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Is Sub-Saharan Africa an Optimal Currency Area?

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Mothae Maruping wrote an interesting and thought-provoking chapter. The objective of his chapter is to analyse the achievements, lessons and challenges facing sub-Saharan African countries in promoting regional integration and to assess the importance of macroeconomic convergence as a key component of regional integration. The latter in itself is an extremely interesting issue on its own and would deserve a separate treatment, but Mothae Maruping goes further. His task is to look at the various regional integration efforts in Africa and to see how they have performed, what were the main problems in the implementation of these initiatives, why the implementation was not always meeting the objectives of governments. He demonstrates that there have been a great deal of regional integration schemes in sub-Saharan Africa (SSA) and reaches as his first main conclusion that these schemes have not been by and large very successful. He makes a powerful and highly convincing point that most of these regional arrangements have been set up primarily by politicians and have been driven by political objectives. The integration has been constrained, for example, by overlapping and costly memberships,[1] different time horizons for trade liberalisation, ratification problems, and the continued presence of intra-regional trade barriers. It also appears that the architects of all

[1] Mothae Maruping provides perhaps the best direct argument against the proliferation of regional trading arrangements, which has been so much criticised by Jagdish Bhagwati who compared these arrangements to what is now known as "spaghetti bowl" of regional deals (see Figure 7 on p. 118).

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these initiatives have not given much thought to the kind of economic policies and institutions needed to make these arrangements work and make them successful.

The second interesting part of Maruping's chapter is when he looks at the performance of these regional trading arrangements (RTAs). The evidence provided in the chapter is extremely disappointing and, I would almost dare to say, damning to all these initiatives. As we can see from his Table 1, the intra-regional trade within COMESA was 9.7 percent of the members' total trade in 1970 and by 2003 the share had declined. The story is essentially the same for SADC and it applies to both exports and imports with only a small improvement in the case of intra-SADC exports (all assessed in terms of percentages). In other words, the performance is in sharp contrast with ideals, or, as he puts it, the performance reflects "dreams against reality". Needless to say, this conclusion will be shared by most observers who must concur with his disappointment. In brief, the RTAs have not done well in sub-Saharan Africa.

The third message of Maruping, one that may be the most innovative part of the chapter, concerns something that can be called "the new thinking" in Africa, especially in the southern and eastern African region. As a part of this "new thinking", politicians and economists in the region have been apparently calling for deeper forms of integration, moving away from simple free trade area arrangements to something more complex, including not only custom unions but also initiatives calling for coordination of other policies. This corresponds to similar movements in other parts of the world, as the notion of "deeper integration" has been set firmly into the arsenal of alternative policies towards regional integration.[2] Maruping identifies in the chapter a number of such initiatives and practical arrangements that have been adopted in the region over time.

What is intriguing about all these new initiatives and thinking in the region is the fact that these moves come at a time when the more shallow arrangements (RTAs) have not done very well as noted above and by Maruping himself. Moreover, these efforts represent a considerable jump in what I would call a natural sequence of regional integration arrangements. The latter, the "natural" sequence, would involve arrangements that start from free trade areas before members of these areas proceed

[2] For more evidence and discussion of this point, see Drábek (2005), chapters 1 and 2.

to coordinate other policies such as external trade policies, elimination of barriers to movement of labour and capital or coordination of monetary policies. Instead, we seem to be observing an attempt in SSA to move directly to complex arrangements, including the attempts to policies towards macroeconomic convergence. There is perhaps no need to note that such a convergence would require a certain degree of harmonisation of macroeconomic policies.

There has been a great deal of discussion about regional arrangements in sub-Saharan Africa as well as elsewhere in Africa. Some of the debate has been conducted in the past on the platform of FONDAD. It would have been, therefore, also helpful if the chapter were to identify the main concerns arising from that debate and address them explicitly. It would have been also helpful to have from Maruping more empirical evidence about the performance of RTAs in sub-Saharan Africa. Clearly, the problems with RTAs in SSA must differ from country to country and from a RTA to another RTA. Moreover, the problems with performance or constraints on the effectiveness of RTAs may also vary from case to case.

Three "Convergence" Issues

My main comment is about one specific issue that is addressed at some length by Maruping, and it concerns the question of macroeconomic convergence of sub-Saharan African countries.

I hasten to add that my knowledge of macroeconomic policies in sub-Saharan Africa is very much out of date. My comments will, therefore, address the convergence question in more general terms, which are derived from the theoretical literature or from practical experience of other countries. In this respect, it may be interesting to raise three issues that might be useful in looking at the subject of macroeconomic convergence.

