The East African Community After Ten Years

Deepening Integration

Edited by

Hamid R. Davoodi

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Acknowledgments

This book is the proceedings of a high-level conference that took place in Arusha, Tanzania, on February 27–28, 2012, to celebrate the achievements of the East African Community (EAC) in its first decade and look into upcoming challenges in its second decade.

The conference and the publication of this book would not have been possible without the generous financial support of the Canadian International Development Agency (CIDA). In particular, we would like to thank Robert Orr, the Canadian High Commissioner in Tanzania, and John Moore, Director and Head of Cooperation CIDA-Tanzania.

Organizing a major conference, getting very busy senior policymakers to attend a two-day conference, and getting all the contributions for a book in less than a year after the conference took place is a remarkable achievement and a testimony to team work. In particular, we are deeply thankful to the Tanzanian authorities as the hosts of the conference, to the EAC Secretariat for its masterful organizational management in Arusha and for allowing us to rely on its video feeds and transcripts. The tireless efforts of John Wakeman-Linn, the IMF's senior resident representative in Tanzania at the time of the conference, and Mita Samat, the IMF's office manager in Dar es Salam, were instrumental in organizing a flawless ground game in Tanzania that stretched over several months, easing the publication of the conference proceedings.

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Hamid R. Davoodi
Editor

Abbreviations

AG	accelerated growth
CBK	Central Bank of Kenya
CET	common external tariff
CIDA	Canadian International Development Association
CMA	Common Monetary Area
CMP	common market protocol
COMESA	Common Market for Eastern and Southern Africa
CTA	Certificate of Temporary Assignment
EAC	East African Community
EACB	East African Central Bank
EAMU	East African Monetary Union
EAMI	East Africa Monetary Institute
EASEA	East African Stock Exchange Association
ECCU	Eastern Caribbean Currency Union
ERM	Exchange Rate Mechanism
FDI	foreign direct investment
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
ICT	Information and Communication Technology
IGC	International Growth Center
IMF	International Monetary Fund
MoU	memorandum of understanding
MU	monetary union
NCBs	national central banks
Non-SG	non-sustained growth
NTB	non-tariff barrier
ODA	Official Development Assistance
SADC	Southern African Development Community
SG	sustained growth
TFP	total factor productivity

Overview

Hamid R. Davoodi[1]

The East African Community (EAC)—which comprises Burundi, Kenya, Rwanda, Tanzania, and Uganda—is now in its second decade. The time was ripe to take stock of progress the EAC had achieved and contemplate its future challenges. In February 2012, a high-level conference took place in Arusha, Tanzania—home to the EAC Secretariat— which turned out to be the perfect venue for this occasion.

The conference brought together senior policymakers from the EAC and South Sudan, including ministers and permanent secretaries of finance, governors and deputy governors of central banks, academics, members of civil society, the media, the donor community, and staff of the International Monetary Fund (IMF) and World Bank.

The two-day conference produced a rich dialogue and managed to arrive at some win-win policy and institutional reforms. Although the needed reforms vary in specificity and by sectors, a sense of thinking beyond national borders and the creation of shared infrastructure were deemed necessary to advancing regional integration.

The conference focused on four themes: EAC current status, achievements, and challenges; fiscal, monetary and financial sector policies and institutions; investment and trade; and policy and institution building priorities.

EAC Current Status, Achievements, and Challenges

In chapter 2, Dr. Sezibera, Secretary General of the EAC, summarizes the state of play. EAC established a customs union and a common market, put in place ingredients of a comprehensive regional infrastructure, and began to discuss protocols of a monetary union. The partner states have also intensified the crucial processes of harmonization of monetary and exchange rate policies, payment and settlement systems, financial sector supervision, fiscal policies, coordination and harmonization of statistics, and regionalization of the financial sector in order to create a single financial market. As the EAC makes further progress, lessons emerging from the euro zone as well as from other monetary unions need to be taken into account and calibrated to the EAC. Dr. Sezibera challenged conference participants to share their experiences and best practices in order to advance the community's regional integration agenda and its development objectives.

Mr. Shinohara, IMF's deputy managing director, notes that macroeconomic stability has been a remarkable achievement of the EAC over the past decade or so. Looking ahead, EAC faces four challenges: (i) how to balance the prospective benefits of a larger common market against the greater complexity that comes with a more diverse membership; (ii) how to ensure that all countries benefit from regional integration; (iii) how to advance the customs union and common market; and (iv) how to determine the appropriate pace for moving beyond a common market to monetary union.

Mr. Moore, director of the Canadian International Development Association (CIDA-Tanzania), observes that integration is a win-win policy, and we need to fine-tune it as shown by the experience of North American Free Trade Area. He encouraged conference participants to be bold in their deliberations and underscored the role of mass media in educating the public on benefits of integration and fine-tuning it.

Honorable Githae, Kenya's minister of finance, observes that benefits of monetary union outweigh the costs, which include issues like contagion effects, moral hazard problems, and loss of control over some national policies. Mass media plays an important role in educating the public on integration in the EAC and on how coordination is needed at the regional level among various policymakers.

In chapter 3, Professor Collier, the conference keynote speaker, touches on three aspects of regional integration: market integration, a shared infrastructure, and macro-monetary integration. He observes that EAC has not yet developed the institutions needed for market integration. In particular, trade disputes are still resolved in national courts. One noteworthy issue is that gains from cooperation in infrastructure may exceed gains from cooperation in trade. Shared infrastructure matters to integration. Since investment in good-quality infrastructure is expensive, there is a need to attract

[1]Senior Economist, African Department, International Monetary Fund

private financing where possible and to increase multi-country cooperation, which would reduce the cost of mobilizing funds from the private sector. In this context, political impediments need to be overcome. According to Collier, too much attention may have been given to the symbolism of monetary union and common currency, and too little to opportunities for cooperation in creating a shared infrastructure for the community.

Initiating and sustaining high growth is an objective to which many countries aspire, and EAC is no exception. This is the main theme taken up in chapter 4 by McAuliffe, Saxena, and Yabara of the IMF's African Department. McAuliffe and her co-authors conduct a systematic study of the EAC growth record by looking at key determinants of growth and benchmarking EAC growth performance against a group of countries that have either sustained high growth (SG) or accelerated growth without necessarily sustaining it for long (non-SGs). They find that high growth is accompanied by: (i) low inflation; (ii) high investment and savings rates; (iii) improved fiscal discipline through low fiscal deficits and low external debt; (iv) higher export-oriented growth with improved current account balances, helped by depreciating real exchange rates; and (v) better governance, institutions, and conducive business climates that encourage foreign direct investment.

Interestingly, EAC countries compare favorably to the group of SGs in a number of areas—macroeconomic and government stability, favorable business climate, and strong institutions—but important differences remain. In comparison to SGs, EAC countries have a smaller share of exports, lower degree of financial deepening, lower levels of domestic savings, higher reliance on donor aid, and limited physical infrastructure and human capital. There are also different priorities within the EAC because the countries are at different stages of growth accelerations. Policy choices could make a difference in whether the EAC follows the path of SGs or of other countries where growth upturns later fizzled out. Areas that deserve special scrutiny include better trade integration such as elimination of non-tariff barriers, removing impediments to the creation of a large pool of savings beyond national borders that can be tapped into by all EAC members, raising EAC export potential, a better educated and skilled labor force, and a more business friendly environment.

As the EAC strives to form its own monetary union, many EAC policymakers are wondering if there are any lessons to be learned from the experience of the euro zone, the largest monetary union. This question is tackled in chapter 5 by Mr. Pradhan and Mr. Scott of the IMF's European Department. The current euro zone crisis tells us that the monetary union is incomplete. Despite the very substantial progress to open Europe's economies—both to trade and to capital—the euro zone finds itself in a halfway position. It is well integrated so that shocks are quickly transmitted across the zone, but the architecture and policy arsenal are not sufficiently well developed and integrated to be able to absorb such shocks. Although it is perhaps too early to draw lessons from the ongoing developments in the euro zone, Pradhan and Scott emphasize two possible lessons for EAC. First, macroeconomic imbalances matter, and integration—welcome as it is for a monetary union—may mask inherent risks associated with such imbalances and can, in fact, exacerbate them. Second, there are significant benefits from trade liberalization, which spans well beyond the euro area and the European Union. Indeed, Europe's trade has also increased with many countries in East Africa—in tandem with more integration within Europe.

Fiscal, Monetary, Financial Sector Policies and Institutions

What kind of fiscal, monetary, and financial sector policies are in place in the EAC, and which aspects of such policies need to be reformed in order to enhance EAC integration and ensure a successful transition to an East African Monetary Union (EAMU)? Three chapters in Part II tackle each of these topics.

In chapter 6, Mr. Gupta and Mr. McHugh of the IMF's Fiscal Affairs Department take us through a helicopter tour of the fiscal landscape in the EAC, the existing choice of fiscal convergence criteria, and possible pitfalls in choosing alternative rules and indicators for assessing fiscal policies that are needed for an EAMU. EAC countries will need to consider some unresolved issues that are prerequisites to the long-term success of a common currency. For example, they will need to establish permanent fiscal rules, a multilateral fiscal surveillance regime to oversee the operation of those rules, and enforcement mechanisms. Given the size and frequency of recent economic shocks, effective risk sharing may need to be an essential pillar of the EAMU. Important considerations arise with the overlapping membership of EAC partner states and other regional

integration initiatives in Africa. One implication of the rich analysis offered in this chapter is that EAC's fiscal policy agenda is long and deliberations of key ingredients of such an agenda has to start early.

What about issues related to the harmonization of different monetary policies and monetary policy frameworks across the EAC? In chapter 7, Mr. Morales of the IMF's African Department provides a framework on the diverse and sometimes complicated issues involved in transitioning to a monetary union. Complexity arises, for example, as countries have different initial conditions, such as policy effectiveness, dissimilar depth of financial markets, varying fiscal dominance, and the nature of the current exchange regime in each EAC country. An equally important issue is how to sequence monetary policy harmonization as well as harmonization of monetary policy instruments, such as different reserve requirements and lending facilities. The chapter does not attempt to provide solutions but makes a compelling case for having a rich framework that is capable of steering policymakers to ask the right questions and make the relevant decisions.

In chapter 8, Ambassador Gatete, governor of the National Bank of Rwanda, tackles the issue of EAC financial integration. The EAC countries have made great strides in developing domestic financial markets and accelerating integration, but they still have a long way to go. Infrastructure development is on a good course, yet more needs to be done. Although capacity has improved, Ambassador Gatete notes that more skills are still needed in terms of debt management, legal, accounting, and other capital market professionals. Despite these constraints, the outlook for financial market development and integration is positive.

Investment and Trade in the EAC: Progress and Priorities

As noted in chapter 4, investment and trade are two determinants of economic growth. However, this finding focuses more on macro views. The micro view is addressed in chapters 9 and 10. This focus provides crucial insights on how to boost investment and trade.

In 2010/11, the average economy in the EAC ranked 115th, globally, in the ease of doing business. The fact that this ranking remained unchanged from the previous year is an indication that critical obstacles to entrepreneurial activity remain and that other regions have picked up the pace with improvements. Compared with other regional blocs, the EAC ranks better than the Common Market for Eastern and Southern Africa (126th) and Organization for the Harmonization of Business Law in Africa (167th), but falls slightly behind the Southern Africa Development Community (114th). Yet performance across the EAC economies varies. Rwanda is ranked 45th globally in the ease of doing business, followed by Kenya (109th), Uganda (123rd), Tanzania (127th), and Burundi (169th).

The five EAC economies could benefit from sharing good practices in business regulation and linking reform initiatives on a regional basis. Rwanda is among the places where it takes the least amount of time to start a business. Kenya has some of the most business-friendly regulations for dealing with construction permits. Ugandan courts resolve insolvency relatively efficiently. If each country were to adopt best practices of the region for each Doing Business area, then East Africa would rank 19th on the ease of doing business—comparable to Germany.

In chapter 10, Mr. Mufuruki offers a series of personal stories about living and doing business in East Africa. He raises the point that came up at the macro level in the previous chapters—a shared attitude toward being an EAC citizen and not just a citizen of an EAC partner state. He concludes by noting that the EAC needs to be a community of nations, a community of the people of this region. What we want is a widening of the space we require for our development and well-being. We want to trade not with Kenya against Tanzania, not Uganda against Rwanda or Burundi, but with one another and the rest of the world.

Policy and Institution-Building Priorities: The Second Decade

Chapters 11 and 12 nicely summarize the conference. Key policymakers also offer their own takeaways based on their own experience and listening for two days to many speakers who offered some personal and deep insights on how the integration agenda should advance in the EAC.

Honorable Githae, Kenya's minister of finance, underscores the importance of maintaining single-digit inflation, stable interest rates, and exchange rates, and ensuring sustained high and inclusive growth. Volatility in interest rates and exchange rates is not good for business and investment.

Mr. Bukuku, deputy secretary general of the EAC, singles out the four pillars of EAC integration as policy priorities. These are: Customs Union, Common Market, Monetary Union, and Political Federation. The establishment of regional supranational institutions will support integration as a policy priority. These include a common statistical agency, a competition and enforcement agency, a strengthened court of justice, a railway unit, a research policy think tank, and a bureau of standards. In addition, policy priorities should be the creation of the Single Customs Territory of the EAC and the creation of a single regional financial market.

Jacques Morisset, lead economist at the World Bank, points out the importance of mutual benefits in geographical and economic connectivity. If we have to choose a single priority, then connectivity is the most important. What does connectivity mean for the EAC? It means trading among yourselves, leading to a boom in intraregional trade. But regional integration should go with global market integration—and the beauty is that the two go together. If Rwanda can export more easily to Kenya, then it can export more easily to the rest of the world. It is a win-win situation.

Robert Mathu, executive director for the Rwanda Capital Market Authority and chairman of the East African Securities Regulatory Authority, regards as policy priorities, among other things, acquisition and spread of information and communication technology, financial integration, and greater ownership of wealth through privatization.

Dr. Kasekende, deputy governor of the Bank of Uganda, argues that our mindset in East Africa needs to change from national to regional thinking. Professor Ndulu, governor of the Bank of Tanzania, notes that financial integration is broader than the monetary union and we need to do a lot before reaching a single currency. Ambassador Gatete, governor of the National Bank of Rwanda, notes the importance of having a single authority in charge of regulating and overseeing the financial sector. He hopes that the EAC payment system can link all payment systems, a crucial step to financial integration.

Ms. Sayeh, director of the IMF's African Department, notes that on the question of economic growth and its key drivers, macroeconomic fundamentals matter a great deal—low inflation, fiscal discipline, and a competitive economic system, to name a few—but so do structural reforms, such as a better business environment and better-quality fiscal and monetary institutions. In fact, the achievements of the EAC's first decade are in large part due to getting these fundamentals right. These macroeconomic gains need to be preserved and further consolidated. There was general agreement that the remaining exceptions to the customs union should be tackled and that the common market should be implemented in a decisive manner. Closer integration of trade and investment was frequently described as offering win-win outcomes.

There was also agreement that stronger regional financial integration was necessary, in parallel with moves to make the financial system more inclusive. The rapid growth of M-Pesa or e-banking is one regional success story, but more are needed to foster the growth of regional financial markets and ensure that they are soundly supervised.

On budget policies, there was clear recognition that the planned move toward monetary union needs to be preceded by steps to ensure sound national budgets and debt management. This raises important questions of how to subject national budget policies to what Professor Collier described as "supranational" discipline. As members of a common currency area, national governments would need to be subject to binding limits on fiscal deficits and public borrowing. The euro zone is moving to strengthen this discipline under stronger regional institutions, but it does not necessarily provide an off-the-peg model that can be adopted by the EAC. Similarly, the federal arrangements adopted by the United States are far removed from the actual situation today in the EAC. This is an area where further thought is clearly needed, and where EAC member governments need to consult among themselves and with their populations to develop an EAC model. This is not a straightforward task; it needs to be done carefully if monetary union is to be a success. While Professor Collier suggested that this was perhaps a task for the next generation, others are clearly keen to make earlier progress, stressing that "careful does not need to be slow."

On monetary and exchange rate policy harmonization, there is now a definite interest in setting out a clear work plan and timetable. The challenge here will be to align this work program with that on fiscal integration. For effective monetary union, progress on harmonizing financial policies should not be de-linked from fiscal harmonization.

In concluding, Ms. Sayeh underscores the point that the IMF will continue to provide the technical and analytical support that the EAC and its member countries need in these areas. The IMF cannot and should not provide a standardized model for regional integration. But we are eager to discuss EAC priorities and engage with the EAC and its partner states on how these can be achieved, drawing on international experience. The IMF would like to "help you get to where you would like to be tomorrow."

Mr. Moore of CIDA emphasized the need to improve financial literacy and educate the public in the EAC on integration.

Dr. Sezibera, the secretary general of the EAC, emphasized six messages:

- Removal of non-tariff barriers is critical to EAC integration, as well as taking steps toward a functioning customs union.
- Having a functional common market, especially on free mobility of labor, capital, goods, and services, is a challenge to all partner states.
- Cross-border infrastructure that makes the EAC work
- Financial integration and fiscal integration are necessary as we move toward a monetary union.
- A monetary union protocol should not be equated with a single currency.
- Involvement of the people of East Africa is vital to the integration agenda. Creating a framework for dialogues between sectors and members of civil society and the private sector is crucial in advancing the EAC's integration agenda.

Honorable Mkulo, former minister of finance for Tanzania, noted the commitment of all ministers of finance to forge ahead with the integration agenda, and in doing so he challenged the EAC secretariat to organize more conferences that are educational and to invite as many people as possible to attend them.

Part I East African Community: Current Status, Achievements and Challenges

Opening Remarks

Richard Sezibera[2]

The Chairperson of the East African Community (EAC) Sectoral Council on Finance and Economy; the Honorable Ministers of Finance and Economic Development; the IMF Deputy Managing Director; our distinguished guest, the Honorable Minister Responsible for Finance of the Government of the Republic of South Sudan; distinguished Governors of Central Banks and Governor of the Central Bank of South Sudan; Permanent Secretaries; distinguished representatives of the World Bank and Canadian International Development Association (CIDA); leaders of business and civil society and representatives of the media; distinguished delegates, resource persons, invited guests; ladies and gentlemen.

I am very pleased to welcome you to this timely high-level conference aimed at brainstorming on the current status, achievements, and prospects of the EAC, with special reference to the integration of the financial sector.

I would like to thank CIDA and the IMF for their contribution to the organization of this important conference and indeed for their support sustained over the years to the EAC integration.

I am particularly encouraged by the choice of the topics and presenters, reflecting a coherent endorsement of the new dynamic in regional integration; a dynamic whose underlying philosophy is the systematic and steady deepening of East African integration.

Established against the backdrop of the rising phenomenon of globalization, the EAC has as its primary objective to develop a single market and investment area in East Africa that is anchored on the twin pillars of internal free trade and liberal trade with the rest of the world. Its ultimate aim is the establishment of a political federation reflective of the aspirations of the people of East Africa.

It is a cause for pride that during its 12 years of existence, the EAC has demonstrated resilience and relentless fidelity to a clear setting of realistic, if also ambitious, goals and objectives, as well as a systematic commitment to the achievement of these goals and objectives. During this period, the EAC has built strong institutions, legal frameworks, and operational modalities in the promotion of a viable and vibrant integrated market, a business- and investment-friendly environment, and development of competitive value-added industries.

We have established a customs union and a common market into which we are currently investing every effort and energy to ensure that these programs work, and work well, for the people in delivering and demonstrating the benefits of regional integration.

We have enlarged the market and we are putting in place a comprehensive program of regional infrastructure to support a viable, vibrant single market and investment area in East Africa.

Today, we are reaching out, not with the mere presentation of a set of development theories and wish lists of our aspirations but with demonstrable achievements and concrete regional projects and programs that are at various active or advanced stages of implementation.

On the whole, we have transformed the East African narrative from that of lethargy, stagnation, dependence, and underdevelopment to that of forward-looking, dynamic progress.

All essential indicators of progress are speaking to this new, bright, and positive narrative, as reflected in the steady growth trends of investments and trade and overall intensification of regional projects and programs intended to turn this region into a new hub of trade and investments.

It is against this background that the EAC has embarked on the deepening phase of regional integration with the launching of the common market in 2011 and the intensification of the processes toward the establishment of the monetary union, a protocol for which we intend to sign this year, and an eventual political federation of the East African states.

There is determination to achieve these ambitious milestones based on the principles of progressive implementation, transparency, fiscal discipline, equitable development, good governance policy, and taking advantage of economies of scale, which have become the hallmarks of EAC integration.

[2]Secretary General of the East African Community.

The fourth EAC Development Strategy (2011–16) not only signals the entry of the EAC into the new phase of deepening the integration process but also marks a watershed in the evolution of the community to the concretization phase, requiring, among other things, that it would not be business as usual as the EAC moves to the next stage.

I am therefore greatly encouraged by the presence in today's conference of an impressive representation of the broad spectrum of stakeholders of the EAC integration and global development partnership. These include policymakers, scholars and researchers, business leaders, civil society, the media, and our development partners.

These are the champions of EAC integration with whom we have walked hand in hand, shoulder to shoulder, on the journey through the conceptualization and consolidation phases of EAC integration and who have indicated commitment to move forward with us into the last phase of deepening integration.

The immediate and key objective of the new phase is the establishment of the East African Monetary Union (EAMU). In this regard, allow me to recognize the IMF support to the EAMU process through a number of activities at the regional level, including technical studies, statistics, and continued technical assistance at the partner state level.

It was a great honor for the EAC to be granted observer status at the IMF, a great gesture of the Fund's belief in us. I would like to assure the Fund that the partner states of the EAC are committed to turning the EAC Monetary Union into reality.

Apart from the ongoing negotiations of the EAMU Protocol, the partner states have intensified preparedness for the crucial harmonization of monetary and exchange rate policies, payment and settlement systems, financial sector supervision, fiscal policies, coordination and harmonization, statistics, and regionalization of the financial sector in order to create a single financial market.

Further support is required for statistics beyond monetary and financial statistics, to include government finance statistics, balance of payments, national accounts, and consumer price indices.

It has been a widely discussed issue that as the EAC progresses on this agenda, challenges are emerging in the euro zone that the EAC should take into account.

