

MONETARY INTEGRATION IN EAST AFRICA

by

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To the loving memory of my Sister

Marie Claire RWAKUNDA

who was too young to leave us on April 06, 2002.

ABSTRACT

The purpose of the dissertation is to establish a framework with which to assess the prospective gains from regional monetary integration among five neighboring countries in East Africa: Burundi, Kenya, Rwanda, Tanzania, and Uganda. The neo-classical theory assumes that economic and monetary union would stimulate additional growth in such a union as a whole, with the trickle-down effects of overall development, and would enhance factor mobility, solving the problem of regional disparity automatically. Past experiences of African regionalism have shown that countries that participated in a monetary union were able to pursue credible monetary policies. This economic performance has been credited to their monetary policy discipline. Since countries in East Africa are small both in terms of their individual populations and the respective sizes of their economies, the study concludes that regional integration is a useful way of increasing their economic clout and bargaining power on the global scene.

Key words: Monetary integration; economic integration; regionalism; currency union; optimum currency areas; exchange rate arrangements; convergence criteria; payment system; informal cross-border trade; East Africa.

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LIST OF ACRONYMS AND ABBREVIATIONS

ADB:	African Development Bank
AEC:	African Economic Community
ATM:	Automated Teller Machine
BOP:	Balance of Payment
BOU:	Bank of Uganda
BOT:	Bank of Tanzania
BRB:	Banque de la Republique du Burundi
CAEMC:	Central African Economic and Monetary Community
CBK:	Central Bank of Kenya
CFA:	Communaute Financiere d’Africa
CMA:	Common Monetary Areas
COMESA:	Common Market for Eastern and Southern Africa
EAC:	East African Community
EACB:	East African Currency Board
EC:	European Community
ECA:	United Nations Economic Commission for Africa
ECB:	European Central Bank
ECOWAS:	Economic Community of West Africa
EICV:	Enquete Integrale sur les Conditions de Vie des ménages
EMU:	European Monetary Union
EU:	European Union
GDP:	Gross Domestic Product
GNP:	Gross National Product
HIPC:	Heavy Indebted Poor Countries
ICBT:	Informal Cross-Border Trade
ICT:	Information Communication Technology
ILO:	International Labour Organization
IMF:	International Monetary Fund
MMA:	Multilateral Monetary Agreement
NAFTA:	North American Free Trade Agreement
NEPAD:	New Partnership for Africa’s Development
NPS:	National Payment System
OAU:	Organisation of African Unity
OCA:	Optimal Currency Area
ODA:	Official Development Assistance
PTA:	Preferential Trade Area
RMA:	Rand Monetary Area
SA:	South Africa
SADC:	Southern African Development Community
SADCC:	Southern African Development Coordination Conference
SARB:	South African Reserve Bank
SWIFT:	World-Wide Inter-Bank Financial Tele-communication
UK:	United Kingdom
UEMOA:	Union Economic et Monetaire Ouest Africaine
WAMZ:	West African Monetary Zone
WAMU:	West African Monetary Union

CHAPTER I. INTRODUCTION

1.1. Research Background

The meaning of monetary integration within a region appears to be interpreted differently by different people. The definition given by Werner (1970) is among the first interpretations of monetary integration in modern times. It identifies a first set of conditions, called “necessary conditions” by Delors (1989), to define a monetary union:

- within the area of monetary union, currencies must be fully and irreversibly convertible into one another;
- par value must be irrevocably fixed;
- fluctuation margins around these parities must be eliminated;
- capital movements must be completely free.

The second set of conditions identified by Werner concerns the centralisation of monetary policy. In particular, this centralisation should involve all decisions concerning liquidity, interest rates, intervention on the exchange markets, management of reserves, and the fixing of currency parities vis-à-vis the rest of the world.

The definition given by Corden (1972) is amongst the pioneering interpretations of monetary integration. He describes it as an institutional or legal monetary link between states and defines this institutional structure as an exchange rate union; others are more flexible, defining monetary integration in terms of a variety of institutional arrangements.

Gros and Thygesen (1982) argue that since there are different interpretations of monetary union, there are different degrees of monetary integration that approximate to different interpretations of monetary union.

Padoa-Schioppa (1988) suggests the following categorisation of monetary integration:

Exchange rate unions: exchange rates between the participants are irrevocably fixed and margins of fluctuations are not permitted. However, monetary policies need not be coordinated. As a result, some forms of capital controls are needed to influence domestic liquidity conditions.

Pseudo exchange rate unions: this terminology is due to Corden (1972). These involve fixed exchange rates among the members, free capital movements and pledges of policy coordination, but no formal integration of monetary policies.

Monetary integration: this arrangement, which is typically used interchangeably with the concept of currency areas, involves exchange rate unification: i.e. an irrevocably fixed exchange rate and the absence of margins of fluctuation. Monetary integration also includes full and irreversible convertibility of currencies (i.e., the absence of exchange controls); financial market integration; the complete liberalisation of movements on currency transactions; and a common (union-wide) monetary policy. Consequently, monetary integration corresponds to the arrangement that has been envisaged to be in place at the beginning of the third stage of monetary unification in the European Union, as embedded in the Maastricht Treaty. In turn, financial integration involves more than just the liberalisation of capital transactions. As Robson (1985) observes, financial integration also entails the concerted adoption of measures to harmonise national financial regulations and structures of institutions. It should be pointed out that although some writers (e.g., Ingram, 1973, and Masson and Tallor, 1972) presume that the above items are consistent with “irrevocably” fixed exchange rates, this outcome is by no means a certainty, as will be discussed in chapter three.

Monetary unification: this concept involves monetary integration plus a single currency and a common central bank. Here, the use of the standard instruments of monetary policy is consigned to the community and exercised solely by its monetary authority, leaving no independence for member states. Monetary unification also implies that responsibility

for exchange rate policy with other currencies and for the balance of payments of the community lies with the monetary authority of the community, which controls the pool of foreign exchange reserves.

It is thus important to note that integration is desirable, not as an end in itself, but because there are some fields in which states are too small to be viable decision units in the globalising world. In some cases this is because efficiency demands a larger market than the state can provide; in others because spillovers beyond national boundaries have become critically important; and in still others because the small states carry little weight on the world scene unless they act together. Where such factors as these indicate the desirability of centralising decision-making, integration should be encouraged. But where no such rationale exists, centralisation should be resisted and individual countries, or regions, should be encouraged to develop in their own individual way. Initially, the term “monetary integration” will mostly refer to monetary union in this dissertation.

1.2. Problem statement

The challenge is how to achieve monetary integration between countries with serious economic and political problems. For integration to be successful, African countries need to put their houses in order and open up their economies externally by removing the obstacles to trade posed by poor exchange rate policies, tariffs, poor transportation infrastructure and divergent regulations.

1.3. Research objectives

The main objective of the dissertation is to define and discuss monetary integration with reference to the old literature and the “new” one and to establish its relevance to the task at hand.

The secondary objective is to analyse the success or the failure of existing monetary integration in Africa and draw out lessons that will help the implementation of monetary integration in East Africa.

The third objective is to research the feasibility of monetary integration in East Africa and the benefits and costs relative to that integration, and to identify the countries that are promising to gain or to lose from giving up monetary independence.

The fourth objective is to analyse the stages towards the successful implementation of a monetary union.

1.4. Research methodology

This dissertation is of a qualitative nature, in the sense that literature reviews will be used to study monetary and economic integration. Interpretations of historical and current events, including quantitative data, form the essence of the study. Interviews will be carried out together with staff of African regional organisations and different central banks in East Africa to obtain region specific information in order to discuss the relevance and feasibility of economic and monetary integration in East Africa.

1.5. Structure of the dissertation

Chapters two and three review the literature on economic and monetary integration, with specific attention to the theory of optimum currency areas. These chapters examine the costs and benefits for states of joining an economic and monetary arrangement.

Chapters four and five focus on the analysis of regional economic and monetary integration in Africa, with an emphasis on the East African monetary integration, while chapter six discusses some economic policies regarding the best strategies for implementing monetary union. The final chapter offers some concluding remarks.

1.6. Value of the dissertation

The overall purpose of the dissertation is to enhance the understanding and appreciation of an important integration arrangement in East Africa. Economic integration in Africa has suffered from a tendency to be over ambitious, and for this reason the building of an East African monetary union, which provides valuable lessons from past, existing and prospective integration, is important. This dissertation will thus be of use both to other academics interested in the field and as a tool for policy makers involved in the area of monetary arrangement and policy.

CHAPTER II. THEORY OF ECONOMIC INTEGRATION

2.1. Introduction

Economic integration as a term has often been used in discussion by economists although up to date there has not been a precise consensus as to its meaning. Some authors include social integration in the concept; others subsume different forms of international cooperation under this heading, and the argument has also been advanced that the mere existence of trade relations between independent national economies is a sign of integration.

Wolf (2001) argues that neither the markets for goods and services nor the markets for factors of production appear more integrated today than they were a century ago. He adds that current integration is unique due to the falling costs of transport and communication, and liberalising economic policies. Short-term capital today is much more mobile than before. Public infrastructure projects are financed by foreign capital (Dollar & Kraay, 2002) and a large proportion of foreign direct investment is in services and manufacturing. This leads to the new concept of globalisation, which includes factors such as the unification of capital markets, the internationalisation of production and distribution networks and the mega-revolution in communication and transport technology.

Countries and businesses will have to become global players in order to stay competitive and achieve growth (Kosmicki, 2001). Globalisation has become the most important economic, political, and cultural phenomenon nowadays. This section will focus on the definition of certain terms, the different forms of international economic integration and the benefits and costs involved in being a global player.

2.2. Economic integration defined

According to Balassa (1961), economic integration is both a process and a state affair. Regarded as a process, it encompasses measures designed to abolish discrimination between economic units belonging to different nation states; viewed as a state affair it can be represented by the absence of various forms of discrimination between national economies. Attempting to make a more precise definition, he proposes a distinction between integration and cooperation. He contends that whereas cooperation includes actions aimed at lessening discrimination, the process of economic integration comprises measures that include the suppression of some forms of discrimination. For example, international agreements on trade policies belong to the area of international cooperation, while the removal of trade barriers is an act of economic integration.

Economic integration, also often termed regionalism, is defined by Robson (1998:1) as “the institutional combination of separate national economies into larger economic blocs or communities”. It can be seen as a method to promote efficiency in resource use on a regional basis. It also involves the elimination of all barriers to the free movement of goods and factors of production within the integrated area. Robson (1998:6) proposes that it can be viewed as “a state or process for enabling its participants to achieve a variety of common goals more effectively by joint or integrated action than they could by unilateral measures”.

In these definitions, one finds the process of integration to be one involving nation-states, which are supposed to act in unison for the particular purposes of integration. This will definitely involve some, if not total, loss of sovereignty to the extent of the form of economic integration involved.

It should be noted, at any rate, that regional integration might also include countries which are not in geographical proximity. Thus,

regional integration as a concept may be stretched further to cover a variety of socio-economic activities of countries which are not so close to each other, but which realise the benefits of mutual dependence and interaction.

Regional integration is by no means a substitute for sound domestic economic policies and is unlikely to succeed in their absence. In order to achieve integration one should leave matters to free market forces and competition. Speeding up economic integration speeds up globalisation. Regional economic integration can be seen as a result of economic globalisation (Kosmicki, 2001).

2.3. Globalisation defined

According to Wood (2000:1), globalisation is defined as “international economic integration”. It is very often linked to corporate power. Wolf (2001) explains a globalised economy as “one in which neither distance nor national borders impede economic transactions”. Kosmicki (2001) states that “globalisation should be understood as the expansion of interrelated economic and social activity beyond national borders and towards more world-encompassing dimensions”. He also states: “globalisation is frequently understood as a broad scale liberalisation based on the introduction of world-scale market relations, the abolition of restrictions in international trade and creation of a single global market”.

Globalisation could be seen as a choice to enhance a country’s economic well being (Wolf, 2001). The opening up of trade and capital flows enriches most citizens in the short run and almost all citizens in the long run. It is fundamentally a commercial rather than a political phenomenon. Global integration can also be viewed as a substitute for a development strategy. Globalisation is also a process that integrates all economic sectors and economies into one vast global economy that is open to all entrepreneurial contenders and is inclusive of all countries.

2.4. Forms of economic integration

To integrate independent countries into a regional market involves a process with a number of different stages, each more difficult than the previous. Each step requires more loss of autonomy. The type of economic integration that may be chosen and the extent to which countries will be involved in that scheme depends on many factors such as the level of economic development, the similarity of political systems and socio-cultural values which are likely to facilitate not only economic integration but also integration between peoples of different countries (Daltrop, 1986).

