Designing fiscal institutions for an East African Monetary Union

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Designing Fiscal Institutions for an East African Monetary Union

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Abstract

This paper discusses the fundamental macroeconomics of monetary union and their implications for the design of the fiscal architecture for monetary union in East Africa. In doing so we highlight some of the weaknesses in the design and operation of the Eurozone, the only direct contemporary comparator to the proposed East African Monetary Union. Aspects of the incomplete fiscal architecture of the Eurozone are reflected in the Protocol. The paper makes recommendations on the design of subsequent and supporting enabling legislation.

This paper has been prepared for the Secretariat of the East African Community in Arusha and the Committee on Fiscal Affairs under the aegis of the International Growth Centre (www.theigc.org Contract No. VCM-VTZA-VXXX-40212). The opinions expressed are our own.

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Appendix I: Lessons from the Eurozone: cumulative divergence and delayed response .......... 54
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If a country or region has no power to devalue, and if it is not the beneficiary of a system of fiscal equalization, then there is nothing to stop it suffering a process of cumulative and terminal decline. I sympathize with the position of those (like Margaret Thatcher) who, faced with the loss of sovereignty, wish to get off the EMU train altogether. I also sympathize with those who seek integration under the jurisdiction of some kind of federal constitution with a federal budget very much larger than that of the Community budget.

What I find totally baffling is the position of those who are aiming for economic and monetary union without the creation of new political institutions (apart from a new central bank), and who raise their hands in horror at the words ‘federal’ or ‘federalism’.

Wynne Godley, a British economist, in his essay “Maastricht and All That” in the London Review of Books (8 October, 1992)

1. Introduction

On 30th November 2013 the Presidents of the then five Partner States of the East African Community initialed the Protocol on the Establishment of the East African Community Monetary Union committing them to full monetary union by 2024. As has become painfully evident since the creation of the Eurozone in 1999, however, the success of monetary union depends much less on the mechanics behind the operation of a single currency than with the fundamental fiscal architecture that underpins the union. Thus while the centrepiece of the Protocol is the eventual introduction of a single East African currency, issued and managed by a new supranational East African Central Bank (EACB), most economists would argue that the critical requirements for East African Monetary Union (EAMU) and the single currency to be sustained without repeated periods of crisis include: (i) continued integration of the real economies of the region; (ii) a process of unification that ensures all partner states enter monetary union in a broadly balanced macroeconomic configuration; and (iii) a set of fiscal institutions and policy measures that help keep the union on a balanced growth path and provide for coherent short-run macroeconomic management in the face of shocks. Establishing these latter institutions is likely to require a greater degree of coordination on fiscal issues, and possibly closer political integration, than currently prevails in the region, despite the Community’s commitment to eventual political federation.

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1 President Yoweri Museveni of Uganda; President Pierre Nkurunziza; Uhuru Kenyatta of Kenya; President Paul Kagame of Rwanda; and President Jakaya Kikwete of Tanzania. The sixth member of the East African Community, the Republic of South Sudan joined the EAC in March 2016.

2 Although the Preamble to the Protocol reiterates the Community’s ambition to establish an East African political federation, progress in advancing this goal has been extremely slow. A ’Committee to Fast-Track the
extent to which Partner States will need to pool political and economic sovereignty in support of monetary union is hard to determine at this stage, but it is likely to be greater than many in the region are yet prepared to acknowledge. In practical terms, therefore, the challenge facing the architects of monetary union in East Africa is to strike a balance between the need to establish effective national and supranational governance institutions for the union on the one hand, and recognizing the inevitable resistance on the part of national governments to the delegation and pooling of authority and accountability this demands, on the other. The relevant institutions include not just the fiscal and monetary institutions that are the focus of this paper but also those governing the payments system, financial sector surveillance and regulation, and the generation of harmonized economic statistics for the union.

Our aim in this paper is twofold. The first is to offer some guidance on how the fundamental economics of monetary union ought to shape the eventual design of the fiscal architecture for monetary union in East Africa. The second is to provide a commentary on specific institutional proposals contained in the Protocol. In doing so, we adopt a pragmatic approach based on two considerations. The first is that although all the Partner States have publicly committed themselves to greater economic integration, up to and including full monetary union and eventual political federation, the domestic political implications of these commitments, in particular for the extent to which Partner States will be required to relinquish sovereignty over key economic policy choices in the interests of the monetary union, have yet to be fully tested. It is important therefore that our analysis acknowledges that full monetary union may take longer than scheduled to be achieved; it may not even occur at all; or it may be achieved only by a subset of Partner States – the so-called ‘variable geometry’ outcome. Second, given this uncertainty, new fiscal institutions and policy commitments need to be proportionate and flexible. They need to be relevant to providing the appropriate degree of fiscal coordination along a transition path of uncertain duration; to a

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EAC Political Federation’, known as the Wako Committee, reported on the constraints to federation to the Summit in November 2004 (at a time when the EAC consisted only of the ‘big three’ of Kenya, Uganda and Tanzania). The Committee recommended an ‘overlapping and parallel’ process to accelerate the move towards federation that would fast-track the functional economic elements of integration (customs union, single market and monetary union) and would institute the election of a federal head of state and executive and legislative branches of government. The Wako Committee report anticipated the first federal elections to take place in 2010, and as a result of the consultative process, the office of Deputy Secretary-General responsible for Political Federation was established in 2006 to coordinate this process. As of the time of writing, however, there has been no formal revision to the Wako Committee report nor has a new timetable for political federation been issued.
single currency environment where full monetary union is accompanied by incomplete political union; and to the case that full monetary union *does not* in fact occur.

This approach follows closely that pursued in our earlier work on exchange rate policy in the transition towards monetary union.³ There we examined options for exchange rate policy that sought to place Partner States on a credible ‘glide path’ towards the adoption of a single currency in due course (again noting that this may possibly not even occur) but to do so in a manner that would both preserve and enhance the substantial gains that had already been achieved in macroeconomic management in the individual countries and also maximize the potential benefits from closer coordination between Partner States in the conduct of independent monetary and exchange rate policy. Given the uncertainty about the likely trajectory towards monetary union and the non-negligible probability that it may not take place, this same approach makes sense here.

The remainder of this paper is structured as follows. In the next two sections (Sections 2 and 3) we review some of the basic economics and political economy of monetary union in order to draw out the role of fiscal institutions in supporting effective monetary union. The key point we make in Part I of the paper is that all monetary unions are vulnerable to pressures that lead towards economic divergence and that are not necessarily self-correcting. Therefore, the fundamental elements of an effective governance structure for a monetary union must include institutions to monitor and manage these pressures. As we describe in Section 3, however, a consistent argument in the literature about monetary union is that the containment of these fundamental pressures may require ‘full’ political union and that without political union monetary union is a fundamentally flawed project. According to this argument, if full political union is unlikely to materialize then the Partner States may be better served by concentrating efforts on deepening real economic integration through the development of the customs union and single market at least until the process of political confederation is further advanced.

This ‘no-monetary-union-without-political-union’ view has, of course, been reinforced by the recent experience of the Eurozone where it is argued that lack of structures to manage the pressures for divergences has undermined European monetary union. The countervailing view is that the instability and vulnerability of the Eurozone is not inevitable but rather reflects failures of design and that with appropriate design, especially of fiscal institutions, a successful monetary union can thrive

in circumstances where full political union is not in place or is likely to take an extended period of time to be realized. Having these in place would not have completely shielded from the enormity of the global financial crisis but it is likely they would have substantially mitigated the subsequent crisis that has engulfed the Eurozone from 2010. (In Appendix I of the paper we briefly describe how in Europe, despite the presence of explicit convergence criteria, latent pressures for economic divergence built up over time, creating the conditions in which a disorderly adjustment following the global financial crisis was almost inevitable.)

An important argument for moving towards monetary union ahead of political confederation is that doing so creates a clear and specific macroeconomic anchor for the region which has important implications for policy and institutional choices over the short- and medium-term. Committing to a path towards monetary union favours some macroeconomic policies (those that support convergence), and also, importantly, rules out others so that sensible macroeconomic policy becomes locked-in even if the final objective is ultimately not achieved. Poland is a good example of this lock-in mechanism where the pursuit of integration and the convergence towards EMU since the mid-2000s helped to embed the principles of sound macroeconomic management even though there is no planned date for joining the Eurozone.4

The critical point for the EAC remains, however, that while the crisis in Europe is still far from over -- and while some of these missing elements in the fiscal architecture of the Eurozone monetary union are being retro-fitted, often against substantial resistance from some Eurozone members -- those charged with the design of the EAMU have the opportunity to lean from Europe and avoid these errors by building the right fiscal features into the framework from the start.

This background leads into the second part of the paper (Sections 4 and 5) which review the fiscal provisions in the Protocol, draw lessons from the European experience and make specific recommendations on the design of provisions for the EAC. If accepted, these recommendations do not require retrospective modification of the Protocol but could be readily incorporated in subsequent enabling legislation and in the development of the terms of reference and operating procedures of the institutions of a future monetary union.

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4 Along with other EU members Poland is obliged to join the Eurozone at some point. Initially the Polish government had aimed to join in 2012 but in the current political and economic climate there are no plans to join before the mid-2020s at the earliest.
Part I: The Economics of Monetary Union

2. The economics of monetary union

Creating a monetary union involves the member countries relinquishing nominal exchange rate adjustment as an instrument of (country-level) economic policy and simultaneously accepting a common monetary and exchange rate policy, typically set and/or managed by a supra-national central bank. The common monetary policy may take various forms depending on choices over the nominal anchor: the bank may choose to fix the common exchange rate (as in the CFA Franc Zone); it may let the (common) exchange rate float and set the common interest rate in order to stabilize the union-wide aggregate economy in the face of external shocks (as anticipated in the Articles 11 and 12 of 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 (see for example, Ostry et al 2012). This latter case is the closest to the current national monetary policy frameworks in the ‘Big Three’ EAC partner states, where monetary frameworks are fundamentally focused on hitting an inflation target but where consideration is also given to managing exchange rate movements, 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. As noted, the second consideration is a stated objective of the EAC and has typically played a role in grand plans for monetary union across Sub-Saharan Africa, although 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 and promote greater macroeconomic stability.

Whatever the mix of considerations in particular cases, however, the benefits of union come at the cost of a loss of policy sovereignty for each member state. National central banks become

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subordinate to a union-wide central bank, where decisions on liquidity, interest rates, and exchange rates automatically become union-wide and though they may reflect the relative economic weight of the members of the union they will necessarily reflect some compromise or consensus position. 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 fewer instruments to stabilize the economy in the face of asymmetric or idiosyncratic shocks, and unless faced with a common union-wide shock, the monetary policy response by the new central bank – i.e. the setting of the common interest rate -- will, in general, not be optimal from the perspective of any individual country.

This sacrifice is potentially costly because the nominal exchange rate may have a role to play in two types of macroeconomic adjustment. The first is the elimination of real exchange-rate misalignment. The literature on optimal currency areas emphasizes 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 all countries the required adjustment can be accomplished through movements in the union currency. Asymmetric shocks, in contrast, create divergences in the degree of misalignment between countries of the union – divergences that can no longer be addressed through movements in intra-union exchange rates. Countries experiencing economic slack may favour monetary easing, for example, while those experiencing rising inflation may favour tightening; 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.

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’ (Mundell, 1961). 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 forcing
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 so 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, and 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 basis for monetary union.

2.1 Economic sustainability in a monetary union

Monetary unions are, however, vulnerable to forces leading to cumulative economic divergence. The presence of these latent centrifugal forces means the macroeconomic framework for a monetary union must satisfy three core functions:

First, from the beginning each partner state must join the union in a macroeconomic configuration that is reasonably close to its sustainable (i.e. medium term) competitive equilibrium path. This requires that aggregate external debt is broadly stable relative to GDP over the medium term, which in turn means the current account balance is broadly stationary; and internal balance, which implies similar conditions on the public sector debt (both internal and external) and the fiscal balance. Given structural differences across member states in terms of private sector saving and investment positions, however, it is possible that each country’s equilibrium may entail different prudential limits on the fiscal balance. In reality, as we know from Europe, these differences tend to be subsumed in favour of common fiscal convergence criteria.

If on entry initial real exchange rates are misaligned across the union, Partner States with relatively strong currencies at conversion will be high-cost economies by global standards, and hence at a competitive disadvantage directly with respect to each other and also indirectly in third markets, and those with relatively weak currencies will be low-cost economies enjoying competitive advantage. In principle, these differences should erode over time, through differential wage and price adjustments, sped along by cross-border labour migration in search of higher wages. But there may be substantial macroeconomic strains in the interim, including impacts on investment patterns and fiscal performance. The high-cost economies will tend to have lagging exports and employment, while the low-cost economies may find themselves to be differentially strong exporters and
recipients of foreign direct investment inflows. Depending on each country’s tax structure, these differentials will also imply potentially different fiscal performances.

Second, the framework needs to effectively monitor deviations from equilibrium and to respond to these pressures quickly. This means identifying and tracking structural changes to competitiveness coming from price and wage pressures and/or productivity shifts that lead to deviations from equilibrium, in other words to persistent real exchange rate misalignment. This is difficult in any circumstances but is likely to be particularly so in an environment such as EAMU where the partner states are undergoing rapid structural change which is not necessarily coordinated across the union and are subject to a range of supply-side shocks, which again are not necessarily coordinated.

Finally, the framework needs to respond effectively to asymmetric short-run shocks (or to common shocks with differential impacts across partner states). This is necessary both because failure to do so may lead to divergence but also because monetary union deprives countries of an instrument and institutions that might otherwise fulfil this function.

In the following sub-sections we discuss each of these issues in turn.

