Executive summary: Designing fiscal institutions for an East African monetary union

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Introduction

1. The Protocol on the Establishment of the East African Community Monetary Union was signed in November 2013 by the then five Heads of State of the EAC Partner States, committing them to monetary union by 2024. The centrepiece of the Protocol is the creation of a common currency issued and managed by a new supranational central bank (the East African Central Bank). While the introduction of a new currency is undoubtedly a technically demanding task, the coherence and sustainability of the putative monetary union depends as much on key policy measures in the fiscal domain as it does on purely monetary and exchange rate measures. To date, however, discussion and debate about the key elements of the fiscal architecture has been piecemeal and has not yet been grounded in a clear analysis of how fiscal policy and fiscal institutions must necessarily change when countries enter a monetary union. This absence is partly explain by history: the initial plans for an East African Monetary Union (EAMU) drew heavily on the design of monetary and fiscal structures in Europe in place in the early 2000s, prior to the post-2009 crisis in the Eurozone, and this design has been taken as settled. However, as recent events have shown, key aspects of this European fiscal architecture were critically flawed. Since 2010, and often under the pressure of events, there have been significant efforts in Europe aimed at correcting earlier errors in design.[1] Policymakers in East Africa need to make sure that these original European design errors are not baked into the institutional architecture of EAMU and that the lessons currently being learnt in the context of the Eurozone are taken on board.

2. The comparison with the European experience is relevant. Other monetary unions do exist – the Common Monetary Area of Southern Africa, the East Caribbean Currency Union and the Communauté française d'Afrique (CFA) Franc Zone of west and central Africa – but these unions have tended to emerge from particular historical circumstances and are characterised by deep asymmetries in size and power or other structural characteristics that do not translate directly to the circumstances of the EAC. What makes EAMU strikingly different from these examples 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 therefore only be guaranteed by the credibility and commitment of the partner states to the union. In this respect, the European experience of monetary union remains the most relevant basis for comparison.

3. Part I of this paper revisits the core economics and politics of monetary union to identify how these ought to shape the eventual design of the fiscal architecture in East Africa. The key point we make here is that all monetary unions are vulnerable to pressures that lead

[1] See for example the Five Presidents' Report on Completing Europe's Economic and Monetary Union (June 2015) http://ec.europa.eu/priorities/publications/five-presidents-report-completing-europes- economic-and-monetary-union_en

towards economic divergence and that these are not necessarily self-correcting. The fundamental elements of an effective governance structure for a monetary union must therefore include institutions that monitor and manage these pressures. Some of these elements are missing in the current design envisaged by the Protocol, and therefore Part II of the paper focuses on the specific elements of this architecture, making recommendations for their modification and (re-)design.

4. Three features shape these recommendations. First, we acknowledge 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, and for the same reason, new fiscal institutions and policy commitments need to be proportionate and flexible enough to provide an appropriate degree of fiscal coordination along a range of alternative 'glide paths' towards the adoption of a single currency in due course (again noting the possibility that full union may not even occur). Finally, we suggest that modifications and re-design of fiscal institutions do not require re-negotiation of the Protocol. Modifications can be reflected in the enabling legislation required to establish monetary and fiscal institutions, including the East African central bank; in the operational procedures of surveillance and compliance institutions; and in the supporting reforms to the operational procedures of national fiscal institutions.

Part I: The Economics and Politics of Monetary Union

The basis for monetary union

5. By establishing monetary union, participating countries relinquish the nominal exchange rate as an instrument of (country-level) economic policy and simultaneously accept a common monetary and exchange rate policy, typically set and managed by a supra-national central bank.

6. Countries enter into monetary unions for three main reasons: to promote and support trade, financial and real economic integration; to accelerate a process of union-wide political integration; and to improve the quality of monetary and exchange rate policy. These benefits, however, come at the cost of a loss of policy sovereignty for each member state. National central banks become subordinate to a union-wide central bank, where decisions on liquidity management, interest rates, and exchange rates automatically become union- wide. Unless the economic shocks faced by separate member stages are common across the union, monetary and exchange rate choices will therefore reflect some compromise or consensus position: monetary policy set by the new central bank will, in general, not be optimal from the perspective of any individual country. Moreover, while other policy instruments, notably on the fiscal side, remain within the domestic domain they too may be heavily circumscribed by union-wide considerations.