Usually, economic integration is concerned with the discriminatory removal of all trade impediments between participating countries and with the establishment of certain elements of cooperation and coordination between them. The free movement of goods and services requires not only the removal of tariffs and quotas, but also the elimination of non-tariff barriers that include state subsidies, anti-competitive business strategies, domestic fiscal arrangements, discriminatory public purchasing, border controls etc.

Several forms of economic integration may be identified in terms of a region or nation's progress towards economic integration, which may at times overlap but may not necessarily constitute stages in a process.

2.4.1. Sectorial integration

This involves the removal of barriers to trade in the output of a single industrial sector. A well-known example was the establishment of a common market for coal and steel in the former European Coal and Steel Community (1951). The latter is now incorporated into the Treaty of European Union. Canada and the United States also had an agreement for sectorial integration, in which only a limited number of industrial products were given preferential treatment. This agreement is now part of the North American Free Trade Agreement (NAFTA). The advantage

of such an agreement is that it builds up a foundation for wider integration.

2.4.2. Free trade area

In a free trade area, member states agree to remove all impediments to trade, that is, tariff and non-tariff barriers, among themselves but each retains the freedom to determine the level and nature of tariffs against third parties. Good examples are the North American Free Trade Agreement (NAFTA) and the Common Market for Eastern and Southern Africa (COMESA).

In less developed countries, a free trade area runs the risk of creating an opportunity for non-members to take advantage of the wider market by bringing in their goods through a member state with low tariff rates. To avert this danger, “Rules of Origin” are often used as a device to uncover the origin of particular goods and whether they are eligible for tariff reduction.

2.4.3. Customs unions

This form of integration has some characteristics of a free trade area in the sense that member states agree to remove all restrictions to trade. But they also have a common external tariff between member parties to apply a common level of protection against goods coming from third countries. The existence of a common tariff wall against any third parties makes the formulation of rules of origin unnecessary. The common external tariff can be set at any desired level with the purpose of maximising the social welfare of the participating countries as a group.

2.4.4. Common market

According to Robson (1998), this higher form includes a common external tariff, tariff-free movement of goods and services and free

movement of labour, the professions, capital and enterprise. Common markets usually have a supra-natural authority whose decisions are binding on all member states. A good example is the European Union.

2.4.5. Monetary union

Robson (1998) explains that this form of regional integration requires the adoption of a single currency, a central bank and a monetary policy. Its formation also requires the harmonisation of exchange rate mechanisms and the implementation of structural adjustment programmes with member-countries. The new central bank requires anti-inflationary credentials and is responsible for policy coordination and preserving regional economic stability. The Euro-space is a good example.

2.4.6. Economic and monetary union

This is a form of integration with a common market, a common currency and the integration or harmonisation of a range of policies in other areas. The economic, financial and social policies of the participating governments are coordinated through a single unit, which also handles economic relations with other countries. A common bank may or may not be adopted to control the supply of the common currency and to determine the union's interest rates. A good example is the European Union with its European Central Bank (ECB).

2.4.7. Complete economic union

This is a common market that involves complete unification of monetary and fiscal policies. In this form of regional integration, a control organ is introduced to exercise authority over monetary and fiscal policies so that member states effectively become regions of one nation.

2.4.8. Complete economic and political integration

In this case, members of the union virtually become one nation. The central authority that is created for overseeing monetary and fiscal policies does not just end at this but is also answerable to a central parliament, which exercises the sovereignty of a nation's government. This is in fact the highest form of regional economic integration.

2.5. Advantages and problems of economic integration

According to international trade theory, the advantages of economic integration are related to increased productivity and efficiency. Increased market size would facilitate the expansion of production, based on economies of scale, specialisation, and comparative advantages. However, one of the problems of economic integration is that tariff reduction may not necessarily confer trade preferences on partner states. Another problem is related to unequal distribution of costs and benefits among member countries. Then, participation in economic integration will depend on the weight that can be given to its advantages or problems and will differ from country to country.

2.5.1. Advantages of economic integration

Advantages of economic integration can be summarised as follows:

- More efficient division and allocation of capital and labour between member countries, which should make the integrated economy more competitive internationally, with modest interest rates, a firm currency and low inflation.
- Greater currency stability simplifies business decision-making.
- A single currency will improve monetary cooperation in the banking sectors, leading to more efficient payments and clearing systems.
- The benefits of a currency that becomes an international medium of exchange are: greater liquidity, a lower cost of capital, the

elimination of currency risk, higher returns for domestic savers, and seignorage fees for the national government.

- Reduced investor risk through diversification.
- A broader choice of products and technology.
- A reduction of dependence on primary product exports for developing countries, due to an increase in the number manufacturing industries.
- Improved allocation of resources and higher living standards, due to increased investment, job creation, and growth. Higher growth rates in developing countries have translated into higher incomes for the poor.
- Cost savings that will be gained through not using several currencies and having to convert them at different parities. Movements in exchange rates will not affect business transactions within the community.
- It creates competition among governments. Countries with uncompetitive economies will not survive, as shown by the fate of the USSR (Wolf, 2001). This competition prevents governments from being autocratic and increases the incentive to provide services valued by taxpayers. Any specific degree of international integration imposes constraints on the ability of governments to tax, redistribute income, and influence macroeconomic conditions.
- Transparency in trading under an economic and monetary union should lead to price homogenisation and in general to a reduction in price levels.
- Financial misbehaviour by member states will be reduced, because they will no longer have control over their monetary policy.
- Economic integration magnifies the difference between good and bad countries.
- International economic integration accelerates the market's responses to policy by increasing the range of alternative options available to those affected. For example, a government can pursue an inflationary policy over a long period and boost the economy, but if a country is open to international capital flows, the reaction of the

country's creditors is more brutal. This response will often show itself in a collapsing exchange rate, as happened in East Asia in 1997 and 1998 (Wolf, 2001).

- It enhances the common welfare, as can be seen with the European integration. The increased market share that accompanies trade expansion may enable more products to be produced profitably, so generating increased welfare gains from increased product diversity.
- A region's infrastructure may be improved, for example transport systems.

2.5.2. Problems of economic integration

- The reduction of tariffs among members of a regional economic arrangement, while maintaining higher tariffs for third country imports, will produce trade preferences if tariffs inclusive of import prices are the effective determinant of import sourcing. However, in many countries domestic currencies are not convertible and sourcing of imports depends more on securing import licences and foreign exchange allocation (World Bank, 1991).
- The formation of a customs union with a higher common external tariff may be used to support import-substituting industrialisation at the regional level (trade diversion).
- In economic integration as a customs union, the latter will confer more benefits on the more developed member countries, which will attract increased investment in manufacturing. The less developed member countries may suffer from a lower level of industrial development because most of the manufactured consumer goods will be supplied by the more advanced member countries.
- In Africa, customs duties account for a large percentage of total government revenues. Large-scale trade diversion under a preferential trade arrangement may drastically reduce government revenues, which may not easily be recouped by other tax measures.
- The free movement of goods and services makes the regulation of capital flows more difficult, but not impossible. It is becoming

increasingly more difficult to collect information on income and spending. This impacts on tax collection.

- Currently, global power lies in the hands of economic giants that force the weaker global players to accept solutions that are not optimally suited to their needs, while the stronger players are more successful in pushing their demands through. Increasing regulatory measures, improving legislation, and introducing more democracy to international relations may help to solve this problem.
- International economic integration is believed to lead to the further impoverishment of many poor regions. Poverty is a multidimensional phenomenon, encompassing not only a lack of adequate income, but also a lack of access to basic social services and general social exclusion. Dollar and Kraay (2002) state that those globalisation measures such as trade and investment flows are not systematically linked to income inequality within economies. This leads to the debate as to whether globalisation is leading to the creation of a new world where people are denied access to the benefits of the new global economy.
- A country may also experience the potential loss of political sovereignty over certain issues such as the future direction of interest rates, nominal exchange rate adjustments, taxation and spending programmes.

CHAPTER III. THEORY OF MONETARY INTEGRATION

3.1. Optimum Currency Areas (OCA)

The rationale for any monetary integration is provided by the general framework of the theory of optimum currency area (Mundel 1961). According to Gandolfo (1995), this comprises a group of countries which have a common currency (in which case full monetary integration prevails) or which, though maintaining different national currencies, have permanently and rigidly fixed exchange rates among themselves and full convertibility of the respective currencies into one another; instead, the exchange rates vis-à-vis non partner countries are flexible. The problem consists in determining the optimum domain of a currency area and, specifically, whether the adhesion of a country to a currency area (to be set up or already existing) or its remaining in one is beneficial.

The optimum in currency participation is defined by MacKinnon (1963) as a single currency area within which monetary-fiscal policy and flexible external exchange rate can be used to give the best resolution of three (sometimes conflicting) objectives: (1) the maintenance of full employment; (2) the maintenance of balanced international payments; (3) the maintenance of a stable internal average price level. However, joint consideration of all three objectives is not usually carried out.

There are two approaches to the study of the theory of optimum currency areas. The first is the traditional approach, which attempts to single out one or more characteristics of a region that would indicate the desirability or preferability of a currency area encompassing that region. The second is the cost-benefit approach, which believes that participation in a currency area has both benefits and costs, so that optimality has to be evaluated by a cost-benefit analysis.

This chapter will deal with the two approaches in two sections. The remainder of the chapter examines the costs and benefits, compared.

3.1.1. The traditional approach

In the traditional approach, different authors have singled out several criteria as crucial for a region to be an optimum currency area.

3.1.1.1. International factor mobility

Professor Mundel (1961) was the first writer to perceive the key element of an optimum currency area as being a high degree of factor mobility. Countries between which this mobility is high can participate in a currency area, whilst exchange rates should be flexible between countries with low factor mobility between them. Assume, for example, that there is a decline in the exports of a region to the rest of the same country because of a fall in the demand by the rest of the country for the output of an industry located in that region. The region's income and consumption decrease and, to ease the transition to a situation of lower real income, it is necessary for the region to obtain outside financing to be able to consume more than the value of its output (high mobility of capital, possibly stimulated by policy intervention). Furthermore, the unemployed workers can move to other regions and find a job there (high mobility of labour). A similar process would take place at the international level. It is also clear that, in the absence of the postulated factor mobility, the elimination of the imbalances described above would require exchange rate variations.

However, the usefulness of factor mobility as an adjustment mechanism is doubted by Lanyi (1969) and Corden (1972) among others. Their main objection is an important and somewhat obvious one: that labour is simply not mobile over any considerable distance, even within countries, and cannot be expected to become so in the near future. Continents, even regions, are too culturally, racially, and climatically diverse to permit

this. These writers argue instead that economic adjustment by exchange rate change or macroeconomic policy is still far more viable.

3.1.1.2. Degree of openness

According to MacKinnon (1963), the degree of openness of an economy is measured by the relative importance of the sectors producing internationally traded goods or tradable (both exportable and importable) goods and the sectors producing non-traded goods. A country where traded goods are a high proportion of total domestic output can profitably participate in a currency area, whilst it should adopt flexible exchange rates in the opposite case. Assume that a highly open economy incurs a balance of payments deficit: if this is cured by an exchange rate depreciation, the change in relative prices will cause resources to move from the non-traded goods sector to the traded goods sector, so as to meet the increased (foreign) demand for exports and the higher (domestic) demand for import substitutes. This implies huge disturbances (amongst which are possible inflationary effects) in the non-traded goods sector because of its relative smallness. In this situation it would be more effective to adopt fixed exchange rates and expenditure-reducing policies, which reduce imports, and to free for exportation a sufficient amount of exportable goods, previously consumed domestically.

Arguments against these criteria for the degree of openness are adduced by Machlup (1966). He points out that openness reduces the employment impact of tight financial policy and thus justifies policy adjustment rather than exchange rate adjustment to disturbances. Tight policy affects import demand more as openness increases and thus fewer of the negative effects of the deflation are felt locally. Instead, the tight policy is translated into an effective balance of payments (BOP) adjustment.

Tower and Willett (1976) discuss three reasons why devaluation would increase expenditure and thus, through the multiplier, nullify its BOP

effect. Firstly, they argue that local wealth will increase more for devaluation, the greater the level of openness is. This follows from the fact that wealth holders in open countries are likely to hold a larger proportion of foreign assets than otherwise, to minimise the risks involved in the purchasing power fluctuations common to open economies. Secondly, wealth will also increase after devaluation through the effect of devaluation on the stock of physical capital, the value of which will rise if it is mostly imported. These effects of wealth can be expected to stimulate expenditure regarding any BOP improvement. Finally, Tower and Willett point out that investment expenditure can also be expected to rise after a devaluation if imported investment goods make up a large proportion of investments and if investment plans are relatively fixed.