2.2 The tendency for divergence in monetary union

The clearest way to understand how centrifugal forces emanate in a monetary union is through the lens of the so-called ‘Walters Critique’. Named after Alan Walters, who served as economic adviser to British Prime Minister, Margaret Thatcher, the Walters Critique probably did more than anything to keep the UK outside the single currency arrangement. The Critique starts from the observation that the key relative prices keeping an economy on its balanced and sustainable growth path, as defined above, are the real exchange rate (a summary indicator of competitiveness, measured as the relative price of output measured in a common currency), and the real interest rate (i.e. the nominal interest rate adjusted for the domestic rate of inflation) where the latter governs the inter-temporal balance between aggregate consumption and aggregate saving. Monetary union fixes the nominal exchange rate between partner states while the supra-national central bank sets a single nominal interest rate for all partner states. What then determines a country’s real exchange rate and hence competitiveness relative to other members of the union is the difference in their respective price levels and what determines a country’s real interest rate is the difference between the supra-national nominal interest and the domestic inflation rate. Given actions at the supra-national level, both these relative prices are endogenous, in other words not under direct policy control of the partner states. To see how this can lead to macroeconomic divergence under the policy assignment just discussed, consider the following example.
Suppose a member of a monetary union experiences an excess demand shock that puts upward pressure on prices and inflation in that country, and suppose this is an idiosyncratic shock not experienced by other countries in the region. This may be, for example, an unfunded public expenditure shock or a favourable terms of trade shock. If this country was operating its own monetary policy, it would raise the nominal interest rate (by more than the expected increase in inflation) so that the real interest rate rises, choking off the excess demand and bringing inflation back to target. But, if the supra-national central bank does not change the nominal rate (or does so only in proportion to the size of country in the union) the real interest rate in the country will actually fall, which is precisely the opposite of what is needed: in the face of a booming economy, the falling real interest rate stokes price pressure, leading to an overheating of the economy and, as prices rise the real exchange rate for the country appreciates leading to a loss of competitiveness relative to the rest of the union and the rest of the world (exports from the booming country become relatively more expensive and imports from elsewhere in the region and from overseas cheaper). The counterpart to this boom is a worsening of the country’s current account balance with the rest of the union. Exactly the same mechanism works in reverse: a country facing a negative shock which reduces aggregate demand and supressed inflation would have high ex post real interest rates which would exacerbate the recessionary tendency. This is the essence of the Critique: left to its own devices a monetary union with a single common monetary policy will not only be generally suboptimal for any individual country may also be positively destabilizing.

The importance of the Walters Critique is that it is a direct challenge to the conventional view of macroeconomic adjustment within a monetary union that viewed the competitiveness channel as a guarantor of convergence which itself led to the belief, implicit in the Maastricht Treaty, that the real economy (in Europe) was an efficient self-regulating system that would take care of itself. It is true that the competitiveness channel does push the system in the ‘right direction’. Consider the recessionary shock case in which, as a result of the shock the country’s price level falls relative to other countries in the union. This implies the country’s effective real exchange rate depreciates thereby stimulating net exports and putting the economy on a convergent path, resolving the initial asymmetric shock. The speed of convergence depends on the degree of price and wage flexibility which, in turn, leads to the emphasis on supply-side factors, in particular labour market reforms, focussed on increasing this supply-side flexibility.

Nevertheless, as the Walters Critique points out, the factors driving the convergent external competitiveness effect (the fall in domestic prices) are simultaneously driving the real interest rate effect that is pulling in the opposite direction. The key issue is the relative strength of the exchange
rate (competitiveness) effect relative to the interest rate effect. As Walters and others have stressed, the pressures for divergence coming from the interest rate effect will tend to dominate in most circumstances and particularly if there is stickiness in price- and wage-setting (in the sense that agents are locked into nominal contracts and/or form expectations on the future at least partly on the basis of past outturns) or if consumers face rationing in credit markets so that they cannot act on their expectations about the future (see, for example, Allsopp and Vines, 2007 for a more technical discussion of the Critique). In these circumstances, the divergent pressures from the real interest rate effect will dominate the convergent competitiveness effect, thereby setting the economies onto divergent paths.

The key point is that in these circumstances an activist national domestic policy may be one way of offsetting the recessionary effects coming from price stickiness and credit rationing. If there is a strong enough counter-cyclical fiscal reaction, then this can neutralize the tendency for divergence in the monetary union. For example, in the adverse shock case, while the fall in inflation will still impact (favourably) on competitiveness, a counter-cyclical fiscal expansion of sufficient strength can offset the negative effect on private consumption that otherwise comes from the rising real interest rate.

If this activist counter-cyclical response is required – and if it is a stronger response than delivered through automatic stabilizers (to the extent they exist) – it follows that the tight limits set by convergence criteria designed to address medium term fiscal concerns may impede this critical short-term role of fiscal policy and exacerbate adjustment problems. Given what we know about the weakness of automatic stabilizers in the EAC, the risk that the convergence criteria impede an efficient fiscal response to asymmetric shocks is exacerbated.

2.3 Incomplete assignment

The next step is to consider how, in the context of a monetary union, macroeconomic policy instruments should be deployed to address the core objectives noted above. In the context of a single country, this assignment of instruments to targets is often referred to as the ‘New Consensus Assignment’ (see Allsopp and Vines, 2015) and follows directly from conventional ‘New Keynesian’ macroeconomic theory. Under this assignment, monetary policy is assigned the task of providing a nominal anchor for prices (‘controlling inflation’) and, subject to this, stabilizing the economy. It does

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this using the interest rate as its policy instrument. In the case where output volatility emerges from shocks to aggregate demand, the assignment is characterized by the so-called ‘divine coincidence’ in which interest rate movements designed to keep inflation on target also served to stabilize output. Monetary policy also has a regulatory role, in supplying lender-of-last-resort liquidity as required and ensuring financial stability something which – ultimately – requires a fiscal guarantee. With monetary policy shouldering the burden of short-run macroeconomic stabilization, fiscal policy in the ‘New Consensus’ assignment is assigned a dual mandate of anchoring the long-term sustainability of public debt and determining the composition of public expenditure. In more mature economies, however, tax and expenditure systems also embody a fairly powerful degree of ‘automatic stabilization’ which lends support to monetary policy. A natural and credible coordination game between national fiscal and monetary policies can emerge from this assignment when the central bank’s mandate is clear and its actions credible so that the fiscal authorities know and fully anticipate the reaction of the central bank to its fiscal actions. If the fiscal authorities loosen the fiscal stance thereby generating excess aggregate demand, the central bank will tighten the monetary stance to neutralize the fiscal expansion and vice versa if the fiscal authorities tighten fiscal policy. Anticipating this, the fiscal authorities act as a ‘Stackleberg-Leader’ internalizing the monetary policy reaction in their fiscal policy choices. This is essentially a stable configuration.

For a monetary union, the assignment issue has the additional dimension of how responsibilities are partitioned between national and supra-national institutions. The assignment settled on in the Eurozone, which is often referred to as the ‘Issing Assignment’, provides the fundamental rational for the structures defined in the Eurozone’s founding Maastricht Treaty (1992) and the subsequent Stability and Growth Pact (1997). The core macroeconomic policy objectives in a monetary union are: short-run macroeconomic stabilization (i.e. the management of aggregate demand and inflation for the monetary union as a whole); medium-term fiscal discipline / public sector solvency; financial market development and financial integration across the region; and, as discussed above, the regulation of intra-regional competiveness. Under the ‘Issing assignment’, authority over macroeconomic stabilization is handed to the supra-national monetary authority, while medium-

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7 Consider a demand shock which led to over-heating of the economy. A rise in the interest rate would simultaneously reduce excess demand, by reducing the interest-sensitive components of expenditure, and bring inflation back to target. This property does not hold, however, if shocks to output come from the supply side. For example, in the case of a cost-push shock to input prices, arising from a terms of trade shock or from climate-induced reductions on agricultural yields, tightening monetary policy may stabilize prices but at the cost of driving output further from its natural rate.

8 This description assumes the central bank has full discretion over interest-rate setting; this may not be possible, of course, if nominal interest rates are constrained by the zero lower bound, for example.

9 So-called because this assignment was laid out by Otmar Issing, the first chief economist of the European Central Bank (ECB).
term solvency and public expenditure composition objectives are assigned to the national fiscal institutions that retain full authority over taxation, aggregate government expenditure and public debt. In this sense the assignment seems entirely consistent with the new consensus. Responsibility for the third and fourth objectives, on financial market development and critically on intra-regional competitiveness, were also delegated to national authorities.

There are, however, a number of tensions embedded in this assignment which have direct relevance to the design of EAMU frameworks. Consider first the issue of national fiscal policy. Here the tension is that by decisively de-linking fiscal policy from the stabilization function, it fails to pay specific attention to the Walters Critique that argues for national fiscal policy to play a central role in ensuring each economy remains on its balanced growth path over the short- to medium-term.

The second is that in a monetary union the efficient fiscal and monetary coordination described in the single country case must contend with a fiscal free rider problem arising from the fact that individual countries now have an incentive to run a looser fiscal stance (or face a lesser incentive to adopt necessary fiscal contraction in the face of adverse developments). This arises because the supra-national central bank will respond to the impact of fiscal expansion on the aggregate demand of the union as a whole. The expanding country thus faces a less aggressive monetary response to its fiscal expansion and hence expands more than it otherwise would. This will lead to an inflation bias in which the union economy as a whole will end up with higher inflation and lower external competitiveness for all members of the union (without generating any output gains to the country in the long-run). Thus while fiscal policy is a delegated function, the collective action problem means that the system is not self-regulating as in the single country case so that spill-over risks are present which require that delegation is accompanied by constraints on national fiscal behaviour. In practical terms this translated into the set of targets on countries’ fiscal deficits and on public debt stocks specified in the Maastricht Treaty (1992) and the Stability and Growth Pact (1997) aimed explicitly at limiting fiscal free-riding. The convergence criteria defined in the Protocol (both for attaining and maintaining monetary union) mirror directly the Maastricht and SGP criteria.

In the context of economic adjustment in the face of economic shocks, the collective action problem described above presents challenges to the design of supra-national stabilization and structural adjustment facilities. We discuss these in detail in Section 4 below but it is important to note that this problem is fundamental to the design of institutions to support monetary unions and is directly analogous to the problem that faced the Bretton Woods fixed exchange rate system from 1945-71.
and concerns. Without the exchange rate instrument, adjustment to shocks that require a realignment of its real exchange rate can only occur through adjustment in relative prices (so-called ‘internal devaluation’) which tends to be protracted and costly. The provision of temporary financial assistance to member states undergoing adjustment – either short-term (‘stabilization funds’) or medium term (‘structural funds’) – helps mitigate some of the cost of adjustment but at the same time blunts the incentives to drive through the required domestic fiscal reforms: the collective action problem risks delaying this adjustment with long-term costs to the monetary union and the country itself.

The fiscal free-rider problem is a real one and needs to be confronted in any monetary union architecture. However measures designed to anchor medium-term fiscal discipline and address free-riding concerns have important implications for the extent to which fiscal policy can also be used to address concerns about macroeconomic stabilization and about addressing real divergence within a monetary union. In the Eurozone case, the assignment was heavily weighted in favour of addressing the free-rider problem which mean that an active role for counter-cyclical fiscal policy in macroeconomic stabilization was severely curtailed. This might have been reasonable given that national fiscal systems in Europe have reasonably strong automatic stabilizers that supported short-run stabilization. However, it is notable that in the EAC where automatic stabilizers are weak or non-existent, the fiscal convergence criteria as defined in Articles 5 and 6 of the Protocol have followed the situation in Europe and are defined in terms of ceilings rather than reference rates around which the fiscal position can move over the short- to medium-term.

The final issue with the assignment concerns the final two objectives of financial sector development and regulation on the one hand and competitiveness on the other. Within the Eurozone, responsibility over these objectives was also delegated to the national level, although here it was much less clear exactly where this responsibility lay. To some extent, responsibility was handed to the market and the belief that price and wage flexibility and the efficiency of capital markets would ensure labour and capital markets were sufficiently self-regulating to avoid macroeconomic misalignment (in terms of competitiveness and associated current account imbalances). In this respect, Otmar Issing’s analysis probably reflected his own experience in Germany which has a tradition of centralized wage setting within a framework in which concerns for external

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10 David Vines (2016) argues that even the capacity of automatic stabilizers were progressively constrained by the revision of the fiscal targets in the Stability and Growth Pact of 1997 which converted the Eurozone fiscal criteria from ‘reference’ rates, around which automatic stabilizers could operate symmetrically, to ‘ceilings’ which limited the scope for counter-cyclical fiscal actions in the face of recessionary shocks.
competitiveness figure strongly. But elsewhere in Europe, these institutional characteristics were much less prevalent and did not figure at all in the overall institutional design of the Eurozone rules where policy guidance concentrated on promoting supply-side measures designed to improve the flexibility of European labour markets. Financial sector surveillance and regulation were handled in a similar manner, at least in the early stages of European monetary union. Regulation was a national function to be carried out by national central banks and, as such, had a microeconomic, bank-specific focus rather than a macroeconomic or systemic perspective. On either account, very little attention was paid to the cross-border implications of labour market and financial sector regulation and development. We return to this point in Part II.

2.4 Conclusion: concerns for the EAC

This section has considered some of the macroeconomic and fiscal challenges confronting countries when they enter monetary union, adopt a common monetary policy and relinquish nominal exchange rate adjustment. The principal risks surround sustained real exchange rate misalignment and their impact on long-run competitiveness and growth and the corresponding challenges focus on the need to ensure that fiscal policy is sufficiently flexible to lean against this tendency for divergence. Both reflect concerns about price and wage flexibility between and within Partner States and the consequent ease with which real exchange rate adjustment takes place. Specifically, unless wages and prices in Partner States are highly flexible, short-run rigidities can leave real exchange rates far from equilibrium when a macroeconomic shock alters the economy’s equilibrium real exchange rate and without the possibility of nominal exchange rate adjustment, rectifying such misalignment is hard and often protracted.

It is possible, however, that nominal rigidities are not a serious constraint on real exchange rate adjustment in the EAC economies. For example, if the large informal sectors and relatively uncomplicated supply chains that are characteristic of these economies mean that price rigidities are largely absent, then the likelihood of extended real exchange rate misalignments – and hence the urgency of establishing effective activist fiscal policy – may be relatively limited.

In earlier work, we provided some preliminary evidence on this question, by comparing patterns of real-exchange-rate adjustment between the EAC and a set of 19 OECD and emerging-market countries operating flexible exchange rate regimes (Adam et al, 2012). For each country we

estimate separate error-correction equations for the two components of the observed change in the real exchange rate: the rate of nominal exchange rate depreciation against trading partners, and the differential between home and trading-partner inflation. In each case we ask how that component of the overall change in the real exchange rate responds to the lagged degree of misalignment.

Our findings were as follows. First, our estimates imply somewhat greater price flexibility in the EAC and emerging-market economies than in the industrial countries (in the latter, in fact, we find that essentially all real exchange rate adjustment comes through movements in the nominal exchange rate). Second, however, relative price adjustment speeds remain low even in the EAC and emerging-market groups – roughly 5 percent per month on average – and there is no tendency for faster adjustment in the EAC than in the richer emerging-market group. Within the EAC, prices play a somewhat larger role in Burundi and Rwanda than in the three larger economies, but these differences are not statistically significant. There is some evidence, therefore, of greater price flexibility among the EAC countries than among industrial countries, but not enough to eliminate concerns about slow correction of initial misalignments.