I would like to state unequivocally that the lessons of Europe and those of other regional economic communities serve as lessons to help strengthen and shape the EAMU. And no doubt, I hope, this conference will brainstorm on how to avoid the pitfalls being experienced in the euro zone. However, at the end of the day, East Africa will have to craft a monetary union that serves its unique purposes and aspirations.

The challenges in the euro zone, such as those that relate to fiscal policy, statistics, stabilization facilities, and ensuring balanced economic growth, are some of the issues currently under discussion by the team of senior government experts on the EAMU that is negotiating the EAMU Protocol, and your concrete proposals on some of them would make the EAMU more watertight.

We are, of course, regrettably aware that the securities, pensions, and insurance market is yet to be regionalized and the capital account is yet to be sufficiently liberalized by all partner states to enable all our people to participate outside the present framework of cross-listing of market shares at the national level.

Removal of restrictions on capital flows should serve as a catalyst for capital market development and the provision of long-term and risk capital most needed to spur economic development. At the EAC level, there are definitive programs ongoing toward the promotion of a regional capital markets regime and institutions. The EAC welcomes any insights from this conference on how best to expeditiously work on financial sector regionalization.

On the whole, we recognize that we have a big challenge ahead of us. We are, however, equally aware and confident that by coming together, we can achieve our set objectives within the time frames that we have provided. With the resources that could be mobilized, right from the grassroots to the national, regional, and international levels, there is every certainty that we would achieve our objectives.

It is very important therefore that this conference provide the platform to share experiences and best practices as well as identify areas of strategic cooperation and balanced emphasis, in the whole multiplicity of fields, to push forward and make a difference with regard to our regional integration and development objectives.

Allow me to take this opportunity to propose that in the spirit of extending the discussions of this conference with a view to contextualizing them in the ongoing

negotiations of the EAMU Protocol, I am going to convene a retreat of the ministers responsible for finance, permanent secretaries of ministries responsible for finance, ministers of EAC Affairs, and central bank governors during the first week of April 2012. The retreat is expected to facilitate an informal engagement of the top policymakers on the agenda of the EAMU in order to have a common view, as we enter a crucial phase of the negotiations on a monetary union.

I wish to congratulate and welcome the Republic of South Sudan to this conference. You have the support of the people of East Africa as you begin the exciting but difficult journey of building a new nation out of the ashes of a tragic history.

With these remarks, I thank you for your attention and wish the conference great success.

Naoyuki Shinohara[3]

Good morning, honorable ministers, central bank governors, Secretary General of the EAC, the Canadian High Commissioner, distinguished invitees, ladies and gentlemen. I am delighted to join this conference.

It is an honor to share the stage with Dr. Sezibera, Director of the Canadian International Development Agency, Mr. Moore, and Professor Collier. I would like to thank Dr. Sezibera for his kind introduction. I would also like to thank the EAC for their help in organizing this conference. And sincere thanks go to CIDA for generously funding this event.

This is my first visit to the EAC. I look forward to learning much in the next two days—about the region, its achievements, and its challenges. I will join you for several conference sessions and will attend many meetings with the country authorities and with representatives from civil society organizations, think tanks, and the private sector. I look forward to hearing your views.

The EAC is now in its second decade. It has achieved a lot during this time. The community has grown from three to five countries, and other applications have been received—which attests to the EAC's attractiveness. One reason is the strong macroeconomic track record of existing members. Since 2005, average per capita income growth in EAC countries was 3.7 percent, compared to 3.2 percent for sub-Saharan Africa as a whole. Inflation generally has been well contained. After averaging more than 20 percent in the 1980s and 1990s, inflation averaged 7 percent in the last decade. That said, of course, some countries have recently experienced higher inflation, partly on account of food and energy price shocks and partly because of a delayed monetary policy response. Foreign direct investment in the five EAC countries has also been strong, more than doubling to $1.7 billion during the past decade. Poverty remains too high but is generally trending down across the community.

Challenges remain, of course; and I will come to these in a few minutes. But first let me comment on the global economic outlook. The IMF recently published updated projections that take into account developments in the euro area. These projections include mixed news for sub-Saharan Africa.

On the positive side, sub-Saharan Africa is projected to see continuing strong growth. In the baseline forecast, sub-Saharan African economies are projected to keep growing at rates close to last year's 5 percent. A number of countries will benefit from sharply rising mineral exports this year. Indeed, Africa is projected to be one of the world's strongest-growing regions in the next few years. Only developing Asia, led by China and India, is projected to grow consistently faster. Strong growth in Africa reflects several factors. Macroeconomic fundamentals in the region have improved. Commodity exports to fast-growing Asian and other emerging market economies remain buoyant. These have become a major engine of exports for the region, accounting for two-thirds of export growth. A growing African middle class is creating new internal markets for goods and services. In some of the highest-growing economies of the region, there is mounting evidence that the fruits of growth are benefiting all segments of the population, albeit to different extents, and that access to publicly provided services has expanded rapidly. And the private sector is investing in new technologies in areas such as banking and communications to boost productivity.

But there are also concerns. Global prospects have dimmed, and risks have risen sharply. The global recovery is threatened notably by strains in the euro area, which is projected to enter a mild recession in 2012, driven by spillovers from high sovereign borrowing costs, slowing bank credit, and tighter fiscal policies. With only a weak euro area recovery projected for 2013, advanced economy growth is projected to

[3]IMF's Deputy Managing Director.

remain in the 1 to 2 percent range in 2012–13. This is down from more than 3 percent in 2010. And the risks remain squarely on the downside.

This global backdrop has policy implications for East African countries:

- Falling global price pressures may help with disinflation in the region, but terms of trade could also deteriorate. With weaker global demand, food price inflation is projected to slow. Absent domestic shocks, this will help support tighter monetary and fiscal policies in delivering lower inflation in East African economies. But continued high oil prices and the risk of softening commodity markets may also lead to widening trade deficits.
- The outlook for external commercial financing may also be challenging for some countries. Emerging markets saw strong portfolio capital inflows in 2010 and early 2011. These inflows have diminished since mid-2011, and with increased risk aversion and deleveraging by major banks, inflows are not expected to recover quickly. Accordingly, budgets should be prudent about likely access to external commercial financing. Over the medium term, fiscal austerity in Europe may also lead to declining donor funding for the EAC region.
- Weaker global demand will also put a premium on competitiveness. Reflecting the projected mild recession and slow recovery in the euro area, there will be limited market growth in advanced economies in the next few years. And even fast-growing Asian markets will expand more slowly. This makes for a difficult business outlook for exporters, and makes it ever more important to take steps to strengthen domestic business climates and competitiveness.

With these words on the global economic context, I would like to turn back to the aspects of regional integration that I hope we can discuss today and tomorrow.

One question is the optimal pace of integration. The EAC now includes countries with a combined population of more than 130 million, and further expansion of the community to new members is a real possibility. The challenge is how to balance the prospective benefits of a larger common market against the greater complexity that comes with a more diverse membership.

With a diverse membership, a further challenge is to ensure that all countries benefit from regional integration. This is partly a question of productivity growth. Countries benefiting from rapid productivity growth and improving living standards will be more ready to tackle the adjustment challenges involved with membership in a common market. Analysis by IMF staff shows a gap between the countries experiencing rapid productivity growth (Rwanda, Tanzania, and Uganda) and slower-growing Burundi. This is worrisome, because a widening income gap is opening between Burundi and other EAC countries. Moreover, Kenya is not meeting its full potential as an engine for regional growth. One issue here may be the importance of national reforms to strengthen business climates and foster productivity as a supplement to the regional integration effort. A session is devoted to this topic later in the conference.

An important challenge is to advance the customs union and common market. These are ambitious reforms, and there is a long way to go. Important nontariff trade barriers remain between EAC member countries. Without a truly integrated market, the community is not likely to see the full benefits of improved productivity, competitiveness, and welfare. I am encouraged, here, that Dr. Sezibera has identified removal of nontariff barriers as a major work priority for the EAC in 2012.

A final critical question relates to the appropriate pace for moving beyond a common market to monetary union. Certainly, good progress in implementing the customs union and common market will strengthen prospects for successful monetary union. But the latter also will depend crucially on achieving convergent fiscal, debt, and financial policies. These issues of policy harmonization ahead of monetary union will be discussed in several sessions at this conference, and I look forward to these discussions.

John Moore[4]

Integration is a win-win policy and not a zero-sum game. I encourage the media gathered here today to portray regional integration as a win-win situation, especially since there is bound to be fear among the public. Experience of the North American Free Trade Area shows that integration requires continuous fine-tuning. There is a need to deal with the fear factor from further integration. I want to encourage you all to be bold in your deliberations about the success of integration.

[4]Director, Canadian High Commission, Dar es Salam, Tanzania.

Robinson Njeru Githae[5]

I would like to thank the CIDA, IMF, and the EAC Secretariat for organizing the conference, which presents a unique opportunity to think through the EAMU journey while learning from the European model. The EAC's achievements include a successful customs union with a common external tariff (CET) under the Customs Management Act and the Common Market Protocol (CMP) implementation leading to a monetary union (MU). I would like to urge the partner states to strive to implement the provisions of the CMP. Partner states remain fully committed to the integration process at the highest organs, the council and the summit. In the last meeting in Bujumbura, Burundi, the summit agreed that in 2012 the EAMU negotiations would have to be completed, followed by the signing of the protocol.

The MU offers many benefits: a single currency to eliminate bilateral foreign exchange risks and reduce accounting and transaction costs, expanded regional trade due to a larger market, integrated financial markets, a growing financial sector, and increased competition. The benefits of monetary union outweigh the costs, which would include issues like contagion effects, moral hazard problems, and loss of control on some of the national policies. The EAC needs to position itself better to reap the benefits of integration, and more so of the MU.

In a world of uncertainty, the MU could insulate the EAC from crisis as it takes advantage of regional integration. In this regard, coordination is needed at the regional level in order to encourage the private sector to invest and participate in infrastructure, improve the business climate, and enhance human development capacity. The EAC is committed to private sector-led growth and development. The mass media is also important in garnering public support for the integration process and empowering the people with knowledge to improve the quality of life.

[5]Kenya's Minister for Finance and Chairman of Sectoral Council on Finance and Economic Affairs.

Emerging East Africa: Achievements and Goals of the East African Community

Paul Collier[6]

East African Community (EAC) is an unfinished project in restoring the regional integration that East Africa once enjoyed almost half a century ago. Potentially it is a vehicle for economic and political cooperation in a number of spheres. I would like to focus on three aspects of regional integration: market integration, a shared infrastructure, and macro-monetary integration.

Market Integration

An integrated market offers important attractions:

- Mutually beneficial scale effects encourage urbanization.
- Greater international prominence is attractive to foreign direct investment.
- But note that the higher is a common external tariff (CET), the greater is the adverse redistributive effects from less developed to more developed countries, and because of the structure of the CET, from poor households to the non-poor.

The EAC has not yet developed the institutions needed for market integration. In particular, trade disputes are still resolved in national courts. There has been insufficient pooling of sovereignty. For the EAC to attain middle-income status, it needs to create more interdependent economic activities and activities that are subject to economies of scale. Regional integration ensures that these two outcomes are realized. The population of Africa is smaller than India, but it is spread across a much larger area.

Scale economies matter. The population of South Asia lives almost entirely in one mega-country or two large ones. In contrast, the rather smaller population of sub-Saharan Africa is spread across some 50 countries. Does this political fragmentation have economic consequences? We have found that both private economic activity and the provision of public goods benefit from powerful scale economies that confer advantages on the South Asian model. Paradoxically, although as a result Africa has a greater need than other regions for supranational power structures, it has made far less progress toward regional unity.

Integration of all countries is beneficial. Almost everybody wins. A modern economy entails urbanization, and a more urbanized Africa can generate scale economies which will ensure that integration is not a zero-sum game. A single EAC is a big market for investors.

Three issues need to be addressed when thinking about a trade reform agenda for the EAC:

- A high CET discourages trade, with adverse redistributive effects that undermine mutual gains.
- The so-called sensitive product list among partner states needs to be revisited. A timeline is needed to reduce this list.
- There is a need to replace national courts for trade disputes with a supranational system.

A Shared Infrastructure

Gains from cooperation in infrastructure may exceed gains from cooperation in trade. Investment in good-quality infrastructure is expensive, hence, the need to attract private finance where possible. The key impediments have long been political. Currently, private investors view multi-country projects as being even more politically risky than single-country projects. So the costs of private finance are prohibitive. But the EAC has the opportunity to turn the multi-country nature of such projects to an advantage: Potentially, governments can serve as a check on each other, so that an EAC commitment is seen as more credible than a national commitment.

In this regard, three aspects of a shared infrastructure need to be addressed:

- Railroads and ports: The geographic fundamentals are that three EAC members are landlocked and dependent upon the infrastructure of the two coastal members. The EAC needs to develop its railways and ports in order to better integrate.

[6] Professor of Economics and Public Policy, Oxford University.

- Power: With new discoveries of oil and gas, there is an opportunity to rethink power provision on a regional basis. Regional provision is likely to be much cheaper, and reliable cheap energy is hugely important for economic development.
- Financial integration: The EAC should be the world leader in e-banking and should have a common payment system.

The message is that there are large mutual gains; we must learn to trust each other and learn to cooperate. Trade always has a distributional impact, but a common infrastructure is a win-win policy.

Macro-Monetary Integration

We now know from the European experience that there are strong political pressures to commit to the symbolism of a common currency, but that the practical reality is far more difficult. Regional groups are, in effect, clubs. As such they are ill suited to a policing role on highly sensitive issues such as budget deficits. Basically, if an IMF program cannot provide the discipline for good macroeconomic management, regional peer pressure is highly unlikely to be more effective. Yet without common macroeconomic policies, monetary union is doomed to generate crisis. Further, even with common policies, if economies are sufficiently different, then common external shocks will impact differentially and so again a monetary union would risk crisis. In the past, East Africa's economies were structurally very similar, but now that South Sudan and Uganda are oil exporters, there is a major structural difference within the EAC.

My overall assessment is that despite some progress, the EAC could do much more. Trade integration has perhaps been more difficult than it needed to be because the CET is too high, creating powerful and contentious distributional issues. Too much attention has been given to the symbolism of monetary union, and too little to the many opportunities for cooperation on infrastructure.

Sustaining Growth in the East African Community

Catherine McAuliffe, Sweta Saxena, and Masafumi Yabara[7]

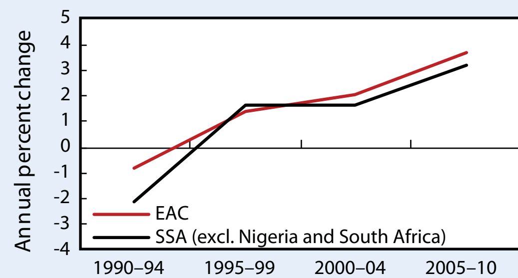
The Growth Record

In the midst of sub-Saharan Africa's (SSA) best decade of economic growth since at least the 1970s, the East African Community (EAC) is among the fastest growing regions.[8] Growth rates have picked up strongly in EAC countries over the last two decades—outpacing the rest of SSA since 2000. During 2005–10, per capita income growth reached 3.7 percent a year in the EAC, compared to 3.2 percent for SSA as a whole, and almost quadruple the rate achieved in the previous 15 year period (Figure 1). Part of the recent high growth is "catching up" after years of very poor growth—in the last part of the 20th century the region suffered periods of severe civil strife and bouts of economic instability. Since then, the region has been committed to strong policies.

However, growth within the EAC has been uneven. Rwanda, Tanzania and Uganda have had the longest periods of high growth. Uganda's growth acceleration started earlier than the other countries and has lasted more than 20 years, with per capita income growth averaging 3.4 percent a year during 1990–2010 (Figure 2). Growth in Rwanda and Tanzania has been strong since the early 2000s. After a period of stagnation, growth is picking up in Kenya—the largest of the five economies—averaging 1.9 percent per year since 2005 compared to minus 0.2 percent in 1990–2004, providing momentum for the region as a whole. Output declined in Burundi in most of the period since 1990—reflecting periods of political conflict—but has shown signs of recovery in recent years.

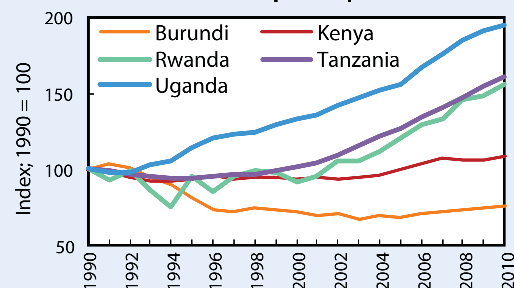
With strong output growth, per capita incomes in the region are catching up. Average per capita income in the EAC reached US$411 in 2010—close to the average of US$425 for SSA (excluding South Africa and Nigeria), but it remains low with wide variations within the region (from US$464 in Kenya to US$147 in Burundi) (Figure 3).[9]

Figure 1: Real GDP per Capita Growth[1]



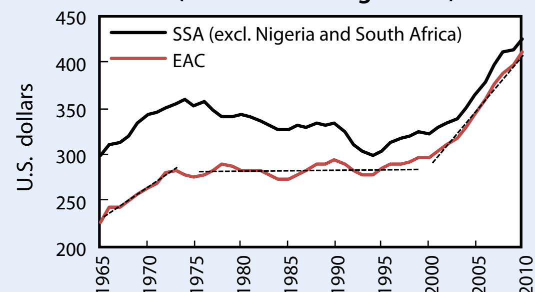
Source: IMF, *World Economic Outlook*.
[1] Weighted by Population

Figure 2: Cumulative Growth in Real GDP per Capita



Source: IMF, *World Economic Outlook*.

Figure 3: Real GDP per Capita Growth (at 2000 exchange rates)[1]



Source: IMF, *World Economic Outlook*.
[1] Weighted by Population

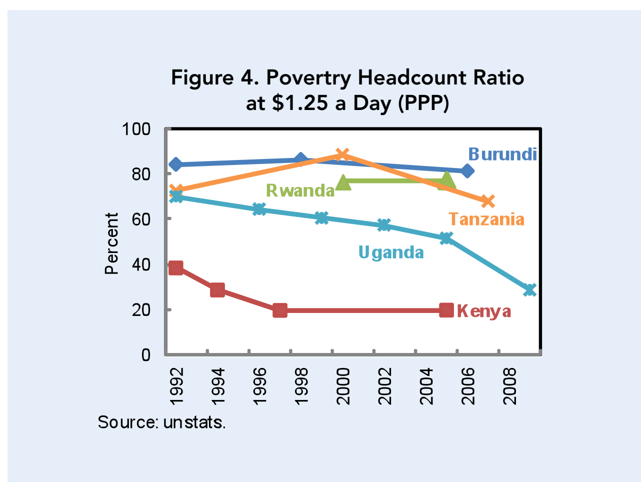
[7]The authors are Deputy Division Chief, Senior Economist, and Economist, respectively, in the African Department of the IMF.

[8]The EAC comprises Burundi, Kenya, Rwanda, Tanzania and Uganda (Box 1).

[9]Real per capita income at 2000 prices and exchange rates.

Addressing Social Challenges

Some progress has been made toward the Millennium Development Goals (MDGs). Most EAC countries are close to achieving universal primary education, and child mortality rates have come down. Poverty was reduced sharply in Tanzania and Uganda, driven by strong income growth (Figure 4).[10] On the other hand, Kenya—despite having the lowest poverty ratio—and Burundi have not made much progress in the last decade; and poverty remains unacceptably high, especially in Burundi, Rwanda and Tanzania. The region's high population growth (close to 3 percent per year over the last two decades, compared with the sub-Saharan Africa's average of 2.6 percent) could constrain efforts to improve social indicators.



Achieving Middle Income Status

The recent growth path will not be enough to achieve middle-income status and substantial poverty reduction by the end of the decade—the ambition of most countries in the region. To achieve these objectives, the region would need to grow at an average rate of about 5.5 percent in real per capita GDP per year for the rest of the decade, about two percentage points faster than in the last five years.[11] Rwanda, Tanzania, and Uganda, with per capita income somewhat below the regional average, would have to grow by about 7-8 percent per capita a year to meet that goal. Kenya is already close to middle-income levels, and should achieve this earlier if current growth rates are maintained. Burundi—the poorest of the EAC members—will take much longer to reach that goal.

What Drives Growth?

There is no consensus on what determines growth—both initiating and sustaining the process. There are many factors that vary from country to country—including macroeconomic policies, investment and trade, political and economic institutions, infrastructure and financial development, human capital, and income distribution. At the same time, it is also widely recognized that the factors behind growth upturns are not necessarily the same as those that sustain growth, and that while starting growth is relatively easy, sustaining it over a longer period is more difficult. We look at the factors that have contributed to growth in the EAC so far and assess the prospects for translating the recent upturn into sustained high growth. To do this, we compare growth performance in EAC countries with other countries that have achieved sustained growth (comparing levels and trends in certain indicators to those observed in the other countries).[12] Are EAC countries undergoing important shifts in growth patterns—similar to other sustained growth countries—that could underpin a longer term period of high growth for the region? We also compare the track record of sustained growth countries (SGs) with countries that started to grow but growth fizzled out subsequently. What are the key factors that distinguish sustained and non-sustained growth and what lessons are there for the EAC? Although this type of benchmarking cannot be used to make unconditional policy advice, it has been used with greater frequency in the growth literature to help judge the growth potential of a country or region by identifying the types of strategies and policy interventions that have been successful, as well as identifying possible constraints to growth.

[10]Preliminary results from a recent household survey in Rwanda also indicate declining poverty.

[11]For illustrative purposes, the calculation assumes a middle-income threshold of US$1,000 GDP per capita in 2010 (close to the US$1006 threshold of middle-income status defined by the World Bank). We assume this threshold grows in nominal terms at about 3 percent a year—the observed growth of the middle-income threshold over the last decade—for the next decade to reach an estimated US$1,331 in 2020.

[12]To support the benchmarking exercise, we also run regressions to understand what institutional measures explain growth and increase the likelihood of achieving accelerated and sustained growth. The latter part is motivated by Hausmann, Pritchett, and Rodrik (2005), with new variables to capture economic liberalization and peace dividends.