McKinnon's argument has been criticised on two points. Firstly, Corden (1972) argues that McKinnon's idea of the price instability of exchange rate variation is conditional on the assumption of external, or world price stability. If price instability is the case then flexible rates are more desirable. Secondly, McKinnon has not demonstrated that there is a positive gain in adopting fixed exchange rate, only that the cost of its adoption is less.

3.1.1.3. Product diversification

A country with high product diversification will also export a wide range of different products. If the macroeconomic events which influence the whole range of exports (for example a generalised inflation which causes the prices of all domestically produced goods to increase) are excluded, in the normal course of events commodities with a good or excellent export performance will exist beside commodities with a poor export performance. It is self-evident that these offsetting effects will be very feeble or will not occur at all when exports are concentrated in a very limited number of commodities. On average, the total exports of a country with a high product diversification will be more stable than those of a country with a low one. Since the variations

in exports influence the balance of payments and so - *ceteris paribus* - give rise to pressures on the exchange rate, it follows that a country with high product diversification will have a lesser need for exchange rate changes and so will be able to tolerate fixed exchange rates, whilst the contrary holds for a country having low product diversification.

3.1.1.4. Financial integration

This partially overlaps with the criteria of international factor mobility, but is especially concerned with capital flows as an equilibrating element of payments imbalances. If there is a high degree of international financial integration, no need will exist for exchange rate changes in order to restore external equilibrium, because slight changes (in the appropriate direction) in interest rates will give rise to efficient exchange rates within the area where financial integration exists. It goes without saying that a condition for financial integration is the elimination of all kinds of restrictions on international capital movements. Scitovsky (1969) suggests that adjustment is achieved by wealth transferral less painfully when the degree of capital mobility is higher. This is because the transfer of assets required to correct imbalances is achieved with fewer price and interest rate adjustments in either country.

Further, Ingram (1973) specifies that integration should apply to long-term securities if this means of adjustment is to have any meaningful effect. If capital flows are mostly short-term, the region will lack the fundamental asset market structure required to produce meaningful capital flow adjustment, since short-term securities are transferred too readily and holding them depends on short run interest rate fluctuations. Thus there may exist no true link between the asset markets of countries, albeit that short-term integration is apparent.

The criterion of financial integration is not accepted by all as a compelling reason for the formation of currency area. Fleming (1971) argues that under a fixed exchange rate and in the absence of exchange

control, high capital mobility may lead to harmful speculative short-term capital flows, which aggravate inflation or depression conditions. This will be the case where changes in desired investment exceed or fall short of changes in desired saving, exacerbating inflationary or demand deficient conditions. Ishiyama (1975) points out a further problem with capital flow adjustment: that of the possibility of a lack of enough acceptable assets to enable capital flows of the required magnitude.

3.1.1.5. Inter regional price and wage flexibility

In the presence of exchange rate flexibility, some other method of relative real income adjustment is required to promote payment adjustment. Capital mobility has already been examined as one method, and labour migration is an indirect way of achieving the same thing. Tower and Willett (1976) suggest that through encouraging wage and price flexibility across regions, it is possible to effect a change (increase or decrease) in the real income of a region relative to another without changing the apparent real income within the area, thus minimising the consumption and employment costs. The relative change in real income will force a change in import expenditure, correcting the payments imbalance in the desired direction. For example, a worsening trade balance due to declining export sector demand will be favourably reduced if prices rather than outputs in the export sector drop and translate through to the rest of the economy as a decline in aggregate demand (through the effects of export sector wage reductions). The decline in aggregate demand will then, it is hoped, effect a reduction in imports, although imports need not decline by as much as the initial imbalance if foreign export demand is reasonably elastic (since part of the deficit will be removed by the increase in export demand).

3.1.1.6. Similarity in rates of inflation

Very different inflation rates do, in fact, cause appreciable variations in terms of trade and so, insofar as these influence the flows of goods, give rise to current-account disequilibria, which may require the offsetting of

exchange rate variations. When on the contrary, the rates of inflation are identical or very similar there will be no effect on the terms of trade and so - *ceteris paribus* - an equilibrated flow of current-account transactions will take place (with fixed exchange rates) within the area.

While the logic behind similarity in rates of inflation is compelling, it may not be an important one if inflation rate equalisation is relatively easily achieved, as is suggested by Parkin (1972). Parkin argues that the primary cause of inflation rate divergence is differential monetary expansion and, since he believes in a high level of price and wage flexibility, he therefore suggests that inflation rate equalisation is easily accomplished. This argument, if valid, would tend to de-emphasise the problem of divergent inflation rates.

3.1.1.7. Degree of policy integration

Policy integration can go from simple coordination of economic policies among the various partner countries to a situation in which these surrender their monetary and fiscal sovereignty to a single supranational monetary authority (which is necessary for consistently managing the international reserves of the area and the exchange rates of the partner countries vis-à-vis the rest of the world, for achieving an appropriate distribution of the money supply within the area, etc) and a single supranational fiscal authority (necessary to coordinate those workers who remain employed notwithstanding full labour mobility, etc). It is clear that this ideal situation presupposes complete economic integration, which, in turn, cannot be achieved without some form of political integration.

Fleming (1971) discusses the requirement of symmetry between regions. If problems do not complement each other - for example a - depressed/deficit region and an inflation/surplus region - then policy clashes may result, eventually exacerbating conditions. Then, it will not be possible to look more closely at policy integration.

Finally, Ishiyama (1975) raises the issue of the political aspects of policy coordination. The surrender of political power required to make monetary and fiscal unification work is often considered too severe by national authorities. This is why a full monetary union is often forgone in favour of an exchange rate union, which often proves to be a sub-optimal option.

3.1.2. The Cost-benefit approach

Participating in a currency area involves benefits but also costs, so that to take the best course of action a careful determination of both is necessary, by weighing these costs and benefits through some kind of social preference function. De Grauwe (1992) argues that the costs of a common currency have much to do with the macroeconomic management of the economy, while the benefits are mostly situated at the microeconomic level. It is evident that the final decision will depend on the set of weights chosen, as these may vary from country to country.

3.1.2.1. Costs of a common currency

According to De Grauwe (1992), the costs of a common currency derive from the fact that when a country relinquishes its national currency, it also relinquishes an instrument of economic policy. This can be beneficial for an individual nation in the sense that the use of an exchange rate as a policy instrument, for example, is useful because countries are different in some important senses, requiring changes in the exchange rate to occur.

Relying on the work of De Grauwe, the costs of a common currency can be showed as follows:

3.1.2.1.1. Shifts in demand (Mundel)

Assume that consumers from country A shift their preferences from country B's products. This is presented in aggregate demand in Fig.3.1:

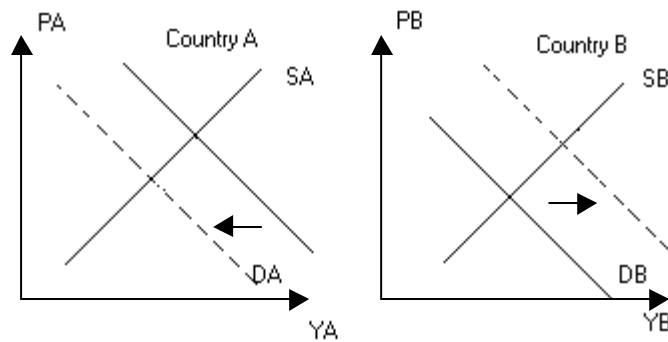


Figure 3.1 Aggregate demand and supply in countries A and B.

SA: Supply curve in country A SB: Supply curve in country B

DA: Demand curve in country A DB: Demand curve in country B

The demand curve is the negatively sloped line indicating that when the domestic price level increases, the demand for domestic output declines. The supply curve expresses the idea that when the price of the domestic output increases, domestic firms will increase their supply, so as to profit from the higher price. The supply curve is drawn under the assumption that the nominal wage rate and the price of other inputs remain constant. An upward movement of the demand curve in country B, and a downward movement in country A, represent the demand shift. The result is that output declines in country A and that output increases in country B. This is very likely to lead to additional unemployment in country A and a decline of unemployment in country B.

There are two mechanisms that will automatically bring back equilibrium in the two countries. One is based on wage flexibility, the other on the mobility of labour (see section 3.1.1.1). Suppose now that wages in country A do not decline despite the unemployment situation, and that the workers in country A do not move to country B; the adjustment to the disequilibria will take the form of inflation in country B. If authorities in country B care about inflation, they will want to resist these inflationary pressures (e.g. by imposing restrictive monetary and fiscal policies). If they want to eliminate them, they will have to

accept the higher inflation. This dilemma can only be solved by revaluing the currency of country B against that of country A. The effects of this exchange rate adjustment are shown in Fig. 3.2. The revaluation of the currency A reduces aggregate demand in country B, so that the demand curve shifts back to the left. In country A the opposite occurs. The devaluation of the currency of A increases the competitiveness of country A's products. This shifts the aggregate demand curve of country A upwards.

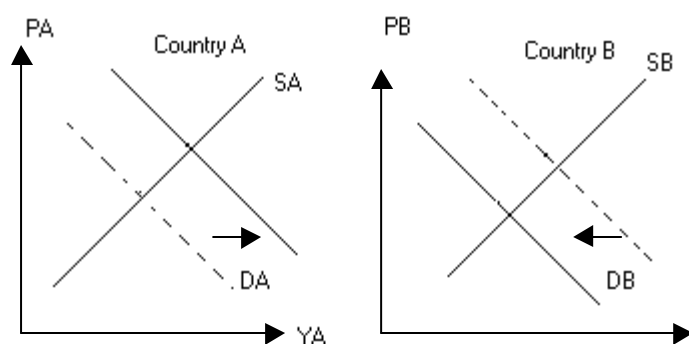


Figure 3.2. Effects of devaluation of the country B.

If country A has relinquished the control over its exchange rate by joining a monetary union with country B, it will be saddled with a sustained unemployment problem, and a current account deficit (current account = domestic output – domestic spending) that can only disappear by deflation in country A. In this sense one can say that a monetary union has a cost for country A when it is faced with a negative demand shock. Similarly, country B will find it costly to be in monetary union with country A because it will have to accept more inflation that it would like.

3.1.2.1.2. Difference preferences of countries regarding inflation and unemployment

The importance of these differences in preferences between countries is developed by De Grauwe (1975). He argues that some countries are less allergic to inflation than others.

Consider two countries, A and B. In Fig.3.3, the Phillips curves of two countries are represented in the right-hand panels. The vertical axis shows the rate of change of the wage rate, while the horizontal axis presents the unemployment rate (assume that these Phillips curves are stable, i.e. they do not shift as a result of changes in expectations of inflation). In the left-hand side panels, the relation between wage changes and price changes is presented. This relationship can be written as follows for the two countries respectively:

$$P'_A = W_A - q_A \tag{1}$$

$$P'_B = W_B - q_B \tag{2}$$

where P'_A and P'_B are the rate of inflation, W_A and W_B are the rates of wage increases, and q_A and q_B are the rates of growth of labour productivity in the two countries (A and B).

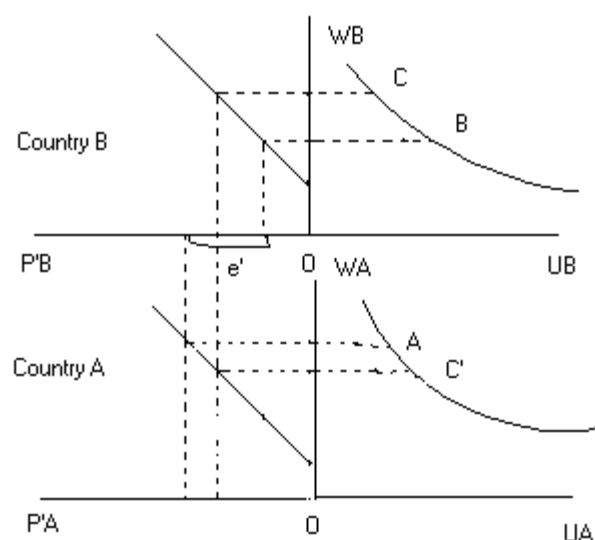


Figure 3.3. Inflation-employment choices in country A and B.

Equations (1) and (2) can be considered to define the rate of price changes that keep profits unchanged (as a percentage of value added). These two equations are represented by the straight lines in the left-hand side panels. Note that the intercept is given by q_A and q_B respectively. Thus, when the rate of productivity increases in country A, the line shifts upwards.

The two countries are linked by the purchasing power parity conditions, formulated as

$$e' = P'_A - P'_B \quad (3)$$

where e' is the rate of depreciation of currency A relative to currency B.