### 3. The Political Foundations of Monetary Union

There are two opposing views about the fundamental nature of monetary unions and the circumstances under which they can be sustained frame the discussion in this paper. The first is that ‘incomplete’ monetary union such as exists in Europe today cannot be a stable (economic and political) equilibrium and hence participants in such a union face the choice between either advancing towards full and credible political union, possibly quite rapidly, or retreating back to structures of regional integration based on single markets for goods and services (and possibly for capital and labour) factors but retaining macroeconomic sovereignty at the national level. In terms of the four stages of the EAC project, this view holds that unless the Partner States are committed to moving to political federation (Stage Four) with all deliberate speed, they must seriously question the wisdom of seeking to establish monetary union (Stage Three) and instead focus their attention on consolidating Stages One and Two (the customs union and single market) of regional integration.\(^\text{12}\)

\(^{12}\) It is worth recognizing, however, that the Brexit debate in the UK was not about monetary union but more fundamentally about the relationship between national sovereignty and the so-called ‘four freedoms’ of Europe – the free movement of goods, services, labour and capital – which define the customs union and
The alternative view takes a more sanguine position on the necessity of full political union and instead argues that the ‘instability’ of the European monetary union, for example, is not inevitable but rather reflects errors in design. In other words, monetary union can endure as a broadly stable equilibrium without full political union, even though effective and resilient design will necessarily require that some degree of economic sovereignty must be ceded to the supranational level.

Proponents of the former view that monetary union cannot survive in the long run without deep political union, often point to the historical record which reinforces the claim that monetary unions not embedded in full political union tend not to endure. It is no accident, they would claim, that three of the more successful monetary unions of current times are the United States, the United Kingdom and, perhaps, the United Republic of Tanzania. The clue is the name: common currencies persist only when underpinned by a sovereign state. Supporters of this view also tend to cite examples of ‘failed’ monetary unions: the incomplete Latin Monetary Union between France, Belgium, Switzerland and Italy that existed from the mid-19th century until the First World War; the Scandinavian Monetary Union of 1873 which eventually collapsed when Norway gained its own political independence from Sweden in 1905; and the Irish monetary union with the UK which ended in 1979 as the Republic of Ireland sought to align itself with the European exchange rate ‘snake’, the pre-cursor of the exchange rate mechanism of the European Monetary System. Amongst those successful unions, the sequencing may differ. In the case of the United Kingdom political unification (the “Union of the Crowns” in 1603) pre-dated monetary union (“the Union of Parliaments” in 1707) by more than a century. But as the example of 19th Century Germany shows, political union may in fact actually post-date monetary union, although the forces driving political union were very much in train by the time the functional components of unification were enacted. The north German Zollverein (customs union) was formed in 1834 out of a panoply of smaller state-level customs arrangements but was dominated by the emergent Prussian state. By 1847 a common central bank and single currency had been established to serve the Zollverein, some 25 years before Bismarck’s eventual creation of the modern German state in 1871. The common central bank became the Reichsbank in 1875 before itself being replaced by the Bundesbank at the end of the Second World War.

single market and the view that the free movement of labour fundamentally undermines the independence of the nation state.

13 By the 1970s, Ireland was the last country of the former Sterling Area to retain its original parity with Sterling.
One of the leading scholars on monetary union in Europe, Paul de Grauwe, recently offered a robust summary of this position in a paper aimed at drawing lessons for East Asia from the recent European experience. His conclusion is worth quoting in full:

“The only governance that can be sustained in the Eurozone is one where a Eurozone government backed by a European parliament acquires the power to tax and spend. This will then also be a government that will prevail over the central bank in times of crisis and not the other way around. This will also be a government that has the political legitimacy to impose macroeconomic and budgetary policies aimed at avoiding imbalances. Put differently, the Eurozone can only be sustained if it is embedded in a fiscal and political union” (de Grauwe, 2016, p16).

If de Grauwe is correct and if the Partner States of East Africa are not genuinely committed to full political union, this leads inevitably to the question of whether effective real economic integration -- in terms of goods and services (the customs union) and factor markets (the single market) -- requires monetary union. Or, to put it slightly differently: does the absence of full monetary union significantly limit the gains from real economic integration between separate sovereign states, particularly over the medium- to long-run? Part of the impetus behind the Eurozone was clearly that it does, but this view is not universally held. For example, the position that ultimately prevailed in the UK in the context of the debate over British membership in the Eurozone in the late 1990s was that the real gains from participation in the European single market would not be jeopardised by failing to adopt the euro and that the balance of risks favoured remaining outside monetary union. The UK thus remained a full and (at least at that time) enthusiastic member of the EU but chose not to participate in the Eurozone. This view is also held much more widely outside the European

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15 See for example, the (much contested) empirical work by Andrew Rose (2000) “One Money, One Market: Estimating the Effect of Common Currencies on Trade” Economic Policy: A European Forum 30 pp7-33, which suggested a common currency had a very large positive effect on trade. Subsequent analysis suggested that this effect was, in fact, much smaller.

16 In 1997 the new Labour Chancellor of the Exchequer, Gordon Brown, established ‘five tests’ designed to assess whether the UK would benefit from membership of the putative monetary union. These were billed as purely economic criteria focused on issues of growth, employment, macroeconomic convergence and the role of the financial sector, although many argued that the five tests had been constructed in such a manner that it would have been virtually impossible to generate an unambiguously positive case for membership, thereby allowing the government to avoid the debate over euro membership becoming (what it surely is) a fundamentally political debate about sovereignty. The Treasury assessment was, in fact, broadly positive but sufficiently cautious to allow the Chancellor to rule out membership, initially though 2005 and then, in 2007, ‘for the foreseeable future’. The UK is the only EU member with a permanent opt-out from the Euro. Other members of the European Union have an obligation to move towards membership of the Eurozone with all deliberate speed.
context, with the foremost example being the relationship between Canada and the US (and Mexico). At no stage in the development of the Canada-US Free Trade area in the 1980s or its successor, NAFTA which was created in 1994, was there a view that real economic integration or the integrity of the free trade area was threatened by the absence of monetary union. A similar story could be told about the ASEAN nations who have made significant steps towards real integration but have not, despite much discussion, made any substantive moves towards monetary union. This is, in fact, the fundamental message of the de Grauwe (2016) paper quoted above.

These are powerful arguments that need to be taken seriously by Partner States and by the architects of EAMU. However, the view is contested by an extensive and respected literature that argues that a well-designed monetary union that recognizes the inherent economic tensions that will arise can be constructed and sustained without full political union or confederation. As we note above, however, such a design is likely to require the Partner States to reform their domestic political structures; put in place fiscal and/or risk-sharing mechanisms at the supra-national level; and ensure that these are adequately resourced. This view, which underpins much of the recent reforms of the Eurozone (some of which are discussed in Section 4 below) is essentially the point Wynne Godley was making in his essay quoted at the top of this paper and is the organizing principle for this paper.

3.1 Lessons from other monetary unions

It might be expected that lessons could be drawn from the small number of monetary unions that do currently exist without full political union, and have done so for an extended period of time. What is striking, however, is these unions have tended to emerge from very particular historical circumstances and are characterized by deep asymmetries in size and power or other structural characteristics that do not translate directly to the circumstances of the EAC. In the Common Monetary Area of Southern Africa, for example, there is no supranational monetary authority and the small states of Swaziland, Namibia and Lesotho have chosen to adopt the currency (and monetary policy) of South Africa, with little or no expectation that monetary policy would be set in the common interest, although the Reserve Bank of South Africa does stand ready to supply reserves to the small countries in times of external crisis. Likewise, in the two cases where

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17 It was for this reason that Botswana chose to exit from the Rand Monetary Area (the predecessor of the CMA) in 1976, not long after the discovery of large diamond reserves in the early 1970s.
supranational central banks do exist, one is the (extremely) small East Caribbean Currency Union (ECCU) which also operates essentially as a currency board with the United States,\textsuperscript{18} while the other is the Franc Zone spanning fourteen countries in west and central Africa. The Franc Zone would appear to be the relevant counter-example of an enduring and apparently successful monetary union operating with a supranational currency, the Communauté française d’Afrique (CFA) Franc,\textsuperscript{19} but this too is a highly unusual monetary arrangement. The key feature of the Franc Zone is that the external value of the CFA Franc, which is held at a fixed peg to the Euro, is underwritten by the French Treasury. By guaranteeing currency convertibility to the CFA Franc, and by providing the two central banks with lines of credit (Les Comptes d’Opérations) on which the central banks can draw in case of reserve shortage, the French Treasury plays a similar role to that played by South African in the CMA, providing the Franc Zone with its nominal anchor and, by effectively acting as the lender of last resort to the system, also provides the \textit{de facto} fiscal institutional underpinning to the system.

What makes EAMU strikingly different from these examples, however, is the ambition to create a monetary union between a community of equals with a common currency that goes beyond a currency board but is guaranteed by neither a regional nor an international hegemon. Monetary union in East Africa will only be guaranteed by the credibility and commitment of the partner states to the union. In this respect, therefore, the European experience of monetary union remains the most relevant basis for comparison.

### 3.2 Being careful about the Eurozone comparison

The experience of the Euro zone necessarily looms large in our analysis, both as the only contemporary example of a monetary union formed from independent national currencies and as a cautionary tale on the dangers of economic divergence once a union is established. However, whilst the lessons from the Eurozone are likely to be valuable for the EAC, the comparison with Europe needs to be treated with care for a number of reasons.

\textsuperscript{18}The six states comprising the Organization of East Caribbean States – Antigua and Barbuda, Dominica, Grenada, St Kitts and Nevis, St Lucia and St Vincent and the Grenadines – have a total population of 610,000 people, somewhat less than that of any of the major cities in the EAC.

\textsuperscript{19}The Franc Zone consists of two unions, UEMOA (Union Économique et Monétaire Ouest Africaine) with central bank BCEAO (Banque Centrale des États de l’Afrique de l’Ouest) and CEMAC (Communauté Économique et Monétaire de l’Afrique Centrale) with central bank BEAC (Banque des États de l’Afrique Centrale). The two central banks issue their own currencies, the West African CFA franc and the Central African CFA franc. These are theoretically separate but because of the guaranteed convertibility to the Euro the two CFA franc currencies are effectively interchangeable.
First and most obviously there are important structural and political factors that distinguish the two regions and reinforce the specifically European nature of the Eurozone and its history, including of its crisis and response. These obviously include the fact that the European economies are, on the whole, far richer. The Eurozone is an economic bloc of 340 million people with a gross nominal income of US$15 trillion. Per capita Eurozone GNI in 2014 is approximately US$40,000, with even the poorest, Greece and Portugal, having a per capita income of around US$20,000. By contrast the EAC (excluding South Sudan) consists of approximately half the population (150 million people) but a combined GNI in 2014 of only US$140 billion implying an average per capita income of less than US$1,000 per annum. Even allowing for differences in purchasing power, per capita incomes in the EAC are less than one tenth of the lowest per capita incomes in the Eurozone.

These enormous differences in incomes reflect key structural differences in the scale and structure of production and consumption and the underlying institutional structures. Production in Europe is in general more diversified and more closely integrated into global markets and global supply chains, while labour markets tend to be characterized by longer-term contracts, greater regulation, higher fixed costs (such as pension provision), and greater prevalence and effectiveness of labour unions. Likewise, the fiscal system in Europe is more developed. Not only does the public sector account for a much larger share of GDP in Europe (general government expenditure in the Eurozone accounted for 49.8% of GDP in 2013, compared to 25.7% in the EAC), reflecting both societal preferences for public expenditure and a greater capacity for revenue mobilization, but these structures are ones in which automatic fiscal stabilizers operate more effectively: it is much easier in principle to run a counter-cyclical fiscal policy in the Eurozone than in the EAC, if required. Finally, European financial markets are deeper and the financial system is much more sophisticated in the Eurozone.

Notwithstanding serious structural concerns about the banking system (including the so-called ‘doom loop’ problem discussed below), banking institutions in Europe engage in more cross-border activities – on both sides of their balance sheets – and across a wider range of instruments and maturities; corporate and government debt markets are deeper and more active and there is a much wider range of non-bank financial institutions. The corollary is that systems of financial regulation are also more developed.

Taken together, these structural features mean that the nature and propagation of shocks and the public policy response to them will inevitable differ, possibly substantially, between the Eurozone and an EAMU. The less diversified and less sophisticated production structures probably mean that EAMU countries are exposed to greater external volatility which, in turn, demands greater real
exchange rate flexibility. However, as the evidence cited in Section 2 suggests, the degree of domestic price and wage flexibility is probably somewhat greater.

The second difference relates to the importance of external donors in the fiscal affairs of low-income countries. In four of the five EAC economies, donors have provided substantial debt stock relief in the past decade and continue to finance large portions of the public budget. Whether the prospect and/or pattern of development assistance will reduce or exacerbate the macroeconomic tensions associated with monetary union is unclear. On the one hand, donor assistance can leverage the effectiveness of domestic and regional fiscal instruments but on the other it can also undermine competitiveness through the Dutch-disease channel. The importance of official donors and creditors does suggest, however, that discussions of fiscal responsibilities post-union should take proper cognizance of this dual burden-sharing and burden-creating role of external donors. We return to this issue of the role of official donors in Section 4 when we discuss the role of fiscal stabilization mechanisms in the monetary union.

Third, it is important to recognize that many of the problems of divergence in Europe reflect the powerfully dualistic nature of the Eurozone. There are essentially two Eurozone groups either side of the Alps: the industrial Northern European core (Germany, Austria, France, Netherlands, Belgium, Luxembourg and Finland) and the substantially poorer (mainly) Southern periphery (Greece, Italy, Spain, Portugal, Cyprus, and Ireland). These are two groups with quite different resource endowments, structures and business cycles which arguably exacerbate the problems of divergence that the Eurozone is required to manage. By contrast, the EAC – and certainly the community of the big three (Kenya, Tanzania and Uganda) – probably approximates the notion of an optimal currency area much more closely than does the expanded Europe / Eurozone. This was certainly true in the past before any of the three began to develop their hydrocarbon resources and when the agricultural sector dominated economic activity and where there was a strong co-movement in countries’ the terms of trade, but it is likely to persist in the future as and if all three countries develop their natural resource export sectors along similar trajectories. Matters differ somewhat for the small states of Rwanda and Burundi who are resource importing countries; and they differ radically for South Sudan, the only established oil exporter at present in the EAC.

