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Considerations for South Sudan joining the East African Monetary Union

In brief

- Given where the economy is at the moment and its prospects over the next two to three years, South Sudan is highly unlikely to be ready to participate in the monetary union at inception, assuming this occurs in the early- to mid-2020s. The focus for South Sudan in the near to medium term is ensuring internal macroeconomic stability.
- Although South Sudan's admission to the East African Community (EAC) will increase its trade within the region, the structural differences between South Sudan's and the other EAC economies are profound enough that South Sudan should be sceptical about potential gains from joining East African Monetary Union (EAMU) at this point in time.
- It is, however, in South Sudan's interest to undertake the necessary steps to be a part of the EAMU to be able to fully benefit from EAC membership. In particular, focusing on adopting and implementing the convergence criteria can support South Sudan's economic management through the external imposition of monetary discipline.
- Overall, monetary unions around the world are always dealing with the tension between aggregate economic efficiency gains and distributional consequences. The intrinsic tendency towards divergence means the politics need to be right within the EAC for EAMU to fully take off and benefit Partner States.

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Introduction

In November 2013, the Partner States of the East African Community (EAC) endorsed the Protocol on the Establishment of the East African Community Monetary Union (the Protocol) committing them to full monetary union by 2024. Monetary Union is the third of the four pillars in the EAC's ambition towards regional confederation. Pillars one and two – the customs union and the common, single internal market – are already in force. By contrast, the Monetary Union Protocol only provides a framework for subsequent legislation, much of which remains under discussion between the EAC Secretariat and the Partner States.

South Sudan, as the EAC's sixth Partner State and its first 'accession country', is necessarily obliged to implement the customs union and single market protocols as they stand, but it will be in a position to participate in the on-going negotiations on the monetary union. As the experience of the Eurozone indicates, while monetary union can confer substantial benefits on an emerging regional trading bloc, it is not without risks, particularly if monetary integration is not supported by complementary reforms in the fiscal and political spheres. It is the incompleteness of these complementary reforms – which themselves reflect deeply divided views on the degree of political integration that monetary union requires – that have exposed the Eurozone to almost a decade of short-run economic crisis and longer-run stagnation. The EAC Partner States must, as a matter of urgency, move quickly to a shared understanding of the broader political implications of monetary union if they wish to put in place an effective single currency for the East African region.

The purpose of this policy brief is to examine the implications of the EAC Monetary Union Protocol for partner states and in particular for South Sudan. Accordingly this brief addresses the following:

- The economics and politics of monetary union;
- The structure of and prospects for the East African Monetary Union (EAMU);
- Opportunities and challenges facing South Sudan as it considers accession to the proposed EAMU;
- The implications of South Sudan's membership of the EAMU for the union and for other Partner States;
- Whether EAMU membership is feasible and/or desirable for South Sudan.

The economics and politics of monetary union

Creating a monetary union involves the member countries relinquishing the exchange rate as an instrument of country-level economic policy whilst simultaneously accepting a common monetary and exchange rate policy, normally managed by a supra-national central bank. In this process, national central banks are reduced to the level of branches of the supra-national central bank, responsible for implementing rather than determining monetary policy. The common monetary policy may take various forms: the common central bank may choose to fix the common exchange rate, such as in the CFA Franc Zone; it may let the common exchange rate float and set the collective interest rate in order to stabilize the union-wide aggregate economy in the face of external shocks, as anticipated in the Protocol; or it may adopt some hybrid framework in which it uses both the interest rate and exchange rate intervention to pursue an agreed set of objectives. This latter case is the closest to the national monetary policy frameworks in the 'Big Three' EAC partner states, namely Kenya, Tanzania, and Uganda, where monetary frameworks are fundamentally focused on controlling inflation but where consideration is also given to managing the exchange rate, at least over the short-term.

Countries enter into monetary unions for three main reasons, the balance of which may vary even across partners within a given union. These include: to promote and support trade, financial, and real economic integration with union partners and the rest of the world; to accelerate a process of union-wide political integration; and to improve the quality of monetary and exchange rate policy.