Equation (3) should be interpreted as an equilibrium condition. It states that if country A has a higher rate of inflation than country B, it will have to depreciate its currency to maintain the competitiveness of its products unchanged. If countries A and B decide to form a monetary union, the exchange rate is fixed ($e'=0$), so that the rate of inflation must be equal. If this is not the case, e.g. inflation in country A is higher than in B, country A will increasingly lose competitiveness.

Suppose now that countries A and B have different preferences about inflation and unemployment. Country A chooses point A on its Phillips curve, whereas country B chooses point B. It is now clear that the inflation rates will be different in the two countries, and that a fixed exchange rate will be unsustainable. The cost of a monetary union for the two countries now consists in the fact that if they want to keep the exchange rate fixed, they will have to choose another (less preferred) point on their Phillips curves, so that an equal rate of inflation becomes possible. Such an outcome is given by the points C and C' on the respective Phillips curves. Country A now has to accept less inflation and more unemployment than it would do otherwise, while country B has to accept more inflation and less unemployment.

Another important source of a possible difference between countries is the growth rate of productivity. Suppose that the growth rate of productivity α is higher in country B than in country A. If both countries decide to form a monetary union this implies that the nominal wage increases in country A must be lower than in country B. This can be seen by setting $e'=0$ in equation (3), so that $P'_B = P'_A$.

From equation (1) and (2) it then follows that

$$W_B - q_B = W_A - q_A \text{ or}$$

$$W_B - W_A = q_B - q_A$$

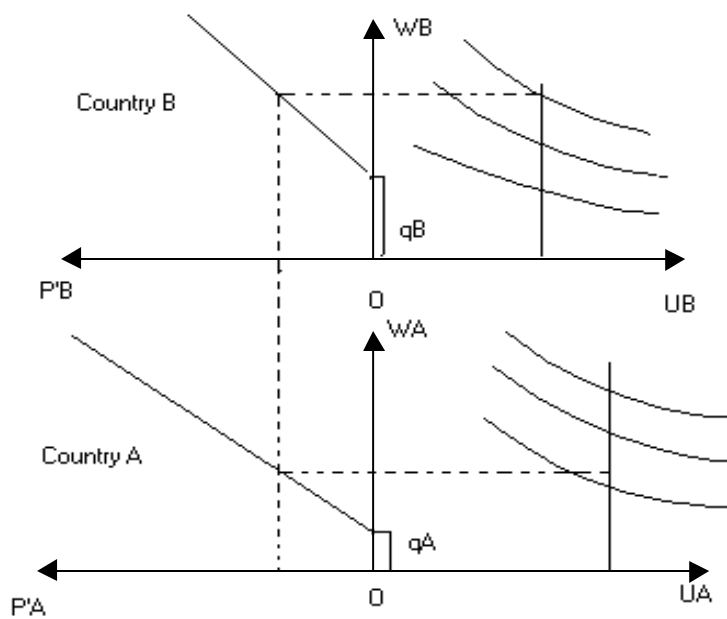


Figure 3.4. Monetary union in a world of vertical Phillips curves

If, following monetary unification, the two countries' labour unions should centralise their wage bargaining and aim for equal nominal wage increases despite the differences in productivity growth, this would spell trouble. The industry in country A would become increasingly less competitive. Therefore, a condition for a successful monetary union is that labour unions should not centralise their wage bargaining when productivity growth rates differ.

3.1.2.1.3. Difference in labour market institutions

Bruno and Sachs (1985) argue that supply shocks, such as the one that occurred during 1979-80 in Europe, have very different macroeconomic effects depending upon the degree of centralisation of wage bargaining. When wage bargaining is centralised, labour unions take into account the inflationary effect of wage increases. In other words they know that excessive wage claims will lead to more inflation, so that real wages will not increase. Things are quite different in countries with less centralised wage bargaining. In these countries individual unions that bargain for higher nominal wages know that the effect of these nominal

wage increases on the aggregate price level is small, because unions only represent a small fraction of the labour force. Each union has an interest in increasing the nominal wage of its members (if it does not do so, the real wages of its members would decline). It is therefore difficult to arrive at wage moderation after a supply shock in countries with decentralised wage bargaining.

Calmfors and Driffil (1988) also show the importance of labour market institutions in a common currency. They noted that the relationship between centralisation of wage bargaining and outcomes is not a linear process. In a very decentralised system of wage bargaining, wage claims will have a direct effect on the competitiveness of a firm, and therefore on the unemployment prospects of individual union members. Excessive wage claims by an individual union will lead to a large reduction of employment. Thus, when faced with a supply shock, unions in such a decentralised system may exhibit a considerable degree of wage restraint. Hence, countries with very different labour market institutions may find it costly to form a monetary union. With each supply shock, wages and prices in these countries may be affected differently, making it difficult to correct for these differences when the exchange rate is irrevocably fixed.

3.1.2.1.4. Growth rates are different

Differences in growth rates could lead to a problem when countries form a monetary union. For example, country A's GDP is growing at 5% per year and country B's GDP at 3% per year. Suppose that the income elasticity of A's imports from B is one, and that similarly B's income elasticity of imports from A is equal to one. Then country A's imports from B will grow at 5% per year, whereas B's imports from A will grow at only 3% per year. This will lead to a trade balance problem for the faster-growing country A, whose imports tend to grow faster than its exports. To avoid that situation, country A will have to reduce the price of its exports to country B, so that the latter country increases its purchases of goods from country A. In other words, country A's terms of

trade must be decreased so as to make its products more competitive. Country A can do this in two ways: by a depreciation of the currency or by a lower rate of domestic price increases than in country B. If it joins a monetary union with country B, however, only the second option will be available. This will require country A to follow relatively deflationary policies, which in turn will constrain the growth process. Thus, a monetary union has a cost for the faster-growing country. It will find it more advantageous to keep its national currency, so as to have the option of depreciating its currency when it finds itself constrained by unfavourable developments in its trade account.

3.1.2.1.5. Different fiscal systems and the seigniorage problem

Different fiscal systems lead countries to use different combinations of debt and monetary financing of the government budget deficit. When those countries join a monetary union, they will be constrained in the way they finance their budget deficits.

The equation below is the government budget constraint:

$$G - T + rB = \frac{dB}{dt} + \frac{dM}{dt} \quad (4)$$

where G is the level of government spending (excluding interest payments on the government debt), T is the tax revenue, r is the interest rate on the government debt B , and M is the level of high-powered money (monetary base).

The left-hand side of equation (4) is the government budget deficit. It consists of the primary budget deficit ($G-T$) and the interest payments on the government debt (rB). The right-hand side is the financing side.

The budget deficit can be financed by issuing debt ($\frac{dB}{dt}$) or by issuing

high-powered money ($\frac{dM}{dt}$). The changes per unit of time are represented

by putting an accent on a variable, thus ($\frac{dB}{dt}$) = B' and ($\frac{dM}{dt}$) = M' .

In the following, variables are expressed as ratios to GDP, thus

$$b = \frac{B}{Y} \quad (5)$$

where Y is GDP, so that b is the debt to GDP ratio.

$$\text{Then, } b' = \frac{B'}{Y} - BY' / Y^2$$

or using (5) and manipulating:

$$B' = b'Y + bY' \quad (6)$$

Substituting (6) into (4) yields

$$b' = (g-t) + (r+x)b - m \quad (7)$$

$$\text{where } g = \frac{G}{Y}, t = \frac{T}{Y}, x = \frac{Y'}{Y} \text{ (the growth rate of GDP) and } m' = \frac{M'}{Y}.$$

Equation (7) can be interpreted as follows. When the interest rate of government debt exceeds the growth rate of GDP, the debt to GDP ratio will increase without limitation. The dynamics of debt accumulation can be stopped only if the primary budget deficit (as per cent of GDP) turns into a surplus (($g-t$) then becomes negative).

Alternatively, large debt accumulation can be stopped by a sufficiently large revenue from money creation. The latter is also called seigniorage. It is clear, however, that the systematic use of this source of finance will lead to inflation. The question remains under what conditions the debt to GDP ratio will stabilise at a constant value. Equation (7) gives the answer.

Set $b' = 0$. This yields $(r - x) b = (t - g) + m$.

Thus, if the interest rate exceeds the growth rate of the economy, it is necessary that either the primary budget shows a sufficiently large surplus or that money creation is sufficiently extensive to stabilise the debt to GDP ratio.

The theory of optimum public finance (Fischer, 1982) now tells us that rational governments will use the different sources of revenue so that the marginal cost of raising revenue through these different means is equalised. Thus if the marginal cost of raising revenue by increasing taxes exceeds the marginal cost of raising revenue by inflation

(seigniorage), it will be optimal to reduce taxes and to increase inflation.

The preceding also means that countries will have different optimal inflation rates. In general, countries with an underdeveloped tax system will find it more advantageous to raise revenue by inflation (seigniorage). Put differently, a country with an underdeveloped fiscal system experiences a large cost in raising revenue by increasing tax rates. It will be less costly to increase government revenue by inflation.

This reasoning leads to the following implication for the costs of a monetary union. Less developed countries, which join a monetary union with more developed countries that have a low rate of inflation, will also have to lower their rate of inflation. This then means that, for a given budget deficit, they will also have to increase taxes. There will be a loss of welfare. This was a particularly acute problem for the Southern European economic countries in the EU. Because they have joined the low-inflation northern monetary zone, they had to increase taxes, or let the deficit increase further. For these countries the cost of a monetary union stems from the fact that they had to rely too much on a costly way of raising revenue.

3.1.2.2. Benefits of common currency

The major benefit of common currency concerns the reduction of the transaction costs of currency conversion and the elimination of risk due to the uncertainty about exchange rate fluctuation, and this enhances allocative efficiency. Following the already cited work of De Grauwe (1992), this section will analyse in detail the benefits of joining a monetary union for a country.

3.1.2.2.1. Direct gains from the elimination of transaction costs

The most visible and easily quantifiable gain of monetary union is the elimination of the costs of exchanging one currency into an other.

However, these gains that accrue to the general public have a counterpart in the banks' revenues. Surveys in the European Community indicate that about 5% of the banks' revenues comprise the commission paid to banks in the exchange of national currencies. In the situation of a common currency, banks will have to look for other profitable activities and their employees who were previously engaged in exchanging money, will now be free to perform more useful tasks for the banks.

De Grauwe (1992) argues that the gain from the elimination of transition costs can only be reaped when national moneys are replaced by a common currency. The reason for this argument is that as long as national currencies remain in existence, even if the exchange rate is "irrevocably" fixed, doubt will continue to exist as to this fixity. In other words, national currencies will not be perfect substitutes.

3.1.2.2.2. Indirect gains from eliminating transaction costs

The indirect gains from eliminating transaction costs derive from the reduction of the scope for price discrimination between national markets. Evidence from the European Community (1988) shows that, although there was agreement on a single market, in the UK the same automobiles were about 60% more expensive than in Denmark and 30% more expensive than in Belgium (net of taxes). In the case of a common currency, consumers would not hesitate to purchase these goods in the countries where they are cheaper. Of course, there are many sources of transaction costs (administrative regulations, differences in taxation), and eliminating the cost of buying and selling foreign currencies may not even be the most important one.

3.1.2.2.3. Welfare gain from less uncertainty

Uncertainty about future exchange rate changes introduces uncertainty about the future incomes of firms. De Grauwe argues that it is generally accepted that uncertainty leads to a loss of welfare in a world populated

by risk-averse individuals. These will, generally speaking, prefer a future return that is more certain than one that is less so, at least if the expected value of these returns is the same. Put differently, they will only want to take the more risky return if they are promised that it will be greater than the less risky. Eliminating the exchange risk reduces a source of uncertainty and therefore increases welfare.

3.1.2.2.4. Exchange rate uncertainty and price mechanism

Economic agents base their decisions concerning production, investment, and consumption on the information that the price system provides for them. If these prices become more uncertain the quality of these decisions will decline. A well-known example is the appreciation of the dollar during 1980-85, which was largely unpredicted and which went much farther than the inflation differential between the US and the other industrial countries. This “misalignment” led to large and unpredicted changes in the profitability of many American industrial firms, which were obliged to compete in world markets. A few years later the dollar depreciated substantially and more than corrected the real appreciation of the first half of the 1980s. These large real exchange rate movements led to large adjustment costs for the American economy. Thus, a decline in real exchange rate uncertainty, due for example to the introduction of a common currency, could reduce these adjustment costs.

It is also known that an increase in risk, due to price uncertainty, will in general increase the real interest rate. This follows from the fact that when the expected return on investment projects becomes more uncertain, risk-averse investors will require a higher risk premium to compensate them for the increased riskiness of the projects. In addition, in a riskier economic environment, economic agents will increase the discount rate at which they discount future returns. Thus, exchange rate uncertainty, which leads to this kind of increased systemic risk, also increases the real interest rate.