Fourth, it is important to recognize that the dynamics of the Eurozone are also heavily influence by the politics of its dominant economy, Germany, which has for a long time had an ambivalent attitude

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20 This classification excludes a number of small accession Eurozone members including Slovenia, Slovakia, Malta, Lithuania, Latvia and Estonia.
to monetary union in Europe but whose economic power and influence has had a profound effect on aspects of the architecture of the Eurozone. It is often argued that the political elite in Germany are not and never have been in favour of monetary union but accepted EMU as the ‘price’ to be paid, essentially to France, for the latter’s support of German reunification in 1990. This reluctance, it is argued, led to an outcome where the structures of the EZ were actually designed to ring-fence and limit the institution rather than invest it with flexibility; it is why, for example, a banking union structure and a robust sovereign debt resolution mechanism were absent from the initial design and why their gradual introduction is being met with significant opposition. While the politics of East Africa are very different, this part of the story matters for the EAMU since so much of the preliminary design and discussion has been informed by the experience of (and advice from) Europe. It is important not to lose sight of how European politics has shaped this design.

One aspect of Europe’s experience that is very important for thinking about the EAC’s transition concerns the depth of the institutional foundations on which the Eurozone is built. The global financial crisis and the events that followed have placed the Eurozone under immense stress that has shaken member states’ commitments to monetary union. However, at least to this point, the Eurozone has survived. This probably owes something to a convergence process that occupied nearly three decades and conferred substantial political legitimacy on supra-national policymaking bodies and to a design that embodied a view that the union was inviolate and membership irreversible, even to the extent that there is no provision in the enabling legislation for exit from the Eurozone. The Eurozone crisis has shown that membership of a monetary union may in fact be reversible which arguably undermines value of the union as a mechanism of credible commitment, for Europe and, presumably, for other putative unions. This is of potential concern in the EAC, where the political legitimacy of union-wide authorities is less well established than it was in the Eurozone. In the European case the European Parliament, the Commission and other supra-national institutions, however flawed and contested these may be, predated the European Central Bank. Quite independently of other considerations, therefore, the credibility of an EAC central bank – and of the union itself – may be on a weaker footing at the outset than in the case of the Eurozone.

Fifth and finally, there is a natural risk as we examine the anatomy of the European crisis, that we get drawn into the trap of believing that the risks confronting future EAC will be of the same form or follow a similar trajectory to the European crisis. While it is important to draw lessons from the experience of Europe – since some of the risks are generic -- it is equally important not to fall into the generals’ trap of preparing to re-fight the last war.
Part II Designing Institutions for EAMU

4. Institutional governance in the Protocol

The discussion in Part I identifies some key principles that should shape the governance structures for EAMU to be feasible and enduring. These institutions are required to operate at two levels: to secure the integrity and prosperity of the union in circumstances where pressures of economic divergence are present; and to ensure that partner states can implement efficient response to macroeconomic imbalances when nominal exchange rate adjustment is not an option but where real exchange rate adjustment via price and wage movements – “internal devaluation” -- may be difficult and/or protracted. Moreover, it is important that once in place these structures do not compromise good economic management, either during the transition phase or even in the eventuality that full monetary union does not come about. The specific form of these structures follows directly from an understanding of the efficient assignment of policy instruments to objectives in a monetary union. Institutional design must also reflect an appreciation of how in Europe key elements of this architecture were not in place, at least initially, and what implications this had for the evolution of the Eurozone.

This institutional structure will consist of:

- **Institutions to secure convergence**: the EAMU needs a set of institutional arrangements that will help place countries on a path towards an initial macroeconomic equilibrium at which nominal exchange rate unification can occur without excess disruption and without ‘baking-in’ structural imbalances to the post-union configuration;

- **Institutions to maintain convergence once monetary union has been established**: since regional economic integration structures, including monetary unions, are vulnerable to centrifugal forces that can lead to economic divergence, governance structures need to identify and respond to emerging macroeconomic disequilibrium and address the structural
imbalances that emerge from underlying tensions that tend to favour the core of a regional grouping at the expense of the periphery;21

- **Institutions for shock management**: instruments are required to manage and adjust to idiosyncratic and asymmetrical shocks across the union so that their impact is limited in circumstances where individual countries no longer have recourse to nominal exchange adjustment and/or domestic interest rates;

- **Institutions to manage liquidity**: Traditionally, national central banks stand ready to provide liquidity to government and the financial sector, if required, through their lender-of-last-resort function. With these facilities devolved to the supranational level, governance structures must be able to guarantee sufficient emergency liquidity to ensure liquidity crises do not become solvency crises.

- **A system of macroeconomic monitoring and surveillance**: With the separation of roles between national and supranational institutions, mechanisms are required to monitor economic conditions and pre-empt disruptive shocks to the system and to support adjustment when it is required.

We discuss these in turn, starting with institutions of convergence. First, however, we briefly discuss the broad outlines of the core governance structures as described in the Protocol. At this point, the design embedded in the Protocol is skeletal and many of the details still need to be worked out, most likely through enabling legislation, but it embodies both an aspiration and a basic architecture. There is, therefore, scope for putting in place effective structures. But in doing so, it is necessary to note that the current architecture bears a close resemblance to the ‘pre-crisis’ architecture of the Eurozone as defined in the Maastricht Treaty (1992) and the subsequent Stability and Growth Pact (1998). As such, it embodies an assignment of economic responsibilities that adheres closely and perhaps too closely to the ‘Issing Assignment’ discussed in Section 2 of this paper. Short-term macroeconomic stabilization is thus delegated to the putative supranational East African central bank while national-level fiscal policy is firmly anchored in the achievement and maintenance of a set of convergence criteria for the fiscal balance and public debt. On the fiscal side, rather more weight is placed on the avoidance of the free-rider problem arising from the adverse spill-over

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21 It is important to note that these arise as much from the customs union and single market elements of regional integration as they do from monetary union itself.
effects from fiscal dominance in a single state than on the ‘Walters Critique’ perspective on the role a more activist fiscal policy.

The Protocol consists of a Preamble, locating monetary union in the broader project for East African integration, plus ten main sections covering: the objectives of monetary union; pre-requisites for union; the economic policy framework; financial integration and the payments system for the union; the single currency; institutional structures; and a range of general provisions. From a fiscal and monetary governance perspective, the relevant provisions are covered in Parts C, D, E, I and J consisting of Articles 5 to 13 and Articles 20, 21 and 24. Issues of macroeconomic convergence are covered in Articles 4 to 6 which delineate those responsibilities delegated to the level of the Partner States both on the convergence path to monetary union (Article 5) and when full monetary union has been achieved (Articles 4 and 6). Part E (Articles 7 to 13) defines the putative macroeconomic policy framework. Articles 10 and 24 anticipate some scope for discretionary fiscal or quasi-fiscal action aimed at addressing short-term stabilization and structural divergence respectively. Convergence criteria will be monitored by the institution responsible for surveillance, compliance and enforcement to be established in Article 21. Subsequent draft legislation (The EAC Surveillance, Compliance and Enforcement Commission Bill, 2016) provides substance to the surveillance function.

We refer to specific Articles in the following sections.

4.1 Managing Macroeconomic Convergence

Responsibility for achieving and maintaining macroeconomic convergence is delegated to the individual Partner States and is defined by a set of fiscal and monetary criteria [Articles 6(2) and 5(3)]. The core convergence criteria, to be achieved and maintained for a period of three years prior to full monetary union and maintained thereafter once union has been effected, consist of four fiscal and monetary indicators:

- 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.

These primary criteria are to be supplemented by a set of (non-binding) ‘indicative’ criteria consisting 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 revenue-to-GDP ratio of 25%.

A number of features of these indicators need to be noted.

The first, and arguably least important, is the potential for incompatibility between the primary and indicative criteria on inflation and the fiscal deficit. Whilst it is clear that favourable performance on the indicative criteria will generally increase the likelihood that a country is on track relative to the primary criteria, it is nonetheless entirely possible for a country to meet the indicative criteria and breech the primary criteria, and vice versa. For instance, in circumstance where non-core inflation is high, perhaps because of high fuel price inflation or rising food prices, a country might meet its indicative core inflation target but with headline inflation in excess of the primary target. Similarly, if grants were low relative to GDP (i.e. less than 2% of GDP) it could be possible to meet the indicative target but not the primary target. And, of course, none of the primary criteria are directly dependent on the revenue target, although countries exceeding the tax-to-GDP target are likely to find the other fiscal targets easier to achieve.

These incompatibilities raise, first, questions about exactly what the Protocol was seeking to elicit by defining the targets differently between the primary and indicative criteria. Second, and more importantly, differences between the indicators (between headline and core inflation and between the fiscal balance before and after grants) are entirely due to the evolution of factors that are not, in fact, under the direct control of the relevant authorities. For the inflation measures the difference between the two indicators is due to movements in ‘non-core’ inflation, precisely those components of inflation determined by exogenous and world factors, while for the two fiscal deficit indicators differ solely as a result of exogenous grants from donors that are not under the direct control of the domestic authorities. In consequence, assuming that the authorities can measure these exogenous factors (which they can with ease), then observing the alternative definitions of either indicator generates no additional policy-relevant information than contained in a single indicator plus information on the exogenous factors. Put differently, these alternative measures are not independent in terms of the relevant policy responses.

Third, as we note below, once monetary union is established, it does not make sense to directly charge Partner States with the responsibility of hitting an inflation target in the conventional sense. Only the supranational central bank will have control over the conventional monetary policy instruments and hence responsibility for hitting the inflation target will fall to it. It also follows that
the relevant inflation target must be precisely defined in terms of a (harmonized) country-weighted price index defined for the monetary union as a whole (see Section 4.3 below).

It is worth recalling, however, that Article 5 of the Protocol assumes that Partner States will retain responsibility for conducting independent monetary policy under flexible exchange rates regimes during the convergence phase and only in the period immediately prior to the introduction of the single currency (the ‘conversion phase’) will they introduce bands and gradually fix their bilateral exchange rates.  

22 The fact that once the single currency is introduced and the monetary union created, hitting the inflation target becomes a supranational responsibility does not, however, completely absolve Partner States of responsibility to monitor price developments within their own economies. As we discussed above, the evolution of domestic prices, relative to the union-wide inflation target, is a critical indicator of underlying pressures leading to real economic divergence. So partner states and the surveillance institutions of the EAC do need to monitor country-level prices; and act to ensure they diverge in an unsustainable manner. In this instance, the focus must be on the price level and the relevant prices are core prices (which are dominated by non-tradable goods and services and hence are likely to be a better indicator of underlying domestic excess demand) and the relevant metric for policy makers is the evolution of country specific prices relative to the union-wide price level. The failure to track and respond to price levels across the Eurozone came out clearly from our earlier discussion of the incompleteness of convergence criteria in Europe (see also Appendix I).

Fourth, by focusing entirely on the public sector balance – as was the case in the Eurozone – the convergence criteria established in the Protocol are rendered incomplete for the reasons discussed in Part I of the paper. While failure to hit the fiscal criteria (i.e. the deficit and debt targets) will certainly tend to indicate risks of divergence, hitting these targets does not necessarily imply the absence of underlying economic divergence.

This argues for augmenting the current convergence and performance criteria by three measures that provide the authorities with a line of sight on pressures on individual countries’ external balances – the proximate indicator of the tendency for divergence in monetary unions discussed in Section 2 above -- which outside a monetary area would be clearly (and quickly) reflected by exchange rate measures.

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• **Current Account Balance.** There is a strong case for including the aggregate current account balance as an explicit convergence criterion. As with the fiscal balance condition, this should be defined after un-required grant transfers from donors. In practice, however, as we discuss below, given the difficulties in defining an appropriate target level of the current account balance, it is probably more appropriate to maintain the current account as an indicative measure rather than as a primary convergence criterion. This allows for a more flexible interpretation of current account sustainability and avoids the need to define difficult-to-enforce ‘escape clauses’ to account for deviations from indicative targets.

• **Real Exchange Rate Indicators.** Performance indicators and criteria should also include a direct measure (or measures) of the evolution of country-specific real exchange rates as a proxy measure for changes in the underlying competitiveness of the individual partner states.

• **Private non-guaranteed external debt.** The target for public debt includes publically guaranteed debt. However, even if it is not explicitly guaranteed by the public sector, private external debt (in particular the private external debt liabilities of the financial sector) carry an implicit public sector guarantee if ‘too-big-to-fail’ considerations draw the public sector into supporting private firms and banks against the risk of private debt default. Public debt indicators should therefore be complemented by indicators that track the evolution of bank and non-bank private non-guaranteed external debt. This could, in principle, be achieved by formally modifying the current public debt target (which is defined over external and domestic debt) or by augmenting the primary criterion on public debt with an additional, possibly indicative, criterion on private external debt. The latter is preferable: it avoids the conflation of domestic and external debt; it draws a distinction between explicitly and implicitly guaranteed external debt; and, since private debt is contracted on market terms, there is no need to account for the grant element in official public debt.

Given its ratification in 2015, it is neither politically feasible nor desirable to seek to revise the Protocol itself to reflect these considerations. However, such revisions could be embodied directly in subsequent enabling legislation or could form the basis of a future compact or other treaty-like agreement building on the original Protocol. This has been the case in Europe where, for example, the original Maastricht Treaty of 1992 establishing the principles of monetary union was expanded and clarified by the Stability and Growth Pact of 1999 which in turn was revised in 2005 and is in the process of further development and revision in the aftermath of the Eurozone crisis.
Before considering how these additional indicators might be structured, it is worth noting that these concerns about countries’ external balance were clearly articulated in an earlier report on monetary union by the Monetary Affairs Committee (2009)\textsuperscript{23}, where the core convergence criteria (essentially inflation and fiscal deficit targets) were accompanied by a set of ‘secondary indicators’ that focused clearly on assessing macroeconomic convergence. Crucially, these indicators included the stability of real exchange rates and the ‘reduction of current account balances to levels consistent with debt sustainability’. 