The first of these motivations is virtually always present and is a crucial part of the motivation for union in the EAC. A single currency eliminates the costs of currency conversion and hence reduces the direct costs associated with trading with other countries both within the same union and with countries outside the region as the market for the regional currency expands. A study by the European Commission in 1990, on the eve of adopting the Euro, suggested countries could save up to 0.4% of GDP on average in terms of reduced transactions costs if they were to adopt a common currency. A common currency also eliminates exchange rate risk – the change in the value of transactions and of assets as a result of the movement in exchange rates between the order and delivery of goods. It also promotes price transparency as it allows consumers to easily compare prices of goods and services in different countries. This is particularly true in a regional economic bloc, which aims to promote economic integration and the free flow of goods and services.

The second consideration is a stated objective of the EAC to move towards a political confederation as well as having typically played a role in grand plans for monetary union across Sub-Saharan Africa. However, as the European case has shown, questions of political confederation are highly contentious.

The final motivation is particularly relevant for countries with histories of monetary instability: these countries may view the delegation of policy to a supra-national authority as a way to reduce 'inflation bias' – the tendency for political pressures to allow inflation to creep up to inefficient levels – and thereby promote greater macroeconomic stability.

Loss of national monetary policy sovereignty

Whatever the mix of considerations in particular cases, the benefits of union still come at the cost of a loss of policy sovereignty for each member state. National central banks become subordinate to a union-wide central bank. This means decisions on liquidity, interest rates, and exchange rates automatically become union-wide decisions. It is likely that although these decisions will reflect the relative economic weight of the members, they will rarely be driven by the preferences of any single member. Other policy instruments, notably on the fiscal side, remain within the domestic domain but may be heavily circumscribed by union-wide considerations. Regardless of exactly how the new central bank chooses to configure policy, the key point is that the national authorities now have one less instrument to stabilise their own economy in the face of asymmetric or idiosyncratic economic shocks. Unless all countries are faced with a common union-wide shock, the monetary policy response by the new central bank will, in general, not be optimal from the perspective of any individual country.

This sacrifice is potentially costly because nominal exchange rates play a role in two types of macroeconomic adjustments. The first is the elimination of real exchange rate misalignments. The literature on optimal currency areas emphasises that the cost of sacrificing the exchange rate instrument depends on the degree to which shocks tend to be symmetric or asymmetric across countries. Symmetric shocks may generate union-wide exchange-rate misalignments, but since the degree of misalignment is similar across countries the required adjustment can be accomplished through movements in the single union-wide currency.

Asymmetric shocks, in contrast, create divergences in the degree of misalignment across the union – divergences that can no longer be addressed through movements in intra-union exchange rates. Countries experiencing recession may favour a loose monetary policy, for example, while those whose economies are over-heating may favour a tighter monetary policy; countries facing external competitiveness problems may favour a weak exchange rate while other countries have no need for devaluation; while those with severe fiscal challenges may favour more generous monetary finance than those closer to fiscal balance. In each case, policy tensions, and the associated costs of union, are greater when country-level economic environments differ more sharply across the union.

Optimal currency area

The cost of moving to a common currency therefore depends on the nature of shocks that the authorities are likely to face and on the structural characteristics of the individual economies. The classic argument for monetary union derives from two features of the 'optimal currency area'. The first is that such an area defines a cluster of countries or regions that have broadly similar economic structures so that shocks, whether emanating from external factors or common internal factors, affect the separate economies in broadly similar ways so that a single harmonized policy response is appropriate.

The second feature is that to the extent that the shocks are not similar, because structures are never identical, or simply because certain shocks are idiosyncratic so that there will always be some asymmetry between regions or countries, the loss of the exchange rate instrument does not matter if economic structures are highly flexible. Flexibility in this sense means that labour and/or capital can move between sectors and countries and price and wages adjust quickly in response to excess demand or supply pressures. When this is the case, factor movements and domestic price adjustment are sufficient to effect the adjustment in relative prices that changes in the nominal exchange rate would otherwise achieve. In these circumstances the loss of exchange rate flexibility is not costly but rather, to the extent it removes one element of trade costs, confers a net gain on the region. This is the core rationale for monetary union.

