

The Road to Monetary Union in East Africa

Keynote address at the Validation Workshop of
the Draft Final Report of the Monetary Union
Study: 18-20 January 2010, Kampala

Prof. E. Tumusiime-Mutebile, Governor Bank of Uganda

Hon. Syda Bbumba, Minister of Finance, Planning and Economic Development

Ambassador Alloys Mulabingwa, Deputy Secretary General of the East African Community,

Distinguished participants

Ladies and gentlemen

The purpose of this workshop is to discuss what we, as policymakers in East Africa, have to do to realise our vision of East African monetary union. As the Hon. Minister of Finance makes clear in her opening remarks to this workshop, the governments of the five East African Community Partner States are committed to establishing a monetary union, to complement the East African customs union and the common market. It has already been decided, at the 2006 Extraordinary EAC Summit, that the EAC Partner States should move expeditiously to establish monetary union.

Whether or not to pursue a monetary union is, therefore, not an issue for discussion. The issue we must address at this workshop is how to achieve the monetary union. We should, however, recognise that setting up a monetary union is a very challenging project that will require a lot of hard work and careful design. We will need to keep our nerves in the face of inevitable setbacks. But I believe that the project is worthwhile and once monetary union comes to fruition, it will be one of the most important institutional foundations for the economic prosperity of East Africa in the 21st century.

Why is Monetary Union Essential for the Future of East Africa?

A monetary union is crucial for the future prosperity of East Africa for two reasons. The first reason pertains to the role which East African economic integration will play in spurring economic growth and development in this region. The second pertains to how we, as East African countries, relate to the rest of the world.

The need for monetary union can only be understood within the context of regional economic integration more broadly. The current drive towards economic integration in the East African Community began with the implementation of the customs union in 2005. This will be followed by the implementation of the East African common market, beginning in 2010, under which there will be free movement of goods, services, labour and capital within East Africa.

The primary rationale for the monetary union is to reduce the costs and risks of transacting business across the national boundaries of those countries which comprise the members of the monetary union. For example, monetary union removes the costs of having to transact in different currencies and the risk of adverse exchange rate movements for trade within East Africa. Monetary union will, therefore, deepen the integration of East African economies and, in doing so, enhance the benefits which can be derived from the East African common market. A well functioning common market in East Africa will stimulate competition and help domestic firms to realise economies of scale, thereby raising productivity, which will strengthen our competitiveness on world markets and raise living standards. Domestic firms, which have hitherto concentrated on their domestic markets, will be forced to extend their horizons to the regional market. A larger, more integrated, market will also be much more attractive for foreign investment and will help spur the advance of our economies towards “emerging market” status.

The global economy is changing, at an ever increasing pace. The 21st century global economy will be characterised by the emergence of major regional economic blocks, groups of countries whose economies are closely integrated, alongside the largest economies such as those of China and the United States. Multilateral relationships between states and regional economic blocks will play a key role in shaping the institutional rules which will affect the development of the global economy and the national economies within it, especially in multilateral institutions such as the World Trade Organisation and in international fora. The recent global economic crisis has vividly demonstrated the importance of multilateral solutions to economic problems which have a global dimension.

Small economies will find it very difficult to make their voice heard and ensure that their interests are taken into account when decisions which affect the global economy are made, unless they are prepared to join together and present a common front. This is a reality which the European Union has recognised. It is even more essential for the East African countries, with far smaller economies than those of the European Union, to conduct their economic relations with the rest of the world as a single, united entity. Economic and monetary integration in the East African Community will amplify the influence which individual East African countries can exert on the international scene. Monetary union will send a powerful signal to the rest of the world that East Africa is united with a single market. It will thus signal that East Africa intends to be an important player in the global economy of the 21st century, and that each of the member states is prepared to put aside purely parochial interests to achieve this.

The Road to Monetary Union

Preparations for the monetary union started with the formation of the East African Community Monetary Affairs Committee (MAC). The MAC has made important progress in the areas of monetary policy coordination and harmonization, financial markets development, harmonization of financial sector supervision, payments systems development and integration, and statistical harmonization. This is a valuable foundation on which the roadmap towards monetary union can be built.

The road ahead will need to be carefully planned and implemented. We can learn important lessons from the experience of the European Union in the 1990s, some of which are highlighted in the study by the team from the European Central Bank that we will be discussing at this workshop. The monetary union project requires radical changes in economic policies backed by reforms to institutions and legal changes. From the standpoint of macroeconomic policy, the most critical requirement is the gradual convergence of all the East African economies during the transition to monetary union, especially in terms of the synchronisation of the economic (or business) cycles of the different member states. Without convergence, a monetary and exchange

rate policy which is optimal for one member of the monetary union will not be optimal for the others. The greater is the degree of convergence of the economies of the member states before the monetary union takes effect, the lower will be the subsequent costs of adjustment to macroeconomic shocks which affect the member states asymmetrically.

Monetary and Exchange Rate Policy During the Transition

The most essential policy reform is the progressive locking together of the bilateral exchange rates of the five Partner States. This process will begin by imposing bands within which bilateral exchange rates will be constrained. The bands will then be progressively tightened until the bilateral exchange rates of the East African Community Partner States are irrevocably fixed as a prelude to the replacement of national currencies with a single regional currency. Some sort of external anchor for the exchange rate bands, to a major international currency or a basket of currencies, will be needed during the transition.