7. The loss of monetary autonomy is potentially costly when the nominal exchange rate plays an important role in addressing real exchange rate misalignment. With flexible nominal exchange rates, countries can respond rapidly to emerging macroeconomic imbalances, eliminating real exchange rate misalignment and restoring appropriate incentives for macroeconomic resource allocation. Without recourse to the exchange rate instrument, all adjustment must be through domestic prices (so-called 'internal devaluation') which is often sluggish and costly.[2] The cost of moving to a common currency therefore

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[2] The real exchange rate, which is a summary indicator of a country's competitiveness, is a measure of prices in the domestic economy relative to world prices, all expressed in a common currency. Defined as $e = Ep*/p$ where e is the real exchange rate, E the nominal rate (in local currency per US dollar, for example), $p*$ is the 'world' or dollar price level and p the domestic price level, an increase in e is a depreciation of the real exchange rate or an improvement in competitiveness. Suppose a depreciation is required to restore macroeconomic balance: assuming the world price index is given, this can be achieved through a depreciation (increase) of the nominal exchange rate or through a fall in domestic prices or some combination of the two.

depends in part on how vulnerable an individual member state is to ‘asymmetric’ shocks -- to shocks that differ in timing, scale and duration from those facing other partner states – which is a question about the structural similarity of economies, and in part on how easily labour (and/or capital) can move between sectors and countries and how quickly price and wages adjust to excess demand or supply pressures. When shocks are broadly symmetric and/or economies are flexible, the loss of the exchange rate instrument is not costly but rather, to the extent it removes one more element of trade costs, confers a net gain on the region.

Managing pressures for divergence

8. The symmetric shocks / high flexibility case – the so-called ‘optimal currency area’ model -- is a useful benchmark for thinking about the economics of monetary union. In reality, however, economies are rarely that flexible, certainly not in in Europe and most probably not in East Africa. This means that macroeconomic management will be directly concerned with situations in which real exchange rate adjustment may be difficult and macroeconomic imbalances are correspondingly persistent.

9. The tendency towards economic divergence arises both on entry and once monetary union is established. Partner States must join the union in a macroeconomic configuration that is reasonably close to its sustainable (i.e. medium term) competitive equilibrium path. If initial real exchange rates are structurally misaligned across the union, Partner States with relatively strong currencies will be at a competitive disadvantage while 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, which may have long-lived effects. These pressures remain once the union is formed and so the macroeconomic policy framework needs to effectively monitor deviations from equilibrium and to respond to these pressures quickly.

10. Why this is so and what it means for the design of fiscal institutions is best understood through the lens of the so-called Walters Critique, named after Alan Walters, economic adviser to British Prime Minister Margaret Thatcher, and a staunch opponent of UK membership of the European single currency arrangement. The essential insight of the Critique is that in a monetary union with a single common monetary and exchange rate regime, monetary policy will not only be generally suboptimal for any individual country (as noted above) but may also be positively destabilising. Consider the case where a member of a monetary union experiences a positive demand shock (for example, from public expenditure) that puts upward pressure on prices and inflation in that country, and where this shock is not experienced by other countries in the region. If this country was operating its own monetary policy, it would raise the nominal interest rate so that the real interest 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 by less than the increase in domestic inflation) the rise in domestic prices means the real interest rate in the country will actually fall,[3] which is precisely the opposite of what is needed: in the face of a booming economy, the falling real interest rate stokes price pressures, leading to a further overheating of the economy and, as prices rise, the economy becomes less and less competitive and the current account balance with the rest of the union and the rest of the world worsens. 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.

11. The logic of the Walters Critique is that national fiscal policy may need to play a more

[3] The real interest rate, r, is the nominal interest rate, i, less the rate of inflation, π. Thus $= i - \pi$.

active counter-cyclical role to lean against the tendency for the monetary union's common monetary policy to exacerbate the problem of macroeconomic stabilisation. This insight has important implications for the deployment of economic policy instruments.

Deploying policy instruments

12. There is a clear consensus amongst economists on the assignment of policy instruments to targets in the context of a single country. Monetary policy is assigned the task of providing an anchor for prices (i.e. controlling inflation) and, subject to this, stabilising the economy. Monetary policy also has a regulatory role, in supplying lender-of-last-resort liquidity to the financial sector as required, and ensuring financial stability, something which – ultimately – requires a fiscal guarantee. With monetary policy shouldering the burden of short-run macroeconomic stabilisation, fiscal policy 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 stabilisation' which lends support to monetary policy in delivering macroeconomic stabilisation.