4.2 *Measuring external imbalances: practical considerations on defining targets*

*The Current Account*

It is easier to declare that private debt, the current account balance and real exchange rate measures should be included in the convergence criteria than to translate these into simple numerical targets, and it is not obvious that this should be done. In part this is for the simple practical reason that the current account balance in particular is traditionally hard to measure in an accurate and timely manner. Whilst trade data are generated relatively quickly the other components of the current account are typically less timely. The EAMU surveillance authority and the national central banks will need to prioritize the timely reporting of the current account and its financing. The more persuasive concerns are conceptual. First, private debt, the current account, and the real exchange rate, are endogenous variables reflecting private and public sector behaviour and, crucially, a range of external developments including the terms of trade, the volume and cost of private capital flows, and global interest rates that lie outside the span of control of the national or the surpa-national authorities in East Africa. External balance measures are therefore best thought of as final rather than intermediate objectives. Moreover, the transmission channels from policy instruments, operated at either the national or supranational level, to external balance are multiple and imprecisely understood. Knowing exactly how to respond when the current account deviates from its target, for example, is therefore a complex exercise in economic analysis. 

This leads to the second concern which is how to define an appropriate target for the current account balance. This is a far from straightforward task but before engaging with the core question two points are worth noting. The first is that the difficulties in defining an appropriate numerical target is not restricted to the current account; the targets set for a range of macroeconomic

\textsuperscript{23} East Africa Community, Monetary Affairs Committee (2009) Achievements, Challenges and the Way Forward (1998-2008) 14\textsuperscript{th} Meeting of Monetary Affairs Committee, Kampala, May 2009.
indicators, whether for inflation or for the fiscal targets already included in the Protocol, are very rarely underpinned by precise analytical foundations. For example, while there is widespread agreement that ‘too high’ a public debt ratio is clearly problematic and should be avoided, there is nothing to say that a present value ceiling on the ratio of 50% or any other similar number is in any sense ‘optimal’ or even safe. Likewise for the fiscal deficit: too large is clearly dangerous but exactly what the right level should be (and indeed whether this should be gross or net of grants) is unknown. The reality is that, as in the case of the Eurozone, targets such as these emerge from a political process where the target values are presumed to lie within a reasonable margin of safety but, more importantly, are deemed to be politically feasible targets for Partner States to aim for. This is equally true for the current account balance. It should be recognized that numerical targets are as likely to reflect political rather than simple economic considerations.

Second, it is far from obvious that the optimal or even safe ceiling for the current account balance is either a common value for all partner states or even constant over time. There will be circumstances where efficient macroeconomic management will imply a wider or narrower current account balance, depending on both domestic and external circumstances. The essential economics of this point are described in Appendix II, but the key point is that the current account is simply the window through which foreign savings are absorbed into the domestic economy and hence will reflect underlying patterns of both domestic and foreign saving and investment. For example, in circumstance where foreign capital is flowing in to augment domestic savings and finance investment as the economy undergoes structural change or invests heavily in the development of new opportunities, such as in the hydrocarbon sector, a temporary widening of the current account balance is desirable, particularly if the relevant capital flows are not directly debt-creating (i.e. the foreign savings are in the form of FDI or official grant financing). Similarly, if growth slows, or if the global private sector loses its appetite for the assets of EAC partner states diminishes, the efficient current account balance is likely to narrow.

_Real exchange rate indicators_

The reason for focusing on the current account position is the concern, articulated in the Walters Critique, that monetary unions are vulnerable to cumulative economic divergence and the effect of this divergence on countries’ competitiveness vis a vis other partner states and in third markets. This concern suggests that the institutions of surveillance and response should focus directly on the evolution of competitiveness, as proxied by the real exchange rate itself.
The challenge here is, again, that the equilibrium real exchange rate for a country is both unobservable and evolves over time as a function of productivity growth and the structure of production, trade and aggregate demand. There is a large literature, much of it emanating from the IMF Consultative Group on Exchange Rates (CGER), concerned with assessing competitiveness in low income countries. This type of analysis is increasingly part of the IMF’s regular Article IV country assessments and needs to be embedded in the surveillance work of the EAC and in built directly into the convergence criteria themselves.

As an aside, it is worth noting that it is exactly this methodology that will need to be employed to assess relative real exchange rate misalignment as Partners States move from through the convergence phase towards defining conversion parities for the separate nominal exchange rates. It therefore makes sense to embed these methods in the analysis from the beginning.

None of these extensions to the convergence criteria are as neatly defined or as easy to track as the existing indicators. They are therefore likely to meet resistance on simple operation grounds. However the fact that it is difficult to measure divergence, competitiveness and misalignment doesn’t mean the authorities should shy away from the task.

4.3 Escape Clauses

If we accept that monitoring the current account is highly desirable but not reducible to a single point target, the question is then how a ‘current account target’ should be incorporated. One approach would be retain the spirit of numerical targets, as used for the existing indicators, by including the current account balance as a primary indicator anchored on a long-run target, but accompanied by an ‘escape clause’ mechanism to allow for legitimate deviations from this target. An escape clause could be triggered by specific events (such as a foreign investment surge, significant temporary movements in the terms of trade etc.). It could also be linked to a target on (total) external debt, so that, for example, a widening of the current account deficit could be tolerated as long as: (i) the reserve position was maintained; and (ii) external public and private debt targets were respected. Under such circumstances, a widening of the current account deficit does not threaten debt sustainability since it is by definition, being financed by non-debt-creating capital inflow.

Escape clauses have a clear appeal but experience from elsewhere suggests they do not, in fact, provide the flexibility that is often hoped for. They tend to be extremely difficult to define -- the task of defining the criteria under which an escape clause is triggered often turns out to be extremely complicated as each possible trigger event needs to be defined. Moreover, where they are in place
(often in the context of inflation targeting regimes) they tend either to be used ‘too frequently’ so that all deviations from targets are deemed exceptional and therefore accommodated or ‘too little’ (for fear of the moral hazard effect that using them once makes it more likely they will be used repeatedly). In either case, the escape clause mechanism is rendered ineffective. The experience of escape clauses tends simply to underline the futility of attempting to produce a watertight escape clause mechanism and in doing so emphasises the need for flexibility in assessing outcomes and defining responses.

The alternative to a ‘primary criterion-plus-escape-clause’ approach would be to avoid the have the current account balance as a (non-binding) indicative target deviations from which would be used to trigger enhanced surveillance by the national and supranational central banks and by other surveillance bodies as appropriate. One way of formalizing this more flexible alternative to escape clauses is to institute a system of ‘open letters’ similar to the system used by the Bank of England in the context of its inflation targeting regime. This system eschews the use of escape clauses around its inflation target but has a system where deviations of inflation from its target range trigger an ‘open letter’ from the governor of the Bank of England to the Chancellor of the Exchequer (the finance minister) that offers an explanation for the deviation and outlines a programme of actions designed to bring inflation back on track. This ‘open letter’ system, which provides a transparent and verifiable statement of intent by policymakers, is one that could be used as part of the monitoring and verification of performance criteria in EAMU without needing to institute specific escape clause mechanisms. Deviation of outcomes from more fiscal or current account targets would require national authorities to write an ‘open letter’ to the surveillance board and East African council of ministers explain the reasons for deviations and outlining policy responses. We recommend that this flexible but transparent surveillance and response system should be adopted instead of attempting to put in place formal escape clause procedures.

4.4 Managing Short-Run Shocks once monetary union has been established

The discussion in the previous section was primarily concerned with medium-term convergence and the evolution of competitiveness. The second principal element of the policy assignment and associate institutional structure concerns the management of short-run shocks. Article 10 of the Protocol requires Partner States to “build and maintain resilience and stabilize the Monetary Union or the economy of a Partner State in the event of an economic shock”. To achieve this, two structures are anticipated, an early warning system to regularly monitor Partner States’ risk profile and ensure adequate mitigation mechanism are in place (a structure that could build on the ‘fiscal
risk statements’ that accompany annual budgets and are being implemented by Partner States under the guidance of the EAC Sectoral Council on Finance and Economic Affairs); and a stabilization facility to provide assistance to a Partner State experiencing or threatened with severe exogenous economic shock [Article 10.3(b)]. Article 10.4 further provides for a form of escape mechanism “…the Council may allow a Partner State to exceed the fiscal deficit target provided the Partner State does not breach the convergence criteria ceiling on the debt to GDP ratio”.

We shall consider the early warning system in Section 4.7 on surveillance but first we examine the question of a stabilization facility.

4.5 Establishing an EAC Stabilization Facility [EACSF]

The term ‘stabilization facility’ is taken to mean some form of risk-sharing mechanism designed to mitigate the costs of adjustment faced by any Partner State dealing with shocks that are less than fully accommodated by the common union-wide monetary actions, either because the shocks are idiosyncratic (and hence elicit no common monetary response), because they are asymmetric (so that from the perspective of one or more partner states monetary policy moves in the ‘wrong direction’), or because the magnitude of the shocks differ (policy moves in the right direction but not far enough).

Rationale and the concept of stabilization

In order to think about the design of a stabilization facility, it is important to clarify what is meant by stabilization, as opposed to structural adjustment. To do so, consider first how the authorities might respond to adverse economic events (‘shocks’) in an economy not in a monetary union. These shocks might be domestic, such as climate-related shocks that adversely affect agricultural yields, or they may be external and originate either in the current account, for example through movements in the terms of trade, or in the capital account through changes in the world interest rates or the risk premium facing the country. Importantly, shocks might be temporary or persistent where the relevant distinction is whether the shock is likely to significantly alter the fundamental long-run equilibrium of the economy. In the case of the persistent or permanent shocks, (for example, a long-run secular decline in the world price of key exports) the focus is on structural adjustment or how to move the economy to its new macroeconomic equilibrium. This will typically entail correspondingly permanent changes to the structure of private consumption, production and real wages, and the fiscal balance. In the case of the temporary shocks, the key issue is a short-run one of how the authorities stabilize the economy in response to events that temporarily knock it out of equilibrium.
Conventionally, in a single-country setting where the authorities maintain a broadly flexible exchange rate regime, the authorities will tend to respond to an adverse (idiosyncratic) economic shock through some combination of nominal exchange rate adjustment plus measures to adjust aggregate spending in order to bring about the appropriate degree of real exchange rate adjustment and place the economy back on its equilibrium path.\textsuperscript{24}

Depending on the nature of the shock this domestic adjustment might be accompanied by short-term domestic or external financing, either from private or official sources, geared towards smoothing expenditures in the case of temporary shocks to income and at easing the transitional costs of adjustment (in the case of persistent shocks). In the latter case, financing needs to be structured in a manner that does not blunt incentives to undertake the necessary underlying adjustment to the new equilibrium.

*Stabilization in a monetary union*

The rationale of a supranational stabilization facility in a monetary union emerges from three simple ideas. The first is that when the authorities are unable to use the exchange rate (or monetary policy) they whole burden of adjustment falls on fiscal instruments. It can then be the case that with no support from monetary policy fiscal policy can be temporarily overwhelmed.

The second is that even if fiscal and expenditure-reduction policies are in play, since relative prices never adjust as quickly as a flexible exchange rate could, real exchange rate adjustment which relies purely on price adjustment (what is referred to as ‘internal devaluation’) is necessarily more sluggish and, as a result, more costly to achieve. For example, when resistance to nominal wage rigidities are prevalent, economies tend to experience longer and deeper periods of unemployment and recession when they seek to adjust the real exchange rate through internal devaluation than through exchange rate adjustment.

Third, even in the context of short-term stabilization, the premium on external market finance may be strongly counter-cyclical, falling when the economy is strong and rising when it is hit by adverse conditions so that external finance may be punitively expensive or even unable exactly when government needs to borrow.

\textsuperscript{24} The balance between the use of exchange rate ‘expenditure switching’ and fiscal ‘expenditure adjusting’ instruments will depend on a range of structural factors. In most of the small open economies of East Africa, it is likely that the optimal mix will entail a significant degree of nominal exchange rate adjustment.
This rationale for a supranational stabilization facility in these circumstances is directly analogous to the fundamental principles of IMF core lending facilities. Article I[v] of the Articles of Agreement of outlining the purposes of the IMF states...

“To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.”

This is the guiding principle underpinning all the Fund’s standard short-term lending instruments, most notably the Stand-By Arrangement (SBA).

Two elements of the Fund’s structure are important to note. First, it is important to recognize that this clause was drafted in the context of the fixed exchange rate arrangements of the Bretton Woods system, in other words at a time where nominal exchange rate adjustment was not available for responding to short-term shocks (although the IMF’s founders, particularly John Maynard Keynes expected exchange rate adjustment would be used as an appropriate instrument to deal with sustained macroeconomic disequilibrium). Hence Fund resources were to be made available to avoid ‘damaging’ internal devaluation.

The second is the “making the general resources...temporarily available...under adequate safeguards” provision. What this emphasises is that the stabilization facility is a revolving fund that is expected to be neutral in the long run and based on temporary loans that are repaid and that in order to ensure that the stabilization fund is sustainable the lender (in this case the IMF) is empowered to impose conditions on the borrowing members. The underlying principles here is that the IMF’s stabilization function must not be used to support ‘permanent’ transfers (in other words there should be no ‘one-way’ traffic) and, moreover, the stabilization fund does not undermine incentives at the national level to put in place appropriate policy instruments that are designed to improve fiscal flexibility and resilience.

It is worth emphasising two points at this stage. The first is that the preceding analysis assumes that the loss of monetary autonomy deprives a country of its capacity to conduct short-run stabilization precisely because monetary policy was previously effective in stabilizing output. While this might have been the case in Eurozone countries, it is less clear that in the EAC, individual countries’ monetary policy actually played any decisive role in stabilizing output (as opposed to anchoring inflation over the medium term). This does not preclude consideration of a stabilization facility in
the future: the relevant criteria is whether such a mechanism supports effective macroeconomic management in the future, regardless of individual countries’ past track-record on stabilization.

The second consideration is whether fiscal- or quasi-fiscal stabilization is better conducted at the national rather than supra-national level. National-level fiscal stabilization may be feasible if a high degree of fiscal flexibility prevails and/or if automatic stabilizers are strong so that individual countries can quickly adjust level of public expenditure and taxation in response to shocks to aggregate demand. In this case, the fiscal governance institutions should probably favour seeking to provide greater scope for discretionary fiscal policy at the national level (see Section 3 above). On the other hand, a supranational mechanism is likely to be favoured if domestic fiscal structures are relatively inflexible and pro-cyclical and if domestic debt markets are thin so that domestic interest rates are pro-cyclical and/or crowding-out is strong. Supranational mechanisms are also favoured if fiscal inflexibility is exacerbated when national central banks are unable to provide short-term liquidity or lender-of-last-resort facilities. Current structural conditions in the EAC clearly favour the latter and therefore argue for any stabilization mechanism to operate at the supra-national level.