Collective action challenges

Monetary union also entails a set of challenges associated with collective action. Countries must stand willing to pool their economic resources to support individual member states that suffer adverse idiosyncratic shocks; but at the same time they need to guard against the 'moral hazard' problem that collective action entails. Knowing that the other partner states will bear some of the cost, however, individual members have an incentive to underinvest in prudent macroeconomic policy, thus putting the entire union in a weakened economic position. Moreover, by ceding authority over monetary policy to a supranational body raises a set of potentially difficult issues of political governance sometimes referred to as the problem of the 'democratic deficit'.

At the national level, and particularly at the supra-national level, central banks tend to be technocratic organisations enjoying delegated policy authority. For the reasons noted above, the implementation of this authority in a monetary union will often entail a macroeconomic policy configuration that is not necessarily the one that individual countries would choose for themselves. When the supranational bank can place the people of a country into this sort of economic situation political tensions can quickly arise. Economic policymaking can easily be seen to be unresponsive to the needs of the people who they are supposed to serve which can threaten the legitimacy and effectiveness of such supra-national institutions. The point is that monetary union is a political as much as an economic institution and it therefore essential that partner states are committed to the institution at a political level and are able to manage the political tensions that will inevitably arise.

The East African Monetary Union (EAMU)

The Protocol for East Africa Monetary Union – the region's equivalent to the Maastricht Treaty that established Economic and Monetary Union (EMU) in Europe – is heavily influenced by the European experience. The basic architecture establishing a supra-national monetary authority and defining its basic functions is broadly similar, although the exchange rate unification process is likely to be much more truncated[1]. The emphasis on the harmonization of fiscal and other policies as well as on macroeconomic policy convergence are also comparable. Under the Protocol, partner states are required to achieve and maintain four fiscal and monetary targets for a period of three years prior to full monetary union and maintained thereafter once union has been effected:

- A ceiling on headline inflation of 8% per annum;
- A ceiling on the fiscal deficit after grants of 3% of GDP;
- A ceiling on the net present value of public debt of 50% of GDP; and
- A floor on net international reserves equivalent to 4.5 months of imports.

Partner states are also required to eliminate direct central bank funding of the fiscal deficit. These primary criteria are to be supplemented by a set of non-binding 'indicative' criteria designed to reinforce the mandatory primary criteria; these consist of a ceiling on core inflation of 5% per annum; a ceiling on the fiscal deficit before grants of 5% of GDP; and a floor on the tax-to-GDP ratio of 25%.

These criteria are designed to deliver stability to the common currency and to ensure that it does not come under pressure as a result of markedly divergent economic performance across the Partner States. These convergence criteria recognize the symbiotic relationship between real economic integration and a monetary union. This means that for a monetary union to be successful, the acceding countries need to achieve and

1. See Christopher Adam, Pantaleo Kessy and Stephen O'Connell (2012) "Exchange Rate Arrangements in the Transition to East African Monetary Union" IGC Working Paper http://www.theigc.org/project/exchange-rate-study/#outputs

maintain a level of economic integration with the core bloc of countries. Achieving the convergence criteria will therefore depend as much on making progress on trade and factor market integration, through the customs union and common market protocols, as it will on the explicitly macroeconomic and fiscal convergence criteria.

An integral element of the EAMU Protocol, which is not so present in the customs union and single market provisions, is the notion of 'variable geometry.' This is the idea that partner states are not obliged to participate in the single currency and, indeed, are only permitted to do so as and when they have demonstrated a consistent adherence to the convergence criteria. These 'multi-speed' provisions, which partly echo those laid out for the so-called 'accession countries' seeking to join the European Union, provides a critical element of flexibility serving the interests of the putative monetary union as well as the interests of the countries involved. The variable geometry provisions were initially designed to accommodate the differences between Kenya, Uganda, and Tanzania and the smaller states of Rwanda and, in particular, Burundi. They are, however, essential to making it feasible even to consider South Sudan as a possible future member of the monetary union.