13. For a monetary union, the assignment question has the additional dimension of how responsibilities are partitioned between national and supra-national institutions. In the Eurozone, the assignment has drawn a sharp distinction between the roles of monetary and fiscal policy. Authority over monetary policy and macroeconomic stabilisation was handed entirely to the supra-national monetary authority, while the primary roles of the national fiscal authorities were to secure medium-term fiscal solvency and shape public expenditure. Authority over taxation, aggregate government expenditure and public debt remained with national governments, as did responsibility for financial market development and, critically, for maintaining intra-regional competitiveness.

14. This assignment – embedded in the Maastricht Treaty (1992) and Stability and Growth Pact (1997) and now mirrored in the EAMU Protocol --is characterised by a number of tensions, particularly around the appropriate role of fiscal policy in a monetary union. The tension pits the challenge of the Walters Critique against the management of a fundamental 'fiscal free rider' problem to which any monetary union is prey. The former argues for greater fiscal discretion to ensure each economy remains on its balanced growth path over the short- to medium-term, while the latter argues for rules to constrain fiscal behaviour.

15. The free rider problem reflects the fact that a common monetary policy shares the costs of adjustment across the members of a monetary union. As a consequence this means any individual country faces an incentive to run a looser fiscal stance (or face a lesser incentive to adopt necessary fiscal contraction in the face of adverse developments) than it would if it were a single country operating on its own. 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 but without generating any output gains to the country in the long-run. This collective action problem argues for fiscal rules that limit discretionary fiscal policy.

16. Clearly, measures designed to address free-riding concerns have important implications for the extent to which fiscal policy can also be used to address concerns about macroeconomic stabilisation. In the Eurozone, the assignment was heavily weighted in favour of addressing the free-rider problem so that active discretionary fiscal policy was heavily circumscribed. This might be reasonable in Europe given that national fiscal systems have reasonably strong automatic stabilisers that supported short-run stabilisation, but in the EAC, where automatic stabilisers are weak or non-existent and fiscal policy tends to be more naturally 'pro-cyclical', following this tight fiscal line raises the risk that the fiscal regime becomes mildly de- stabilising.

17. Within the Eurozone, responsibility for financial sector development and regulation and for competitiveness was also delegated to the national level, although there appears to have been a widely-held belief that labour and capital markets were sufficiently self-regulating (in terms of competitiveness and associated macroeconomic imbalances) that the policy focus was almost entirely on microeconomic or supply-side reforms. 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. In both areas, very little attention was paid to the cross-border implications of labour market and financial sector regulation and development.

18. Much of the institutional reforms in the Eurozone since 2010 (many of which are still underway) have been directly concerned with problems associated with the initially ill-conceived fiscal architecture; these reforms need to be reviewed in the context of the institutional design of the EAMU.

The politics of monetary union

19. There are two opposing views about the politics of monetary union. The first is that an 'incomplete' monetary union, such as exists in Europe today, cannot be a stable (economic and political) equilibrium: partner states 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 a customs union and a single markets for goods and services. In terms of the EAC project, the logic of this view is that unless the Partner States are committed to moving to political federation (Stage Four) with all deliberate speed, they must 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. The essential argument underpinning this position is that the pressures for economic divergence that are inherent in monetary union can only be managed if there is a fiscal union and that effective fiscal union requires a government that has the political legitimacy to impose macroeconomic and budgetary policies aimed at avoiding imbalances.

20. The alternative view takes a more sanguine position on the necessity of full political union and instead argues that the observed 'incompleteness' of the European monetary union, for example, is not inevitable but rather reflects errors in design. Monetary union can endure as a broadly stable equilibrium, even without full political union, but only if the inherent economic tensions that monetary union entails are recognised and if a robust institutional architecture that explicitly recognises these tensions (and the fact that these tensions will not be resolved by market forces themselves) can be constructed. This view, which underpins much of the recent reforms in the Eurozone, is the relevant one for the EAC. Critically, it requires Partner States to recognise that successful monetary union entails significant dilution of economic sovereignty; that fiscal and/or risk-sharing mechanisms at the supra-national level are put in place; and that these institutions are adequately resourced.