Finally, it is important to draw a distinction between stabilization needs which are short-term and temporary (and which might otherwise be met by financing from financial markets) and support for one-off or permanent shocks – possibly from natural disasters or structural shifts in the long-run terms of trade -- which fundamentally require a mixture of adjustment combined with long-term funding. The members of a union may stand ready to provide this long-term adjustment financing but this should be seen as a separate lending instrument with no presumption that it is self-financing. The relevant principle in this case is one of solidarity and mutual self-interest (since the whole of a union will generally bear at least some of the cost of protracted recession in any member state).

Stabilization vs structural funds

Although the focus here is on short-term stabilization facilities these may well co-exist with structural funds designed to provide medium- to longer-term support to peripheral areas and to sectors than might be perceived as particularly vulnerable to the centrifugal forces created by economic integration. Structural and region funds have played an important role in the development of the European Union with outlying regions and ‘sunset’ sectors receiving transfers from the common budget either to improve access to the core of the regional economy (the ‘European Roads Fund’ for example); to help the management of declining industries that may have moved to lower-cost locations within the union (for example, transitional support to the UK steel
industry when the UK was still a member of the EU) or to industries in long-run decline (through agricultural support mechanisms). The current budget for structural funds is approximately US$100bn per annum or 0.5% of EU GDP.

Article 24 of the Protocol provides for ‘measures to support a Partner State that experiences macroeconomic or structural imbalances arising from the implementation of the monetary union protocol’. Unlike the specific macroeconomic challenges arising from monetary union we have discussed at length above, the rationale for structural funds does not, however, emerge directly from the process of monetary union but rather from the underlying process of real integration. But left unaddressed, structural imbalances can exacerbate the pressures for macroeconomic divergence to which monetary unions are vulnerable. It is therefore important for the architects of the EAC to have in place the mechanisms (and financing) for the management of structural funds. It makes most sense for structural funds to operate as a system of transparent fiscal transfers, financed from country contributions to the EAC budget and administered through the Secretariat under the authority of the Council of Ministers.

Rules vs discretion and the design of stabilization funds.

A key property of a successful stabilization facility is its flexibility so that it can respond quickly to (or even in anticipation of) shock that might otherwise have triggered a monetary policy response. This requires a degree of discretion on the part of the managers of the stabilization fund. This need for discretion and flexibility immediately confronts a range of difficult problems that can undermine the very rationale of a quick-disbursing stabilization fund and swing the pendulum back in favour of relatively inflexible fiscal rules.

These problems come in a number of forms, but the ultimate risk is that failing to address them increases the likelihood that an initially flexible stabilization fund designed to operate as a rotating ‘insurance-like’ institution morphs into a ‘transfer union’ that channels resources from consistent creditors to consistent debtors in a manner that leads to the exhaustion of the fund, pressures to replenish and a growing perception that the underlying insurance rationale has been eroded.

These risks are not unique to the stabilization fund anticipated in the Protocol but are generic to all such institutions. There are two big challenges the designers need to think about. The first concerns the nature of the shocks to which the facility is designed to respond and hence the efficient size of the fund. Conceptually, and as with any insurance fund, the pay-out pool would need to be large enough to cover the expected value of the loss of consumption faced by the group. Clearly this expected value will increase the larger the individual shocks are assumed to be, the longer their
duration (or the more serially correlated they are through time) and the more correlated they are across members of the group. There is, of course, a caveat to this last point since the more correlated are the shocks across countries the more the common monetary policy in the union will act in the interest of each member and the less demand will be placed on the stabilization fund.

The hardest issue to address concerns the duration of shocks. The theory of ‘consumption smoothing’ tells us that it only makes sense to draw finance from the stabilization facility if the initiating shocks are perceived to be transitory. If the shocks are persistent, or indeed permanent, the appropriate policy response entails some degree of structural adjustment (to the level of consumption) rather than drawing down on a stabilization fund (although some resources may be released to smooth the transition). The problem facing policymakers and their representatives managing the stabilization fund is to determine whether a shock, such as a fall in commodity prices, is transitory and when it is permanent. Treating shocks as transitory when in fact they are actually persistent, not only undermines the financial sustainability of the fund (since timely repayment of advances is not possible) but more problematically delays the necessary adjustment by the debtor partner state. And if the stabilization facility is debt-based (see below) delayed adjustment raises the risk of an unsustainable accumulation of debt.

This problem of delayed adjustment – which, of course, is a fundamental challenge in all transfer-based arrangements, be they transfer unions, federal disaster relief mechanisms, aid relationships or the mechanisms of the IMF – is exacerbated by a moral hazard problem that is intrinsic to any fiscal, monetary or other solidarity-based unions. This is the classic ‘fiscal free-rider problem’ and runs as follows. Consider a set of countries operating within a federal structure with a fiscal stabilization facility. Countries are subject to potential economic shocks and can confront these by investing in domestic mitigation mechanisms (ex ante) or by undertaking costly measures to deal with the shock (ex post). The third option is to declare a fiscal crisis, avoid the costly remedial measures (ex ante or ex post), and appeal to the stabilization fund for relief. Those running the stabilization fund can choose to grant relief or enforce a ‘no-bailout’ rule and deny financing from the fund on the grounds that countries have not undertaken the relevant investment in mitigation or response to the shock. The fundamental problem is that denial is difficult and the stabilization fund comes under pressure to provide the bailout. But knowing this, the country authorities will face incentives to underinvest in mitigation and to run policies that leave them more vulnerable to shocks in the knowledge that the fund will step in. The incentive to do so is simple: the national authorities enjoy the full domestic benefit of their fiscal choices while bearing only a fraction of the costs (i.e. their contribution to the
stabilization fund). The ‘free-rider’ problem undermines both the financial integrity of the stabilization fund and its political credibility as a risk-management institution.

There are many reasons why it may prove difficult for the stabilization fund to credibly enforce the fiscal rule (so that a stabilization fund can function as designed). The most obvious is the ‘Samaritan’s dilemma’, the idea that the fund is not able to credibly commit to withhold stabilization funds when the costs are concentrated on a particular group or groups of individuals, but denial is also difficult when a stabilization fund operates by country vote or consensus it can end up being run as a ‘solidarity network’ in which country delegates do not want to deny clemency to their compatriots, in order not to be denied clemency themselves in the future.

This challenge may be exacerbated if the union is perceived to include a deep-pocketed player that may find it hard to deny a bailout to a partner state in distress. This is the challenge facing federal governments in the US, India and Nigeria, for example and it is the same challenge facing France in its role as implicit guarantor of the CFA Franc zone. Germany plays the same role in Europe (although the German electorate and its government have demonstrated a remarkable resistance to pressures to yield, even in circumstances where a supra-national response may be warranted).

The key lesson from this discussion is that this form of socially inefficient outcome for the union may be an equilibrium unless a fiscal stabilization facility can be underpinned by a credible institutional entity that operates independently of short-term political advantage.

Design

The final design factor with which the authorities need to grapple is the form of a stabilization fund (independent of the scale of the fund). In fund could be set up as a budgetary ‘transfer union’ making direct and timely horizontal fiscal transfers from the EAC budget replenished on the basis of regular contributions from the partner states. This transfer union mechanism would then be similar in structure to that anticipated to deal with medium structural or regional fund transfers.

In practice, given that a stabilization facility should be able to provide quick-dispersing support to partner states, a short-term lending facility might be more suitable. In terms of operation, this fund could function in a manner similar to the IMF’s trust-fund financed facilities, such as the PRGF, providing short-term credits (in the EAMU common-currency) to partner state governments under the monitoring and enforcement of the Surveillance, Compliance and Enforcement Commission (SCEC). The obvious institutions to manage this credit facility would be either the Secretariat (as current EAC budget holder) or the new EACB. In principle, it would be possible for the fund to augment partner state direct contributions by raising bond finance, by selling mutualized EAC bonds.
against the balance sheets of the partner states. These bonds could be issued in the new East African currency and/or foreign currency depending on the cost of capital and on-lent through the stabilization fund. In either case, the status and seniority of such EAC bonds, relative to other official financing (for example from the IMF) would need to be established.

One important final lesson from the European experience is that the costs, both economic and political, of introducing stabilization or other risk-sharing mechanisms are likely to be much lower if these institutions are in place ex ante rather than built ex post following a crisis. If they are in place, such stabilization facilities are more likely to be perceived as genuine insurance mechanisms, available to any country that finds itself the victim of a shock; when constructed after the event such mechanisms are often perceived as a bailout or one-way transfer mechanism and hence attract hostility from the population or tax-payers of the creditor nation with all its attendant problems. This has been very much the experience in Europe where such reform proposals -- such as European Stability Mechanism (ESM) and its predecessor the European Financial Stability Facility (EFSF) which issued bonds to support crisis countries -- that would probably have been accepted initially by member states but which have consistently faced opposition from Europe’s major creditor nation, Germany, on the ground that they function simply as bail out mechanisms for Greece and other southern debtor nations.

*Design considerations: evidence from Europe*

These principles, which should inform the design of an EAC stabilization facility, are also those that define the European Stabilization Mechanism and other explicit stabilization mechanisms.

Recent thinking about the reform of fiscal institutions in Europe is helpful in designing an East African stabilization facility. We have already discussed the ‘incomplete fiscal architecture’ in Europe. Discussions following the Eurozone crisis from 2010 are beginning to articulate a more coherent design of fiscal structures for Europe. A key step in this process is the July 2015 publication of the *Five Presidents’ Report*[^25] which outlined critical next steps for strengthening and completing Europe’s Economic and Monetary Union. Whether the recommendations in the Report will eventually be instituted remains moot but the recommendations are nonetheless valuable.

Some of the recommendations of the *Five Presidents’ Report* are concerned with issues of financial sector regulation, responding to one of the key lessons of the Eurozone crisis that a single banking system is the mirror of a single currency and that to establish supra-national confidence in the banking system the institution requires both a single financial supervisory mechanism and a single resolution mechanism to support it.

But the centrepiece of the report are its recommendations on the fiscal architecture and in particular the need for much greater investment in national level fiscal flexibility. In particular the report recommends: (i) the creation of national-level “Competitiveness Authorities” aimed at tracking competitiveness to make sure wages are evolving in line with productivity; (ii) a stronger “macroeconomic imbalances procedure” designed to track public and private sector current accounts, intra-union and for the Eurozone as a whole; and (iii) a new “European Fiscal Board”.

The purpose of the EFB is to coordinate the work of national fiscal authorities, providing an advisory function to the national authorities (with enforcement remaining the responsibility of the European Commission through the Council of Ministers). The advisory domain will be based on an assessment on the fiscal stance and fiscal policies at the national and supra-national level against the performance criteria (the SGP in Europe) and against the broader economic context. The Board will also be able to issue opinions on national fiscal plans and budgets.

*The European Stability Mechanism*

The purpose of the Board is to establish medium-term resilience and mechanisms to anticipate the need for, and support the implementation of, permanent medium-term structural adjustment between national authorities, leaving the European Stabilization Mechanism (ESM) to focus on short-run crisis management. The underlying principle is that a good medium-term fiscal stabilization mechanism diminishes the need for countries to call on the ESM, for at least two reasons. First, greater investment in fiscal resilience and flexibility obviates the need for external financial support and second, the more credible are underlying fiscal structures the more likely private capital markets will be willing to provide finance at non-punitive rates.

But crises will inevitably occur for which a stabilization is required. The ESM was created in October 2010 as a follow-on from the European Financial Stability Fund (EFSF) created in May 2010. From 2012, all stabilization activities in Europe are financed by ESM.

ESM issues bonds and other debt instruments on private capital markets to raise funds to support member states. The capital base is €700bn of which €140bn is paid-up capital, supporting lending activities of around €500bn, and equivalent to 4.5% of Eurozone GDP.
Requests for support are made to the ESM Board of Governors who are empowered to make short-term advances to member states in at least three ways: (i) direct loans to government; (ii) intervention in (private) debt markets; or (iii) recapitalization loan to banks.

**BOX: Terms of Reference for an EACSF**

1. **Purpose and design**
   The purpose of the EACSF is to provide short-term financial assistance to Partner States in response to temporary economic shocks in order to support domestic authorities to restore macroeconomic economic balance without resorting to measures that are damaging to national economic prosperity.

   The EASF is a revolving fund capitalized by Partner States (see below) with assistance provided under adequate safeguards which will be codified in terms of a policy and performance agreement between the EACSF and the Partner State. This performance agreement – analogous to an IMF programme – will be defined and approved by the EACSF Board as a condition of making resources available and will be based on advice from the EACB and the Surveillance Committee.

2. **Governance and Operation**
   The EACSF will be an independent institution of the EAC created under international public law. Governance will be vested in a board of governors on which each Partner State has equal representation (a governor and alternate) and the Board may be chaired by one of the governors or an independent chair, in either case elected by the governors. It makes sense that the governors are ministers for finance and their alternates their permanent secretaries.

   The EACSF can operate in a number of ways. One option is as a straight revolving fund limited by the extent of contributions in which case loans can be made up to the limit of resources in the Fund and more lending can be extended only when the fund is replenished by repayments and any new contributions. An alternative, which is adopted by the European Stabilization Mechanism (ESM), uses the capital contributions as collateral in order to issue ‘ESM bonds’ in private capital markets, the proceeds of which are then on-lent to member states (either to the government or financial sector institutions) allowing the ESM to leverage its capital base.

   The EACSF will be supported by a secretariat but given capacity constraints in the region it may make sense for the Surveillance, Compliance and Enforcement Commission (SCEC) to be the institution providing the analysis and advisory work to the governors of EACSF.

3. **Capital and Contributions**
   The effectiveness of the EACSF depends on two main considerations: the nature of the ‘hazard’, in other words the expected frequency size and duration of the shocks to which the Fund is designed to respond; and the level of coverage against these shocks partner states decide is desirable, where the ‘un-covered’ risk will be met by ex post fiscal measures or other sources of external finance, if available.
The hazard will depend in part on the degree to which shocks to individual countries are expected to be correlated across countries, ex ante and ex post if shocks to one country spill over to another. The lower the correlation the less likely will there be simultaneous calls on the Fund. But this is not a linear relationship since the more highly correlated are the shocks so that more of the members of the monetary experience similar shocks the greater the role played by the common monetary policy in stabilization efforts. The degree of coverage will, in turn, reflect the risk aversion of partner states but it will also reflect the willingness or ability to pay, and may also be influenced by how concerned individual countries are about the moral hazard aspects of a risk-pooling stabilization fund.