Box 1. East African Community: An Overview

The EAC was established in 2000 by Kenya, Tanzania and Uganda; Burundi and Rwanda joined in 2007. Its objectives are to deepen cooperation among member states in political, economic, and social fields—including establishment of a customs union (2005), common market (July 2010), monetary union and ultimately political federation of East African States. Burundi and Rwanda joined the customs union in 2009.

EAC members are diversified in terms of incomes and social indicators. The EAC has a population of about 133 million, a land area of 1.8 million square kilometers and nominal GDP of $79 billion (2010). Kenya has the largest economy, with a nominal GDP of US$ 32.1 billion (41 percent of total EAC GDP). Measured in GDP per capita, Burundi is the poorest member, with an average nominal per capita GDP of US$180, less than one-third of the EAC average (US$590). Large shares of the population live in rural areas across the region. Three of the countries are landlocked (Burundi, Rwanda and Uganda); one is currently actively exploiting natural resources (gold in Tanzania), and two have resources on stream.

While the current EAC has existed for a little more than a decade, there has been a long history of cooperation under successive regional integration arrangements in the region. Kenya, Tanzania and Uganda have participated in regional integration arrangements dating back to 1917, starting with a Customs Union between Kenya and Uganda in 1917, which the then Tahnganyika joined in 1927; the East African High Commission (1948–1961); the East African Common Services Organization (1961–1967); the East African Community (1967–1977) and the East African Co-operation (1993–2000).

EAC Countries: Selected Indicators, 2010

	Burundi	Kenya	Rwanda	Tanzania	Uganda
GDP and inflation					
Nominal GDP (US$ billions)	1.5	32.1	5.6	22.5	17.0
Nominal GDP per capita (US$)	180	808	558	545	501
Real GDP per capita (US$) [1]	147	464	364	453	374
Real GDP growth (percent, annual average 1995–2010) [1]	1.2	3.5	7.6	5.8	7.3
Consumer price inflation (percent, annual average 1995–2010)	13.1	7.7	10.1	9.5	6.2
Social indicators [2]					
Population (millions)	8.3	39.7	10.0	41.3	34.0
Population growth (percent, annual average 1995–2010) [3]	2.2	2.5	3.6	2.3	3.3
Rural population (percent of total population)	89.0	77.8	81.1	73.6	86.7
Mortality rate of infants (per 1,000 live births)	87.8	55.1	59.1	50.0	63.0
Literacy rate (percent of people ages 15 and above)	66.6	87.0	70.7	72.9	73.2
Geographical factors					
Landlocked	√		√		√
Natural resources [4]			√	√	√

Sources: IMF, *World Economic Outlook*; World Development Indicators; Barro and Lee (2010); and UNdata.

[1] At constant 2000 prices and exchange rates.

[2] Most recent data available.

[3] For Rwanda, 1998–2009.

[4] Methane gas in Rwanda and oil in Uganda are not yet on-stream.

Our Findings

We find that countries that continued to follow prudent macroeconomic policies and further improve institutions were able to translate growth upturns into sustained growth. Specifically, countries that have sustained strong growth tend to maintain (i) low inflationary environments; (ii) high investment and savings rates; (iii) improved fiscal discipline through low fiscal deficits and low external debt; (iv) higher export-oriented growth with improved current account balances, helped by depreciating real exchange rates; and (v) better governance, institutions, and conducive business climates that encourage foreign direct investment.

EAC countries compare favorably to the group of SGs in a number of areas—macroeconomic and government stability, favorable business climate and strong institutions—but important differences remain. In comparison to SGs, EAC countries have a smaller share of exports, lower degree of financial deepening, lower levels of domestic savings, higher reliance on donor aid, and limited physical infrastructure and human capital. There are also different priorities within the EAC because the countries are at different stages of growth accelerations. Policy choices could make a difference in whether the EAC follows the path of SGs or of other countries where growth upturns later fizzled out.

The rest of this chapter is organized as follows. The first section provides a review of recent growth literature. The second section explains the methodology used to identify growth accelerations and sustained growth episodes, and highlights factors contributing to sustained growth. The third section provides a comparison of EAC growth with other growth episodes. The last part concludes with some policy recommendations.

What Does Literature Offer?

There is a copious body of growth literature searching for policies to boost income, with no consensus on what determines growth.[13] As a recent study puts it, there are "no recipes, just ingredients."[14] The problem is that growth is not a steady process. The variation across time is about as large as the variation across countries. Easterly and others (1993) note that, "with a few famous exceptions...countries are success stories one period and disappointments the next."

According to the recent literature, there is some evidence that sustained strong growth is linked to favorable performance in investment and trade, competitive exchange rates, and productivity improvements. There is also some evidence that institutional reform is important—both in triggering stronger growth, and in consolidating export diversification and other reforms.

One recent trend in the growth literature focuses on the information content contained in turning points in countries' growth performance by looking at correlates of accelerations in growth. Hausmann, Pritchett and Rodrik (HPR) (2004), in particular, identify 80 episodes of growth accelerations sustained for at least eight years in 1950¬–2000. They focus on the turning points in the growth episodes—where trend growth experiences clear shifts. These episodes are correlated with increases in investment and trade, and with real exchange rate depreciations. Political regime changes are significant predictors of growth accelerations, while external shocks tend to produce growth accelerations that eventually fizzle out. Economic reform is a statistically significant predictor of growth accelerations. However, growth accelerations tend to be highly unpredictable: unrelated to standard determinants and not necessarily produced by economic reforms.[15]

In a related study, Johnson, Ostry and Subramanian (JOS) (2007) identify 12 cases of sustained growth (SGs) in countries that started with weak institutions. They highlight a virtuous circle between exports and institution building.[16] Most of the identified SGs followed a manufacturing exports-based development strategy. The expansion of trade created profound changes in the distribution of economic power, with consequences for political power and, consequently for institutions. While weak institutions may not be a binding constraint on growth for African countries, risks may be seen in developing institutions for commodity exporters and countries that receive sizeable aid inflows.

Selassie (2008) examines Uganda, a member of the EAC, to understand why its sustained growth for 20 years did not translate into structural transformation. Selassie finds that strengthening the country's infrastructure and enhancing export competitiveness is required to improve the quality of growth.

Other Africa-specific studies attribute growth to institution and human development. For example, Page (2009) and Arbache and Page (2009) find that growth in Africa since 1995 has been due to better macroeconomic policies, while changes in such "growth determinants" as investment, export diversification and productivity have not accompanied the growth boom. Page (2009) suggests that for sustained growth Africa needs to manage natural resources better, push nontraditional exports, build the private sector and create new skills. It also identifies the challenge for commodity exporters to develop institutions that promote and support growth. Radelet (2010) highlights a group of 17 emerging countries in SSA that since the mid-1990s have broken away from the rest of the region and achieved steady economic growth, deepening democracy, stronger leadership, and falling poverty.

[13]See Barro (2003) and Barro and Sala-i-Martin (2004) for comprehensive analysis.

[14]Commission on Growth and Development (2008).

[15]Xu (2011) revisits the HPR methodology and extends their sample, findings that the HPR results are fragile to changes in sample and measures. Specifically, he finds that economic reforms are correlated with sustained accelerations, while negative regime changes are associated with both unsustained and sustained growth accelerations.

[16]Arora and Vamvakidis (2004) find that trading partners' growth and relative income levels have a strong effect on domestic growth, even after controlling for the influence of common global and regional trends.

Explaining Growth: The Empirical Framework

Identifying Growth Episodes

We build on the methodology established in HPR, and further developed in JOS (2007) and Xu (2011) to identify countries that achieved growth accelerations and sustained growth. Our methodology modifies these earlier studies in a number of important areas: *First*, we extend the time series to 2009 (or 2006 depending on the explanatory variables) whereas the HPR data only go through only 2000, effectively excluding the high growth period in SSA and particularly in the EAC.[17] Second, our sample consists of commodity–exporting low income countries (i.e., countries with similar economic characteristics to EAC countries); whereas the HPR sample includes all countries (including industrial), and JOS uses only countries that had weak initial institutions.

According to the methodology, *growth acceleration* episodes must satisfy three criteria: (i) a period of *rapid growth* in per capita GDP of at least 3½ percent a year for seven years; (ii) an *improvement* in growth in per capita GDP of at least two percentage points (which captures the idea of acceleration); and (iii) *a higher post-acceleration income level* than the pre-acceleration peak (this requirement rules out cases where accelerations are simply a rebound from a prior period of bad performance, owing to conflict or other shocks) (Box 2). On the basis of these criteria, and using the latest available data through 2009, we can identify growth acceleration episodes starting as late as 2002.[18]

Not all countries can sustain high growth once their growth accelerates. Therefore, to identify *sustained high growth* episodes, i.e., countries that not only exhibited accelerated growth, but also sustained it after the

Box 2. Defining Accelerated and Sustained Growth Episodes

Based on the earlier studies, growth acceleration episodes for countries are defined as follows:

(i) $g_{t,t+7} \geq 3.5$ percent	*Growth is rapid*
(ii) $g_{t,t+7} - g_{t-7,t} \geq 2.0$ percent	*Growth accelerates*
(iii) $y_{t+7} \geq \max\{y_i\}, t - 20 \leq i \leq t$	*Post-acceleration output exceeds pre-episode peak*

Where t is the year of growth acceleration, y_t is real GDP per capita, and $g_{t,t+7}$ is the least squares growth rate of real GDP per capita over eight years.

For *sustained growth* episodes, growth rates must remain above 3 percent for at least five years after the first seven years:

(iv) $g_{t+7,t+12} \geq 3.0$ percent	*Growth acceleration is sustained*

We further filter out growth episodes using the following criteria:

- We single out classified as commodity exporters, that are not "advanced economies" or "countries in transition" as defined in WEO.
- As in HPR we exclude countries with population less than two million and countries with fewer than 20 data points.
- In cases where several consecutive years meet the above requirements, the first year is chosen as a growth episode.

[17] We use Penn World Tables (PWT) 7.0 (May 2011) which covers 1950 to 2009 for 189 countries for identifying growth episodes. World Economic Outlook (WEO) and the World Development Indicators (WDI) are used in benchmarking the EAC growth experience against identified growth episodes, and they cover data starting in 1960.

[18] Since growth episodes must last for at least 7 years to qualify as a growth acceleration (criterion ii), the latest year for the start of an acceleration is 2002 using PWT 7.0, which includes data through 2009.

acceleration, we add a fourth criteria (iv) that growth rates must stay above 3 percent for at least five years after the first seven years, similar to methodologies used in HPR and subsequent studies.[19] Given the end-year 2009 in our data set and the addition of the fourth criterion, we can only identify sustained growth episodes that started on or before 1997. There are growth acceleration episodes that started before 1997[20] which did not meet the fourth criteria simply because their episodes were too short. However, these episodes which we refer to as *non-sustained growth* episodes are useful to study since they provide a different benchmark against which the recent experience of EAC countries can be compared with.

We identify 34 episodes of *sustained growth* in 28 countries (SGs), as well as 35 non-sustained growth episodes in another 28 countries (non-SGs). Table 1 shows all of the growth episodes and the years of acceleration (time *t*). The list of SGs includes most of the well-known growth episodes that followed significant policy changes or policy reforms. None of the EAC countries make this list. Three EAC countries (Uganda, Tanzania, and Rwanda) have achieved growth accelerations (satisfying criteria i-iii)—with acceleration in 1992 for Uganda, 1999 for Tanzania, and 2002 for Rwanda. However, they are not SGs (none meet criteria iv—the growth episodes for Rwanda and Tanzania are too short while Uganda fell just short of the threshold

Table 1. Growth Episodes of Commodity Exporters

Sustained Growth (Meet all the criteria (i)–(iv))		Non-Sustained Growth (Meet all the criteria but (iv))	
Brazil	1966	Afghanistan, I.R. of	1977
Cambodia	1994	Argentina	1989
Cameroon	1971	Benin	1976
Chile	1974* 1983	Chad	1997
China,P.R.: Mainland	1967 1976 1989	Haiti	1970
Colombia	1967 1991*	Honduras	1972
Congo, Republic of	1968 1976*	Jordan	1972
Dominican Republic	1965 1999	Lao People's Oem. Rep.	1978 1988
Ecuador	1966	Lebanon	1978
Egypt	1958* 1972 1988*	Mali	1972 1983
Ghana	1964* 1997	Nicaragua	1958
Guatemala	1963	Papua New Guinea	1970 1989
Indonesia	1967 1985	Peru	1958
Iran, I.R. of	1964	Philippines	1969
Malawi	1961	Sri Lanka	1976 1991
Malaysia	1966 1986	Tunisia	1969
Mexico	1962	Uganda	1992
Morocco	1957 1970*	Uruguay	1972 1987
Mozambique	1994	Zambia	1962
Nigeria	1957* 1966* 1996		
Oman	1982		
Pakistan	1959		
Panama	1957 1974*		
Paraguay	1968		
Syrian Arab Republic	1969 1989*		
Thailand	1957 1983		
Turkey	1964		
Vietnam	1988		

Source: Penn World Tables Version 7.0; and authors' calculations.
Note: denotes a non-sustained growth episode.*

[19]Although these studies commonly use the criterion of 10 years after growth acceleration to be considered sustained, HPR and Xu (2011) use the criterion that gt+7,t+17 ≥ 2 ppa, whereas JOS use the criterion that growth per capita must stay above 3 percent after 7 years.

[20]Modification of this criterion from HPR methodology allows counting Uganda's episodes as accelerated growth episodes.

of sustaining growth for seven years beyond growth acceleration and is the only EAC country that has a non-sustained growth episode. In contrast, Burundi and Kenya, two countries with the lowest and highest per capita income in the EAC, respectively, have not yet registered a growth acceleration, failing to meet criteria i–iii. For the rest of this chapter, Rwanda, Tanzania and Uganda (referred to as EAC-AGs) are treated as a group given similarities in their growth performance, while Burundi and Kenya are assessed individually because they are subject to different constraints on achieving growth accelerations.

Differentiating Sustained and Non-Sustained Growth

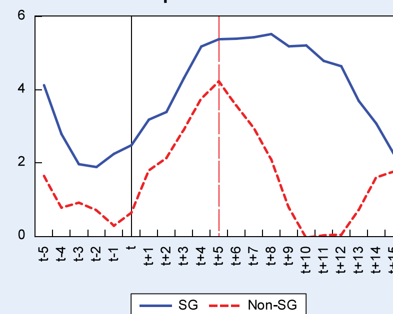
A simple review of the economic characteristics of countries with different growth experiences can be informative.[21] The events that give rise to a growth acceleration may well be different from those that sustain the upturn, and contributory factors may be self-reinforcing or offsetting. In short, growth outcomes possibly reflect multi-faceted processes that may be difficult to identify through econometric analysis alone. This section looks at possible lessons using a more low-tech approach to examining the evidence.

On average, growth tends to start stronger and last twice as long in SGs. For the sample of countries in Table 1, average real per capita growth in the first 6 years of growth acceleration was 4 percent for SGs, compared to just 1.8 percent for non-SGs (Figure 5). The growth upturn was also more durable. For SGs, growth remained at initial rates for a ten-year period, whereas for the non-SGs, growth peaked after the first 5 years and subsequently slowed rapidly.

This suggests that at least two different sets of growth-contributing factors may be at work. The first can be seen as contributing to the faster pace of growth in SGs during the initial expansionary period, while a second set may contribute to the collapse of growth rates in non-SGs around the five-year mark. Possible candidates for these roles are considered below.

Growth accounting analysis suggests important roles for both foreign direct investment and productivity in explaining differences in growth performance. There is little evidence that domestic investment contributes to the faster initial growth of SGs, because average investment rates during the first five-year period are very similar to non-SGs (Figure 6). Domestic investment declines *beyond* the five-year mark for non-SGs, but it is not clear whether this is a contributory factor to slow growth: most likely it is caused by the growth slowdown in these countries. The story is different for foreign direct investment, which rises much more sharply in SGs, paralleling the higher growth rates for this group. Similarly total factor productivity (TFP) rises faster for SGs, and continues to grow beyond the five-year mark, in contrast to a slump in productivity for non-SGs.[22] These findings are consistent with other studies that find FDI is an important source for transferring technologies and enhancing productivity at firm levels, important for the growth process.[23] While causalities are unclear, it seems likely, then, that sustained strong growth is closely linked to a successful and sustained upturn in productivity growth. This may make SGs more attractive investment locations, reflected in the higher foreign direct investment flows.

Figure 5. SGs vs. Non-SGs: Real GDP Per Capita Growth Rate



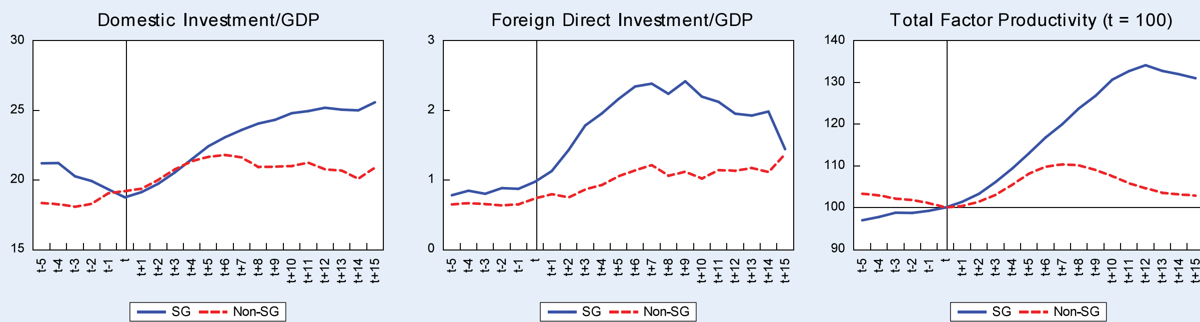
Source: IMF, World Economic Outlook; and authors' calculations.
Note: Five-year moving average.

[21]As a complementary analysis, we also ran regressions on drivers of growth, using models developed in the literature extended for additional variables relevant for the EAC, e.g., peace dividend. We found that maintaining peace and a move toward financial liberalization improve the chances of experiencing both growth accelerations and sustained growth after some 5-7 years, i.e., persistence pays off.

[22]Total factor productivity (TFP) for countries is estimated using a growth accounting methodology developed by Bosworth and Collins (2010) as follows: $\Delta\ln(Y/L)=0.35[\Delta\ln(K/L)]+(1-0.35)\Delta\ln H+\Delta\ln A$, $K_t=K_{t-1}(1-d)+It$, and $H=(1+r)^s$, where Y denotes real GDP, L work force, K capital stock, A total factor productivity, I gross fixed investment, and H educational attainment or human capital. d is a depreciation rate of capital, which is assumed to be five percent, while r, a return to each schooling year s, is assumed to be 7 percent.

[23]For example, see Javorcik (2004).

Figure 6. SGs vs. Non-SGs: Investment and Productivity



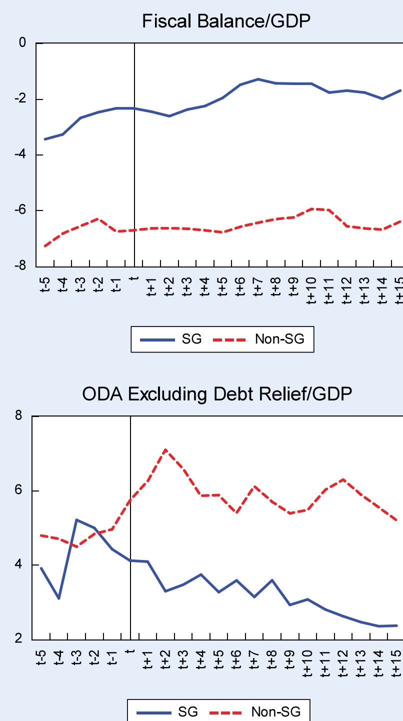
Source: IMF, World Economic Outlook; Regional Economic Outlook: Sub-Saharan Africa; Johnson and others (2007); Bosworth and Collins (2010); Barro and Lee (2010); and authors' calculations.
Note: Five-year moving average.

Various factors may contribute to the favorable productivity trends associated with SGs' performance. A list of possible contributory factors is provided below and discussed in more detail in the following paragraphs:

- **Public sector finances and institutions.** Large fiscal deficits can be destabilizing to the macro economy, while high levels of foreign aid inflows may be able to finance growth-promoting investments. The quality of public sector institutions could also potentially influence national productivity performance.
- **Inflation discipline.** There is evidence that high rates of inflation undermine growth performance.
- **Health and education.** A healthy and well-educated population would be more productive.
- **Infrastructures.** Strong public infrastructures would support overall productivity.
- **Financial sector depth.** A well-developed financial sector can help mobilize domestic savings and allocate resources productively.
- **External competitiveness.** Strong growth performance is frequently linked to favorable contributions from the export sector.

On public sector finances, there are strong indications that large deficits are not helpful to growth. There is a striking and sustained difference between the size of fiscal deficits in SGs (1.9 percent of GDP on average over the 15-year period since the take-off) and those for non-SGs (6.5 percent of GDP on average over the same period) (Figure 7). This suggests that the macroeconomic instability that can arise from large deficits is a more important negative influence on growth than the possible benefits that larger deficits could offer in financing, say, higher public investments. There is little evidence, in this sample, that higher levels of overseas development assistance (ODA) support productivity and growth. Average ODA was about 3 percent of GDP for the SGs, compared to 6 percent for non-SGs. *Overall, fiscal deficits appear to be a major risk factor for sustaining growth.*

Figure 7. SGs vs. Non-SGs: Public Sector Finance



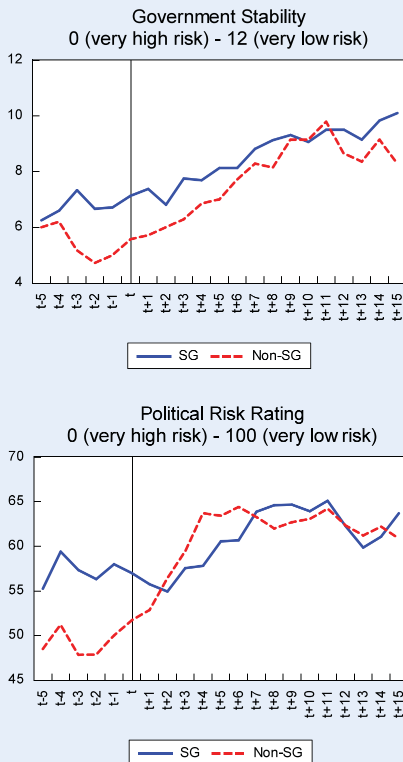
Source: IMF, World Economic Outlook; OECD, OECD.Stat; and authors' calculations.
Note: Five-year moving average.