21. One aspect of Europe's experience that is highly relevant to policymakers in the EAC is the depth of the institutional foundations on which the Eurozone is built and the financial and other commitments that have been made to the institutions of monetary union. The global financial crisis and the events that followed have placed the Eurozone under immense stress that has shaken many member states' commitments to monetary union. But so far the Eurozone has survived and this probably owes something to a convergence process that occupied nearly three decades and conferred substantial political legitimacy on supra- national policymaking bodies; 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; to growing cross-border financial regulation structures; and to substantial financial commitments, including through structural and stabilisation funds and the range of facilities used by the ECB, that have allowed economic policy makers to restore stability to the Eurozone. Although the EAC differs substantially from the Eurozone in many respects, the scale of these commitments must be acknowledged.

Part II: Designing Institutions for EAMU

Principles of design

22. For EAMU to succeed requires governance structures 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 'internal devaluation' may be difficult and/or protracted. It is important that these structures do not compromise good economic management during the transition phase, which may be protracted.

23. This structure will consist of: (i) institutions to secure convergence and place countries on a path towards an initial macroeconomic equilibrium without 'baking-in' structural imbalances to the post-union configuration; (ii) institutions to maintain macroeconomic convergence once monetary union has been established; (iii) institutions to manage and adjust to idiosyncratic and asymmetrical shocks across the union; (iv) central banking institutions to manage liquidity to government and the financial sector, if required, through their lender-of- last-resort function; and (v) a system of macroeconomic monitoring and surveillance to monitor economic conditions and pre-empt disruptive shocks to the system and to support adjustment when it is required.

Macroeconomic Convergence

24. Explicit macro-convergence criteria are spelled out in Articles 5 and 6 of the Protocol, spanning initial convergence towards and subsequent maintenance of macroeconomic equilibrium. Aside from some incompatibilities between the 'core' and 'indicative' convergence criteria, consideration needs to be given to two key issues.

25. First, once monetary union is established, the East African Central Bank will have control over monetary policy instruments and will have responsibility for hitting the inflation target. However, Partner States will still need to monitor price developments within their own economies. As noted 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. Partner states and the surveillance institutions of the EAC therefore need to monitor country-level prices and act to ensure they do not diverge from the union-wide average in an unsustainable manner.

26. Second, by focusing entirely on the public sector balance – as was the case in the Eurozone – the convergence criteria are incomplete for the reasons discussed in Part I of the paper. While failure to meet the fiscal criteria (i.e. the deficit and debt targets) will certainly tend to suggest macroeconomic risks, hitting fiscal targets does not necessarily imply the absence of underlying economic pressures. The current convergence and performance criteria should be augmented 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. These are: (i) the aggregate current account balance; (ii) the evolution of country-level real exchange rates; and (iii) the evolution of

private non-guaranteed external debt.

27. Given the difficulties in defining an appropriate target levels for these indicators, it is appropriate to maintain them as indicative measures rather than as primary convergence criteria. 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. The primary value of these measures is to provide early indicators of emerging pressures on Partner State external balances.[4]

28. It is neither politically feasible nor desirable to revise the Protocol itself to reflect these considerations. However, revisions could be embodied directly in subsequent enabling legislation or could form the basis of a future compact or other treaty-like agreements building on the original Protocol.[5]

Measuring current account imbalances and the role of escape clauses

29. Tracking the current account is essential but it is not straightforward and not easy to translate into a simple numerical target. The current account balance reflects private and public sector behaviour and, crucially, a range of external developments that lie outside the span of control of the national or the supra-national authorities, including the terms of trade, the volume and cost of private capital flows, and global interest rates. Moreover, it is far from obvious that the optimal or even safe ceiling for the current account 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. Similar arguments follow for the real exchange rate whose equilibrium path evolves over time as a function of productivity growth and the structure of production, trade and aggregate demand.

30. The practical implication is that while it is essential that the authorities invest in the capacity of measure and analyse the evolution of the current account (as well as real exchange rates and private debt levels), the case for seeking precise numerical targets for these indicators is weak. This has a bearing on whether escape clauses should be built into the system. Escape clauses on macroeconomic convergence criteria such as the fiscal deficit and the current account balance have a clear appeal by seeming to balance the discipline of a rule with the flexibility of a discretionary response of unanticipated events. The experience from elsewhere, however, suggests escape clauses do not, in fact, provide the flexibility that is often hoped for. For a start, 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 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.

31. A more flexible alternative to a ‘convergence-criterion-plus-escape-clause’ approach is a system of ‘open letters’ similar to the system used by the Bank of England in the context of its inflation targeting regime.[6] Deviations of outcomes from formal (or indicative) targets

[4] It is worth noting that concerns about countries’ external balance were clearly articulated in an earlier report on monetary union by the Monetary Affairs Committee (2009), where governors sought to include these indicators to ensure the ‘reduction of current account balances to levels consistent with debt sustainability’

[5] This has been the case in Europe where, for example, the provisions of the original Maastricht Treaty of 1992 were expanded and clarified by the Stability and Growth Pact (1997) which was revised in 2005 and is in the process of further revision in the aftermath of the Eurozone crisis.