It is therefore not possible to specify required capitalization levels at this stage. However it may be instructive to note the level of financing underpinning the European Stabilization Mechanism. Individual countries' capital subscription to the ESM is determined by ability to pay (as measured by GDP) and is levied at approximately 6% of GDP, of which approximately one tenth (0.6% of GDP) is in the form of paid-up capital.1

It is an open question as to whether an EACSF needs to be proportionally larger or smaller than the ESM. Arguments for being larger include the fact that hazards may be larger in the EAC compared to the shocks that might hit the Eurozone; that the domestic fiscal capacity in EAC countries, and especially the automatic stabilizers, are weaker than in the Eurozone; and finally, since there are fewer members of the EAC than the Eurozone, a shock to one is likely to be proportionally larger as a share of the total monetary union. The arguments for a proportionally smaller fund would be first, that while external shocks may be larger in the EAC than in the Eurozone they are also more highly correlated so that the common monetary policy will do more of the work on stabilization; and second, that with a less developed financial sector, the risks of financial contagion and especially too-big-to-fail concerns are arguably less.

The final consideration for an EACSF is the currency in which capital contributions need to be made. In the ESM, given the reserve-currency nature of the Euro and the fact that the shocks to the region are overwhelmingly ‘internal’, contributions are exclusively in the currency of the monetary union. For the EAC, however, there may be a case for requiring contributions to be partly in the new East African currency and partly in foreign currency.
4.6 Monetary Provisions and Liquidity

The commitment to a common pan-territorial monetary and exchange rate policy is enshrined in Articles 11, 12 and 13, while the intention to implement this through a single currency, managed by a common supranational central bank (the East African Central Bank, EACB) sitting at the apex of an integrated system of (national) central banks [Article 20]. This mirrors almost exactly the structure of the Eurosystem of central banks.

Less clear is the governance structure for the EACB where there still appears to be some tensions, or at least incompleteness, in the design. On the one hand, the EACB mandate appears to be fully defined in the Protocol. Article 11 declares the primary objective of monetary policy will be to “achieve and maintain price stability” and, conditional on this, to “contribute to financial stability and economic growth and development”. In pursuit of this objective, the EACB will adopt a “free floating” exchange rate regime for the single currency [Article 12]. In the same vein, Article 20(4) asserts a degree of independence from influence by the Partner States, “…in the performance of its functions”. Again, this is clearly consistent with contemporary views on the importance of instrument independence in central banking.

There are elements of the governance structure that are missing from the Protocol and which need to be addressed in the enabling legislation creating the East African Central Bank. For completeness, and to emphasise the key complementarities between the fiscal and monetary governance structures, it is useful to note the key concerns here.

First, although there is a presumption that the East African Central Bank will be jointly and equally ‘owned’ by the Partner States participating in the single currency zone in East Africa, there is currently no discussion of who or what institution proscribes the powers of the EACB, either in terms of its monetary policy objective or of its other functions, including its lender of last resort function. If the primary objective of the single monetary policy is, as stated, to “achieve and maintain price stability”, price stability must be precisely defined for the monetary union as a whole. Moreover, responsibility for meeting this objective must be delegated to the EACB (and not to the individual Partner States). The authority to set (and change) this target for inflation must be vested in the Council of Ministers of the EAC, or equivalent governing body, to which the EACB governor is responsible and, to whom he or she must report as and when monetary outcomes deviate from the objectives.

In global central banking there are a variety of ways in which the primary objectives of the central bank are set and interpreted. In the United States, the statutory objectives of the Federal Reserve, which are declared to be “maximum employment, stable prices and moderate long-term interest
rates”, are established by Congress through the Federal Reserve Act. It is then up to the Board of Governors of the Federal Reserve to interpret these statutory objectives. In the ECB system, the supranational central bank is obliged to keep inflation “below, but close to, 2% over the medium term” where the measure of inflation is defined in terms of a country-weighted harmonized index of consumer prices (HICP) across the Euro area. This target has been established by the Governing Council of the ECB which consists of six executive members (including the President of the ECB) and the governors of the 19 participating central banks. In the Bank of England, which is representative of many single-country inflation targeting central banks, the monetary policy objective is “to deliver price stability and, subject to that, support the Government’s economic objectives including those for growth and employment”. Price stability is defined by the Government’s inflation target. The Government’s inflation target is announced each year by the Chancellor of the Exchequer in the annual Budget statement: it has remained at 2% per annum since the establishment of the monetary policy committee in 1997.

This lack of coherence is amplified by Article 6 of the Protocol which defines the macroeconomic criteria imposed on Partner States “…to attain and maintain macroeconomic convergence” once monetary union has been established [emphasis added] to include alongside fiscal and reserve requirements, a ceiling on headline inflation at the level of the Partner State. This requirement does not make sense in the context of a delegated monetary policy in which the instruments for inflation targeting are not vested at the country level; countries simply do not have the instruments with which to conduct monetary policy.

But even supposing (as it should be) that the objective of pursuing a single inflation target is delegated to a new supranational central bank, it is not clear that it should be defined in terms of headline inflation as opposed to core inflation. Headline inflation, especially in the low-income economies of the EAC is driven to a large extent by ‘non-core’ price movements which in turn reflect factors outside the control of the monetary authorities, by global developments in commodity market or by local climatic conditions affecting food supply and prices. Using monetary policy to lean against movements in non-core prices can be harmful to welfare. Consensus thinking is that policy should be geared to addressing potential spillover effects from non-core price shocks on core prices (see, for example, Adam et al, 2016)26.

It is important to note, however, that even if it is the supranational central bank that controls the monetary policy instruments and is responsible for deploying them to hit the common inflation

target, this does not mean that Partner States should ignore price developments at the national level but rather should be central to any credible imbalances procedure. The reason derived directly from the discussion in Section 2 about economic divergence: with a fixed nominal exchange rate relative to other members of the monetary union, the evolution of domestic prices, relative to the union-wide inflation target, is a measure of movements in that country’s real exchange rate and hence critical leading indicator of underlying processes of divergence. Partner states, and the joint surveillance institutions, therefore must monitor country-level prices. Again the relevant prices are probably core prices (which are dominated by non-tradable goods and services and hence are likely to be a better indicator of underlying domestic excess demand) and the relevant metric for policy makers is their evolution relative to the union-wide inflation target.

Lender of last resort

Also undefined at this stage is the lender of last resort function of the EACB. Within a monetary union, while national governments can still issue debt (in the common currency but against their own national balance sheet) and subject to the constraints of the convergence criteria, the inability of national central banks to directly provide liquidity to holders of claims on governments (or on other issues of debt in local markets) removes a source of security to bond holders; without lender-of-last-resort functions national short-term liquidity problems can quickly turn into solvency problems for private or sovereign debtors. To avoid this, the delegation of monetary policy to the supranational level must be accompanied by a corresponding delegation of lender-of-last-resort powers to the supranational central bank (even if, in practice, they may be implemented through the integrated central bank system). But this raises a set of technical issues on the design and resourcing of such facilities as well as potentially difficult political issues of legitimacy, neither of which are currently addressed in the Protocol.

Article 5.2(a) of the Protocol provides for the first part of the transfer of responsibility for liquidity management to the EACB. This requires that Partner State eliminate their national central banks’ credit function to government and public entities (although it remains silent on whether national central banks could provide credit to private institutions including the banks and other financial institution off their own balance sheets): the logic of a monetary union is that they cannot. The counterpart to Article 5.2(a), namely the definition of what liquidity provision and lender of last resort functions the EACB should have remains unspecified. The key question is under what circumstances and against what sort of security will the EACB be permitted to use its balance sheet to provide liquidity to the market, for what duration, and on what terms?
4.7 Surveillance

Article 21 provides for “an institution responsible for surveillance, compliance and enforcement” to support monetary union. The objectives of this institution, as outlined in the draft *East African Community Surveillance, Compliance and Enforcement Act, 2016* – referred to as the Commission (the Surveillance, Compliance and Enforcement Commission) -- will be to promote the attainment of the pre-requisites for all Partner States [Article 5 of the *Protocol*]; the enforcement of the convergence criteria once the single currency is established for those Partner States participating in the single currency [Articles 4 and 6]; and to facilitate convergence amongst accession countries not yet in the single currency group.

The draft legislation anticipates the Commission having the authority to request data and reports from the Partner State governments and to make on-site visits but ultimately it will be an advisory body, with ultimate enforcement powers retained at the level of the Council of Ministers.

On the surveillance side, the Commission’s core function would be broadly similar to the surveillance and assessment role currently carried out at a country level by the IMF. The Commission would therefore: (i) specify the fundamental principles of fiscal discipline to be followed by Partner States; (ii) during the convergence phase, analyse and evaluate each country’s ‘Medium Term Convergence Program’ in terms of macroeconomic coherence and feasibility and issue an opinion based on this assessment; (iii) apply a similar analysis and evaluation of partner states’ budget strategy and fiscal risk assessments; (iv) review fiscal outturns; and (v) submit an ‘annual convergence report’ to the Summit and Assembly of the EAC through the Council.

The Commission’s role would also include: (i) the identification of significant deviations from an agreed Medium Term Convergence Program; (ii) the formulation of policy recommendations on corrective action; and (iii) follow-up and monitoring of such actions.

Once the single-currency is in place, partner states may be subject to disciplinary action by the Council, on the recommendation of the Commission, for persistent deviation from convergence. The Council may demand corrective action and enhanced surveillance, with sanctions for non-compliance consisting of either suspension of financial support from the EAC to the partner state in question (which could be on regional or other funds) or the imposition of fines.

Thus despite formally being only an advisory body, the anticipated operational authority of the Commission is extensive and potentially highly political. Once operational, the Commission is
empowered to assess Partner States’ macroeconomic and fiscal performance and determine whether a country is ‘on-track’. It is charged with recommending specific corrective measures when countries are deemed to be off-track and to require Partner States to engage in dialogue with the Commission over the implementation of these measures. And finally, if the Commission deems Partner States not to be in compliance with the corrective measures it is empowered to refer the State to the Council that may impose additional conditions of the country involved up to and including financial sanctions (EAC, Surveillance, Compliance and Enforcement Act, Articles 25 to 27).

Assessment

The basic architecture of the surveillance system appears reasonably robust although it rather inevitably reflects the ‘Eurozone’ style of the Protocol. A number of issues deserve further consideration.

First, the surveillance structure remains narrowly focused on fiscal indicators. Reflecting the analysis of the risks to monetary union, the surveillance structure needs to be embedded in a broader ‘imbalances’ framework and therefore focus more closely on the evolution of competitiveness; real exchange rate misalignment; country-level current account developments; and private sector debt. This should emerge as the precise structure of the medium-term convergence plans are developed (Article 19 of the Act).

Second, the Commission will need to develop a close working relationship with the East African Monetary Institute and its successor, the EACB. This is important in terms of: generating and accessing timely information (the EACB, through the system of national central banks, will remain the best institution for generating relevant data on prices and the external balance at the country and union level); for the mobilization and coordination of technical expertise; and for the design and implementation of coherent macroeconomic management for the monetary union as a whole as well as for the individual Partner States.

Third, and reinforcing the previous point, the EAC Secretariat and the political authorities in the Partner States need to develop clear view about the formulation and implementation of economic policy for the monetary union as a whole, where this is appropriate. Reflecting the fundamental concerns that surround monetary union, however, much of the focus of the Protocol and the Surveillance, Compliance and Enforcement Act is naturally (and correctly) on the management of idiosyncratic, country-specific shocks so as to avoid economic divergence and put pressure on the internal coherence of EAMU. But unlike the Eurozone area which when created constituted one of the largest economic blocs in the world with an enormous domestic market, the aggregate EAMU
A region will still be essentially a ‘small open economy’ and will continue to face many of the macroeconomic challenges that currently confront the Partner States individually. An efficient response requires a clear division of responsibility between national ministries of finance and the supranational central bank which, in turn, will require policy coordination across the separate fiscal authorities and between the finance ministries as a group and the EACB. The key point here is coordination – since fiscal policy remains a delegated function – but this will require institutions that have the capacity (and authority) to fulfil this role.

To be more specific, consider the following example. Suppose the region is confronted by a common adverse current account shock. Standard economic theory would suggest that efficient adjustment to such a shock will require some degree of depreciation of the real exchange rate (what economists call ‘expenditure switching’) and some reduction in aggregate spending (‘expenditure reduction’). The balance between the two depends on the nature and duration of the shock and the structure of the aggregate economy but in most circumstances the efficient adjustment trajectory will require some expenditure switching and some expenditure reduction. In principle, the former lies within the sphere of responsibility of the EACB and will be achieved by letting the nominal exchange rate depreciation and accompany this by a tightening of the common monetary policy to translate the nominal exchange rate depreciation into a real depreciation. By contrast the expenditure reduction element lies in the domain of the decentralized fiscal authorities: questions of how much expenditure adjustment is required, by what means it should be achieved – for example between tax increases or expenditure cuts – and where the burden of adjustment should fall need to be determined through some collective agreement. Without a coordinated response across the fiscal authorities, the region is exposed to the ‘free-rider’ problem discussed above with the result that the effectiveness of the aggregate economic adjustment is undermined to the detriment of all countries. It is here where the Commission must play a role. Working closely with the EACB and Partner State ministries of finance, the Commission needs to provide the technical advice on the appropriate mix of fiscal and monetary policy responses and support the process through which the allocation of the burden of the adjustment is determined. This is a highly political process which necessarily proscribes the limits of the Commission’s authority: as with the management of within-EAMU divergence, the authority to compel must be embedded in the political process, through the Council of Ministers.

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27 It is worth noting that the challenges facing the Eurozone are almost entirely ‘internal’. Since its creation and even through its recent crises, the Eurozone as a whole has run a more-or-less balance current account with the rest of the world with aggregate price stability.
Fourth, the Surveillance, Compliance and Enforcement Act pays close attention to the governance structure and terms and conditions for the Board of Commissioners. What is missing at this stage is consideration of the technical staffing requirements of the Commission. Given the scale of work and the technical demands likely to be placed on it, the Commission will require substantial high-level resourcing. In effect, the Commission will need to function as a ‘regional IMF’ producing timely economic analysis akin to regular Article IV and other surveillance reports produced by the Fund. Securing this quantity of technical (PhD-level) capacity, without cannibalizing the built capacity already in national central banks and finance ministries will be a serious challenge for the region and one that will have a non-trivial budgetary implication for the Partner States.