Critically, even if a country does not seek immediate membership of the monetary union, there is an expectation that the convergence criteria and other provisions, including the prohibition on central banks financing of the fiscal deficit, should be pursued. Indeed, if the logic of the EAC prevails, so that monetary union is seen as an integral step towards full political confederation, this implies there is no scope for a permanent opt-out of the single currency mechanism so that, as in Europe, accession countries are expected to move towards full monetary union membership with all deliberate speed[2].

South Sudan and EAMU

Given where the economy is at the moment and its prospects over the next two to three years, South Sudan is highly unlikely to be ready to participate in the monetary union at inception, assuming this occurs in the early- to mid-2020s. Nonetheless, it is worthwhile considering the key benefits (and costs) that might arise in due course if South Sudan were to join the union. Monetary independence vs. exchange rate stability.

One of the major features of the EAMU will be the establishment of the East African Central Bank (EACB). A well-structured independent regional

2. There is a well-articulated view in the politics and economics literatures that monetary unions that are not supported by deep political union are inherently unstable and therefore 'incomplete' unions with variable geometry are vulnerable to collapse (see for example, Paul de Grauwe, "European Monetary Unification: A Few Lessons for East Asia" Scottish Journal of Political Economy 63 (1), pp1-17.

central bank should be able to establish a monetary policy that is more coherent and credible, and hence more supportive of macroeconomic stability, than the Bank of South Sudan could achieve operating on its own. This would be conducive to investment as well as trade and could eliminate some of the macroeconomic instability in the region.

As noted, however, this loss of monetary independence may have consequences. But these may not be as costly in reality as they might appear. In an environment such as South Sudan where monetary policy is currently relatively ineffective, the loss of monetary independence is relatively unimportant. In fact, it may even confer direct and powerful gains in two respects. First, as noted, the country stands to gain from the greater capacity of the supranational central bank to establish price stability and credibility. Second, removing the capacity to 'money-finance' fiscal imbalances imposes an important discipline on government, by turning the spotlight on the importance of measures to improve domestic revenue mobilization in order to augment external concessional financing, and by creating incentives to develop the capacity to meet short-term funding needs from domestic debt markets.

In a monetary union, and indeed in most other countries as well, the short-term market for government debt, namely the Treasury Bill market, tends to represent the residual financing source for government. The national central bank may act as government's agent in this market, organising the sale and roll-over of debt and this may be complemented by transactions in its own liquidity paper, the REPO market, giving it some short-run influence over local market liquidity even if it is not directly involved in the overall setting of monetary policy.

Asymmetric shocks

The key issue for South Sudan when considering surrendering its monetary policy is whether the potential shocks it could face are similar enough to those that the rest of the countries in the EAC are likely to face. It is also important for South Sudan to consider whether the country will be subject to a similar economic cycles as that of other EAC member states. Although the oil and gas sectors are expanding across the EAC, South Sudan is the only country in the bloc whose economy currently depends heavily on oil for both exports and government revenue. Therefore, South Sudan's economy is vulnerable to events in the international oil market, irrespective of what happens in the EAC region. Over the medium term, therefore, shocks to the South Sudanese economy are unlikely to correlate well with those in other partner states and indeed may be almost perfectly out-of-synch. In particular, when oil prices are high the South Sudanese economy may be booming while the rest of the region, which are oil importers, will face the pressures of high oil prices.

The question then is how monetary and exchange rate policies are set. To the extent that the net oil importers dominate the regional economy and hence weigh heavily in the collective policy response of the EACB, there is a risk that South Sudan may often find itself facing inappropriate monetary policy. This means that with monetary policy acting as a drag on performance, macroeconomic management in South Sudan will need to lean more heavily on fiscal instruments, which may be costly and less effective. The capacity of the South Sudanese economy to lean against the thrust of monetary policy is currently very limited. However, this capacity will improve over time as the government posts successes in meeting the convergence criteria stipulated by the EAMU Protocol and in developing domestic financial markets.