Higher interest rates, however, lead to increased problems in selecting investment projects in an efficient way. Eliminating the exchange risk by moving towards a common currency will reduce the amount of risky projects that are selected by the market and lead to a more efficient functioning of the price mechanism.

3.1.2.2.5. Exchange rate uncertainty and economic growth

The elimination of exchange risk can therefore lead to an increase in economic growth. This can be illustrated by using the neoclassical growth model, and its recent extension to a situation of dynamic economies of scale. The model is presented in Fig.3.5.

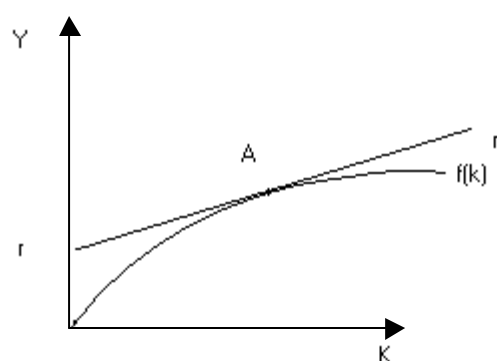


Figure 3.5. The neoclassical growth model

Where K = capital stock per worker

Y = output per worker

Equilibrium in the model is obtained where the marginal productivity of capital $f(k)$, is, equal to the interest rate consumers use to discount future consumption (rr). This is represented by the point A in Fig. 3.5, where the line rr is tangential to the production function. Suppose that the elimination of the exchange risk reduces the systemic risk so that the real interest rate declines (Fig.3.6). The reduction of the risk-adjustment rate of discount makes the rr line flatter. As a result, the equilibrium moves from A to B. There will be an accumulation of capital and an increase in the growth rate while the economy moves from A to B. In the new equilibrium, the output per worker and the capital stock he

has at his disposal will have increased. Note, however, that the growth rate of output then returns to its initial level, which is determined by the exogenous rate of technological change and the rate of growth of the population. Thus, in this neoclassical growth model, the reduction of the interest rate due to the monetary union temporarily increases the rate of growth of output. In the new equilibrium, the output level per worker will have increased: note also that the productivity of capital has declined.

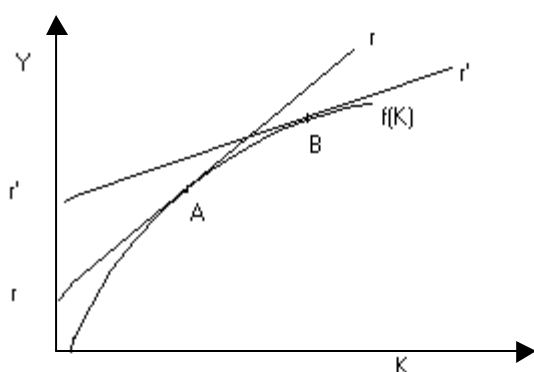


Figure 3.6. The effect of lower risk in the neoclassical growth model

3.1.2.2.6. Benefits of monetary union and the openness of countries

The welfare gains of a common currency that have been identified in the above chapter are likely to increase with the degree of openness of an economy. For instance, the elimination of transaction costs will weigh more heavily in countries where firms and consumers buy and sell a large fraction of goods and services in foreign countries. Similarly, the consumers and firms in these countries are more subject to decision errors because they face large foreign markets with different currencies. Eliminating these risks will lead to a larger welfare gain (per capita) in small and open economies than in large and relatively closed countries. The relationship between the benefits of a common currency and the openness of countries that are candidates for a union can be represented graphically (Fig.3.7).

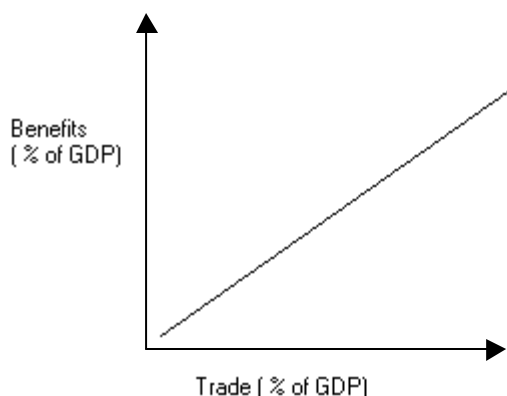


Figure 3.7. Benefits of a monetary union and openness of the country

On the horizontal axis is shown the openness of the country relative to its potential partners in a monetary union (measured by the share of their bilateral trade in the GDP of the country considered). On the vertical axis are represented the benefits (as a percentage of GDP). With an increasing openness towards the other partners in the union, the gains from a monetary union (per unit of output) increase.

3.2. Costs and benefits compared

Fig.3.8 combines the figures relating benefits and costs to the openness of a country. The intersection point of the benefit and the cost lines determines the critical level of openness that makes it worthwhile for a country to join a monetary union with its trading partners. To the left of that point, the country is better off keeping its national currency. To the right, it is better off when it relinquishes its national money and replaces it with the money of its trading partners.

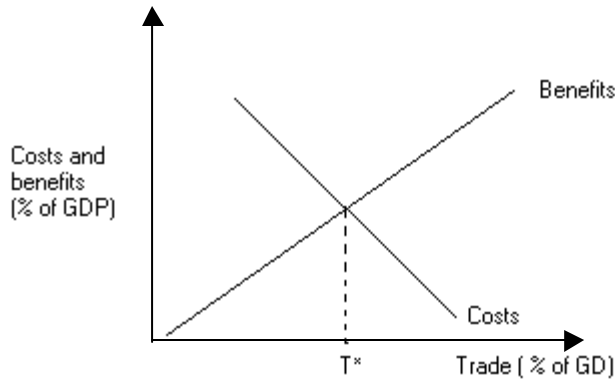
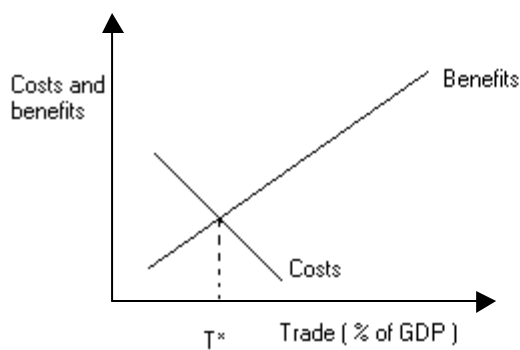


Figure 3.8. Costs and benefits of a monetary union

There are two interpretations of Fig.3.8; at one extreme, there is a view, termed “monetarist”, claiming that exchange rate changes are ineffective as instruments to correct for these different developments between countries. And even if they are effective, the use of the exchange rate policies typically makes countries worse off. In this monetarist view the cost curve is very close to the origin (Fig.3.9(a)). The critical point that makes it worthwhile to form a union is close to the origin. Thus, in this view, many countries in the world would gain by relinquishing their national currencies, and by joining a monetary union.

(a) The monetarist view



(b) The Keynesian view

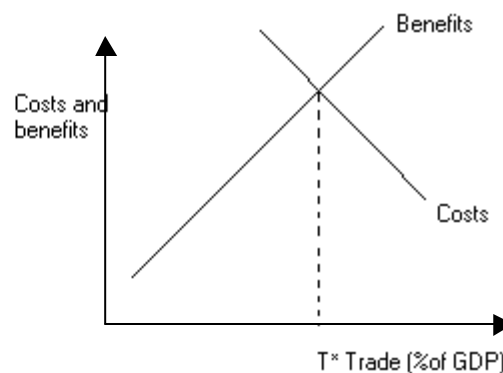


Figure 3.9. Costs and benefits of a monetary union: different views

At the other extreme, there is the Keynesian view that the world is full of rigidities (wages and prices are rigid, labour is immobile), so that the

exchange rate is a powerful instrument in eliminating disequilibria. In this view, the cost curve is far away from the origin, so that relatively few countries should find it to be in their interest to join a monetary union.

The above analysis leads us to the question about the issue of whether a country would benefit from a monetary union. One can answer that the cost-benefit calculus is likely to produce very different results for the different countries that would join a monetary union. For some countries with a large degree of openness relative to the other countries who are their partners, the cost-benefit calculus is likely to tilt towards joining a monetary union. For other countries that have a relatively low openness toward the rest of the zone, the case for joining a monetary union does not appear to be overwhelming. However, some countries with a low trade share in the zone may nevertheless find it advantageous to join a monetary union. The case of credibility issues makes it clear that high-inflation countries might decide that it is in their interest to join a monetary union despite the fact that their share of trade with the members of the union is relatively low. The “monetarist” view argues that for countries with such a low degree of openness, the benefits could also make sense for them from an economic point of view.

The cost-benefit calculus of a monetary union is also greatly influenced by the degree of wage and price rigidities. Countries in which the degree of wage and price rigidities is low, experience lower costs when they move towards a monetary union (Fig.3.10).

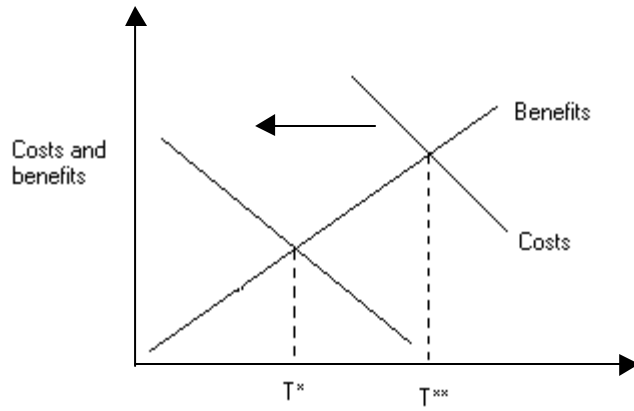


Figure 3.10. Costs and benefits with increasing rigidities

A decline in wage and price rigidities has the effect of shifting the cost-line in Fig.3.10 downwards. As a result, the critical point at which it becomes advantageous for a country to relinquish its national currency is lowered. More countries become candidates for a monetary union. In a similar way, an increase in the degree of mobility of labour shifts the cost curve to the left and makes a monetary union more attractive.

CHAPTER IV. ECONOMIC INTEGRATION IN AFRICA

4.1.Introduction

Many African countries have changed since the end of their struggles for independence. Africa's economies have expanded, modern communications have speeded up the acquisition of knowledge and conducting of business, and a sizeable elite enjoys a standard of living on a par with any others in the richer world (Kayizzi, 1999). However, since the 1980s African states, like other developing areas, have had to face the crises of declining living standards, inadequate social services and education, weak institutions, low volumes of foreign investment, high external debt, high inflation, weak currencies, political and economic instability. Over-reliance on the public sector for economic development, war and insurrection, rapid population growth, deteriorating terms of trade for raw materials, massive unemployment, growing urbanisation, environmental degradation and HIV/AIDS are typical areas of concern for African countries. Economic and monetary integration is more complex in Africa, due to the different stages of development within the continent.

Kimuyu (1999) states that, in terms of economic arrangements, the fear of African countries is that, while they are too weak to resist external pressure for concessions, they are equally unable to exert much influence on the emerging configurations. He argues that, in recent gatherings, countries in Africa have emphasised economic cooperation as the basis of their individual and collective prosperity. This change of attitude, coupled with rapidly changing domestic economic structures, may provide the continent with a better bargaining position in its efforts to derive more benefit from the expanding global economy.

Economic cooperation very often focuses only on trade related topics, but for Africa in general, integration can also be seen as "a vehicle for reduction of economic and political dependence upon countries" (Weeks,

1996:7). The purpose of this chapter is to analyse the regional integration schemes in Africa in the perspective of the rapidly changing global economy. The chapter reviews the economic integration experience in Africa, discusses impediments to the success of regionalism in Africa and considers requirements that could make it more effective under African conditions.

4.2. Prerequisites for economic integration in Africa

In 1991, governments of the Organisation of African Unity (OAU) recognised that the economic integration of the continent is a prerequisite for the realisation of the OAU and signed the Treaty establishing the African Economic Community (the Abuja Treaty). The objectives of the community that was established (in principle) by the Abuja Treaty are to: increase economic self-reliance, promote an endogenous and self-sustained development, and raise the standard of living of African people, in order to promote economic development on the continent.

The Abuja Treaty emphasises social, cultural and economic integration as the means by which economic development will be achieved on the continent, but it downplays political integration as a necessary factor in the search for social, cultural and economic integration and, ultimately, economic development. Mukisa and Thompson (1995) state that the Treaty mentions the concept of political integration only once, and even then, only in passing. They add that by downplaying the importance of political integration on the continent, the Treaty fails to meet the requirements for the attainment of its objectives. So much depends on political integration that any model ignoring, or even downplaying, the importance of that factor is bound to be, in the final analysis, of limited use to proponents of economic development on the continent.