[6] When inflation strays outside its target range this triggers an ‘open letter’ from the governor of the Bank of England to the

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 designed to bring economies back on track. This system provides a transparent and verifiable statement of intent by policymakers and would sit comfortably as part of the monitoring and verification of performance criteria in EAMU.

Managing short-run shocks once monetary union is established

32. Article 10 of the Protocol requires Partner States to "build and maintain resilience and stabilise the Monetary Union or the economy of a Partner State in the event of an economic shock".

33. A stabilisation facility is a risk-sharing mechanism designed to mitigate the costs of short- term adjustment faced by any Partner State dealing with shocks that are less than fully accommodated by the common union-wide monetary actions. Persistent or permanent shocks (for example, a long-run secular decline in the world price of key exports) require deeper, persistent structural adjustment that moves the economy to its new macroeconomic equilibrium.

34. The rationale for a supranational stabilisation facility in a monetary union emerges from three ideas. The first is that when the authorities are unable to use monetary and exchange rate policy the whole burden of adjustment falls on fiscal instruments which can can be temporarily overwhelmed. Second, 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 ('internal devaluation') is necessarily more sluggish and, as a result, more costly to achieve. Third, even in the context of short-term stabilisation, the premium on external market finance may be strongly counter-cyclical so that external finance may be punitively expensive or even unable exactly when government needs to borrow.

35. National-level fiscal stabilisation may be feasible if a high degree of fiscal flexibility prevails and/or if automatic stabilisers are strong. On the other hand, a supranational mechanism is favoured if domestic fiscal structures are relatively inflexible, and if domestic debt markets are thin. They 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 stabilisation mechanism to operate at the supra-national level.

36. Short-term stabilisation facilities need to be accompanied by 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. The rationale for structural funds emerges directly from the tendency for divergence in the underlying process of real economic 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.[7]

37. A stabilisation fund could also be set up as a budgetary 'transfer union' making direct and timely horizontal fiscal transfers from the EAC budget replenished on the basis of

Chancellor of the Exchequer that offers an explanation for the deviation and outlines a programme of actions designed to bring inflation back on track

[7] Structural and region funds have played an important role in the development of the European Union; the current budget for structural funds is approximately US$100bn per annum or 0.5% of EU GDP.

regular contributions from the partner states. Alternatively it could be structured as a lending facility similar to the IMF's facilities such as the PRGF, providing short-term credits to partner state governments under the monitoring and enforcement of the Surveillance, Compliance and Enforcement Commission. In principle, the fund could augment Partner States' direct contributions by raising bond finance, through selling mutualised EAC bonds against the balance sheets of the EACB or the Partner States themselves. These bonds could be issued in the new East African currency and/or foreign currency depending on perceived need and the cost of capital.

38. One important lesson from the European experience is that the costs, both economic and political, of introducing stabilisation 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 stabilisation 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 they are often perceived as a bailout or one-way transfer mechanism and hence attract hostility from the population or tax-payers of the creditor nations.

Monetary provisions and liquidity

39. The commitment to a common pan-territorial monetary and exchange rate policy implemented through an East African Central Bank is enshrined in the Protocol. Two key elements of the governance structure still need to be addressed in the enabling legislation.

40. First, although there is a presumption that the East African Central Bank will be jointly and equally 'owned' by those Partner States participating in the single currency arrangement, 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. These should 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 agreed targets.

41. Second, also undefined at this stage is the lender of last resort function of the EACB. Within a monetary union, national central banks lose the capacity to directly respond to short-term liquidity problems that 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 (even if, in practice, they may be implemented through the integrated central bank system). However, at present, the definition of what liquidity provision and lender of last resort functions the EACB should have remains undefined. Policymakers need to clarify 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.

Surveillance

42. Article 21 of the Protocol provides for "an institution responsible for surveillance, compliance and enforcement" to support monetary union. The draft East African Community Surveillance, Compliance and Enforcement Act (2016) provides for these functions. 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.

43. First, the surveillance structure remains narrowly focused on fiscal indicators. Reflecting our 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.

44. 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; for the mobilisation 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.

45. 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. 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.

46. 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.

47. 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.