greater diversity and overall lower costs. There can also be losses as a result of regional integration e.g. to domestic producers.

The attempts to understand the balance of gains and losses come from the analysis of the economics of trade creation versus trade diversion and the overall net effect for the country. However, a lot of the discussion of trade creation and diversion is very static. What really matters are the dynamic growth effects from larger markets and increased efficiency. These are also the drivers of the convergence and divergence effects.

Regional integration can also support an overall security agenda, by "locking in" countries and thus making conflict relatively more expensive. For example, the European Union moved rapidly to bring Spain, Portugal and Greece into the EU because, at the time, they were new democracies. The question of how to ensure that the gains from integration outweigh the costs, in the context of fragility will also be an important consideration for South Sudan within the EAC.

Divergence matters and thus the relatively equitable distribution of gains will matter for stable unions. History's example of the very near break up of a monetary union, was the American Civil War as one of the major underlying issues was about tariffs and the distribution of income across states. The collapse of the first EAC was arguably also about the perception of the unequal distribution of the gains from trade. Divergence will also exist in new EAC, and therefore the challenge will be to get the governance structures right to adequately lean against these forces.

One of the biggest gains from joining the EAC for South Sudan will be their incorporation into regional infrastructure projects. The regional public good provision will be key also in their domestic development of markets. Ultimately, increases in trade will reflect the better connection through this infrastructure.

In this context, it is also important to understand that the EAC is not yet a mature institution. Therefore, there is still a lot to play for and thus having a seat at the table, as a member state at this point, will be important for South Sudan to help shape the processes. However, if a group of countries is serious about regional integration, then their core structures have to be well funded. This is not the case for the EAC: much of the funding for the core institutions is coming from outside funding rather than the member states themselves. Therefore a lot more needs to be done to mobilize resources to ensure the second EAC is successful.

The Monetary Union Protocol

The Monetary Union Protocol was signed and ratified in 2013. There are still various steps to the final implementation of the overall provisions in the Protocol. According to the Protocol, the monetary union is supposed to come into force in 2024. However, this is a moveable date as the most important factor is that the acceding states fulfil the convergence criteria.

Unlike in the European Union where all the member states are obliged to join the monetary union, the EAC has instituted variable geometry. This means that all members of the EAC are welcome to participate in the common currency, but they are not obliged to. This is a very important feature of the EAC overall and for South Sudan in particular.

A monetary union has little to do with common currency and rather more to do with real convergence that has to occur first. This implies that convergence can take place over a very extended time period. During this time the economies are able to converge to get to relative balance, which in turn is a good thing as it creates fiscal discipline and supports the development of financial markets, amongst other factors. Therefore the process in itself is valuable even if a country decides not to join a common currency then

The convergence criteria are meant to bring the economies into relevant balance. When there is sufficient convergence, there will be broadly stable inflation and steadily growing productivity. The Monetary Union Protocol tries to set out guidelines, which are on the European Union and include a deficit target, a debt target and a government revenue mobilization target. The idea is to hit the targets and then maintain them for a period of time. However, the criteria are incomplete as they miss the interrelation between the public and the private sector. The undoing in Europe is as a result of the balance of payment deficit that builds up over time, i.e. the fiscal measures are necessary but not sufficient.. Therefore, in the EAC it would be important for the convergence criteria to also take into consideration the external current account balance between the players.

The move to a fully monetary union is a journey of an uncertain length. This is a good thing, as a hasty convergence will lock in a fundamental disequilibrium, which in turn will create fundamental tensions. Ultimately, it will require a lot of resources to rectify or result in the dissolution of the monetary union as a whole (e.g. Greece and the EU).

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The three key points and questions when thinking about South Sudan's accession to the EAC are as follows:

1. Can countries grow together or will they grow apart? Will there be divergence or convergence?

2. What are the differences between EAC 1 and EAC 2 and what is the role of the economic and monetary union in this?

3. The great importance of managing the integration process as the EAC still is a work in progress.

South Sudan is not the first "little brother" to join the EAC. If you look at Rwanda and Burundi's GDP when they joined, it was also much lower than the rest of the EAC countries. South Sudan can benefit from the natural experiment, based on what has already happened with Rwanda and Burundi's accession. If you look at the growth rates before and after the EAC, Rwanda is doing well. Even though Burundi is not doing as well, it is still growing faster than before the EAC. Rwanda is very well managed and very committed to the integration process.

The "big brother" is not winning and you cannot have one country "winning" on all the export markets. It is not sustainable. If you look at the data, the share of the EAC market has not been growing for Kenya, but rather for Uganda and Rwanda. Highlight Divergence is not inevitable but there are significant challenges that have to be managed.

The first EAC was about a customs union in the context of a currency union. This second iteration of the EAC goes way beyond this e.g. trade in services, education, health among other sectors. The EAC is very important with regards to the competiveness of landlocked countries in particular, as there is a reduction in overall transport costs. With regards to the monetary union, it is not necessarily where you end up but rather the steps you take to get there. In this respect, governance is very important.

Management of the integration process is crucial. This points to the convergence criteria in the EAMU Protocol. There are critical issues for South Sudan to manage (e.g. tariffs sugar and rice) as currently the political economy of the EAC still favours the first members. However, there is a difference to dealing with the fall out of a policy versus actually managing the process to get there. Now South Sudan has the tools to manage the process. In the monetary union and the monetary convergence - it is the work in progress.

The main challenges for the EAC will be:

1. Feedback loops between economic and political are very strong and for smaller countries, output legitimacy is very important in this context;
2. For smaller countries, like South Sudan, the infrastructure benefits of joining the EAC are great. Therefore it is not whether but rather how they should integrate;
3. Institutions are not just the buildings and committees you have, but structure of relationships. In this respect the new EAC is fundamentally different from the old.