For the aligning of national exchange rates to succeed, it will have to be accompanied by an alignment of monetary policies in all the East African Community Partner States. This is because, as the East African economies become more financially integrated, with money and capital able to flow freely across our common borders, significant differences in interest rates between the East African Community Partner States will cause capital flows between member states which will destabilise their bilateral exchange rates. Hence as we align our exchange rates, we will also have to harmonise our monetary policies. This will tend to bring about convergence in the inflation rates of the Partner States, although each country's inflation rate will not necessarily be equal to that of all the others.

I am under no illusions that the process of aligning our bilateral exchange rates in a sustainable manner, so that they can eventually be replaced with a single currency, will be anything other than very challenging for policymakers. There are important lessons to be learned from the experience of the European Exchange Rate Mechanism in the 1990s, the precursor to the Euro.

Some of you may recall the exchange rate crisis of the ERM in 1992, when the exchange rates of some of the ERM members were ripped from their bands by a whirlwind of speculation in the foreign exchange markets. I hope that our colleagues in the European Central Bank will be able to provide useful advice on how we can mitigate the risks of experiencing a similar exchange rate crisis during the transition to monetary union in the East African Community.

In recent years the national central banks of the East African Community have mostly pursued flexible exchange rate policies, with only limited intervention in foreign exchange markets, mainly to dampen exchange rate volatility. Therefore, the transition to monetary union will require radical changes to exchange rate policy as well as to monetary policy. The national central banks will have to devote more technical resources to understanding what the optimal levels for their exchange rates are and how to manage their exchange rates using both monetary policy instruments and intervention in the foreign exchange markets. Our monetary policy frameworks will have to be refocused primarily on our exchange rate objectives and each central bank will have to pay close attention to the monetary policies of its partners in the East African Community. At the regional level, the central banks will have to determine how we can best harmonise our exchange rate policy objectives with the objective of maintaining low inflation within the East African Community. Clearly, very close collaboration between the central banks in setting monetary and exchange rate policy is imperative, if the transition is to be successful.

Fiscal Policy

Fiscal policy is the second pillar on which a successful monetary union rests. Fiscal policy is crucial for both economic convergence, and perhaps even more importantly, for the credibility and sustainability of the Monetary Union.

Fiscal policy matters for economic convergence because it affects aggregate demand and interest rates. Hence if there are major differences in the fiscal stances of the East African Community

Partner States, this will undermine efforts to synchronise economic cycles, and may also create pressures on bilateral exchange rates, because of the interest rate differentials.

The success and sustainability of the monetary union will depend at least partly on its credibility. Crucial to its credibility will be fiscal discipline and this requires fiscal rules to prevent free riding by any individual Partner State. In a monetary union, the costs of fiscal indiscipline by one member of the union are partly externalised to the other members. The possibility that the profligate sovereign borrower might be bailed out, directly or indirectly through higher inflation, by its partners, will drive up public borrowing costs for all members of the monetary union. The future of the monetary union itself could be thrown into doubt if the financial markets and public believe that a member with serious fiscal problems cannot solve these problems within the monetary union, essentially because the solution would be too deflationary, and hence opts to leave the monetary union. This is the concern which many commentators have expressed in relation to the current economic and fiscal problems of Greece.

To avoid these problems we must put in place binding, transparent fiscal rules covering fiscal deficits and public debt, which will operate both during the transition to monetary union and after the monetary union has been established. I trust that the principle of fiscal rules is generally understood and accepted within the East African Community. However there are some who argue that these rules should be made less stringent - i.e. the fiscal deficit targets should be loosened - to allow for much higher public spending, on the grounds that there are large unmet demands for public investment within the East African Community. Unfortunately this misses the point. If the monetary union is to be successful, the targets for fiscal deficits and public borrowing must be tight enough to ensure that the Partner States of the monetary union run fiscal policies which are sustainable, and are perceived to be sustainable by the markets, even in the face of adverse fiscal shocks, such as a cyclical downturn in the tax base or a cutback in donor aid.

Conclusion

The 21st century global economy will present enormous opportunities for East Africans to lift their economies to middle income status, raise living standards and eradicate mass poverty. We will be much better placed to take advantage of these opportunities and to face up to the challenges if we can achieve deep and meaningful integration of the East African economies. Monetary union is an essential component of regional economic integration.

Establishing a monetary union in East Africa will be difficult and will pose risks. It will require an enormous amount of work to reform institutions, change legislation and revise macroeconomic policies. It is a long term undertaking, whose benefits will be realised over many decades. Support for this project, among the public, politicians and technocrats, has started to gather momentum alongside a more widespread appreciation of its long term benefits. We must use this momentum of support to make monetary union in East Africa a reality. To quote the words put into the mouth of Brutus by Shakespeare: “There is a tide in the affairs of men, which taken at the flood, leads on to fortune”. If we have the courage and foresight to grasp this opportunity to create a monetary union we can make a huge contribution to the future prosperity of our people in East Africa.