The quality of public institutions does not seem to help sustain growth upturns. Survey results on government stability are slightly higher in the first 5 years of the growth upswing for SGs, but the difference is not large; moreover, government stability continues to improve in non-SGs through year 10, even as growth weakens (Figure 8). And survey data on political risk is very similar across both types of countries. Overall, there is little here to suggest that the quality of public institutions makes a large difference in whether countries can sustain their growth accelerations.

Inflation appears to be inversely related to growth performance. For the SGs, inflation averages about 11 percent in the decade after the growth acceleration, compared to 18 percent for non-SGs (Figure 9). This may be linked to the higher fiscal deficits for non-SGs. *Inflation, then, is another possible risk factor.*

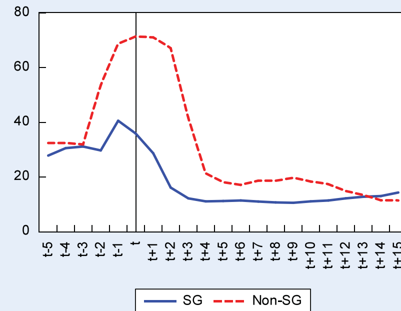
There is little evidence that superior health and education outturns sustain growth upturns. Health and education indicators change only slowly over time, and

Figure 8. SGs vs. Non-SGs: Quality of Institutions



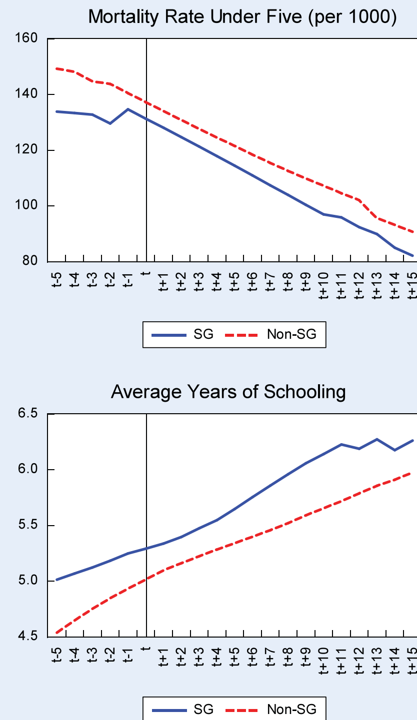
Source: ICRG; and authors calculations.

Figure 9. SGs vs. Non-SGs: CPI Inflation



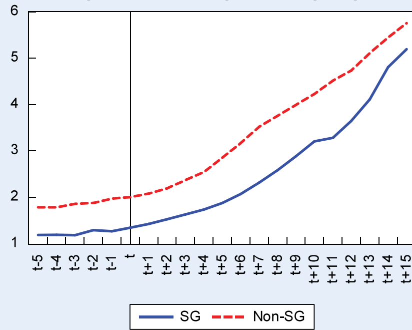
Source: IMF, World Economic Outlook; and authors' calculations.
Note: Five-year moving average.

Figure 10. SGs vs. Non-SGs: Human Capital



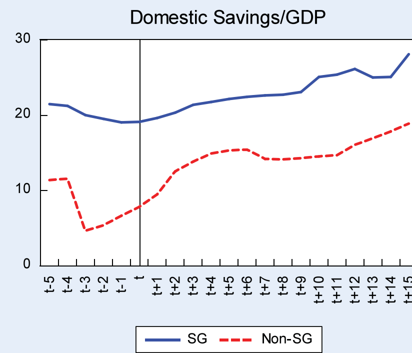
Source: World Bank, World Development Indicators; Barro and Lee (2010); and authors' calculations. Note: Observations are linearly interpolated because source data are available only in every five years. For average years of schooling, only observations whose t are after 1980 are included.

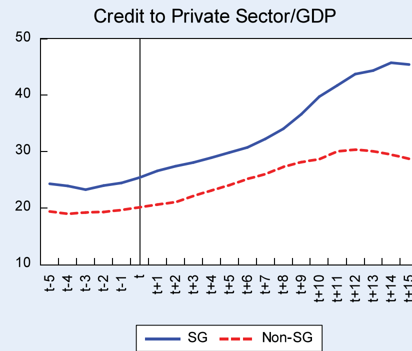
Figure 11. SGs vs. Non-SGs: Infrastructure -Telephone Lines (per 100 people)

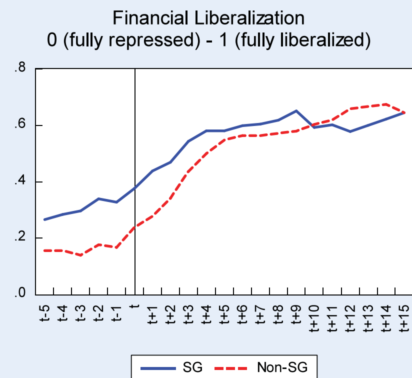


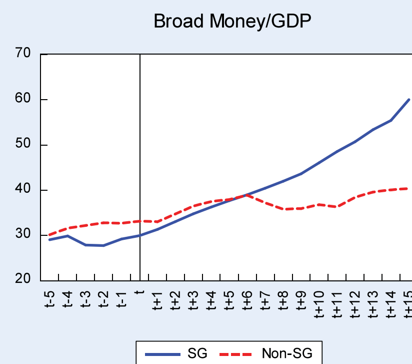
Source: World Bank, World Development Indicators; and authors' calculations.
Note: Observations are linearly interpolated because source

Figure 12. SGs vs. Non-SGs: Financial Development









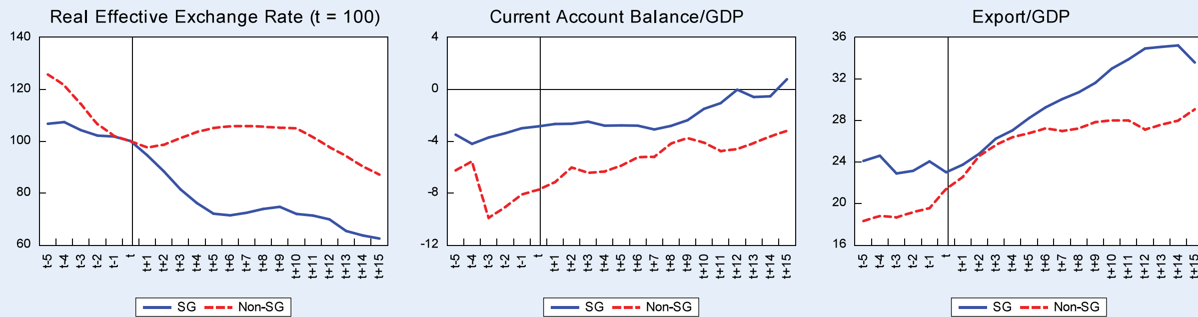
Source: IMF, World Economic Outlook; World Bank, World Development Indicators; Abiad, Detragiache, and Tressel (2008); ICRG; and authors' calculations. Note: All the series besides financial liberalization are represented by five-year moving average.

there is little evidence that they either trigger growth upturns or make a difference on how long they last. Based on the country sample in this study, childhood mortality figures are better, and school attendance higher for SGs (Figure 10). Both samples show steady improvements largely unrelated to short-term growth performance, and the difference between SGs and non-SGs is broadly stable over time. While investments in better health and education are important, especially in the long term, they appear to be unrelated to the chances of sustaining faster growth performance in the 5–10 year range.

This chapter has only limited data on the quality of public infrastructures. Evidence of the density of telephone landlines suggests that infrastructures is, on average, worse for SGs, albeit improving over time (Figure 11). Although there is no evidence in this assessment, it is difficult to make a case that the quality of infrastructure does not play a role in triggering and sustaining strong growth.

There is some evidence that the financial sector can make a difference to sustained growth. Domestic savings tend to be much higher, as a share of GDP, in SGs—though this may not entirely reflect financial sector performance (Figure 12). (Smaller fiscal deficits also tend to increase domestic savings.) At the same time, private sector credit tends to be higher in SGs—private sector credit increased by 20 percentage points of GDP in a 15-year period compared to 9 percentage points for non-SGs, with credit picking up strongly in outer years in those countries that sustained high growth. SGs also typically made an earlier start in financial liberalization (though after five years, the head-start in reforms relative

Figure 13. SGs vs. Non-SGs: External Competitiveness



Source: IMF, World Economic Outlook; and authors' calculations.
Note: Five-year moving average.

to non-SGs is significantly narrowed). In sum, deep and efficient financial systems, providing access to finance, may play a role in triggering and supporting sustained strong growth.

External competitiveness appears to be critical to sustained strong growth. One of the largest differences between SGs and non-SGs is in terms of the more favorable real exchange rates of the former during the growth upswing.[24] In the first five years, the real exchange rate is depreciated by about 30 percent in SGs, compared to a slight appreciation for the non-SGs (Figure 13). For SGs, real exchange rates continued to depreciate during most of the period of sustained growth. The more competitive currency is associated with smaller current account deficits in SGs, and with higher export-to-GDP ratios. While competitiveness appears important, it likely reflects other contributory factors, rather than being a direct policy instrument for growth promotion. For instance, large fiscal deficits, higher inflation, and low domestic savings will tend to appreciate the real exchange rate and foster larger current account deficits. Based on the above review, a number of factors appear to be associated with differences in growth outcomes. These factors—summarized below—are examined next in the context of

Table 2. Possible Drivers and Risk Factors for Sustained High Growth

Contributory Factor	Possible Impact on Sustained Growth	Comments
Productivity	Sustained strong growth in productivity critical to sustaining growth upturns.	Sustained strong growth reflects productivity more than investment.
Fiscal deficit	Larger deficits result in slower and shorter growth upturns.	Possible impacts through inflation, currency appreciation, and crowding-out in credit markets.
Inflation	Higher inflation is associated with slower and shorter growth upturns	Possible adverse impact on business climate.
Financial sector depth	Higher domestic savings, higher private credit-GDP, and earlier financial liberalization appear to be associated with strong sustained growth.	Possible contribution to level and quality of private investment.
Competitiveness	Improved competitiveness appears to be closely linked to sustaining faster growth.	Possibly reflects other factors, like fiscal performance. But weak competitiveness would be a red flag for growth.

[24]Although the link between real exchange rate and growth is tenuous, Rodrik (1999) finds that undervalued real exchange rates stimulate economic growth.

the EAC countries. In particular, how do EAC countries compare to sustained growth "benchmarks" for each variable? Does the benchmarking exercise suggest important risk factors for sustaining strong growth in Rwanda, Tanzania, and Uganda? And what does the exercise show regarding the prospects for initiating sustained strong growth in Kenya and, importantly, Burundi?

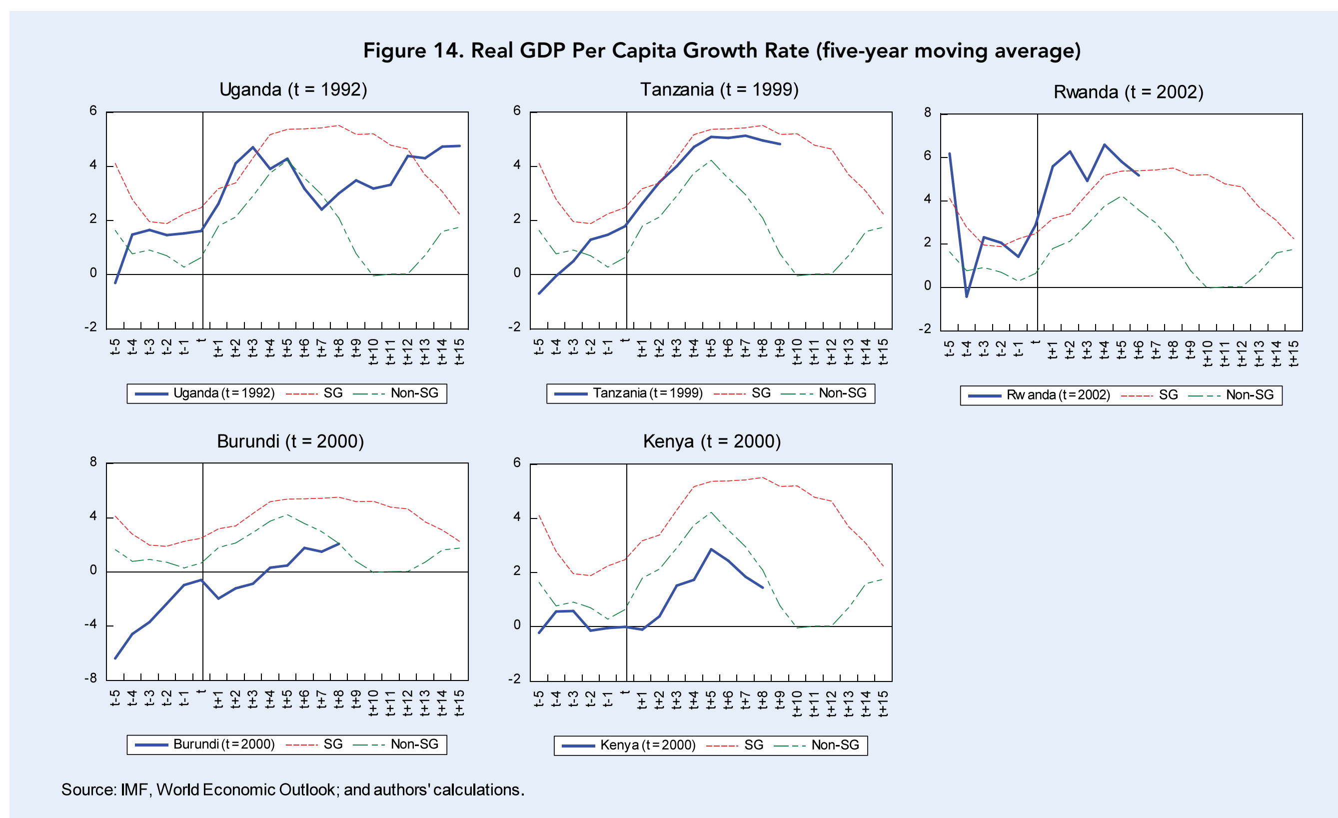
Benchmarking EAC Growth Against High Growth Countries

The growth performance of EAC-AGs in the initial phase of growth take-off is comparable to those experienced by SGs, whereas Burundi and Kenya are largely falling behind (Figure 14). Rwanda, Tanzania, and Uganda achieved strong growth during the first 5-years of the take-off—exceeding SGs in the case of Rwanda and Uganda. Burundi and Kenya are trending upward since 2000, but have not yet reached the growth experienced by SGs and EAC-AGs in their early take-off periods.[25]

Sustaining growth for EAC-AGs, however, has been more difficult. Only Tanzania has sustained high growth beyond the critical five-year mark—when growth rates started to trend down in non-SGs. Growth rates in Uganda were sharply lower in the second 5-year period, before rising in later years. In Rwanda, growth rates have been more erratic, but are recently trending downward.

Staying on sustained growth path is important for raising per capita income. The differences in growth rates between SGs and non-SGs resulted in a significant gap in per capita incomes. While real per capita income almost doubled in the 15 years since take-off in SGs, per capita incomes increased only by 30 percent in non-SGs during the same period (Figure 15).[26] Assuming Tanzania and Rwanda can stay on the path of SGs and sustain real per capita GDP growth of about 4.3 percent a year

Figure 14. Real GDP Per Capita Growth Rate (five-year moving average)



Source: IMF, World Economic Outlook; and authors' calculations.

[25]In the following benchmarking exercise, we assume time t is 2000 for Burundi and Kenya for illustrative purposes.

[26]These estimates assume that per capita GDP for SGs and non-SGs grows at a constant rate between t and t+15 equal to the average real growth rate of the respective country grouping during the period (4.3 percent a year for SGs and 1.8 percent a year for non-SGs).

for the rest of the period to *t+15*, they could come close to doubling per capita income by 2014 and 2017, respectively (Figure 16). Although Uganda fell below the SG path for a number of years, it has still achieved a doubling of its per capita income (in 2010 or *t+18*) reflecting the pickup in GDP growth rates in the outer years. For the other EAC countries, it could take until 2025 to see a doubling in per capita incomes, assuming a growth acceleration that starts in 2010 and sustained for 15 years.

To identify areas that can help EAC policymakers in Rwanda, Tanzania and Uganda turn their growth take-offs into sustained growth—and help accelerate growth in Kenya and especially Burundi—the following section looks at factors that have contributed to EAC's experience so far and benchmarks them against the group of SGs.

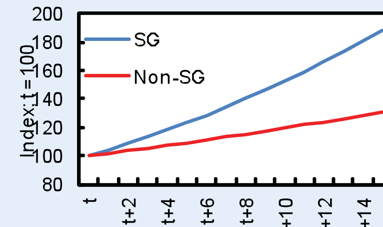
Investment and Productivity

Similar to SGs, productivity gains have played an important role in explaining the recent growth performance in the EAC. For the EAC-AGs, improvements in productivity have been rapid since the start of their growth episodes (Figure 17).[27] Productivity gains in Tanzania and Uganda outpaced SGs during the take-off period, and Rwanda's productivity has tracked closely the SG's experience. In contrast, in Burundi and Kenya—where growth has stagnated—productivity has declined, although there has been a turnaround in Kenya in recent years.

FDI also surged in the EAC-AGs during their growth take-off, similar to SGs. FDI has surged in Uganda for about 15 years since the start of its growth take-off, in contrast to SGs where FDI declined over time because these countries eventually relied more on domestic investment to sustain their growth rates (Figure 18). Tanzania had sizeable FDI at the start of its growth episode—significantly higher than SGs and other EAC-AGs at the start of the growth episode—but has since been trending down, approaching levels in SGs. FDI increased sharply in Rwanda during the growth take-off and is trending toward SGs. After stagnating, FDI has recently picked up in Kenya, while FDI has remained low in Burundi.

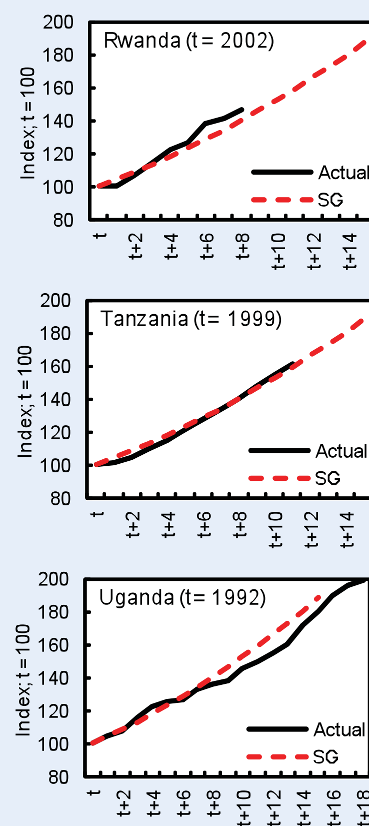
[27]Since the mid-1990s, SSA as a whole has registered a rebound from low or negative TFP growth and a corresponding decline in the contribution of factors of production to growth (IMF, 2008b; Radelet, 2010).

Figure 15. Cumulative Growth in Real Per Capita GDP for SGs and Non-SGs



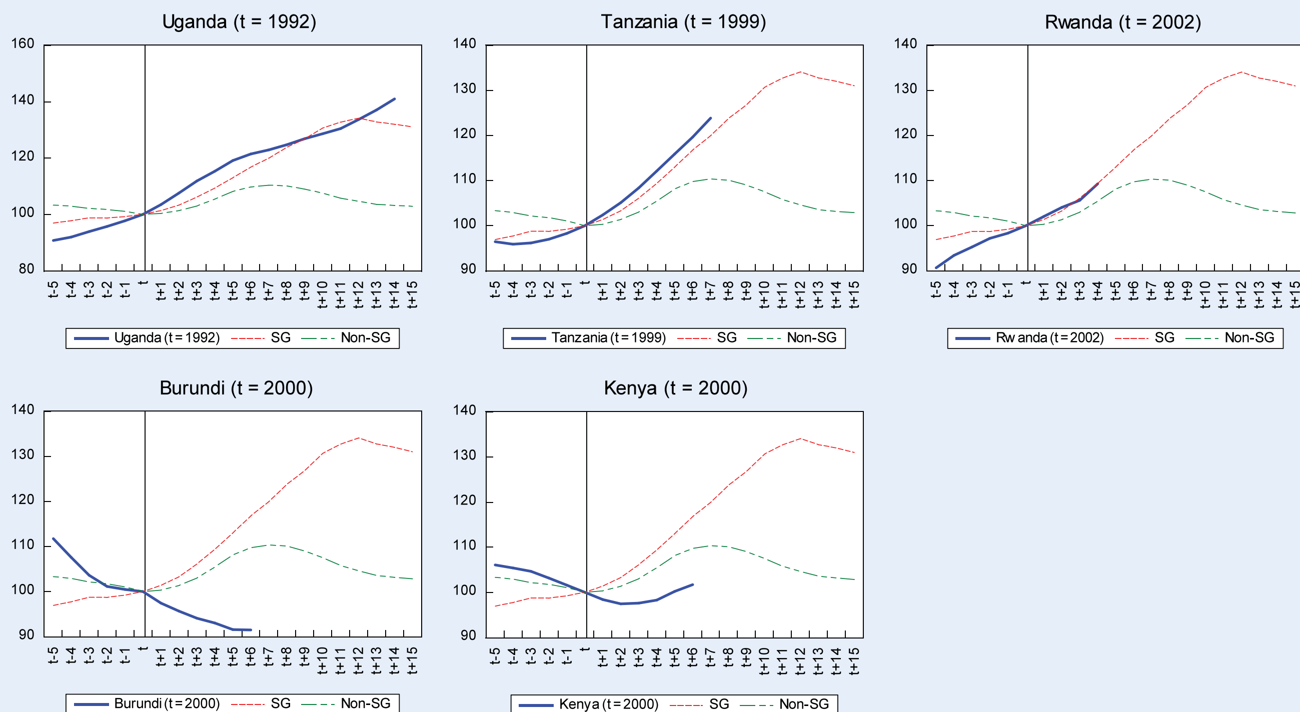
Source: IMF, *World Economic Outlook*; and authors' calculation.