There is not much of any dispute or controversy about the convergence criteria that have been proposed in the chapter, even though I do have a small point to make which I will do further below. The limitation of the chapter is that the author does not discuss the conditions under which policies aimed at macroeconomic convergence are likely to be successful – an issue I wish to discuss here. Let me also add that the idea of macroeconomic convergence in sub-Saharan Africa is not new. What is new about Maruping's chapter is that the idea of convergence is extended beyond the Common Monetary Area in Southern Africa by including other countries in the sub-Saharan Africa region.[3]

In general, the starting question about convergence is: What is the mechanism to ensure that the convergence will succeed? Or to put it differently, what is in the present system that is preventing a more successful convergence of macroeconomic indicators? I would suggest that there are probably three broad areas of factors inhibiting macroeconomic convergence that should be taken into account. The first area concerns the role of product and factor markets. The second one concerns what I would call the compensatory mechanism that needs to be normally put in place in attempts of that kind. The third issue is the question concerning speed and sequencing of convergence. I shall now briefly turn to each one of these issues.

Product and factor markets. The first critical condition for a successful macroeconomic harmonisation is the presence of efficient product and factor markets. It is difficult to imagine that efforts to achieve macroeconomic convergence will be successful in the presence of serious distortions in product and factor markets, or policies that do not allow those markets to operate efficiently. While it may be possible to harmonise some elements of macroeconomic performance it would certainly not be possible to harmonise the rest of macroeconomic indicators. Consider, for example, two countries, one of which maintains restrictions on the inflow and outflow of foreign capital and both countries pursue policies targeting a convergence of inflation rates. The inflation rates of both countries may converge even in the presence of the restrictions on capital flows (i.e. distortions in financial markets) provided governments are prepared to change their monetary policies until the rate of inflation in the high-inflation country drops or the one in the low-inflation country increases. However, this is clearly not an optimal pattern of convergence, since it leads to interest rate differentials that are maintained through restrictions on the movement of capital across borders. Differences in interest rates lead, in turn, to different incentives to investment in both countries and, therefore, different growth paths of the countries. In addition, the interest rate

[3] The Common Monetary Area (CMA) in Southern Africa began as the Rand Monetary Agreement (RMA) in 1974 and it included South Africa, Botswana, Lesotho and Swaziland. The RMA was replaced by an agreement on CMA in 1986 and signed by South Africa, Lesotho and Swaziland. Namibia joined CMA in 1992. Botswana has been formally out of the agreements since 1976 but maintained informal but tight links to the monetary arrangements. For more details, see Grandes (2003).

differences may also be accompanied by higher inflation rates in at least some of the countries. In general, judging from the experience elsewhere, the product and factor markets need to function reasonably well in order to ensure sustainability of macroeconomic policies and to meet the convergence targets. Without efficient markets, the convergence policies would be under threat and, most likely, not sustainable.[4]

Now, suppose that product and factor markets work well and are unconstrained by wrong policies. Would there still not be an argument against policies towards macroeconomic convergence? The answer is still potentially the same – countries whose markets are not well integrated economically will probably not succeed in integrating their policies and institutions including policies towards monetary convergence. As shown by Dorrucci *et al.* (2002), institutional integration interacts with economic integration on regional level, and this link constrains the policy space of governments aiming at closer institutional integration.[5] In addition, the process of (macro)economic convergence is greatly dependent on a variety of factors that have been so well identified in the literature on *optimal currency areas* as developed by Mundell (1961).[6] Whether these conditions are present in SSA remains an open question even though there are some indications that some of the SSA countries do meet the criteria.[7]

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[4] The assumption of well functioning markets in the SSA is particularly questionable in the case of financial markets. The latter are generally seen as "special" markets for a variety of reasons such as information asymmetry and fragility but they are particularly vulnerable in emerging markets of developing countries such as those in SSA. The presence of distorted financial markets is, of course, extremely serious for macroeconomic convergence since the link between monetary policy and financial markets is very tight and both are mutually dependent. For a useful summary of these issues see, for example, Baldwin and Wyplosz (2004), chapter 15.

[5] At the same time, economic integration is driven co-driven by forces of gravity and geographic factors. This explains why countries often form RTA within their regions but, for a variety of reasons, these forces are not powerful in SSA. See also Greenaway and Milner (2002).

[6] These conditions relate partly to the operations of factor and product markets (flexibility of domestic prices and costs, high mobility of factors) and partly to structural features of the countries' economies (highly diversified structure of production, symmetry of shocks between countries).

[7] The model of optimal currency area was tested by Grandes (2003) who analysed the functioning of the Common Monetary Area (CMA) in Southern Africa. He also identified benefits and costs from macroeconomic convergence to member countries. See also footnote 3 above for details on CMA.