Labour market liberalisation

Coping with the 'loss' of the monetary and exchange rate instruments will be eased the more flexible labour markets are, both in terms of wage-setting and labour mobility, between sectors in the domestic economy and between the domestic and regional economies. The more flexibility in labour markets, the less need there is for the exchange rate to bring about economic adjustment and the closer the economy will converge to its potential economic output. This 'additional' adjustment mechanism underscores the importance of the customs union and single market provisions of the EAC. Hence the liberalisation of labour flows is a step in the right direction in terms of promoting labour mobility.

In reality, labour movement within the EAC is still hindered by many processes, such as visas and quotas, and thus is likely not swift enough to provide the kind of response required for an economic shock. The liberalisation of labour, as envisaged in the EAC, is gradual. Therefore, full liberalisation may not be achieved, which is imperative for smooth economic adjustments to occur. Furthermore, labour migration may be easier for certain professions and levels of education than others, limiting its effectiveness as a tool for the economy to adjust.

In the case of South Sudan, there is further reason to be concerned by the fact that labour mobility may be asymmetric. Labourers from the rest of the region may be in a more favourable position to relocate to South Sudan during a positive economic shock. Yet during periods of downturn, South Sudanese labourers may not be as able to move to other countries in the bloc due to lower skills, low education levels, and for some, language barriers.

The single currency as a managed float

The EAMU Protocol anticipated that the common currency would operate as a managed float anchored by region-wide inflation targeting. This preference reflects in large measure the success recorded by Kenya, Uganda, and Tanzania in using floating exchange rates to stabilize inflation over the last two decades.

South Sudan recently adopted a floating exchange rate regime in December 2015. Although many resource rich economies tend to have fixed exchange rates or managed floats, this was no longer sustainable within the context of South Sudan due to a variety of issues resulting in a large divergence in the official rate and black market exchange rate.

The main question for South Sudan when considering adopting the EAMU common currency is whether the new EAC common currency will be less or more volatile than the South Sudanese Pound. As mentioned, the common currency is likely to be more stable and therefore subject to less exchange rate volatility as it will enjoy the backing of a more diversified and mature economies of the other EAC countries. Even though South Sudan will have to worry about the exchange rate risk associated with the new currency vis-à-vis the US dollar, the volatility is likely to be less than the current situation. Thus, joining a common currency could reduce the exchange rate risk and improve the investment climate for South Sudan to develop its non-oil economy and therefore diversifying its economy overall.

Proceed with caution

South Sudan's admission to the EAC is likely to result in an increase in trade between South Sudan and the Member States. However, the structural differences between South Sudan's economy and those of other EAC countries will not disappear. In fact, they are profound enough that South Sudan should be sceptical about potential gains from joining EAMU at this point in time.

As the EAMU Protocol correctly notes, monetary unions thrive where the economies of the member countries are deeply integrated, but participation in a well-functioning monetary union will itself promote further integration. This is very much the vision underpinning the EAMU of building a more resilient and integrated East African economic bloc. Thus, it is in South Sudan's interest to undertake the necessary steps to be a part of the EAMU to fully benefit from membership in the EAC. For example, adoption of the convergence criteria can support South Sudan's economic management through the external imposition of monetary discipline. However, it should proceed on this journey with caution, recognizing the structural differences (and the structural weaknesses) of its economy with respect to the other partner states, and recognizing the political demands that regional integration and monetary union will place on the state. South Sudan will still need time to fully implement the provisions of the Customs Union and the Common Market Protocols, which is an imperative step before considering a move to join the Monetary Union.

As South Sudan implements the Customs Union and Common Market Protocols to catch up and integrate its economy with those of other

EAC countries, it should also use the opportunity to deeply reflect on the Monetary Union Protocol, fully participate in any further negotiations and ensure that the final provisions are suitable for the needs of its economy as well.

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