Figure 16. Real GDP Per Capita (t=100)



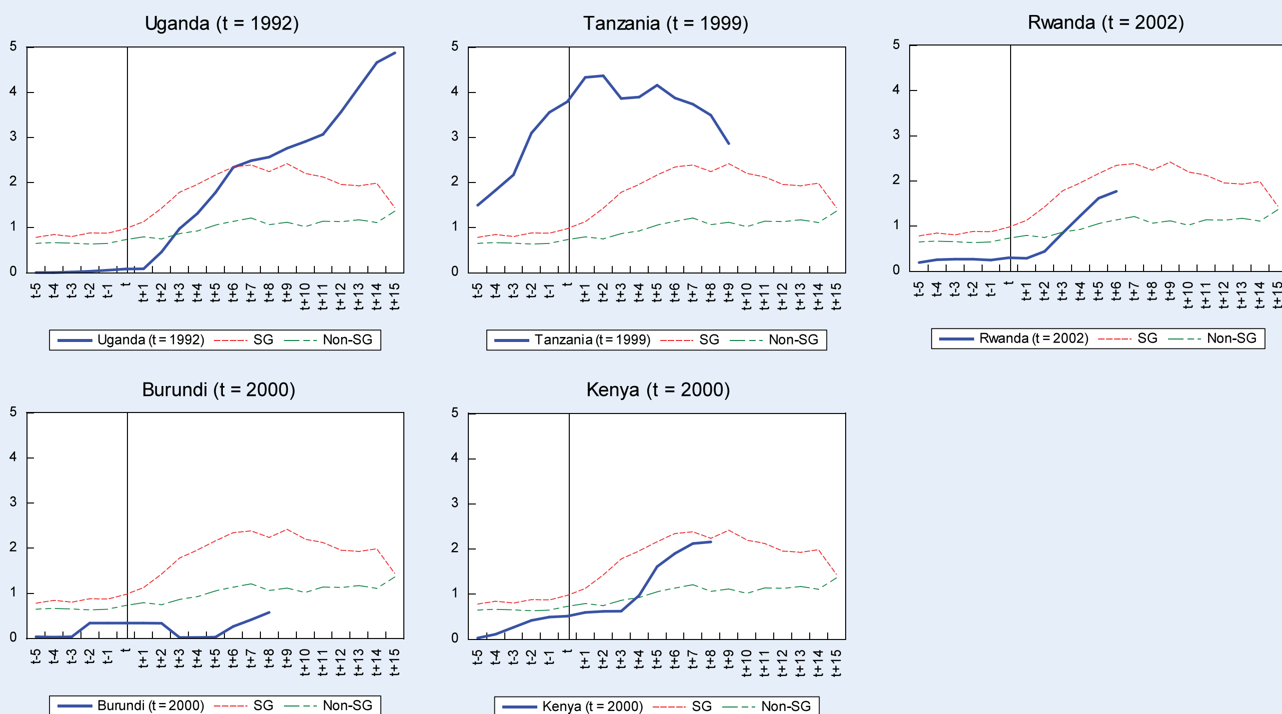
Source: IMF, *World Economic Outlook*; and authors' calculation.

Figure 17. Total Factor Productivity (t=100, five-year moving average)



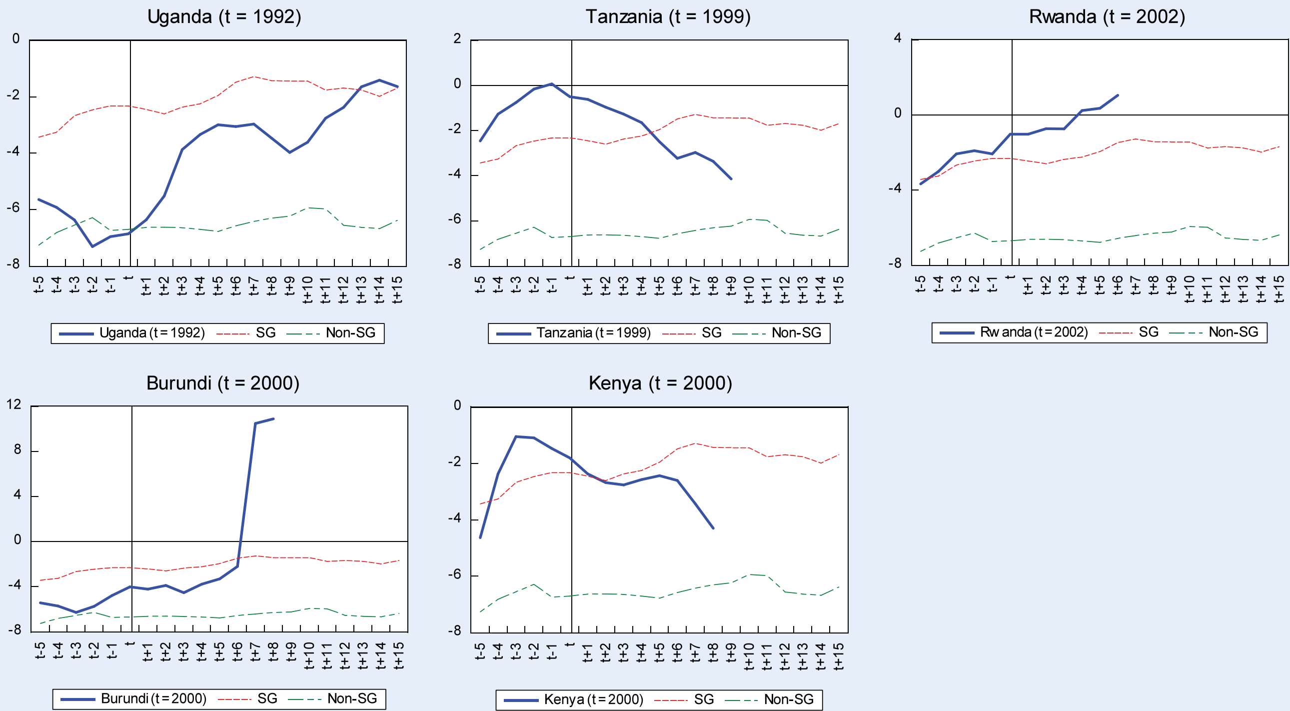
Source: Johnson and others (2007); Bosworth and Collins (2010); Barro and Lee (2010); IMF, Reginal Economic Outlook: Sub-Saharan Africa; and authors' calculations.

Figure 18. Foreign Direct Investment-to-GDP, (five-year moving average)



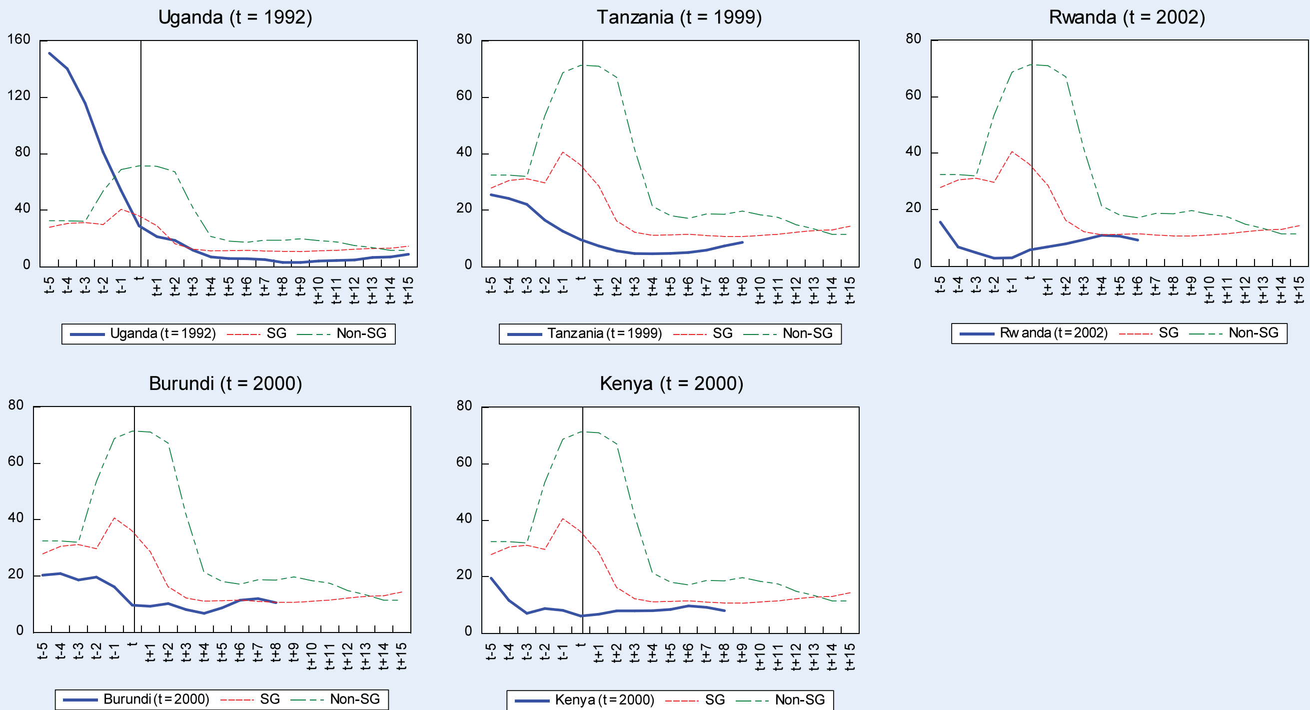
Source: IMF, World Economic Outlook; and authors' calculations.

Figure 19. Fiscal Balance-to-GDP, (t=100, five-year moving average)



Source: IMF, World Economic Outlook; and authors' calculations.

Figure 20. CPI Inflation (five-year moving average)



Source: IMF, World Economic Outlook; and authors' calculations.

Improved Macroeconomic Stability

Similar to SGs, sound macroeconomic management, especially in public finances, has coincided with stronger growth performance. For the EAC-AGs, the period since the growth upturn has generally coincided with declining fiscal deficits (Figure 19). Fiscal deficits declined in Uganda and Rwanda during the growth take-off; Rwanda outperformed SGs, while Uganda trended toward SGs. On the other hand, Tanzania has seen a steady deterioration in its budget deficit since its growth upturn, in sharp contrast to SGs. Budget deficits have also been growing in Kenya, while Burundi significantly improved the budget balance—thanks to substantial donor support. Inflation has generally been lower in the EAC compared to SGs during the initial growth take-off years. For the EAC-AGs, in particular, tighter fiscal—as well as monetary—policies led to significantly lower inflation—9.5 percent y-o-y on average during the seven years since the growth turnaround, down from 45 percent before the turnaround (Figure 20).

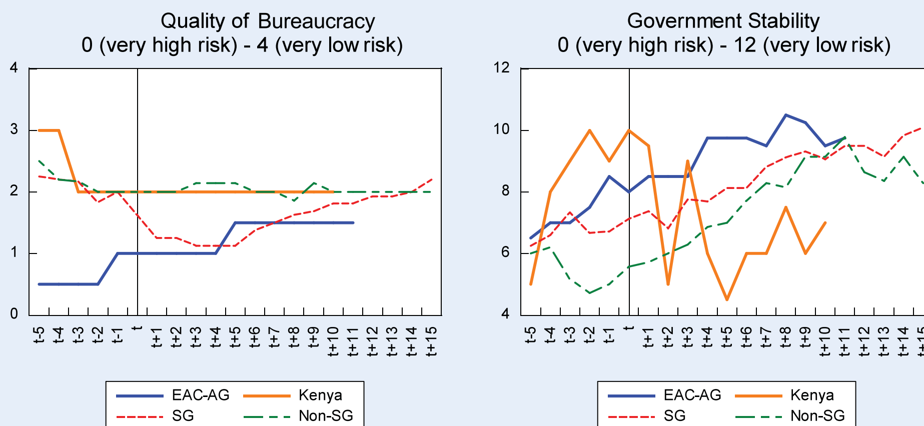
Quality of Institutions and Infrastructure

Contrary to the findings for SGs and non-SGs, the quality of public institutions matters for growth performance in the EAC. Since the mid to late 1990s, all EAC countries—at different times—have introduced extensive liberalization and structural reforms (Box 3). The EAC-AGs, in particular, appear to have benefitted from improved government stability (Figure 21). In contrast, in Kenya, less stable government conditions—at least during the period under consideration—may have contributed to lower productivity and lower growth, given the extent of the country's structural reforms and high capacity of labor and institutions.

Inadequate infrastructure is a constraint to accelerating and sustaining growth in the EAC, as in the rest of SSA. Using the proxy of telephone lines for infrastructure, all EAC countries are at very low levels (Figure 22). Other anecdotal evidence also points to infrastructure constraints in the EAC. Electricity supply in the EAC is lagging far behind other SSA countries (Ranganathan and Foster, 2011), and close to 60 percent of EAC businesses identified inadequate or poor electricity supply as one of the top problematic factors for doing business in the EAC (World Economic Forum, 2010). Better provision of transportation and energy services is now high on the agenda of all EAC members, and a number of projects have been initiated in these areas, including at the regional level. Technical as well as financing difficulties have, however, limited progress in delivery so far.

EAC countries have made continuous progress in improving human capital, but remain well below SGs, with the exception of Kenya. Health conditions in the

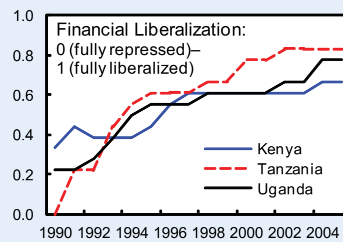
Figure 21. Quality of Institutions

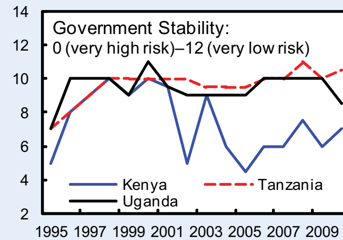


Source: ICRG; and authors calculations.
Note: EAC-AG is the average of Uganda and Tanzania. For Kenya, t is set to be 2000. Rwanda and Burundi are not covered by the source data.

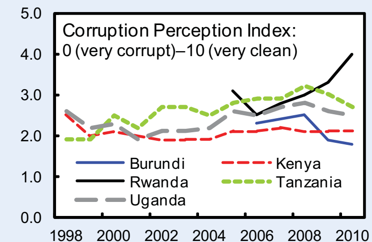
Box 3. Structural Reforms and Institution Building in the EAC

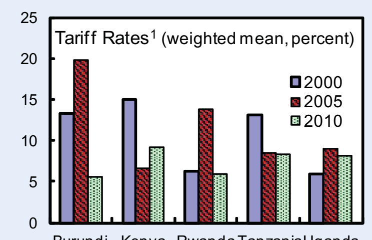
Since the mid to late 1990s, all EAC countries—at different times—have introduced a range of pro-market reforms that eliminated the most onerous taxes and restrictions to economic activity. Key reforms included liberalizing financial and exchange rate markets; strengthening budget processes and public financial management (most often through binding cash budgeting procedures); building capacity and reforming institutions, (including the central banks, tax revenue administration, and regulatory agencies) with well-defined mandates, stable legal frameworks, and high professional expertise.[1] Trade reforms, including the establishment of the customs union, have led to substantial reductions in the level and dispersion of tariffs and non-tariff barriers in all the countries in the region. In Uganda, one of the first sub-Saharan African countries to embrace the process of liberalization and pro-market reforms in the late 1980s, virtually all sectors of the economy have been liberalized. Tanzania, Kenya and Rwanda have focused on restructuring and privatizing state-owned banks, opening the system to foreign banks, and creating new prudential frameworks, while interest rates and exchange rates were liberalized and most restrictions on capital account transactions were removed. Burundi has made significant progress as a post-conflict economy and is also embracing these reforms, albeit at a slower pace.





Source: Abiad, Detragiache, and Tressel (2008); ICRG; and authors' calculations.





Source: Transparency International; World Bank, World Development Indicators; and authors' calculations.
[1] Bars for Burundi and Rwanda in 2000 refer to data in 2002 and 2001, respectively.

[1] With the exception of Burundi, EAC countries have consistently ranked higher than the SSA average in the World Bank's Country Policy and Institutional Assessment (CPIA) ratings.

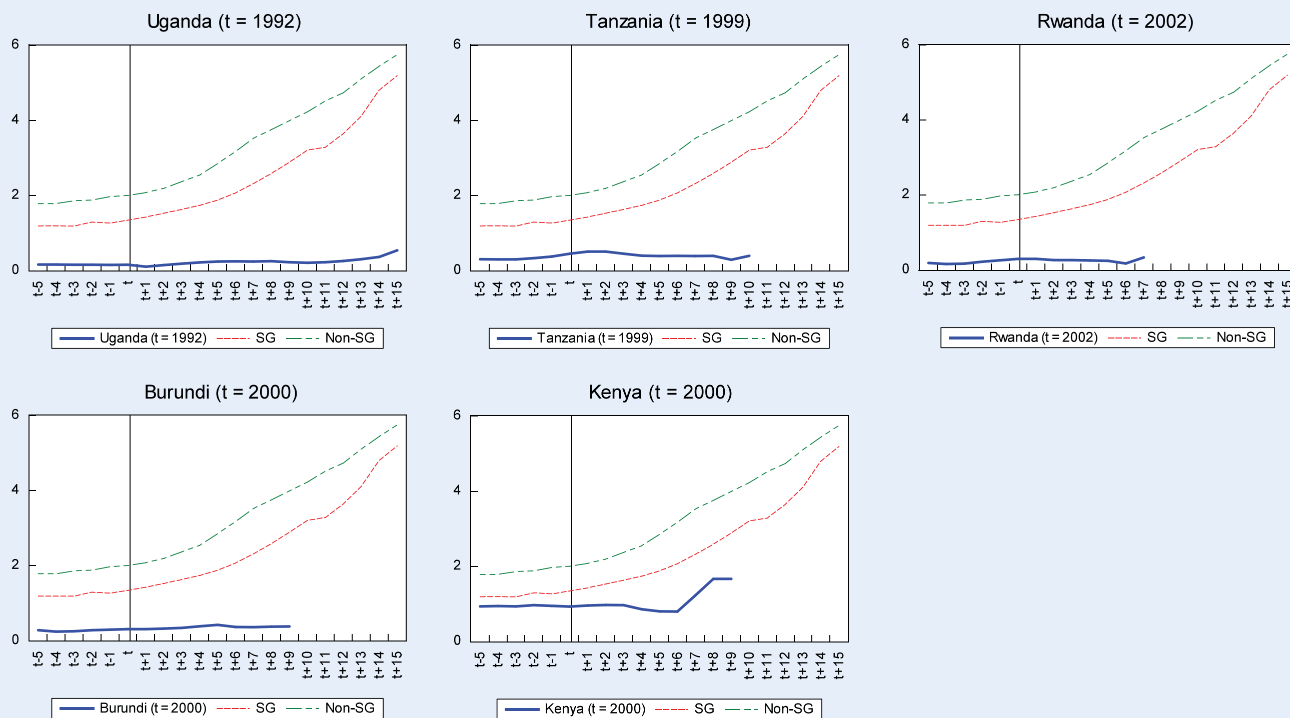
EAC-AGs have improved rapidly—catching up with SGs—and the pace of lengthening years of schooling is similar to those of the comparators (Figures 23 and 24). Kenya has consistently outperformed SGs, both with respect to health conditions and education, giving the country a comparative advantage in terms of human capital. Burundi suffers a much higher rate of child mortality with a slower pace of improvement, and has persistently remained at the low level of schooling years, without converging to the benchmarks. Burundi lags behind the other EAC countries in health and education, factors that have likely contributed to its steady decline in productivity and lower growth.

The EAC falls short of SGs in two important areas for sustained growth: (i) domestic financial depth generally associated with high domestic savings—unlike the SGs, EAC countries are highly dependent on foreign savings; and (ii) external competitiveness—EAC countries are less competitive with significantly small and undiversified exports compared to SGs.