The United Nations Economic Commission for Africa (ECA), along with the OAU member states, has held that economic development on the continent can best be achieved through economic integration. This

position is based on the belief that many African states are too small to be economically viable. According to Adedeji (1992), the head of ECA, “more than ever before, Africa needs fundamental change and transformation - political, economic, social and cultural”.

The Abuja Treaty included in the modalities establishing the AEC “the free movement of people, goods, capital and services, as well as the provisions herein regarding the rights of residence and establishment” and the “integration of all sectors namely economic, political, social and cultural”. This highlights the relevance of social integration to the goal of economic integration.

Mukisa and Thompson (1995) assume that frequent contact and communication lead people to get to know one another better and, hopefully, to abandon stereotypes and caricatures of one another. This may merge them together politically and then encourage social integration through removal of barriers to such integration.

Other factors leading to social and cultural disintegration include institutionalised racism (as in apartheid South Africa), religious conflict, extreme nationalism, national boundaries, ignorance (narrow world views), unenlightened political leadership, etc.

The resolution of these problems requires a certain degree of political integration. Without this, it is difficult to see how social and cultural integration will be achieved, since the latter will always be held hostage to the political relations among the partner states. Furthermore, political integration can lead to international peace by reducing the number of potential contestants in the political and military arenas, and to economic saving by reducing the number of standing armies on the continent and pooling security costs.

4.3. African integration schemes

During the OAU summit in 1973, a declaration on economic independence, development and cooperation was adopted, which compelled member countries to establish procedures and mechanisms for co-ordinating trade policies in order to move the continent towards economic growth, via joint trade and development institutions. Further, a “Lagos Plan of Africa” was drawn up in 1980 under which African governments committed themselves to pursuing collective self-reliance and the strengthening of existing groupings, as well as initiating new ones. The ultimate goal was the creation of an African Economic Community (AEC) by the year 2000.

African regional integration schemes have either failed or have stayed in existence only on paper, with very little progress towards taking the measures that would be necessary to make them happen. The AEC is very specific in its goals to accomplish its objectives, but it is facing the same obstacles that the other regional attempts experienced. There is also no guarantee that African leaders will place continental interest above nationals' interest. There is generally a fear among member countries that the degree of economic integration benefits depends on the level of each country's economic development and the size of their domestic economy. The AEC will address this problem by granting special assistance to the least developed, landlocked, semi-landlocked and island countries.

Recently, the New Partnership for Africa's Development (NEPAD) was presented to African leaders at the OAU Summit in Lusaka in July 2001, and was endorsed by the Summit. NEPAD is a holistic, integrated sustainable development initiative for the economic and social revival of Africa (NEPAD progress report, 2002). According to this report, it constitutes a pledge by African leaders, based on a common vision and a firm and shared conviction that they have a pressing duty to the African people to eradicate poverty and to place their countries, both individually and collectively, on a path of sustainable growth and

development and, at the same time, to participate actively in the world economy and body politic. NEPAD is the socio-economic development blueprint for the Africa Union to implement its objectives, and it is the mechanism for accelerating the implementation of the Abuja Treaty.

4.3.1. The Economic Community of West African States (ECOWAS)

4.3.1.1. Background

ECOWAS is an important grouping that includes French and English speaking countries. It was founded in 1975 with fourteen members, namely Benin, Burkina-Faso, Cote d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, Togo, Nigeria, Ghana, Guinea, Liberia, Sierra-Leone and Gambia. Cape Verde joined in 1977.

The goal of ECOWAS is to promote greater adoption of a common industrial policy, and ensure a fair distribution of benefits from economic integration.

In April 2000, six of the ECOWAS countries (Gambia, Ghana, Guinea, Liberia, Nigeria and Sierra-Leone) declared their intention to adopt a common currency by January 2003 and to work towards merging their planned monetary union with the West African Economic Union (WAMU) by January 2004. The objective of the West African Monetary Zone (WAMZ) is to merge with the CFA (Communaute Financiere Africaine). The CFA zone has been in existence since the colonial period and was the first monetary zone, formed by francophone countries, in the region. The region is the most populous and economically, as well as culturally, the most diversified of the Sub-Saharan African groupings (World Bank, 2002).

4.3.1.2. Objectives of ECOWAS

The overall objective of ECOWAS is to promote cooperation and integration in order to create an economic and monetary union for

encouraging economic growth and development in West Africa. In order to do this, the following actions are envisaged:

- the suppression of customs duties and equivalent taxes;
- the establishment of a common external tariff;
- the harmonisation of economic and financial policies;
- the creation of a monetary zone.

However, the slowness of the realisation of those actions has led ECOWAS member states to revise the 1975 Treaty. The principles of supranationality in the application of decisions and the autonomous funding of the budgets of the institutions have been introduced. Furthermore, the creation of supranational institutions of control and arbitration has been envisaged in the application of decisions, regarding a court of justice, a parliament and an economic and social council.

4.3.1.3. Convergence criteria

In order to reflect the wish to harmonise the ECOWAS economic policies within the framework of the objectives of the revised Treaty and to accelerate the creation of an ECOWAS monetary zone, member states spelt out in 1997 some objectives regarding convergence indicators.

The convergence criteria, which will be closely monitored within the framework of the monetary cooperation programme, have been expanded as follows:

4.3.1.3.1. Primary criteria

Member states should adhere strictly to the following four criteria which have been chosen for their usefulness in the assessment of the degree of macroeconomic stability attained and, particularly, for the achievement of the internal and external balance of the economies of member states. These will render the proposed single currency more viable:

- ratio of budget deficit (excluding grants) to GDP. This will be calculated on the basis of commitment and should be lower than 4 per cent by the year 2002;
- inflation rate: 5 per cent by 2003;
- central bank financing of budget deficit limited to 10 per cent of the previous year's tax revenue. Member states to comply by 2003;
- gross revenues: gross external reserves should represent no less than six months of imports by 2003.

According to Anon (2001), up until 2000, only Gambia had met all criteria, Nigeria, the domineering economy, had met three, Guinea two and Ghana and Sierra Leone one. Failure to meet the criteria was apparently due to external factors like sharp declines in the prices of cocoa and gold during 1999 and increases in oil prices. This especially affected Ghana negatively. However, Nigeria and Gambia have both now satisfied the convergence criteria for joining the WAMZ.

4.3.1.3.2. Secondary criteria

Member states should also adhere to the secondary criteria, which are designed to sustain the primary criteria and facilitate achievement of the convergence targets:

- prohibition of new domestic arrears and liquidation of all existing arrears;
- tax revenue/GDP ratio equal to or more than 20 per cent;
- wage bill/tax revenue equal to or less than 35 per cent;
- real exchange rate stability;
- interest rates: countries must maintain positive real interest rates;
- public capital expenditure/ tax revenue ratio: equal to or more than 20 per cent.

In spite of the difficulties, ECOWAS has chalked up remarkable progress in certain areas, like the free movement of persons, telecommunication, and roads (World Bank, 2000). It is in the area of

economic integration that the efforts of the community have been most frustrating. In fact, the trade liberalisation schemes are not yet operational, as shown by the lower level of the intraregional trade, which is only 11 per cent as compared to trade within the third countries. Besides, the common ECOWAS external tariff has still not seen the light of day and the economic and financial policies have not been harmonised although a framework has been established for this.

4.3.1.4. Achievements and prospects of ECOWAS

As said above, ECOWAS has made remarkable progress in the area of free movement of persons, construction of regional roads, development of telecommunication links between the states and maintenance of peace and regional security. However, numerous problems have been encountered by ECOWAS in the enhancement of the process of regional integration of West Africa. Among the most important of those problems are: the political instability and bad governance that have plagued many of the countries; the weakness of the national economies and their insufficient diversification; the insufficient political will exhibited by some member states; the multiplicity of organisations for regional integration with the same objectives; the failure to involve civil society, the private sector and mass movements in the process of integration; and the economic and political dominance of France over its former colonies is adding to intra-regional conflicts (Danso, 1995).

There are, however, promising signs which indicate better prospects for the future. Among these are: the advent of democracy in most ECOWAS countries, particularly in Nigeria which is the dominant economy in the region; the gradual withdrawal of the states from the sectors of productive activity, and the realisation that the private sector must be the mainspring of growth and economic integration; the adoption of a strategy for accelerating the ECOWAS process of integration in order to create a single regional market based on trade liberalisation, to establish a common external tariff and harmonise economic and financial policies; the harmonisation of the programmes of ECOWAS and UEMOA in

connection with the acceleration of the process of integration in West Africa; the common challenge that is thrown down by the creation of trade blocs in other regions of the world and by globalisation, which risks marginalising Africa; this makes it necessary to accelerate the transitions towards an autonomous and self-financed development within the framework of African integration.

4.3.2. The Common Market for Eastern and Southern Africa (COMESA).

4.3.2.1. Background

COMESA was established in November 1983 by a treaty which entered into force in 1984. Its membership comprised a total of twenty-two states: Angola, Burundi, The Comoros, Djibouti, Ethiopia, Kenya, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Rwanda, The Seychelles, Somali, Sudan, Swaziland, Tanzania, Uganda, Zambia and Zimbabwe. The preamble of the COMESA Treaty makes provision for both Botswana and South Africa to join the regional grouping upon fulfilment of such conditions as may be determined by the COMESA Authority. As of now, South Africa remains a non-member of COMESA. This organisation was set up to replace the Preferential Trade Area (PTA) for Eastern and Southern Africa, the objectives of which were: to create trade within the Eastern and Southern African region and to divert trade away from the then apartheid South Africa. The process of economic integration under this regional integration scheme has now progressed from a preferential trade area and is designed to have three phases. The first phase relates to the establishment of a preferential trade area. This is followed by the conversion into a common market. Finally, it is expected that the common market will become an economic community.

4.3.2.2. Objectives of COMESA

Article 3 of the COMESA Treaty states the following as the main objectives:

- To attain the sustainable growth and development of the Member States by promoting a more balanced and harmonious development of their production and marketing structure;
- To promote joint development in all fields of economic activities and joint adoption of macro-economic policies and programmes to raise the standard of living of their people and foster closer relations among their Member States;
- To co-operate in the creation of an enabling environment for foreign, cross border and domestic investment, including the joint promotion of research and adaptation of science and technology for development;
- To co-operate in the promotion of peace, security and stability among Member States in order to enhance economic development in the region;
- To co-operate in strengthening the relations between the Common Market and the rest of the World and the adoption of common positions in the international scene;
- To contribute towards the establishment, progress, and realisation of the objectives of the African Economic Community.

In addition to the above objectives, the COMESA Treaty deals with the need for COMESA Member States to harmonise their monetary and fiscal policies so that a much more efficient allocation of resources within the Common Market can be realised. The Treaty also spells out the need for states to establish currency convertibility. The accomplishment of this objective by COMESA Member States would greatly facilitate the setting up of a regional stock exchange and at the same time encourage the foundation of a currency union.

4.3.2.3. Monetary and Fiscal Policies Harmonisation Programme

In 1992, COMESA Member States adopted a Monetary and Fiscal Policies Harmonisation Programme towards the establishment of a

monetary union in the year 2025. This programme has the following stages:

Stage one (1992-1996): consolidation of existing instruments of monetary cooperation and implementation of policy measures aimed at achieving macroeconomic convergence. To gauge progress towards this objective, convergence criteria were formulated;

Stage two (1997-2000): introduction of limited currency convertibility and an informal exchange rate union;

Stage three (2000-2004): formal exchange rate union and coordination of economic policies by a common monetary institution; and

Stage four (2025): full monetary union involving the use of one common currency issued by a common central bank.

The ultimate objective of the above programme is to establish a monetary union as shown at stage four, and thus enable the common market to attain the status of an Economic Community.

To achieve the eventual goal of a full monetary union, there is a need for member states to begin preparing themselves now for this eventuality by developing a coordinated management strategy and promoting national actions towards policy coordination and harmonisation. It is, therefore, essential for the member states to increase interaction among themselves on policy matters by exchanging information on economic developments in individual member countries and on the policy instruments used to influence them.

4.3.2.4. Macroeconomic Convergence Criteria

In order to assess the progress being made towards an Monetary and Fiscal Harmonisation Programme, a number of convergence criteria were formulated, with a view of gauging the progress being made by the member states in the implementation of the programme. The objective of this is to detect obstacles that could stand in the way of implementation and to allow for the expeditious implementation of remedial measures, so that the member states would have achieved sufficient

macroeconomic convergence to set the stage for moving to monetary union.