Compensatory mechanism. The problem faced by policymakers in the process of macroeconomic convergence is that the latter implies an economic adjustment, and adjustment leads to adjustment costs. This means that when countries are targeting a macroeconomic convergence, they are likely to have different costs of adjustment, and the question will be how these adjustment costs will be financed and who will finance them. In the process of establishing optimal currency areas, such a compensatory mechanism (i.e. fiscal tax transfers) has been recognised in the theoretical literature as one of the fundamental conditions for optimality. Such a mechanism is likely to be important also in the case of other arrangements of monetary cooperation. This leads to the question that is pertinent for the convergence process in SSA: Do African countries that are targeting convergence and maybe even harmonisation of macroeconomic policies, have the capacity and resources to fund such a scheme and put an appropriate mechanism in place?

Now, compare the situation in SSA with that of the European Union which is facing the same questions, and in which the same issue is arising as a part of the accession of new countries and in which the issue was faced in the earlier accessions of Spain, Greece and Ireland. All of these new acceding countries started with fundamentally different macroeconomic conditions when they began their process of convergence. The assumption of policymakers both in the acceding countries as well as in the incumbents was that the adjustment costs would be large, and this resulted in a (negotiated) compensatory mechanism in order to facilitate the adjustment of acceding countries. The mechanism included, for example, the introduction of structural funds, various agricultural supports, technical assistance in legal and justice systems, education, technical support for SPS and TBT[8] mechanisms and so on. The presence of similar compensatory financing instruments is something that will have to be in place in SSA if macroeconomic convergence is to succeed.

Timing and sequencing of macroeconomic convergence. The speed and sequence of convergence are also critical issues. There are two kinds of questions that need to be asked by policymakers with regard to timing and sequencing of macroeconomic convergence. The first question concerns convergence targets. Specifically, why do we want to pursue a macroeconomic convergence? The answer to this question is not

[8] Sanitary and Phytosanitary Measures (SPS) and Agreement on Technical Barriers to Trade (TBT).

straightforward since the need for convergence is not obvious. This can be seen from the data in Maruping's tables and his accompanying comments. One gets the impression that the main objective for policymakers should, in fact, be to ensure that they provide for a macroeconomic environment that is conducive to a conduct of *stable* trade policy and *sustainable* balance of payments. This is somewhat different from thinking about macroeconomic convergence, which could be excessively costly under present circumstances.

But suppose that the decision to converge is taken for whatever reason. Under that scenario, my second question to policymakers would be: How should one "anchor" the convergence? Surely, it must make a difference for a country like Malawi to "converge" to the market conditions prevailing in, say, Botswana, rather than in South Africa or the United States. What should be the criteria that should guide the policy to make such a choice? The answer to this question is extremely important. The "anchor" will affect the country's competitiveness in international markets, the degree to which economic cycles are synchronised, the external sources of economic growth and the exposure to financial instability.[9]

This leads to a related question – what is the optimal speed towards macroeconomic convergence? There can hardly be a scientific answer to this question but the question must be addressed by policymakers because different speeds lead to different costs of adjustment. These concerns are quite evident in the similar debate that has been conducted in the United Kingdom where the British government made it clear that the accession of the United Kingdom to the European Monetary Union can only take place if certain conditions are met. The UK Treasury has, therefore, come up with a set of conditions under which the UK would consider joining. Once again, it appears none of these issues seems to be debated in SSA. What should be the exchange rate mechanism under which the countries concerned should enter the process? What should be the level of exchange rate at which would the countries would wish to converge? At what level of unemployment would policies towards convergence be acceptable on political grounds

[9] The answer to the question of *which anchor* should be chosen is, of course, partly related to the link between economic and institutional integrations noted already in the text above. Another part to the answer depends on *how rigid* the chosen anchor could or should be. For a broader discussion of these questions with regard to the choice of exchange rate regimes see, for example, Wyplosz (2000).

and at what level they would not? Surely, these and other concerns should be raised in discussing the speed of convergence, and these examples are only raised here as illustrations of the type debate which is likely to accompany these ambitious objectives.

Finally, a comment about targets. It is often assumed that targets are fixed by definition and cannot be changed. The assumption is not only logical but also reasonable. However, what should happen if targets are found "unrealistic" or simply wrong? Should they not be changed or modified? The problem with changes is that they may adversely affect the credibility of policies. On the other hand, the problem about rigidity is that we may stick to wrong targets. In other words, we could be damned if we do have targets or if we could be damned if we do not! Once again, the debate in the European Union about the so-called Maastricht criteria is quite educational. The criteria restricting the governments' room for fiscal flexibility by setting limits on fiscal deficits and public debt have recently been criticised and strongly resisted by critics even in the traditionally fiscally conservative countries such as Germany. So far, the criteria are kept but the countries have already agreed on rules that may allow more flexible interpretation of the original targets.