Limited Financial Depth and Low Domestic Savings

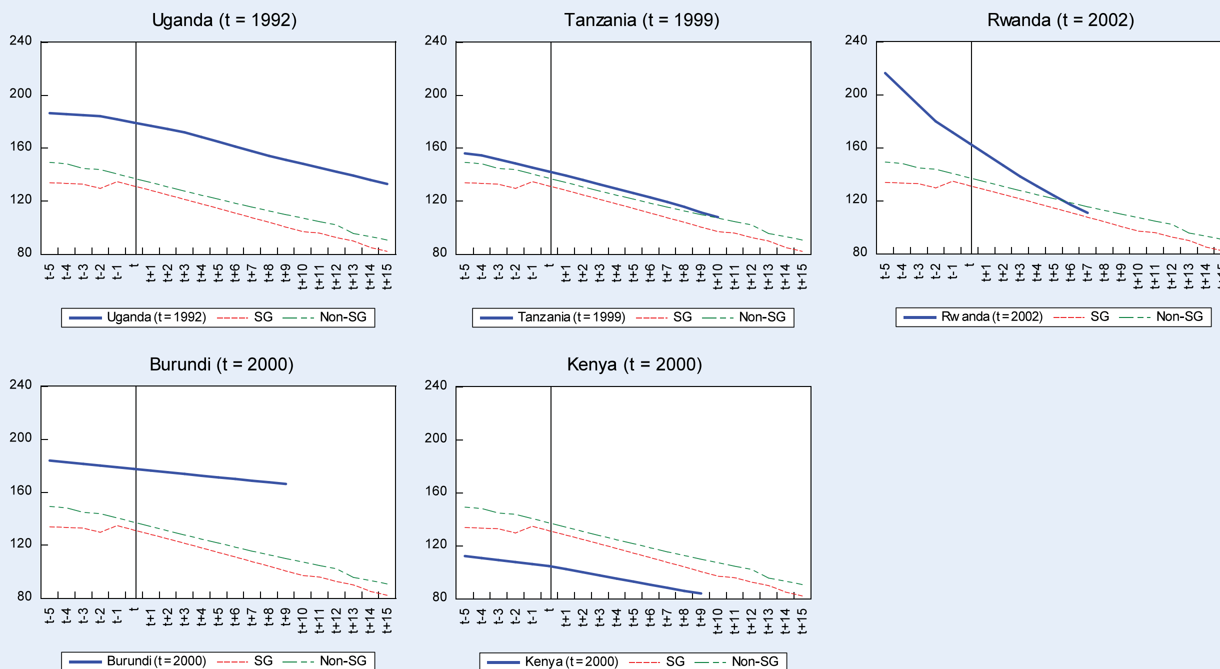
For the EAC, financial deepening is occurring at a very slow pace, and remains well below SGs. Broad money to GDP is less than half the levels in SGs, while credit to the private sector as a percent of GDP is one-fourth the levels in SGs. Kenya—with the most developed financial markets in the region—had a higher level of credit to the private sector around the year 2000 compared to SGs at the start of their growth episode, but the level has since continued to decline (Figures 25 and 26). This

Figure 22. Telephone Lines (per 100 people)



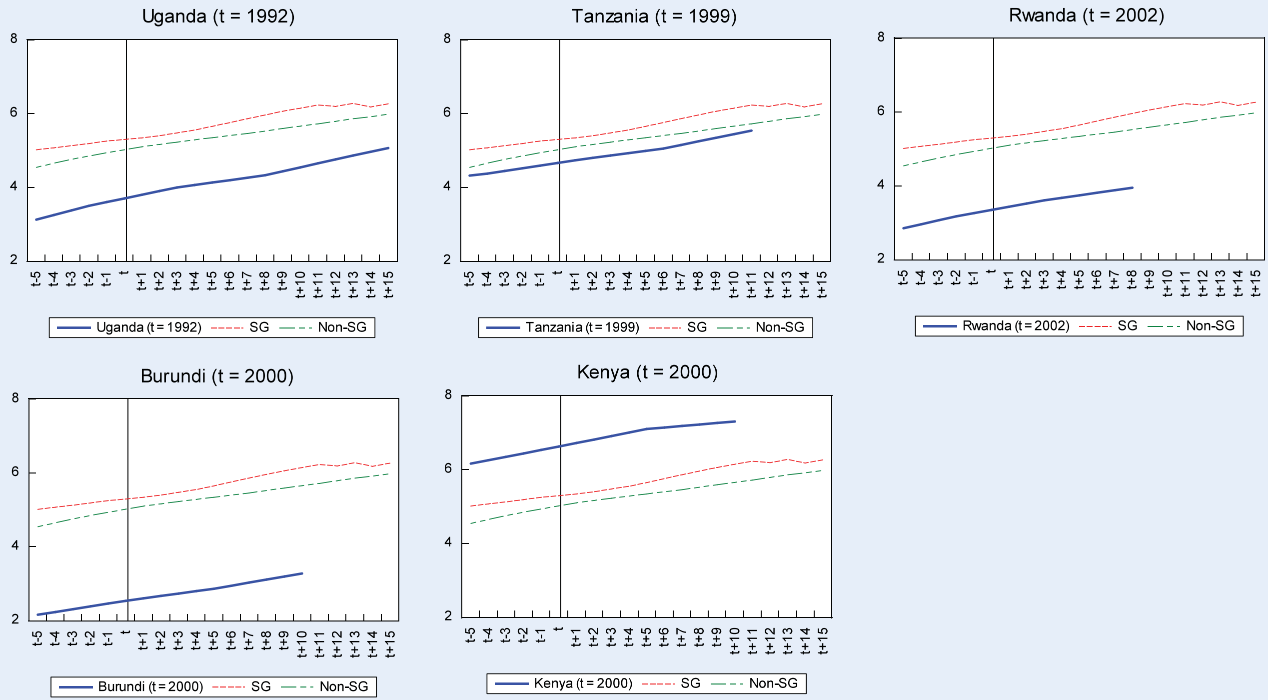
Source: World Bank, World Development Indicators; and authors' calculations.
Note: Observations are linearly interpolated because source data are available only in every five years.

Figure 23. Motality Rate Under Five (per 1000)



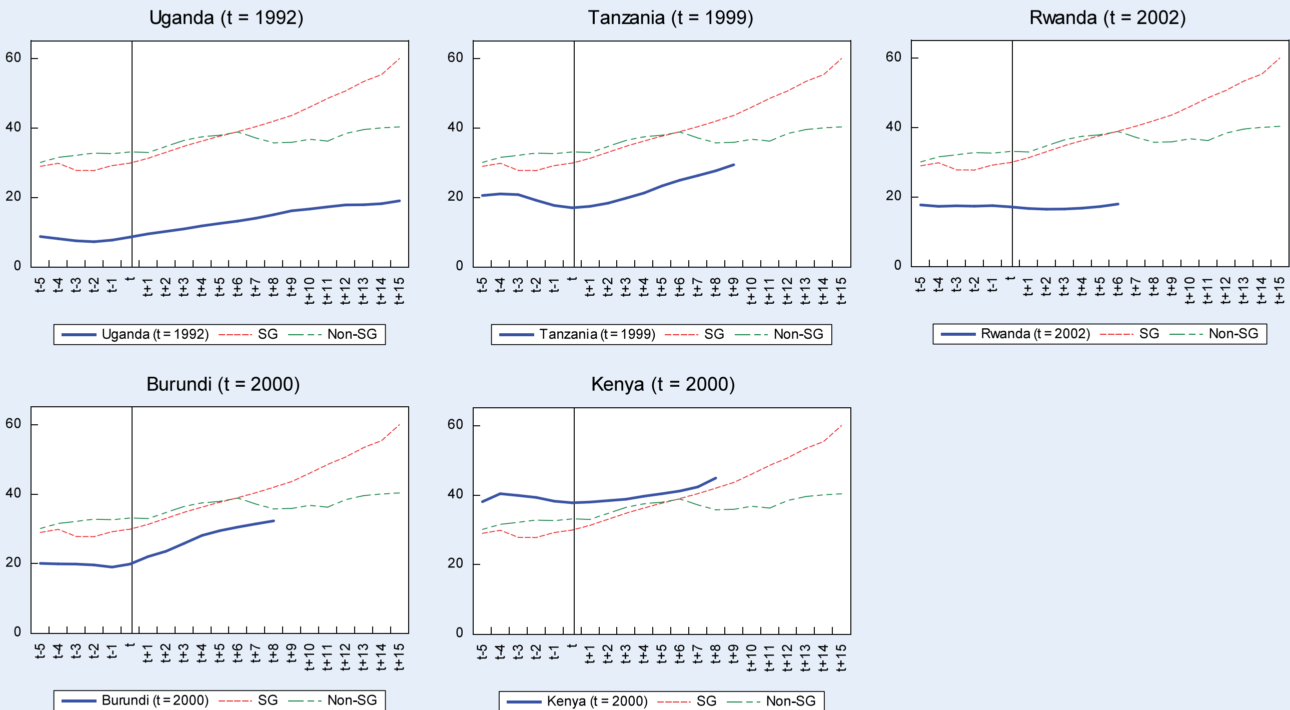
Source: World Bank, World Development Indicators; and authors' calculations.
Note: Observations are linearly interpolated because source data are available only in every five years.

Figure 24. Average Years of Schooling



Source: Barro and Lee (2010); and authors' calculations.
Note: Observations are linearly interpolated because source data are available only in every five years.
For SG and Non-SG, only observations whose t are after 1980 are included.

Figure 25. Broad Money (five-year moving average)



Source: IMF, World Economic Outlook; and authors' calculations.

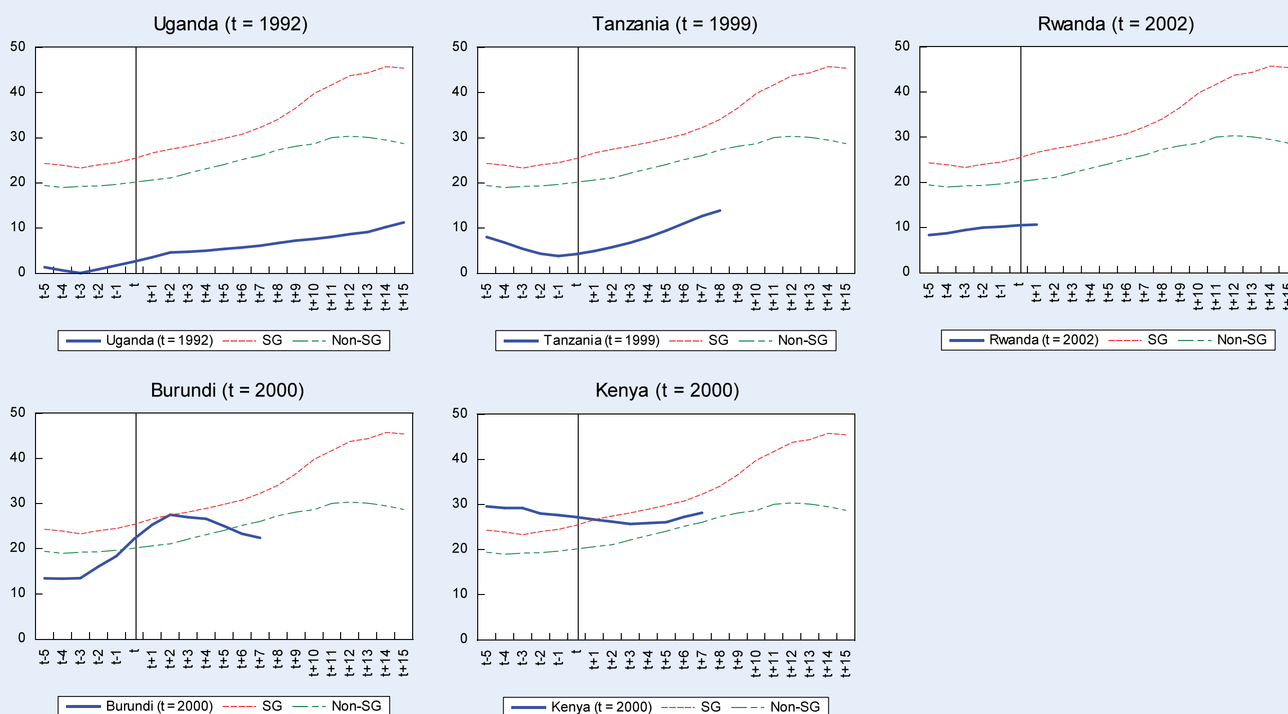
development coincides with the deterioration of the fiscal balance, indicating the possibility of crowding out by the public sector. Burundi, where commercial banks play a dominant role in the economy, experienced rapid credit growth since the end of the civil war, although the pace of growth has declined in recent years.

Unlike in SGs, EAC growth has been financed in part by external savings. While domestic savings picked up rapidly in SGs after their take-off—quickly narrowing the gap between savings and investment—the growth in savings has been weaker in the EAC (Figure 27). Net savings have declined in the EAC since the start of their take-off. Instead, EAC countries have relied on external resources—mainly donor aid—to finance the bulk of investment (Figure 28). Official development assistance (excluding debt relief) has averaged more than 15 percent of GDP since the growth take-off in EAC-AGs, well above the average for SGs (Figure 29). The evidence of SGs and non-SG, however, provides little evidence that donor aid supports higher productivity and growth.

Financial sector liberalization has progressed at a faster pace in the EAC compared to SGs (Figure 30). Structural reforms since the mid-1990s rendered the banking sector more market based—with more competition and privatization. Capital account restrictions have also been reduced. Kenya had a more liberalized financial sector compared to all the comparator groups at the start of their growth take-offs, but has not made much further progress in recent years. Although not covered by the figure, Burundi has made important great strides in reforming its financial sector since the end of the civil war; but it is still lagging behind the other EAC countries in many other aspects. However, since financial sector liberalization alone did not distinguish SGs from non-SGs, a greater focus on maintaining macroeconomic stability—especially avoiding large fiscal deficits that tend to crowd out resources available for private sector credit—may be more important to enhancing financial deepening in the EAC.

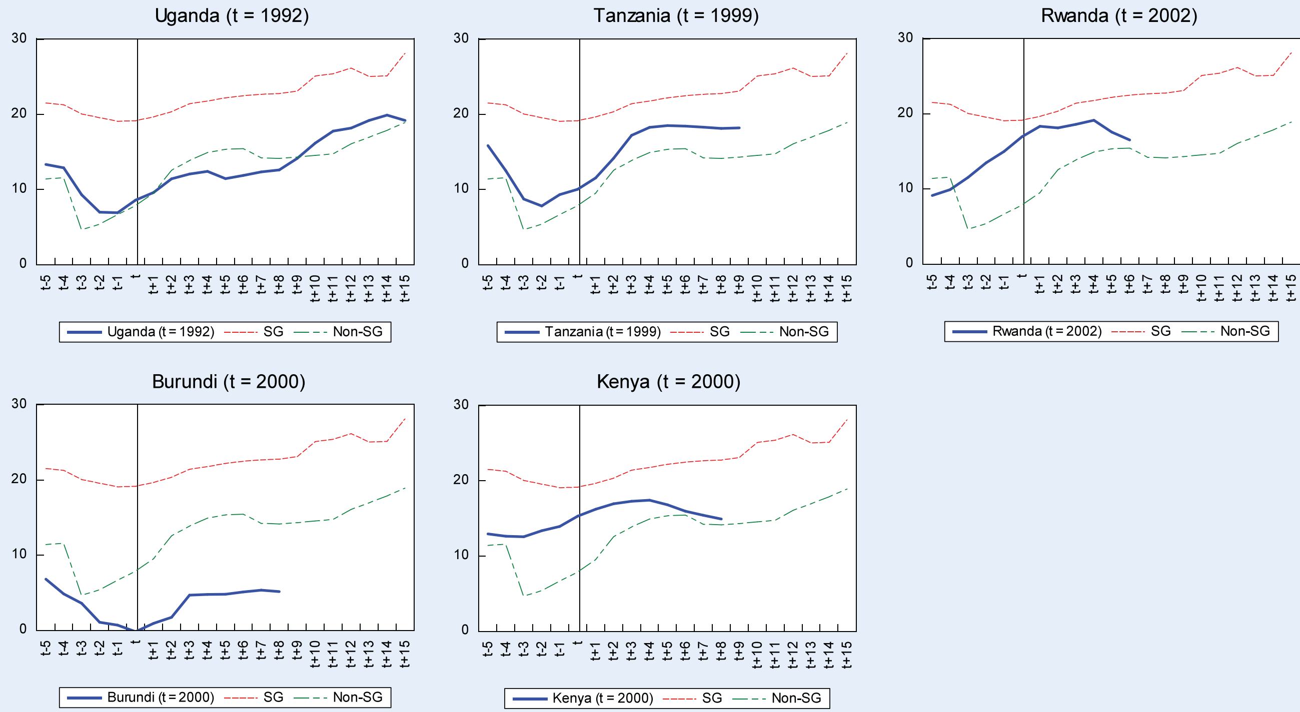
Notwithstanding the extensive liberalization, the region's financial markets remain small, segmented, and illiquid. A recent study by FINSCOPE shows that less than a third of the population in Rwanda, Tanzania and Uganda has access to formal financial services, compared with nearly two-thirds of the population in other developed financial markets such as South Africa. Non-bank financial institutions, such as pension funds or insurance companies, are in most cases only embryonic. Recently,

Figure 26. Credit to Private Sector-to-GDP (five-year moving average)



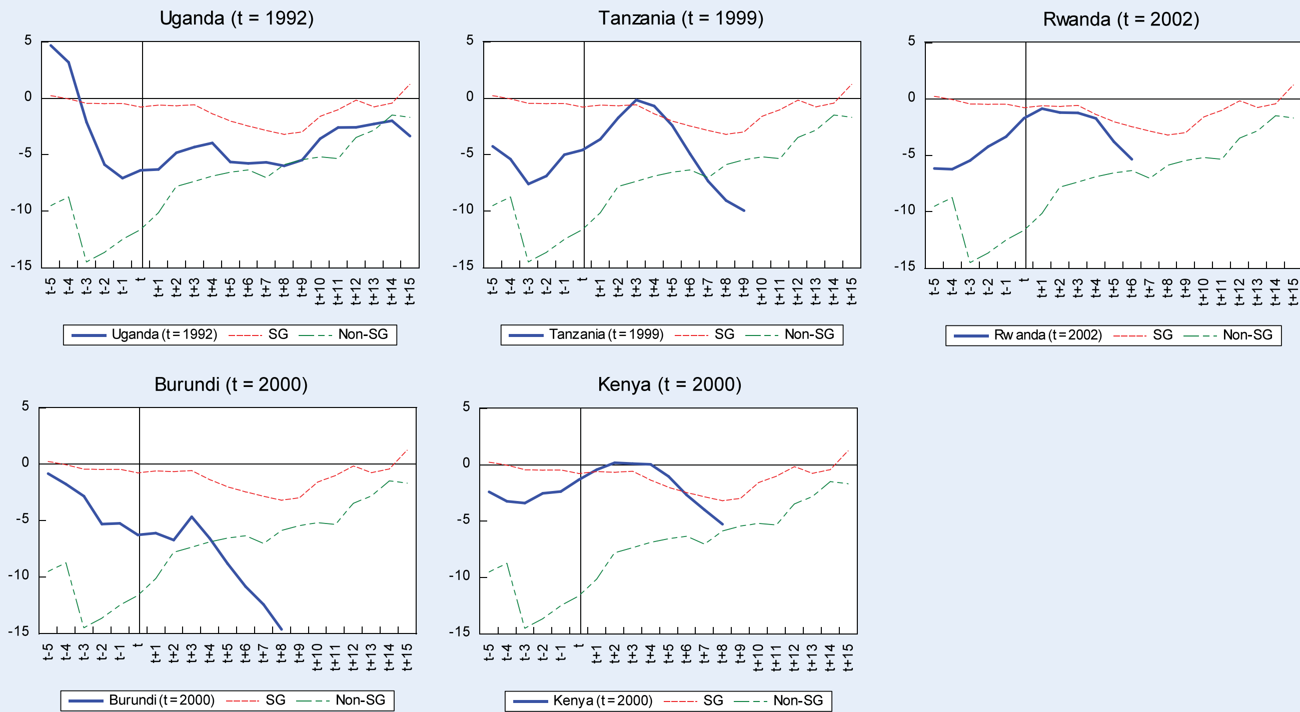
Source: World Bank, World Development Indicators; and authors' calculations.

Figure 27. Domestic Savings-to-GDP (five-year moving average)



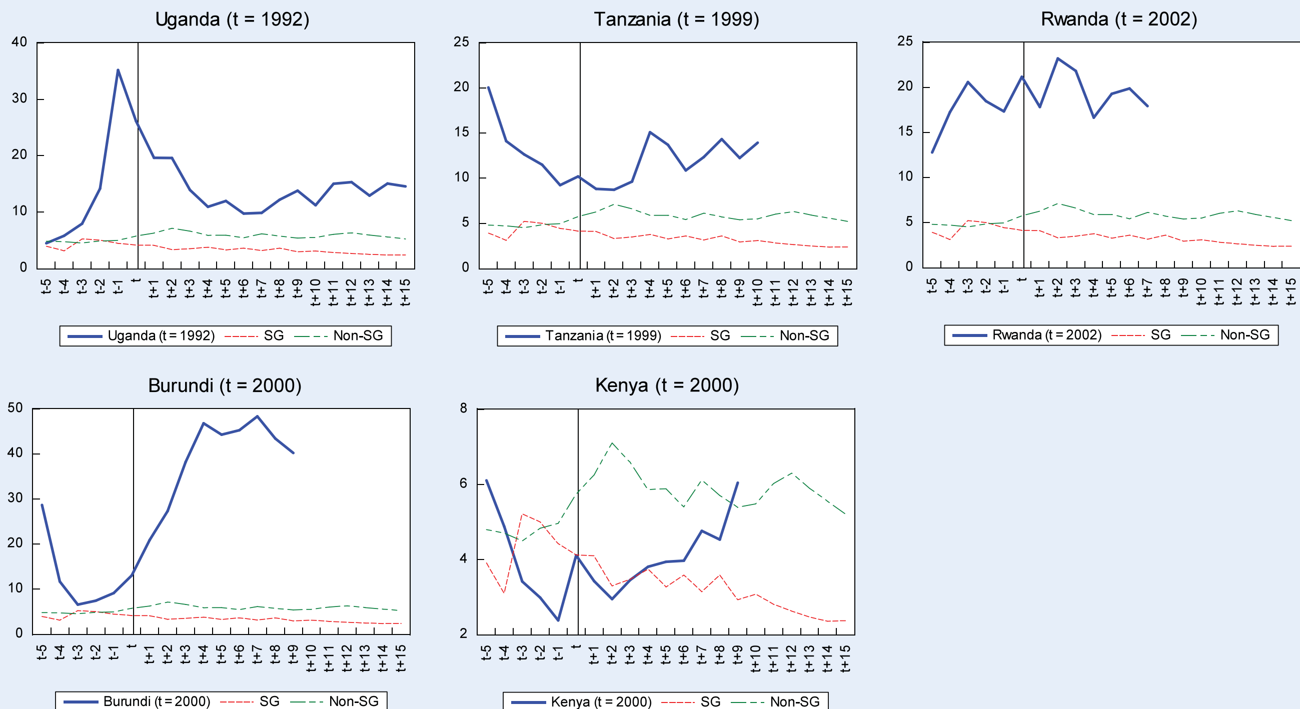
Source: IMF, World Economic Outlook; and authors' calculations.

Figure 28. Savings Minus Investment (five-year moving average)



Source: IMF, World Economic Outlook; and authors' calculations.