These macroeconomic indicators are:

Use of market determined exchange rates: rate of the parallel to the official exchange rate, the real effective exchange rate, and inflation rates;

Harmonisation of fiscal policies: (a) a maximum level of the percentage of fiscal deficit to GDP of 4.5 per cent, annually decreasing to 3 per cent by the end of 1996; (b) a limit of 10 per cent GDP of claims by the central government; (c) a central bank financing of the budget deficit limited to not more than 20 per cent of the previous year's fiscal revenue, in order to harmonise limits on inflationary financing; (d) an increase in tax revenue to at least 10 per cent to GDP by 1996, increasing thereafter by one percentage point annually;

Other indicators of macroeconomic convergence: (a) moderate monetary expansion involving setting of periodic targets for the growth of money supply, money (M1) and quasi money (M2), with an indicative growth rate for money supply derived from multiplying the rate of growth of GDP by one plus the considered tolerable inflation rate plus a margin not exceeding five per cent; (b) adequate flow of credit to the private sector; (c) eliminating of direct credit controls on bank lending; (d) deregulation of interest rates and progressive dismantling of interest rate ceilings; (e) use of indirect instruments of monetary control such as reserve requirements, changes in discount rates and open market operations, according to the stance of the current monetary policy.

4.3.2.5. Obstacles to the success of COMESA as an economic and monetary bloc

The economic rationale behind the development of a regional African trade zone is based on the expectation that free trade will help ensure regional market access for local producers, thereby enabling the region to develop with a greater degree of economic predictability. It is also a step away from dependency on northern markets, which continue to

present African exports with numerous impediments despite several agreements with the first world (Cotonou Agreement, Lome Convention...).

By no means exhaustive, the list of factors below provides a glimpse of the number, magnitude and complexity of impediments to an integrated economic and monetary bloc.

4.3.2.5.1. The challenge of an underdeveloped economic infrastructure

Ndulo (1993) argues that the economic infrastructure in Africa is inadequate to support economic integration. He observes that one of the major constraints on the growth and development of inter-African trade has been the inadequacy of payment and financial systems: "Increased African trade will need finance and financial instruments such as banking networks providing letters of credit, export credits and other financial services". In addition, the political will amongst COMESA member states must be strong before the organisation can begin to think of achieving its goals.

4.3.2.5.2. The self-interest agenda as a constraint to integration

In many parts of the world, different states have different ideologies and often pursue different economic policies at different times. Strong commitment to pursue different national goals militates against the idea of regional integration.

The self-interest problem, which is understandably widespread in COMESA member states, has increasingly become acute in the light of the IMF and the World Bank Structural Adjustment Programs (SAPs). The similarity of IMF and World Bank policy strings, called conditionality, attached to the loans given to many COMESA countries has led to identical measures and programmes in these countries. Privatisation (as part of conditionality) is now being embarked upon at a

competitively hurried pace in many COMESA member states. Foreign investment is being sought ambitiously.

It is hence evident that the harmonisation of, say, national fiscal policies in the region will not be easy to achieve because of the unwillingness of many COMESA member states to forgo some of their so called “national priorities”. Yet national priorities must be seen as complementary to regional interest if regional integration is to succeed in Africa.

4.3.2.5.3. Lack of a supra-national state policing institution

Another problem facing the COMESA regional integration scheme is the absence of a supra-national state policing system. It is well established that international law has limited mechanisms for policing states (Cassese, 1994). The lack of a supra-national institution to enforce treaty obligations and to police member states is a major shortcoming of many regional integration schemes. The COMESA integration scheme is not free from this problem.

4.3.2.6. Political tranquillity as a prerequisite to regional integration

Ndulo (1993) argues that no matter how good the arguments look on paper, the political environment for their implementation and preservation must be right for the effort to succeed. He observes further that economic cooperation and integration flourish better in an environment that is politically peaceful and stable. But sometimes political tranquillity will not facilitate effective regional integration. To illustrate this, the ending of apartheid in South Africa has promoted a period of intense instability in the established regional trading arrangements, a point that Cibb (1997) makes when he states: “In May 1994, South Africa was formally invited to join COMESA. However, South Africa declined the invitation and, as a consequence, other SADC member states that are also members of COMESA delayed ratification of the 1993 COMESA Treaty”. South Africa’s refusal to join COMESA

prompted the then Secretary-General of COMESA to warn South Africa that it could face punitive economic tariffs. Nevertheless, at the September 1995 SADC Summit meeting held in Johannesburg, member states (of the SADC) decided that dual membership of SADC and COMESA was incompatible and that SADC states should resign their membership of COMESA.

4.3.3. The Southern African Development Community (SADC)

4.3.3.1. Background

The Southern African Development Coordination Committee (SADCC) was founded in 1980 to galvanise the “front-line states” in their struggle against apartheid South Africa, and was later broadened to include the former enemy itself (Kimuyu, 1999). It was also created with the purpose of reducing the dependence of the region on South Africa and of seeking foreign financial support for development projects that could not be undertaken by any of the individual countries alone.

Kimuyu (1999) points out that treaties to upgrade interaction between member countries were signed, an overriding concern being to ensure that socio-economic differences among countries did not lead to political instability. He adds that cooperation was established in a vast number of areas and the grouping was renamed the Southern African Development Community (SADC). It is also argued by him that with the entry of the Democratic Republic of Congo, SADC has one of the world’s highest concentrations of non-oil mineral producers and thus some serious global leverage.

SADC was founded with the aims of establishing a free trade area and moving towards an economic community. When South Africa joined SADC in 1994, the prospect of Southern African integration became realisable (Morna, 1994). Member states include Angola, Botswana, Democratic Republic of Congo, Lesotho, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Tanzania,

Zambia and Zimbabwe. The new organisation focuses on production, investment and intra-regional trade (Morna, 1994). Cooperation in the areas of security, peace, democracy and conflict resolution has become a major goal.

The cornerstone of regional economic integration in SADC is the Trade Protocol, which has the goal of increasing intra-regional trade to 35 per cent by 2004 from the 25 per cent in 2000, with an ultimate goal of 85 per cent by 2008. As a result, South Africa has dropped its intra-regional tariffs by 76 per cent in 2001, Mauritius by 51 per cent, Malawi by 41 per cent, and Zimbabwe by 30 per cent (Anon, 2001). However, trade promotion and the ability to attract foreign direct investment depends on a country's and region's macroeconomic performance.

4.3.3.2. Macroeconomic environment of the SADC region

According to Anon (2001), there are some 190 million people in the fourteen SADC countries and, at current rates of growth (average of 2.5 per cent annually), almost all of these will double their populations within the first two decades of the 21st century. As economic growth is unlikely to average more than 2 to 2.5 per cent annually across the region, this implies a steadily declining rate of per capita income.

The issue of HIV/AIDS will be of increasing relevance to both demographic and economic development. Many authors argue that, while it will significantly curtail population growth, it will also hold back increases in GDP. Thus, population growth will be lower in the future due to the impact of AIDS, and mortality rates are also expected to increase in children under the age of five, due to the transmission of the HIV/AIDS virus from mother to child (Du Toit, 2000).

The area occupies about 9.3 million square kilometres, with enormous reserves of gold, diamonds, copper, uranium, nickel and cobalt. Rivers cover almost half of the region and this creates huge potential for the development of irrigation, hydropower, fisheries and tourism.

By the early 1980s, all member states had experienced the Structural Adjustment policies, sponsored primarily by the World Bank and the IMF. These involved a reduction of state control over economies, the liberalisation of internal markets, an opening to international competition, the market adjustment of currency exchange mechanism, a positive attitude towards foreign investment, the privatisation of state-owned enterprises and the promotion of private enterprise in general. But results have thus far tended to be disappointing. Real annual GDP has barely increased by 1.5 per cent between 1980-90, the growth of the manufacturing industry has not significantly improved; exports continue to contain mostly primary commodities (Anon, 2001).

However, recent periods show an increase of growth for the SADC region generally. In 2002, the regional growth rate reached 3.4 per cent compared to 1.8 per cent in 2000.

Anon (2001) argues that while the volume of exports has increased substantially, their value has declined drastically, leading to weak and disadvantaged participation in the global economy. In the same period, the regional external debt was more than US \$ 79 billion in 2000.

It is believed that SADC could be more successful than other African groupings due to South Africa's involvement (Harvey, 2000). Harvey states that South Africa's GDP makes up 45 per cent of the total Sub-Saharan Africa GDP and 74 per cent of SADC's GDP. However, South Africa lags behind Mauritius and Botswana in terms of GDP per capita. In 2000, Mauritius had a GDP per capita of \$ 3500, while South Africa's was less than \$ 3000.

A relatively good infrastructure is present in the region, with relatively advanced telecommunications, railways, ports and road transport systems. However, cost-effective telecommunications need to be developed. Developing countries spend only 2 per cent of their annual budget on research and development, as compared to more than 10 per cent in the first world countries (Hough and Neuland, 2000).

Government and private sector funding in research and development will have to be mobilised in order to increase the region's competitive advantage.

Tourism is reasonably developed in the area with 0.9 per cent of the total world tourism income in 1997, but 71 per cent of that of Sub-Saharan Africa (Du Toit, 2000). South Africa enjoys a considerable border trade in tourism in the SADC region. However, political forces like the high crime in South Africa, and the political disturbance in Zimbabwe influence the perceptions of the international traveller.

4.3.3.3. Obstacles to and prospects for SADC industrialisation

The major constraints of advanced industrialisation in the SADC region include the restricted size of domestic demand, comparatively high factor cost, a scarcity of foreign exchange, the lack of financial resources and the limited number of industrial entrepreneurs. Large local market-oriented enterprises will continue to be constrained by limited domestic purchasing power, lack of international competitiveness and a serious shortage of foreign exchange, and thus will probably remain modest in number and cannot be the base for a dynamic industrialisation with diversification and local integration. The lower level of development of some SADC economies in terms of technology, infrastructure, technical and managerial skills increases the risk of marginalisation.

One major challenge is to develop structures and adopt appropriate policies that transform the region's productive capacity regarding manufactured products for export. There is still a heavy reliance on foreign financing, primarily in the form of external borrowing and official grants, and, excluding Botswana and Mauritius, the region has a combined external debt of around 45 per cent of the combined GDPs.

However, there is much potential for economic development and associated social enhancement. SADC member states recognise that there

are, for instance, many opportunities for foreign investors to improve the productivity of value-added manufacturing through applying new technology. Abundant agricultural and other natural resources, minerals, water, hydropower, fisheries and human resources are yet to be tapped and their effective exploitation could give the region a competitive edge over other markets.

As remarked above, across much of the SADC, there is a relatively good infrastructure, which is a prerequisite for an emerging regional market and investment destination. The region has made substantial investments in telecommunications, railways, and road transport systems and these are increasingly being entered into by the private sector.

The SADC development corridors are underpinned by strong political commitment, public-private partnerships and positive investment implications. Service sector opportunities are enormous, especially in tourism, which is rapidly growing, and also labour intensive.

Robson (1998) states that monetary integration in the SADC region requires that exchange rates must bear a permanently fixed relationship to each other and that full convertibility exists in the sense that there are no exchange controls on the current or capital account. However, Khamfula and Huizinga (2004) suggested that there are low degrees of symmetry of exchange rate shocks across most members of the SADC, so that forming a monetary union among these economies would amass high costs relative to the benefits.

All in all, Southern Africa is an emerging market, which should attract substantial domestic and foreign investment leading to sustained growth and development, provided that its industries are able to compete domestically, regionally and internationally.

4.3.4. The East African Community (EAC)

4.3.4.1. Background

According to Kimuyu (1999), regional cooperation in East Africa has a long tradition going back to the formation of a customs union in 1917. The region possessed a common currency board, common railways, harbours and air services. The education system was based on common curricula, and universities maintained a common admission policy. The East African Community (EAC), established in 1967, was once lauded as the best example of regional cooperation. This community was founded by countries (Kenya, Uganda, and Tanzania) that possessed a common currency, the East African Shilling, under Britain's colonial rule.

In the 1960's, after independence, each country issued its own currency, but the EAC in 1967 specified free exchange between the national currencies at par. After 1966, the rules of the currency board were loosened, giving governments more influence over their central banks and removing the floors on official reserves. Limits on advances to governments were undermined and credit was channelled to governments and public sector entities indirectly via the commercial banks (Guillaume and Stasavage, 2000). In addition, political differences between governments made further cooperation impossible and the EAC was disbanded in 1977.

However, the attraction of an East African market comprising close to 90 million people and more than 100 million, if Rwanda and Burundi joined the Community, continued to be a strong argument for close ties. Thus, a few years ago, regional leaders decided to resume cooperation, even through initially on a smaller scale.