In summary, the lessons from Europe provide again a guidance for the debate about convergence and its speed and sequencing in SSA. As Maruping clearly shows in his chapter, many countries in SSA continue to have a serious debt problem and its management. The solution to the debt problem is not entirely a matter of domestic adjustment but it will also require an agreement with external donors. This means that until that happens it is probably going to be difficult to pursue the policy towards convergence. Second, convergence requires the presence of strong financial institutions without which the convergence process could jeopardise the process of financial intermediation as well as monetary control. Third, another constraint appears to me to be their poor access to external financial markets since it always helps to have better access to external resources. Without external resources, the burden of adjustment will fall on domestic (macroeconomic) policies, and given the size of macroeconomic imbalances in the region, the costs of adjustment may be too high to be entirely funded by domestic resources.

The fourth constraint on the conduct of policies in SSA is specific to the region. Like most African countries, the region has been subject to a great degree of instability due to highly unstable conditions in markets

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for primary commodities on which the region continues to be heavily dependent. The region has also be subject to extremely severe and changing climatic conditions and to debilitating diseases severely affecting health standards in the region and the productive potential of labour. All of these factors are exogenous, and this makes it particularly difficult in the management of balance of payments. That, in turn, poses serious problems for creditors in their assessment of creditworthiness of SSA and of the risks of investing in the region. Moreover, the exogeneity of these factors must make it even more difficult for governments to conduct a sensible fiscal policy, one that is sustainable in medium term. Last but not least, SSA has historically suffered from capital flight, which also needs to be considered by policymakers when pursuing the policy of macroeconomic adjustment. In ignoring capital flight in its financial programming, governments would be making serious mistakes since unaccounted movements of capital could reap havoc into the government's ability to control monetary aggregates.

Conditions for Successful Convergence

Let me conclude in a rather different manner than one is accustomed in similar circumstances. Maruping's chapter raises important questions about regional integration in SSA that remain, in my view, open. A particularly interesting questions concern the desirability of macroeconomic convergence in SSA. Perhaps, politicians and economists in the region will soon provide the answers that will be needed if the region is truly serious and will wish to pursue a policy of macroeconomic convergence. Should countries converge in terms of their macroeconomic indicators or not? Is sub-Saharan Africa an optimal currency area? This is the first fundamental but difficult question because convergence implies limitation of the space in which governments will be able to operate and conduct an independent macroeconomic policy. It is my instinctive belief that on this issue there is a room for positive answers. Low rate of inflation is desirable, a level of debt that is sustainable is also desirable, and a sensible fiscal management is surely also something that must be supported. Moreover, a macroeconomic convergence may be sensible on efficiency grounds if the conditions prevailing in the Common Monetary Area in Southern Africa could be extended to other countries in the SSA region. However, whether all of these targets should call for a rigid macroeconomic convergence or whether they should be a part of a prudent macroeconomic policy towards macroeconomic stability remains an open question. For a distant external observer like me, this is an issue of macroeconomic stability, rather than that of macroeconomic convergence.

The second fundamental question applies in situations in which a decision to converge has already been taken. What would be the conditions for a successful and sustainable convergence in SSA? Can or should, for example, policymakers start macroeconomic convergence before opening up their markets to a reasonable extent? What kind of domestic trade regimes should be adopted? Should convergence target the regional countries even though most of Africa's trade and financial relations are primarily with the rest of the world?[10] Should a country open its capital accounts and if so under what circumstances? Similarly, what are the implications for the conduct of exchange rate policies since macroeconomic conditions differ among countries in SSA? Some of these differences are critical in making a sensible judgment about the exchange rate regime to be adopted since they involve differences in external debt positions, the level of foreign exchange reserves, sources of government revenues, the depth of financial markets to name just a few.

Sensible answers to these questions can only be provided if policymakers carry out a thorough assessment of the desirability of macroeconomic convergence and an economic analysis of costs and benefits of such a policy.[11] Until these costs and benefits are recognised and the constraints on convergence identified, the path to macroeconomic convergence will be arduous.

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[10] As noted above, institutional integration such as measures towards macroeconomic convergence go hand in hand with economic integration. The lack of economic integration among SSA countries could be a major constraint on the policy of convergence. For more details on the link between institutional and economic integration see, for example, Dorrucci e*t al.* (2002).

[11] The interest in macroeconomic convergence and the related concerns about currency regimes, which has been expressed in other parts of the world, has been assessed for policymakers with help of criteria used in the assessment of optimal currency areas. A useful and interesting example of such a study is Buiter (2000).

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