Figure 29. ODA Excluding Debt Relief-to-GDP (five-year moving average)

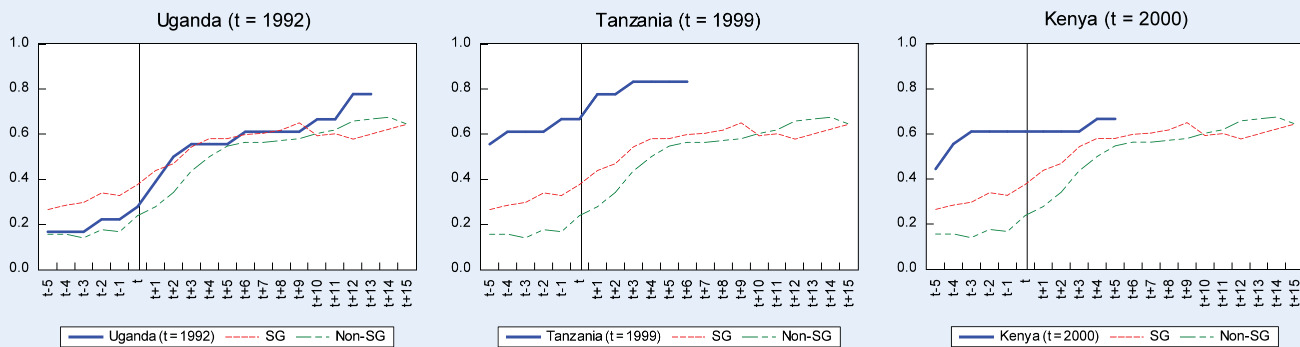


Source: IMF, World Economic Outlook; OECD, OECD.Stat; and authors' calculations.

however, greater efforts are being made to increase financial inclusion by opening more bank branches, promoting micro-finance institutions and saving and credit cooperatives and locating these institutions where the poor and the disadvantaged live and work. To sustain these efforts, financial literacy campaigns are being stepped up in a number of EAC countries (e.g., Kenya, Rwanda) to increase awareness about financial products and their terms and the benefits to the poor of lending to and borrowing from the formal financial sector. These efforts are further complemented with building a sound regulatory framework for non-bank financial institutions and increasing supervisory capacity. Other innovations, such as mobile banking—including the innovative M-PESA mobile banking platform in Kenya—have emerged as a promising vehicle to broaden access to financial services and savings instruments without endangering macroeconomic stability.

Domestic financing costs also hamper financial market deepening in the EAC. Uncertain property rights (in part related to weaknesses in land titling) hamper the assessment and enforcement of collateral, credit information on borrowers is patchy, and the legal and regulatory framework insufficient to facilitate the swift resolution of commercial disputes. All these factors continue to pose risks to credit delivery and increase financial costs. Although private sector credit growth has increased, it has largely focused on consumer financing (particularly mortgages). Access to finance for budding small and medium-size enterprises (SMEs) has been limited to the (largely unregulated) informal financial sector. With the exception of Kenya, domestic capital markets are shallow, and stock exchanges are well below the size required to support the economies' financing needs. Continued efforts are needed to tackle these deeply rooted obstacles to financial deepening. Here again, regionally-coordinated approaches have the potential to bring larger and faster benefits. Recent examples of regional approaches to financing that attracted regional and international investors are encouraging developments. These include: Kenyan authorities' partial financing of their infrastructure investment through a series of local currency infrastructure bonds with long maturities, and several IPOs and cross-listing in Kenya, Uganda and more recently in Rwanda.

Figure 30. Financial Liberalization: 0 (fully repressed) –1 (fully liberalized)



Source: Abiad, Detragiache, and Tressel (2008); and authors' calculations.

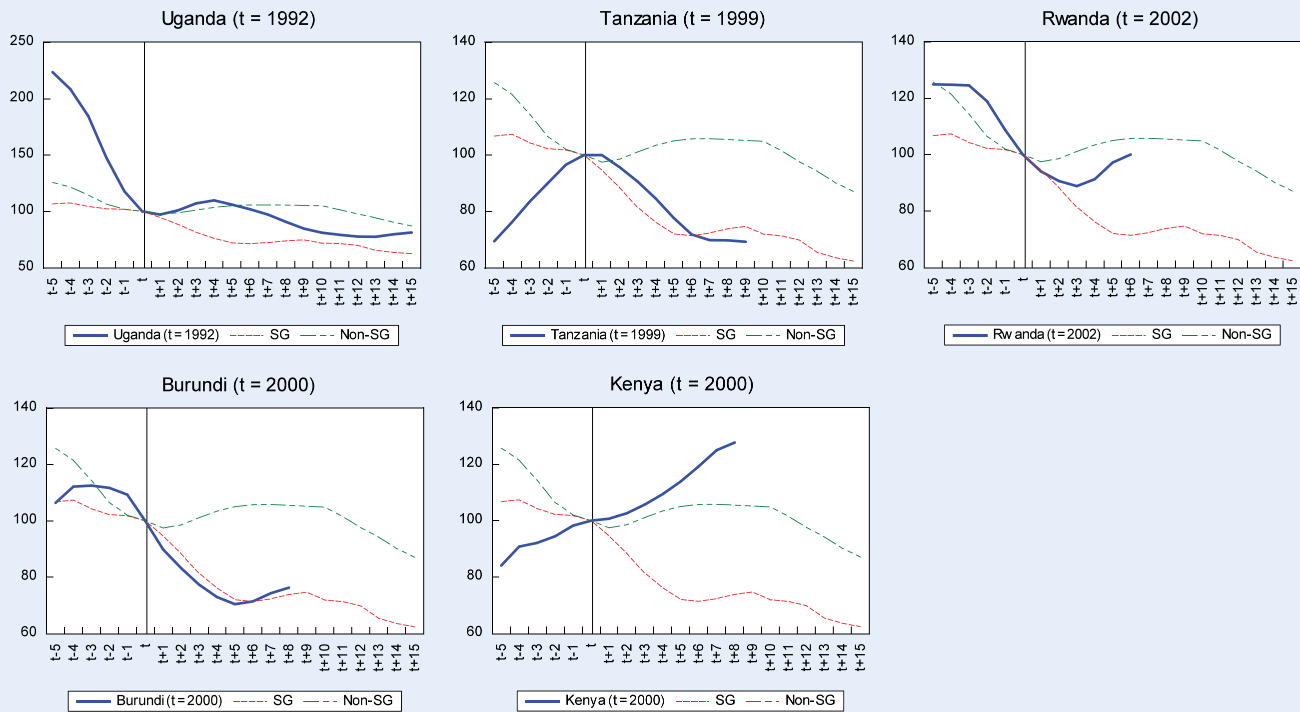
External Competitiveness

Unlike SGs, real exchange rate behavior in the EAC has not necessarily translated into external competitiveness. While real exchange rates depreciated in Burundi and Tanzania, similar to SGs, there was a corresponding deterioration in current account deficits (Figures 31 and 32). In Rwanda and Kenya, current account deficits also deteriorated in the face of real exchange rate appreciation. Only Uganda, where the real exchange rate remained broadly unchanged, has seen a slight improvement in its current account. Structural factors including diversification and regulatory costs of doing business better explain the external competitiveness of EAC countries as discussed below.

Unlike the export-led growth of SGs, exports have played a relatively small—albeit growing—role in the growth take-off of EAC countries. While the SGs rapidly increased the share of exports in their GDP to 30–40 percent soon after their take-offs, the increase has been more protracted and subdued in the EAC (Figure 33). The share of exports in GDP remains at less than 15 percent of GDP in Burundi, Rwanda and Uganda about seven to eight years into the growth episode. Kenya and Tanzania have export shares of about 25 percent of GDP, inching up to SGs.

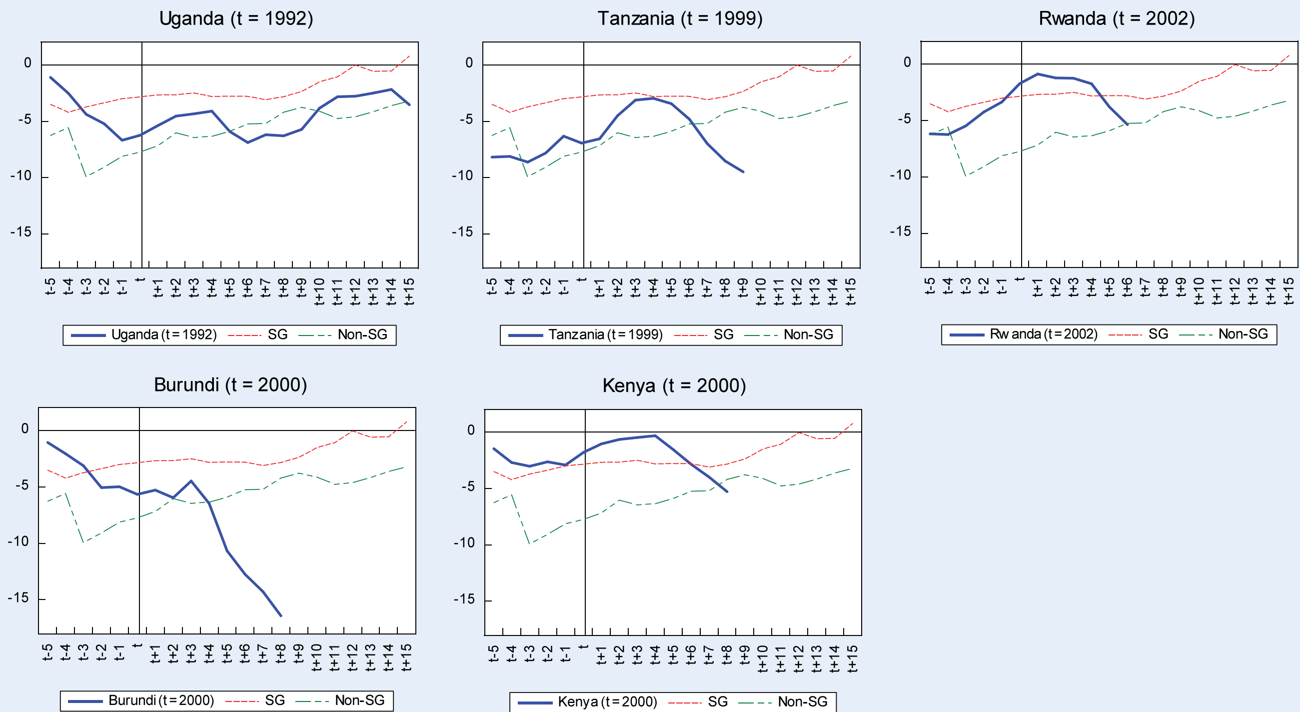
Underlying the more subdued export growth in the EAC, regulatory bottlenecks hamper the region's competitiveness. Although a common market is in place, nontariff barriers are still high in the region and common standards and harmonized regulations are yet to be agreed upon (Box 4).While EAC members have embraced market-supportive policies at the broader level and often put in place legal frameworks amicable to investors, business surveys show that enforcement is problematic (Figure 34). Investment incentives are uncoordinated and often enterprise-specific. Such obstacles not only constrain investment and export levels, but also hamper private investment in infrastructure, further increasing costs; and they deter innovation, and thus output and export diversification. Although most EAC country authorities have plans to improve the investment climate, progress to date has been uneven across the region, with only Rwanda implementing ambitious and comprehensive reforms. In addition, reform efforts have not been closely coordinated at the regional level, reducing to some extent their impact. Removing these remaining obstacles could facilitate faster export growth for the region. Going forward, opportunities exist to expand exports in particular in the mining and oil sectors, but caution is needed to translate the gains into sustained growth. In Tanzania, gold exports already account for more than a third of total exports of goods and services, while in Uganda oil production is expected to account for close to 10 percent of GDP and up to one-third of government revenues. Findings of considerable exploration in nickel, uranium, and oil and natural gas across the region are believed to have significant potential. Export expansion in this area can quickly lift output and government revenues, but harnessing such activities into longer-term growth raises considerable policy challenges—to avoid the "natural resource trap." For East Africa, a region that has remained relatively less commodity-dependent than its African neighbors, the impact of increasing commodity exports could be a double-edged sword: while they could increase output growth and income in the near term, they could also stunt the development of higher value-added

Figure 31. Real Effective Exchange Rate (t=100, five-year moving average)



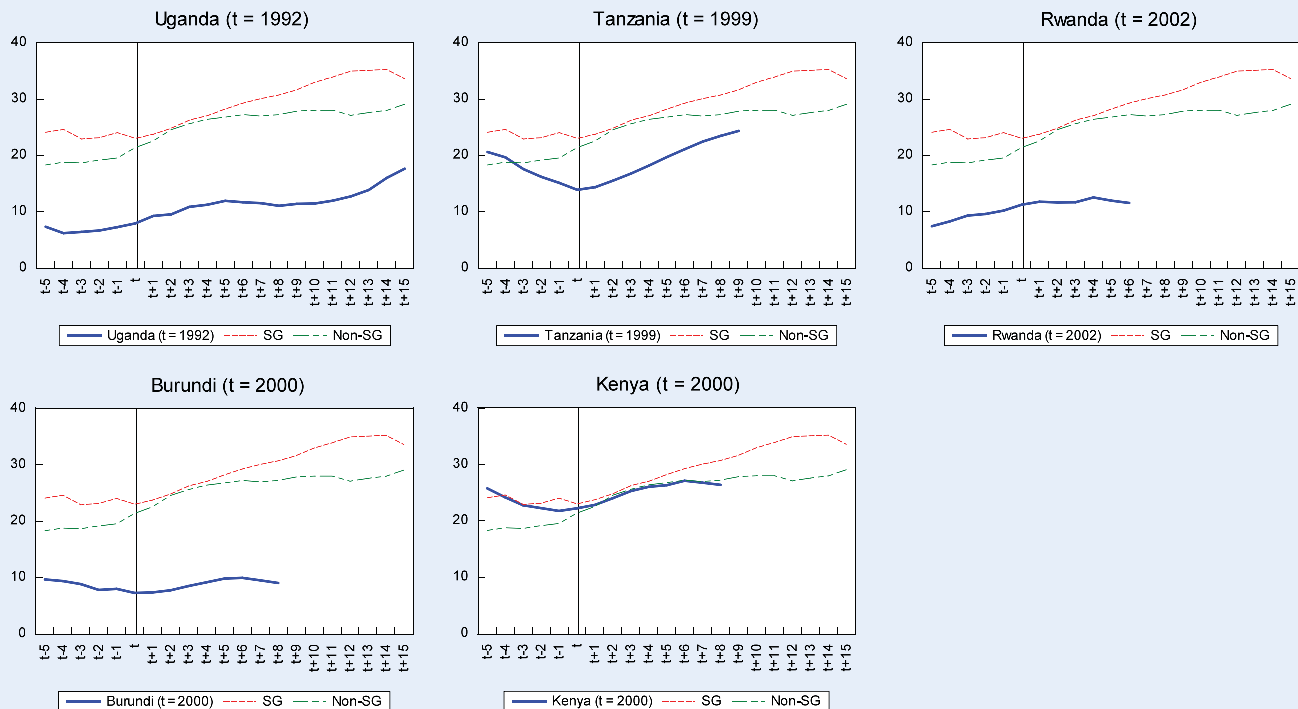
Source: IMF, World Economic Outlook; and authors' calculations.

Figure 32. Current Account Balance-to-GDP (five-year moving average)



Source: IMF, World Economic Outlook; and authors' calculations.

Figure 33. Exports-to-GDP (five-year moving average)



Source: IMF, World Economic Outlook; and authors' calculations.

Box 4. The EAC Common Market: Achievements and Remaining Challenges

Trade integration has been a central objective of the EAC since its establishment. The customs union was established in 2005, followed by a common market in 2010. Internal tariffs on goods from other EAC countries have been eliminated over a five-year period. A common external tariff (CET) was established for imports from third countries: a zero rate for raw materials, a 10 percent rate for intermediate products, and a 25 percent rate for finished goods. The new tariff structure lowered the maximum tariff rate in each EAC country. EAC members also agreed to eliminate gradually restrictions on trade in services, the free movement of workers, and the right of establishment.

In practice, however, significant obstacles remain in the operation of the EAC common market. While agreement was reached to gradually remove non-tariff barriers and mechanisms are in place in each country to monitor implementation, actual progress has been limited. Customs procedures and harmonized regulations are yet to be agreed upon, while delays exist in issuance of certificates of origin, standards are not applied uniformly, and procurement procedures still need to be liberalized. Weak administrative capacity hinders the application of existing rules, while modalities for collecting and accounting for customs revenues at the regional level are not in place. Structural weaknesses, notably inadequate transport infrastructure, also hamper intraregional trade.

exports needed to reach faster, sustained growth over the medium term. Early, determined policy action is needed to preserve competitiveness and ensure that the revenue from commodity exports is successfully intermediated into productive spending and investment in other sectors of the economy.

Conclusions and Policy Priorities for Sustained Growth

Prudent macroeconomic policies, productivity gains, financial sector depth and a competitive external sector are important to sustaining growth. Comparing the growth performance of countries that have achieved sustained growth (SGs) against those that accelerated but failed to sustain growth (non-SGs), we find that SGs tend to maintain (i) low inflationary environments and low fiscal deficits; (ii) steady improvements in productivity encouraging higher investment, especially FDI; (iii) high domestic savings and private sector credit underpinned by liberalized financial markets; and (iv) competitive external sectors fostering export growth with better current account balances. These findings concur with various growth determinants found in the recent growth literature. Our regression analysis also points to the importance of financial liberalization and sustaining peace for growth.

Within the EAC, Rwanda, Tanzania and Uganda (EAC-AGs) have grown at rates comparable to SGs and share many of the key characteristics of sustaining growth. Similar to SGs, the growth upturn in the EAC-AGs has coincided with a period of low inflation and low budget deficits, while improved business environments and government stability have contributed to strong productivity gains and increasing FDI, in some cases exceeding SGs.

A number of challenges remain for the EAC-AGs to stay on the path of SGs. These include deepening financial markets and mobilizing domestic savings, improving external competitiveness—to increase exports—and further developing physical and human capital. Unlike SGs, growth in the EAC-AGs has been financed primarily by external savings, mainly donor grants. The levels of domestic savings and financial deepening in the EAC-AGs are much lower compared to SGs. Similarly, contribution of exports to growth has been fairly limited in EAC-AGs with widening current account deficits, compared to SGs. This is attributable to weaknesses in competitiveness, including high costs of doing business in the region. Physical and human capital are also lagging in EAC countries, which could impede further productivity gains especially over the longer term.

Elsewhere in the EAC, Burundi and Kenya have only recently started to grow after many years of stagnant or declining growth. Burundi has suffered from unstable macroeconomic performance and poor quality of institutions and physical and human capital. Although levels of investment, savings, and exports are all lower in Burundi compared to EAC-AGs, the benchmarking exercise suggests that the more fundamental constraint for Burundi is poor quality of institutions, infrastructure, and human capital: doing business is seen to be the most difficult in the region, the child mortality rate remains stubbornly high, and the level of education is by far the lowest in the region.

Macroeconomic and government instability may be dampening growth in Kenya. Real GDP growth rates have been trending upward since 2000 in Kenya, but not high enough to be considered accelerated. Kenya, unlike the other EAC countries, has a deep financial sector and a large export sector, even compared to SGs. Kenya's health conditions and education perform better than SGs. Nevertheless, productivity of Kenya has been declining until recently. This may reflect rising fiscal deficits and inflation since 2000 and a less stable government at least in recent years.

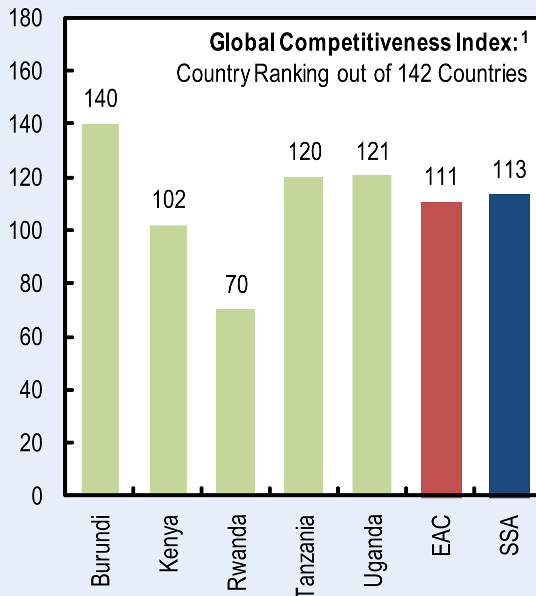
The EAC is at a critical juncture, where policy decisions will determine whether they follow the path of SGs—accelerating the move to middle-income status—or non-SGs. With growth rates of EAC-AGs generally closely tracking those in SGs, now is a critical moment for them to ensure that accelerated growth is translated into sustained growth—and for Burundi and Kenya to boost the current growth momentum into a full-fledged growth acceleration. For this, the following policy recommendations will be important, albeit with different priorities for each EAC country:

- Maintain macroeconomic stability, namely low inflation and low budget deficits;
- Deepen financial sectors to mobilize domestic savings;
- Develop stable institutions and conducive business climate;
- Improve competitiveness and diversify exports; and
- Overcome the bottlenecks of infrastructure and human capital.

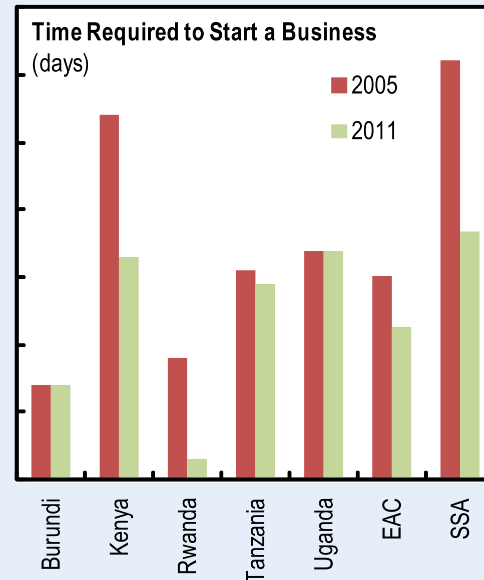
Maintaining macroeconomic stability—low inflation and fiscal deficits— is important for all EAC countries. Fiscal deficits in the EAC have risen in recent years in line with planned fiscal stimulus policies in the face of the global recession. Fiscal deficits have increased from 1.8 percent of GDP on average in 2008—before the global financial

Figure 34. EAC: Competitiveness Indicators

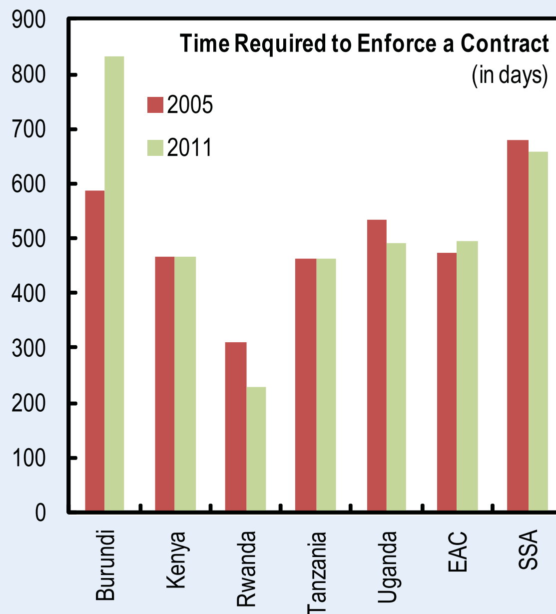
With the exception of Rwanda, the region is lagging on global competitiveness indicators,…



…reflecting high costs of doing business…



…including bottlenecks in legal environments.