Fifth and finally, the demands on the Commission and their implications for the technical expertise required to deliver on this role, highlight the importance of developing an effective working relationship between the Commission (and the Council and EACB) and the IMF. There is very likely to be a substantial overlap in the work of the Commission and the regular surveillance work of the Fund, at least at the level of individual Partner States, while much of the union-wide analysis the Commission will be required to undertake will necessarily draw on similar work done by the Fund (particularly if the Fund develops a formal relationship with the supra-national bodies of the EAC in due course). At the technical level, there will be scope for close cooperation and peer-to-peer learning between the staff of the Commission and their IMF counterparts. An early engagement with the IMF to develop these relationships will be important for the Commission.

5. Conclusion: Key Lessons for the EAC

The Partner States of the EAC have committed themselves to establish a monetary union within a decade. As has become increasingly evident from the ongoing crisis within the Eurozone, many of the fundamental weakness of the Euro can be traced to a failure to fully recognize and confront the fundamental tendency for macroeconomic divergence within a monetary union. This neglect allowed for the build-up of current account imbalances and the loss of competitiveness in the periphery countries in the union. Well-designed fiscal instruments and a fiscal policy framework structured around an expended range of macroeconomic indicators which focus attention on indicators of competitiveness and the evolution of both public and private current account balances can play a key role in anticipating and offsetting potentially adverse macroeconomic consequences so that the potential benefits of monetary union can be realized.
This has two key implications. First, while the design of the fiscal framework anticipated in the *Protocol* and the supporting legislation defining the scope of the surveillance and compliance function is fundamentally well-designed and does not need substantial redesign, a number of key elements are missing. These elements can and should be built into further enabling legislation and operational procedures for the core institutions of the monetary union (the Commission and the EACB).

The second key implication is that an effective surveillance and compliance regime requires a substantial investment in high-quality technical expertise. This has direct budgetary implications for the Community and will take time to put in place if it is not to crowd-out the built capacity in the Partner States. Close cooperation with the IMF and other partners will be essential to this process.
Appendix I: Lessons from the Eurozone: cumulative divergence and delayed response

We concluded Section 3 by arguing that a monetary union requires mechanisms to handle the tendency for economic divergence and that these key elements were missing from the fiscal architecture of the Eurozone. Specifically, it was designed in the belief that union would, in and of itself and working in the context of efficient markets, deliver convergence. This was an error, the consequences of which exposed the Eurozone to enormous economic damage with the onset of the global financial crisis which precipitated a disorderly and extremely costly macroeconomic adjustment across the Eurozone. This adjustment is far from complete and the consequences in terms of growth and employment for the Eurozone as a whole, and the periphery countries in particular, has been far worse than for the other major economies outside the union such as the US, and the UK and, until commodity prices started to fall in 2014, Australia and Canada. It may be unreasonable to expect the architects of the Eurozone to have anticipated the scale and complexity of the global financial crisis. Indeed, even a decade on, the scale of the reckless expansion of sub-prime lending in the US, the unprecedented leverage in the financial sector that was allowed to occur by an almost criminal failure of systems of risk-rating and regulation, and the huge global inter-linking of balance sheets this created are hard to comprehend. But the point is not that the Eurozone’s architects failed to see this specific crisis but rather that the errors in design that allowed macroeconomic imbalances to build necessarily left the region particularly exposed to macroeconomic shocks. The vulnerability of the Eurozone to divergent dynamics was well-understood and was well underway long before the crisis precipitated a ‘sudden stop’ of capital flows and an enforced unwinding of current account imbalances.

This section describes the build-up of imbalances in the Eurozone. Our aim is to describe how the architecture of the zone allowed these to come about and explain how a more active fiscal policy would have helped offset these imbalances. We do not discuss the crisis itself.28

The emergence of macroeconomic balances

The period from the introduction of the euro until about 2007 saw a substantial build-up of macroeconomic imbalances within the Eurozone area. On the one side the periphery countries of Greece, Ireland, Italy, Spain and Portugal (the GIIPS) ran large current account deficits while the northern countries of the Eurozone, especially Germany ran large surpluses. The debt flows associated with these aggregate imbalances were both public (in the case of Greece) and, at least initially, private (especially in the cases of Ireland and Spain). Moreover, a major feature of these imbalances is that capital flowed into non-tradable sectors, especially real estate and the associated construction sector. This had three related effects. First, the growth in aggregate demand in the periphery countries was high – this was the era when Ireland was dubbed ‘the Celtic Tiger’ – and this growth boosted public finances, through increased taxes on income and consumption and lower

welfare payments. Second, however, those sectors attracting capital inflows were not those with high intrinsic growth potential; productivity growth was relatively poor and slipping behind that of the capital-exporting countries such as Germany. And finally, since capital was flowing into the non-tradable sectors, demand pressures were dissipated into non-tradable prices; local inflation in the periphery thus rose relative to the northern core countries such as Germany, further exacerbating the loss of competitiveness and driving relative productivity further apart. A powerful centrifugal process of divergence was well-rooted in the Eurozone from its inception, right up to the crisis.

Figures 1 to 4 illustrate how profound this divergence was in the Eurozone over the period from 1999-2008. For simplicity we focus on only two of the periphery countries, Ireland and Spain, and two of the northern core countries, Germany and the Netherlands. Figure 1 plots the output gaps for the four countries and shows how by late 2001 while output in Germany and the Netherlands was on or just below trend, Ireland and Spain were beginning to experience excess demand.

Under a single-country assignment these pressures would have called forth a rise in the nominal interest rate. However, at the time the Eurozone as a whole was facing a mild recession to which the ECB (correctly) responded by lowering the nominal policy rate to support aggregate demand. But with prices rising faster in Spain and Ireland than in the rest of the Eurozone, ex post real interest rates in both countries were falling just as aggregate demand was booming, fuelling rather than dampening the boom (Figure 2). Although rates began to rise after 2005, real rates in the periphery remained extremely low so that aggregate demand continued to surge in both countries, sucking in imports, sharply widening the current account deficit (Figure 3).

What is striking from this figure is that throughout this entire period, the Eurozone current account (i.e. with the rest of the world) remained more or less in balance; the enormous current account imbalances were almost entirely internal to the zone. Noting that the current account balance is simply the excess of domestic savings over investment, what was happening at this time was that the excess savings in Germany, the Netherlands and other surplus countries were channelled through the banking system to Ireland, Spain and the other ‘Southern’ deficit countries, where, by definition investment exceeded (domestic) saving.

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29 All data are from IMF (World Economic Outlook, March 2016).
30 As the CEPR (2015 op cit) notes, by 2007, Germany and the Netherlands were lending around US$300bn net, with Spain the single biggest destination: in the decade leading up to the crisis in 2008, Spain borrowed roughly 100% of its GDP from elsewhere in the Eurozone.
It is worth reflecting on the nature of the investment. From a neo-classical perspective we would expect capital to flow ‘downhill’ from rich(er) to poor(er) countries, taking advantage of the higher marginal returns to capital in poorer countries (because the latter are relatively capital scarce). The pattern of net saving positions across the Eurozone could (and probably was) viewed as the manifestation of the greater abundance of investment opportunities in these fast-growing ‘emerging market’ economies on the fringes of the European core that were enjoying the initial surge of enthusiasm enjoyed in all the small countries that accompanied the creation of the Eurozone. Moreover, taking this neoclassical logic to its conclusion, these imbalances would be expected to unwind over time as savings rise in the periphery (savings rise with income and may be accelerated by demographic factors), and as diminishing returns to capital set in and hence lower the expected return to and hence level of investment. From this perspective, these ‘early’ imbalances were seen as intrinsic to a monetary union on a stable convergent path. And maybe they would have – possibly strongly so – had other factors not intervened. The point though is not the specific nature of the shock that occurred in 2008/09 but the fact that the build-up of imbalances left the Eurozone vulnerable to shocks of many kinds.
There are at least two factors that magnified this vulnerability. The first is that the elimination of (nominal) exchange rate risk, combined with the (incorrect) belief that monetary union effectively eliminated sovereign risk, drove country risk premia virtually to zero. Along with falling risk-free rates, this compression meant that the cost of capital was too low in the periphery leading to a classic ‘over-lending / over-borrowing’ phenomenon in the periphery. But second, this investment surge was predominantly into the non-tradable sector of the economy which generated a classic Dutch Disease effect that undermined the competitiveness of the tradable goods sector and hence weakened the ‘neo-classical’ convergence process. There is no intrinsic reason capital inflows should be concentrated in the non-tradable sector but it is clear how this can become self-reinforcing in a monetary union. When monetary policy does not lean sufficiently against excess demand, the real interest rate falls – supporting a surge of investment into all sectors – and the real exchange rate appreciates which raises the value of the marginal product of capital in the non-tradable sector. Moreover, the construction boom drove up labour costs (even though this was one sector that saw very substantial movement of labour, especially from eastern to western and southern Europe. This was good for public finances but capital was not flowing into those sectors with the potential for higher long-term productivity growth which further weakened the convergence process but rather exacerbated the tendency for divergence.

Fiscal policy should have reacted to these developments but it didn’t, either at the national or the supra-national level. This failure, however, was compounded by a complacency that markets mechanisms would be sufficient to manage the build-up of current account imbalances. These

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31 This is analogous to the phenomenon in the build up to the East Asian crisis in the late 1990s where investors’ belief that the authorities in Thailand, Malaysia and elsewhere would honour their commitment to their fixed exchange rate peg to the US dollar led them to under-price the exchange rate risk associated with cross-border capital flows. See, for example, Ronald McKinnon and Huw Pill 1999. "Exchange-Rate Regimes for Emerging Markets: Moral Hazard and International Overborrowing," *Oxford Review of Economic Policy*, Oxford University Press, vol. 15(3), pages 19–38, Autumn.
current account imbalances were increasingly viewed as ‘a feature’ of the system rather than ‘a bug’ that demanded corrective action.\textsuperscript{32}

The final key aspect of this period was the fiscal balance, the only national-level convergence criterion thus far considered. As Figure 4 makes clear, right up to the crisis in 2008 the fiscal position in both Ireland and Spain appeared strong and very substantially in excess of the Maastricht criteria. The corollary to the combination of high current growth, low real interest rates and a strong fiscal position in the run-up to the crisis was that the government debt position was favourable and well below the 60% of GDP as established in the Maastricht ceilings. In 2007, the ratio of public debt to GDP was 24% in Ireland and 34% in Spain. The problem was that these fiscal positions were not sustainable. They were boosted by the combination of the periphery economies ‘running hot’ with output above trend and, moreover, with the sectors of most rapid growth being relatively tax intensive, so that even if debt was relatively low, the true underlying fiscal position in these countries was relatively weak.

\textit{The dog that didn’t bark}

In the context of the policy assignment, therefore, both monetary policy and fiscal policy were doing their jobs as anticipated in the Issing Assignment. The interest rate was successfully targeting inflation aggregate at the level of the Eurozone while fiscal policy was focussed entirely on the level of country-level public debt (but not aggregate debt). Where the assignment – and the indicators underpinning it -- failed was to provide for any active response to the third and fourth elements of the response, namely on prices and wages and on capital flows. From the previous description it is clear that these are two sides of the same fundamental imbalances; on the one hand, the divergence in prices and wages were the cause and consequence of the growing real exchange rate

\textsuperscript{32} It is often argued that this tendency for neglect reflected a deeper view that Europe was at its best in crisis and that progress was driven by its reaction to crises. This is what Jean Monnet meant by “l’Europe se fera dans les crises” [“Europe will be made in crises’] which has created a ‘muddle through’ mentality.
misalignment and corresponding current account imbalances between European countries; while on the other, capital market integration was supporting the growth in cross-border capital flows allowing these deficits to be financed (apparently without risk).

In retrospect, there were growing and worrying signs of overheating in the periphery (and an inefficient austerity in the core) that did not register on the instrument panel. Fiscal policy did not react to the (destabilizing) effects on prices and wages so that the divergence in aggregate demand did not elicit a counter-cyclical response in either current account deficit or current account surplus countries. Moreover, the SGP rules in effect signalled an ‘all clear’ to the booming economies and demanded a tightening on the creditor nations such as Germany – in other words operating in exactly the wrong way. Nor was there any fiscal activism against what was (again in retrospect) an emerging credit bubble fuelling and building on an underlying housing bubble.
Appendix II: Debt dynamics and current account

The evolution of a country's external debt-to-GDP ratio can be described by the following differential equation

\[ \dot{d}_t = (r_t - g_t) d_t - s_t \]

where \( d_t \) denotes the aggregate external debt (both public and private) as a share of GDP, \( g_t \) is the rate of growth of GDP, \( r_t \) is the effective cost of new borrowing / roll-over of existing debt, \( s_t \) is the primary balance on the current account (i.e. the current account before interest costs on debt). A dot over a variable denotes the change over time. It follows that the debt-to-GDP ratio rises with the inherited debt ratio and the cost of borrowing and is decreasing in the rate of growth of GDP and in the primary current account surplus. A couple of key points are worth stressing here:

First, the debt ratio is stable where \( \dot{d}_t = 0 \), which implies that the 'debt stabilizing current account balance' is given by \( s_t = (r_t - g_t) d_t \). It follows directly that debt can be stabilized even while running a current account deficit if the rate of growth is high relative to the interest rate (i.e. \( (r_t - g_t) < 0 \)).

Stated differently, as growth declines, and the cost of borrowing rises, the debt-stabilizing current account balance needs to rise; if the adjustment is insufficient, debt rises without limit and the country faces an incipient debt crisis – a situation in which creditors are unwilling to hold or rollover debt without the compensation of prohibitive risk premia. The only ways in which debt can be stabilized in this situation is through an organized (or disorganized) restructuring of debt obligations that reduces the effective cost of debt servicing \( (r_t d_t) \) which may include flow relief and/or explicit write-down in the debt stock. A successful resolution is one that stabilizes (or reduces) debt over time. Debt dynamics are intrinsically unstable and self-reinforcing. When the economy is on an unsustainable path, rising debt service costs place fiscal policy under even greater pressure, driving up the debt-stabilizing surplus, but this squeeze on aggregate demand is likely to lower growth which in turn worsens the fiscal position, while both lead creditors to demand ever higher risk premia on lending. By contrast, with a successful debt restructuring comes a virtuous circle in which the fiscal stance can be relaxed allowing for higher public expenditure and public investment which boosts aggregate demand and supply which in turn lowers the required risk premium on debt.
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