Full cooperation operations started in 1996 when the Secretariat of the permanent Tripartite (Kenya, Tanzania, and Uganda) commission was launched in Tanzania. Considering the need to consolidate regional cooperation, the three governments directed the agreement into a Treaty,

which was signed in Arusha in 1999. The Treaty entered into force in 2000, so that the East African Community came into being once again.

In 2001, the governments of Rwanda and Burundi confirmed their commitment to regional cooperation as a way of promoting sustainable development. They expressed their desire to join the EAC and requested the Secretariat to consider their applications for membership.

4.3.4.2. Objectives of the EAC

The broad goal of the EAC is to enhance cooperation in all areas for the mutual benefit of the Partner States. To achieve this, the following objectives were set:

- Promotion of the sustainable growth and equitable development of partner states, including rational utilisation of the region's natural resources and protection of the environment;
- Strengthening and consolidating the longstanding political, economic, social, cultural and traditional ties amongst partner states, and the associations between the people of the region, to promote a people-centred mutual development;
- Enhancing and strengthening the participation of the private sector and civil society;
- Mainstreaming of gender in all its programmes and enhancement of the role of women in development;
- Promoting of good governance including adherence to the principles of a democratic rule of law, accountability, transparency, social justice, equal opportunities and gender equality; and
- Promotion of peace and stability within the region, and good neighbourliness among the partner states.

4.3.4.3. The Development Strategy of the EAC

The Development Strategy sets out the priority programmes to be implemented during the period 2001-2005. The programmes are in line

with the broad goal of the EAC. The vision of regional integration in East Africa is to create wealth, raise the living standards of all people of East Africa and enhance the international competitiveness of the region. This will be achieved through increased production, trade and investments in the region. During the implementation of this strategy, the focus will be on achieving a customs union and a common market.

The Development Strategy identifies twelve areas of cooperation, namely macroeconomic policies including monetary and fiscal policies; trade liberalisation and development; productive sectors consisting of agriculture and food security, investment and industrial development, tourism and wildlife, and environment and natural resources; infrastructure and supportive services; human resource development, and that of science and technology; social sectors, immigration and labour policies; legal and judicial affairs; political matters including peace, security and defence; broad participation of women, private sector and the civil society; relations with other regional and international organisations; institutional arrangements at the level of the Partner States and the EAC Secretariat; managing distribution of benefits and costs as crosscutting issues.

4.3.4.4. Achievements and prospects of the EAC

The most important achievement of the EAC is the upgrading of the 1993 agreement establishing the Permanent Tripartite Commission for East African Cooperation into a Treaty for the establishment of the East African Community in 1999. Among other promising signs which indicate better prospects for the future, there are: the establishment of Sectoral Councils and Sectoral Committees to articulate policies on each agreed area of cooperation; the implementation of tariff reductions whereby Kenya applies 90 per cent, and Tanzania and Uganda 80 per cent, tariff reductions; the removal of all non-tariff barriers on cross border trade; the ongoing harmonisation of standards and specifications of goods and services; the ongoing harmonisation of the investment incentives and codes of the Partner States.

Besides these, major achievements of the EAC can be found in the harmonisation of monetary and fiscal policies, and in the field of capital markets. There are signs of progress in the development of a macroeconomic framework for the region to be guided towards economic convergence and macroeconomic stability; the convertibility of Partner States' currencies; the harmonisation of VAT rates, which now range between 16 per cent and 20 per cent; the institutionalisation of Finance Ministers' pre and post-budget consultations, regular sharing of information on budgets, tax proposals, trade and economic performance, including the reading of Budget Statements on the same day; the harmonisation of policies and trading practices and regulations in the three stock exchanges under the auspices of the East African Securities Regulatory Authorities (EASRA); and the establishment of the Capital Markets Development Committee to oversee development of the capital markets, particularly cross listing of stocks.

However, the political instability in the region and the multiplicity of organisations for regional integration have threatened the process of integration in East Africa. In addition, the insufficient diversification of the national economies and the self-interested agendas of member states, especially of Kenya, have militated against the economic integration of East Africa.

4.3.5. The New Partnership for Africa's Development (NEPAD)

4.3.5.1. Background

According to the NEPAD Steering Committee, NEPAD is a holistic, integrated sustainable development initiative for the economic and social revival of Africa. It is a pledge by African leaders, based on a common vision and a firm and shared conviction that they have a pressing duty to the African people to eradicate poverty and to place their countries, both individually and collectively, on a path of sustainable growth and development and, at the same time, to participate actively in the world economy and body politic.

Gelb (2002) states that NEPAD is a broad-ranging programme, but that its essential focus is to overcome the problems of weak and incapable states. He continues that for development to take place, states must create a political consensus supporting economic growth and poverty reduction; rebuild institutions; and establish a stable environment for the economic activity of firms and households. In Africa, individual states have been unable to achieve this, and the collective action of states is necessary.

NEPAD is therefore premised on African states making commitments to good governance, democracy and human rights, while endeavouring to prevent and resolve situations of conflict and instability on the continent. Coupled to these efforts to create conditions conducive to investment, growth and development are initiatives to raise the necessary resources to address the development chasm in critical sectors that are highlighted in the Programme Action, such as infrastructure, education, health, agriculture and ICT.

Resources will be mobilised by way of increasing domestic savings and investment; by improving the management of public revenue and expenditure; and by increasing capital inflows, via further debt relief, increased targeted ODA flows, FDI and private capital. The founding document of NEPAD contains both a strategic policy framework and a programme of action.

4.3.5.2. Principles and objectives of NEPAD

The main objective of NEPAD is to give impetus to Africa's development by bridging existing gaps in priority sectors in order to enable the continent to catch up with developed parts of the world by:

- Ensuring African ownership, responsibility and leadership;
- Making Africa attractive to both domestic and foreign investors;
- Unleashing the vast economic potential of the continent;

- Achieving and sustaining an average gross domestic product growth rate of over 7 per cent per annum for the next fifteen years;
- Ensuring that the continent achieves the agreed International Development Goals (IDGs);
- Increasing investment in human resources development;
- Promoting sub-regional and continental economic integration;
- Developing a new partnership with industrialised countries and multilateral organisations on the basis of mutual commitments, obligations, interest, contributions, and benefits;
- Strengthening Africa's capacity to lead negotiations on behalf of the continent on major development programmes that require coordination at a continental level;
- Ensuring that there is a capacity to accelerate the implementation of major regional development cooperation agreements and projects already approved or in the pipeline;
- Strengthening Africa's capacity to mobilise additional external resources for its development.

4.3.5.3. The NEPAD framework

NEPAD is based on a three-pronged strategy for the sustainable development of the continent, namely preconditions for development, priority sectors and mobilising resources.

4.3.5.3.1. Preconditions for development

African leaders have learned from their own experiences that peace, security, democracy, good governance, human rights and sound economic management are conditions for sustainable development. They are therefore pledging to work, both individually and collectively, to promote these principles in their countries and sub regions and on the continent.

Improving governance under “Preconditions for development” will strengthen weak states in Africa, while regional cooperation and integration will increase cross-border trade and investment within Africa, as well as improving international competitiveness through the pooling of African resources.

Governance improvements should be at the heart of the development agenda for this continent. In the arena of economic governance, this means reducing corruption, increasing transparency and accountability in the collection and use of public resources, enhancing regulation in the financial system, and promoting sound accountability and auditing practices in the private sector. In the political governance arena, it means resolving violent conflict in countries and establishing peace and security for citizens, enhancing democracy and the right and obligations of citizenship, and establishing respect for human rights and the rule of law in the criminal justice system.

4.3.5.3.2. Priority sectors

Development in the “Priority sectors” will reverse Africa’s marginalisation and lay the basis for sustainable long-term development. The priority sectors are: infrastructure, ICT, human development and poverty reduction, focussing on health and education, agriculture, promoting diversification of production and exports, and focussing on market access for African exports to industrialised countries.

The structural gap in infrastructure constitutes a very serious handicap to economic growth and poverty reduction. Improving infrastructure, including the cost and reliability of services, would benefit both Africa and the international community, which would be able to obtain African goods and services more cheaply.

The rapid advances in technology and the diminishing cost of acquiring the new ICT tools have opened new windows of opportunity for African countries to accelerate their economic growth and development. The

goals of achieving a common market and an African Union can benefit immensely from the revolution in information technology. In addition to fostering intra-regional trade, the use of ICTs could also accelerate Africa's integration into the global economy.

The human resource development and poverty reduction initiatives include the reversing of the brain drain. Countries should support existing poverty reduction initiatives to develop these strategies at the multilateral level, such as the Comprehensive Development Framework of the World Bank and the Poverty Reduction Strategy approach linked to the debt relief initiative for Highly Indebted Poor Countries (HIPC). It is also necessary to create political, social and economic conditions in Africa that would serve as incentives to curb the brain drain and attract much-needed investment.

Improvement in agricultural performance is a prerequisite of economic development on the continent since the majority of Africa's people live in rural areas. The resulting increase in rural purchasing power will also lead to higher effective demand for African industrial goods. The induced dynamics would constitute a significant source of economic growth.

4.3.5.3.3. Mobilising resources

Governance improvements are also essential to increase resources for (and flows of) investment in development. In the short term, these will focus upon expanded debt relief and aid flows, but in the longer term, success in improving governance and in the priority sectors will lower risk premiums and the cost of doing business in Africa, so that domestic private savings and private capital inflows would be expected to rise. Greater access to the industrialised countries' markets for African exports will also provide additional resources for investment in domestic programmes.

NEPAD seeks the extension of debt relief beyond its current levels (based on debt “sustainability”), which still require debt service payments amounting to a significant portion of the resources gap. The long-term objective of NEPAD is to link debt relief with costed poverty reduction outcomes. Countries will engage with existing debt relief mechanisms - the HIPC and other creditors - before seeking resources through NEPAD. The debt initiative will require agreed poverty reduction strategies, debt strategies and participation in the Economic Government Initiative (EGI) in order to ensure that countries are able to absorb the extra resources.

Domestic resources are needed for effective poverty reduction. These include national savings by firms and households, which need to be substantially increased. In addition, more effective tax collection is needed to increase public resources, as is the rationalising of government expenditures. A significant proportion of domestic savings is lost to African countries as a result of capital flight. This situation can only be reversed if African economies become attractive locations in which residents can hold their wealth.

NEPAD seeks increased ODA flows in the medium term, as well as reform of the ODA delivery system, to ensure that flows are more effectively utilised by recipient African countries. The latter need to develop, with donors, a charter underpinning the development partnership.

The increase of private capital flows to Africa is an essential component of a sustainable long-term approach to filling the resource gap. NEPAD will address investors’ perceptions of Africa as a “high-risk” continent, especially with regard to the security of property rights, regulatory frameworks and markets. Several key elements of NEPAD will help to lower these risks gradually, and include initiatives relating to peace and security, political and economic governance, infrastructure and poverty reduction, as well as the promotion of financial markets within countries, and also cross-border harmonisation and integration, via a

financial market integration task force. Initially, this must focus on setting up the legislative and regulatory environment for the financial system.

African economies are vulnerable because of their dependence on primary production and resource-based sectors, and their narrow exports bases. There is consequently an urgent need to diversify production, and the logical starting point is to harness Africa's natural resource base. Value added by means of agro-processing and mineral beneficiation must be increased and a broader capital goods sector developed through a strategy of economic diversification based on intersectoral linkages. To achieve this, governments should support private enterprises, both in the informal and the manufacturing sector, which are principal engines of growth and development, and should remove all constraints on business activity. This will encourage the creative talent of African entrepreneurs.

Gelb (2002) states that NEPAD is still a nascent process facing many challenges to its success. Perhaps the most urgent is the need to mobilise support and build consensus regarding the plan within the African continent. He adds to state that individuals, firms and organisations should engage with it, neither accepting it uncritically nor dismissing it out of hand as misdirected, over-ambitious or exclusionary, but rather seeking to influence and shape its contents.

NEPAD represents the best opportunity for many years to shift Africa onto a new path, and if it fails it will be a long time before another chance as good as this arises.

4.4. Conclusion

The failure of African integration schemes can mostly be attributed to the fact that regional groupings in Africa were created in the first instance more as an expression of African solidarity than of economic integration and market development. But, even in the enhancement of

economic integration, many factors affect the efficacy of this development. Among them are: differences in the balance of payment positions, differences in economic policies, the issue of convertibility of currencies and the differences in the currency exchange rates. Indeed, with their marginal competitive advantage, African countries are afraid that regional trade liberalisation may have the reverse effect, in generating another wave of regional de-industrialisation.

However, the resurgence of regionalism in Africa, with a strong commitment to economic development, will help countries in Africa to remove the political barriers that have affected cooperation between states and to improve macroeconomic policies, which will establish better conditions for the continent's increased integration with global markets.