Access to finance and corruption, among other things, remain problems.

The Most Problematic Factors for Doing Business (Percent of Responses)

	Burundi	Kenya	Rwanda	Tanzania	Uganda	EAC Average
Access to financing	17.8	13.5	20.2	22.6	17.6	18.3
Corruption	24.0	21.2	0.4	14.8	20.2	16.1
Inadequate supply of infrastructure	6.8	11.0	11.4	12.2	10.3	10.3
Tax rates	6.9	10.1	17.5	12.3	11.0	11.6
Tax regulations	5.3	1.9	7.5	4.3	2.5	4.3
Inadequately educated workforce	3.7	1.5	19.6	4.6	2.8	6.4

Sources: World Bank, *Doing Business 2012*; World Economic Forum, *The Global Competitiveness Report 2011-12*; and IMF staff estimates.

crisis—to 3.9 percent in 2011. While the recent increases in fiscal deficits may have been important to sustain growth over the short-term, they may be an impediment for sustaining growth over the longer term, if they are not appropriately unwound. Also recently, inflation has risen sharply, reflecting rising global food and fuel prices as well as drought-induced food shortages in the region. This will have to be carefully managed to avoid second round effects that could have more lasting effects on longer-term inflation. Maintaining macroeconomic stability also requires that natural resource export proceeds are managed carefully to avoid real exchange rate appreciation (by saving a large part of the foreign exchange earnings) or by investing into other sectors of the economy.

Deeper regional integration can help the EAC to cooperatively achieve its key policy priorities. The mechanism of regional surveillance backed up by appropriate convergence criteria could be used to mutually ensure prudent macroeconomic management by the members. Financial integration would allow the pooling and mobilization of scarce domestic savings and efficient allocation of such savings. Well-designed regional infrastructure projects could help overcome bottlenecks of physical infrastructure and encourage efficient use of invested resources. Free movement of goods, services, and capital would enhance competition across the region, thereby boosting productivity and output growth.

EAC integration is already advancing, but critical obstacles remain. Removing them should become a priority. A time-bound process to eliminate non-tariff barriers would let businesses reap the benefits of the regional common market and prepare them for competition in broader markets. The development of common standards and harmonized regulations would greatly enhance the business environment and facilitate legal enforcement. Regional coordination of investment promotion and tax reform would limit intra-regional incentive competition and help attract financing for larger projects.

In the financial area, stepped-up regional approaches to financing—building, for example, on recent regional bond issuances—could facilitate pooling savings across the region, expanding market size beyond each country, and reducing the fixed costs of developing market infrastructure. The harmonization of national regulatory frameworks, now under way, could be accelerated to facilitate the emergence of regional financial instruments. Deeper government debt markets could enhance the efficiency of monetary policy and serve as a benchmark yield curve for the private sector, facilitating the pricing of financial products.

In the external sector, raising the EAC's export potential requires continued focus on improving productivity across the region. In particular, a better educated and skilled labor force as well as a better business environment, and improved infrastructure—including regional transportation, energy, and information technologies—will reduce production costs and facilitate higher-value exports. Stepped-up efforts to increase agricultural productivity, for example, could both raise the EAC's export potential and lift incomes in the area where the poorest segments of the population are concentrated. In the near term, the region could broaden its export markets to neighboring Democratic Republic of Congo (DRC) and South Sudan, especially exports of food crops and light manufactured goods, while efforts are put in place to penetrate broader international markets over the longer term. This would require some investments in upgrading rural road networks and simplification of customs and border post procedures.

Expanding exports may also demand, at least in the initial years, targeted "catalytic" interventions in natural niche sectors where EAC economies could build up or strengthen their comparative advantage, overcome late-comer handicaps and establish a market presence. Coordinated interventions should cover complementary areas (skills, transportation, technology, market access). These interventions should be carefully targeted, both sectorally and geographically. Resources are insufficient to enhance skills, roads and power in the entire region at the same time. An equal distribution of these limited resources will not give any area sufficient traction to become competitive. Regional coordination—with a common focus, for example, on a few "trade corridors"—could help mobilize financing and increase returns. To prevent "state capture", implementation of the export push policy should be time bound with a clear exit strategy. More broadly, its fiscal cost should be strictly constrained, given the many other demands faced by the government, particularly in the social area.

The private sector should be closely involved in the design of such interventions, helping identify concrete needs and efficient delivery modes. Targeted areas should be selected transparently, with a focus on their impact on sustainability of both exports and productivity. Given its potential for expanding exports and reducing poverty, agriculture would likely offer the greatest payoff from targeted support.

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Economic and Financial Integration in Europe: Recent Stresses and Policy Challenges[28]

Mahmood Pradhan and Alasdair Scott[29]

Economic Integration and Subprime Lending

It is nearly five years since the subprime crisis in the U.S. caused equity markets to tumble and funding markets to seize. During the tumultuous years of 2008 and 2009, it seemed as if the global financial system itself was under threat. Since then, with strong support from monetary authorities, financial markets in the U.S. have stabilized and the economy has begun to recover, though, as in previous downturns associated with financial crises, this recovery is weak and tentative. Strong policy support in the U.S., as elsewhere, continues to be necessary. European economies are also facing an economic and financial crisis of unprecedented proportions and the policy efforts underway are both unique and complex, because of the nature of economic and financial integration. The extent of this integration spans much beyond the Euro area, and also beyond the economies that are part of the European Union. But the construct of economic and financial integration in the Euro area poses unique challenges.

Since the end of 2009 the *European* crisis has centered on the euro area. Yields on sovereign debt in many euro area countries have surged and remained at record highs. Some euro area states have faced very acute funding constraints, necessitating emergency official funding. For a significant proportion of euro area banks, funding has become prohibitively expensive and difficult to obtain, forcing these banks to reduce the scale of their activities (deleveraging). And after years during which credit was channeled from the "north" of the euro area to the "south", capital is now fleeing from those states that need it most to safe havens within and outside the euro area. This has led to financial fragmentation, in part reflected in very large deviations in borrowing costs across the monetary union.

From Subprime Lending to Debt Crisis

At first glance, it seems odd that a crisis that had its origins in subprime lending in the United States should have morphed into a capital and sovereign debt crisis in the euro area. How could this happen?

Our argument in this chapter is that the euro area crisis tells us that the monetary union is incomplete. Despite the very substantial progress to open Europe's economies, both to trade and to capital, the euro area finds itself in a half-way position. It is well integrated in the sense that shocks are quickly transmitted across the zone, but the architecture and policy arsenal are not sufficiently well developed and integrated to be able to absorb such shocks.

To elaborate on this theme, this chapter has three sections. The first documents the integration that has taken place and some of its effects, both negative and positive, during the past two decades. Turning to the current situation, the second section focuses on the links between euro area banks and their sovereigns—a nexus through which the current crisis has been amplified. The final section offers some perspectives on how the architecture can be strengthened towards a more complete union to safeguard the achievements of the last three decades and make the euro area more resilient.

Deepening Integration but Widening Imbalances

The trend toward greater economic integration goes well beyond the euro area. Europe has committed itself to increasingly harmonize legal structures and governance, and the free flow of goods, capital, and, indeed, its own citizens. Members of the European Union now number 27, with others aspiring a similar path to gain access to this economic zone. Even those not part of the European Union, such as Iceland, Norway and Switzerland, share formal ties through other formal pacts and treaties, such as the European Free Trade Agreement.

[28]This paper elaborates on Mahmood Pradhan's presentation at the conference.

[29] Mahmood Pradhan is Deputy Director and Alasdair Scott is Senior Economist in the European Department of the IMF. We are extremely grateful to numerous colleagues at the IMF for sustained engagement on the issues we touch on in this chapter and to Pavel Lukyantsau for his excellent assistance in preparing our presentation.

Figure 1: Interconnections and Business Cycles (1984 - 1999)

Highly correlated countries are placed close on map

Figure 2: Interconnections and Business Cycles (1999 - 2011)

Highly correlated countries are placed close on map

But if Europe has clearly become more integrated de jure, has it made a difference, de facto, in economic relations? The answer is clearly yes. One simple illustration is to look at correlations of business cycles between countries. These correlations, covering the period 1984 to 1999, are illustrated in Figure 1. The most closely correlated economies are grouped together. Some associations are not surprising: Belgium, France, Italy, Netherlands and Spain are relatively tightly clustered, indicating that there were already strong trade and financial linkages between these economies in the pre-euro era. But, overall, the picture is quite dispersed.

By contrast, European economies have become much more closely linked during the past decade. Figure 2 depicts business cycle correlations over the period 1999-2011. Clearly, all economies—not just euro area member states—are much more tightly clustered.

How much of this is because of the currency union? The introduction of the euro played a significant role in promoting greater linkages—as, indeed, it was intended to. Before 1999, for example, sovereign borrowing costs varied widely, and were positively correlated with national debt (Figure 3). This can be seen as a reflection of risk premia, and therefore not surprising. But it also suggests that enterprises in many of the less developed euro area states may have been facing higher costs of credit than in the northern states and in general faced less favorable credit markets.

The introduction of a common currency also brought with it, logically, a common monetary policy and, in principle, the elimination of currency risk.[30] This encouraged capital to shift from the relatively rich north to the poorer south, and differences in yields across the euro area narrowed (Figure 4). Not merely was this expected, it was mostly perceived at the time to be one of the benefits of the currency union: assisted by cheaper credit, poorer economies would be able to catch up more quickly with the advanced north. With the elimination of currency risk and the harmonization of financial and capital market regulation capital was finally able to flow to where it would best be used, and to the benefit of both south and north.

However, while yields fell, the consequent increase in borrowing caused external positions to diverge between north and south (Figure 5). The optimism about the use of these funds has, in retrospect, turned out to be unjustified. Domestic productivity in most of the recipient countries did not improve; rather, credit was used to finance current consumption and investment in real estate rather than productive capital. Whether this was clear at the time and whether national authorities had the instruments to prevent this is a matter for another discussion. But what is now clear is that external

[30] The introduction of the euro did not merely bring a common currency but also a "payments union"—that is, financing imbalances between states would be absorbed within the eurosystem by offsetting balances with national central banks, through a system to be known as TARGET. In the past year these TARGET balances have increased substantially, indicating the stresses on the eurosystem.

Figure 3: International Investment Position and 10-Year Bond Yields, 1995 or the earliest

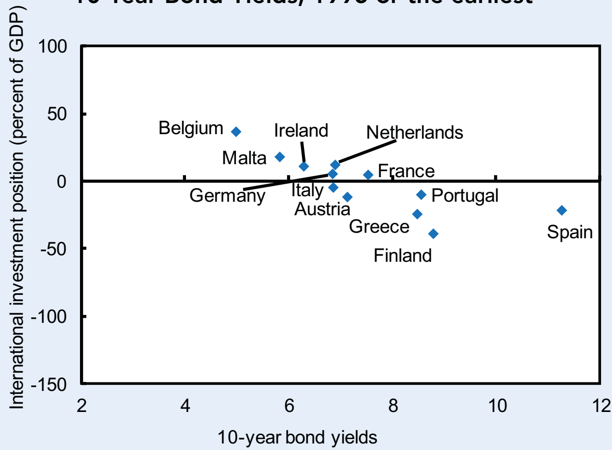


Figure 4: International Investment Position and 10-Year Bond Yields, 2005

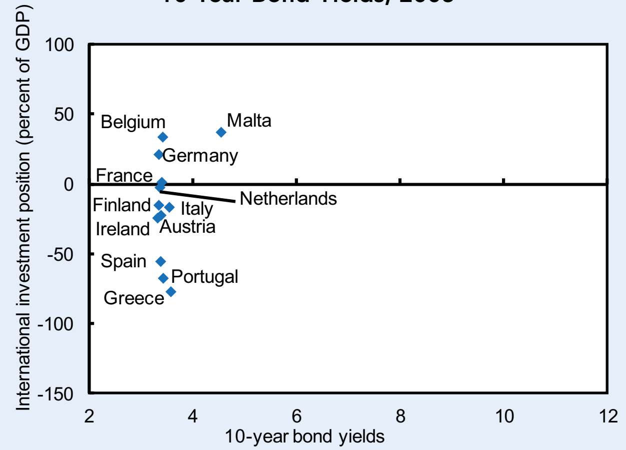


Figure 5: International Investment Position and 10-Year Bond Yields, 2010

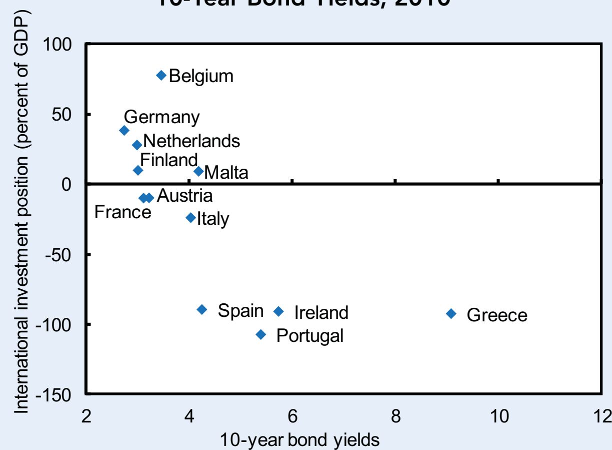
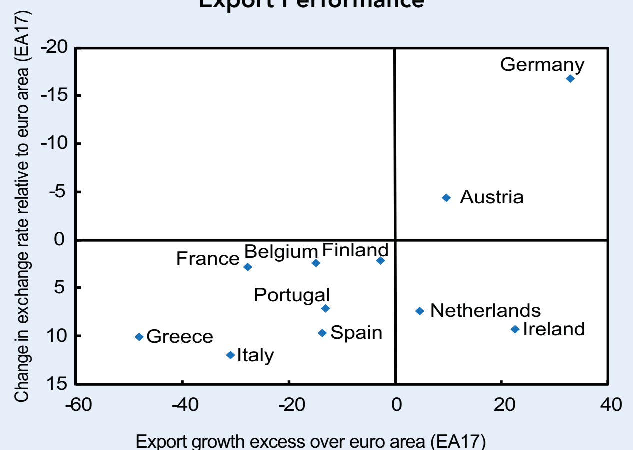


Figure 6: Relative Exchange Rate and Export Performance



competitiveness suffered (Figure 6), leading to wide differences in current account balances (Figure 7). As a consequence external debts increased and servicing this debt is now posing a challenge for many countries.

Hence, widening imbalances within the euro area has led to the re-emergence of sovereign risk, despite these economies operating within a currency union. The pattern of sovereign rates —starting from a wide range, to very substantial convergence, and back to a wide range—suggests that, with hindsight, policymakers should have been guarding against underlying imbalances, even though financial markets appeared less vigilant.

Higher sovereign risk has been compounded with the striking increase in public debt levels experienced by some euro area states during the past three years. To a large degree, this is not surprising—most advanced economies have seen public balance sheets deteriorate during the crisis (Figure 8). Much is simply the result of the combination of collapsing tax revenues and automatic stabilizers (such as unemployment insurance). And it can be argued that, in countries where private demand is weak, particularly in those economies in which households are trying to reduce debt, that the state should step in as "demander of last resort".

However, even before the current crisis, fiscal balances were not kept within the limits designed to ensure that sovereign risk was kept in check. In fact, even at the height of the boom in 2005, a significant number of countries were in violation of the deficit and debt guidelines of the Stability and Growth Pact (Figure 9).

Figure 7: Current Account Balance, 2011
(Percent of GDP)

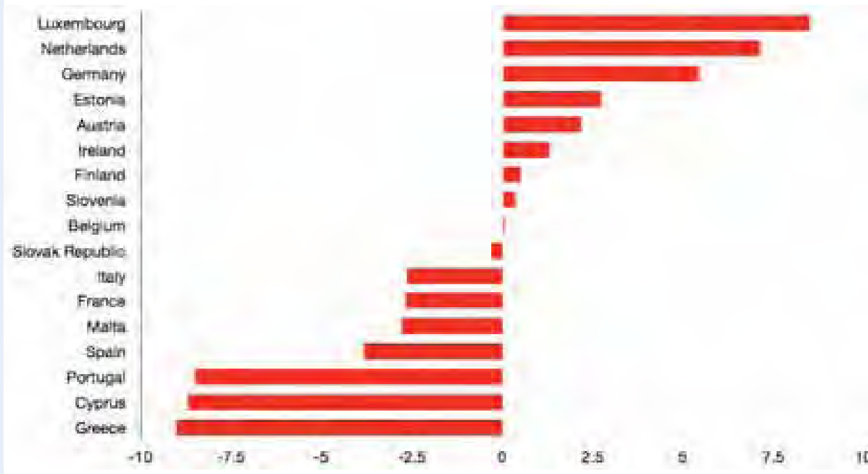


Figure 8: General Government Gross Debt
(Percent of GDP)

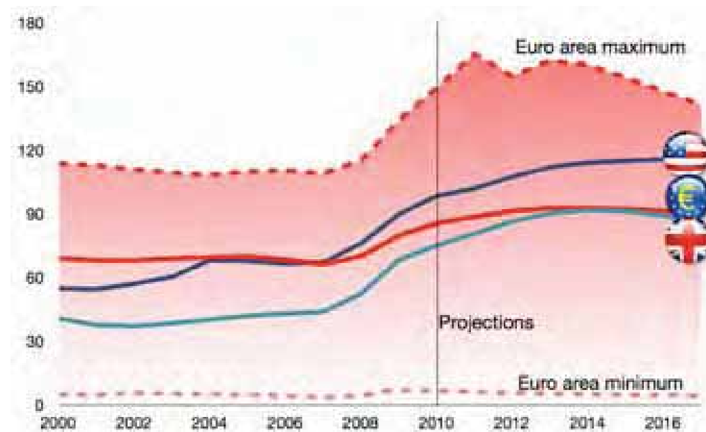


Figure 9

	General Government Balance (percent of GDP)			General Government Structual Balance (percent of GDP)		
	2000	2005	2011	2000	2005	2011
Austria	-1.8	-1.8	-3.3	-3.9	-2.0	-3.1
Belgium	-0.1	-2.8	-4.2	-0.6	0.0	-3.8
Cyprus	-2.4	-2.5	-7.1	-2.8	-3.1	-6.1
Finland	6.9	2.7	-1.1	6.1	2.5	0.3
France	-1.5	-3.0	-5.7	-2.7	-2.8	-3.8
Germany	1.3	-3.4	-1.1	-1.6	-2.6	-1.1
Greece	-3.7	-5.3	-9.8	-2.7	-6.7	-9.2
Ireland	4.7	1.7	-10.1	-2.8	-6.8	-5.7
Italy	-0.9	-4.4	-3.9	-3.4	-5.4	-3.1
Malta	-6.2	-2.9	-3.0		-4.5	-3.2
Netherlands	2.0	-0.3	-4.3	0.5	0.4	-3.7
Portugal	-2.9	-5.9	-5.9	-4.1	-5.6	-6.9
Slovakia	-12.3	-2.8	-4.6	-11.4	-3.0	-3.6
Slovenia	-1.2	-1.0	-5.9	-1.0	-0.8	-3.9
Spain	-1.0	1.0	-8.0	-1.1	-1.6	-6.3

General Government Balance: Lower than -3% of GDP (red); Higher than -3% of GDP (green)

General Government Structual Balance: Lower than -0.5% of potential GDP (red); Higher than -0.5% of potential GDP (green)

This failure to eliminate sovereign risk means that the distribution of debt is an important issue. In comparative terms, the rise in overall euro area public debt is not exceptional—it remains well below levels in Japan and the U.S., for example. But in some euro area member states debt levels are very high. Why does this pose a policy dilemma? Put another way, why should the sovereign debt of a particular euro area state be an issue for the euro area as a whole, whereas high debts of some U.S. states is not considered to be an issue for the U.S. economy?

The answer lies in the nature of European integration. We have seen that financial markets are highly integrated. Capital can (and does) move freely. Euro area banks have held high levels of European sovereign debt. But when it comes to coping with changing macroeconomic conditions, sovereign governments are on their own—and without even their own independent monetary policy that could be used to steer their economies. This sets up a vicious circle, in which shocks in the real economy cause government balances to deteriorate, driving risk premia on sovereign debt higher, causing losses on bank balance sheets, and tighter lending conditions that hurt the real economy even more.

The Sovereign-Bank Nexus

The Stability Growth Pact had been designed to ensure that sovereign finances would not generate sovereign risks; failure to achieve a track record of compliance meant that sovereign risk premia were quick to rise once the global financial crisis focused attention on balance sheet risks. One measure of such premia is the market price of insurance on sovereign default, expressed as credit default swap (CDS) spreads (Figure 10). After increasing sharply during late 2008 and early 2009 following the global financial crisis, average euro area CDS spreads fell back down again during 2009. However, in late 2009, the Greek authorities announced that public deficits were higher than figures provided to Eurostat would indicate. These events set off a marked increase in perceptions of sovereign risk, with the consequence that yields required to sell some government debts increased markedly. And market attention turned increasingly to sovereign financing requirements (Figure 11).

Banks in the euro area faced similar strains as bank CDS spreads increased substantially over the same period. Bank and sovereign spreads are tightly correlated. One reason is that both banks and states have faced common macroeconomic shocks: as real economic conditions have deteriorated, balance sheets of both banks and sovereigns have deteriorated. And risk premia for banks were exacerbated by their by substantial funding needs through 2012 and 2013 (Figure 12).

But the main reason that the fate of banks is so highly correlated to the fate of their sovereign is that European banks hold substantial amounts of European sovereign debt. This "home bias", encouraged by zero risk weighting of all euro area debt despite fundamental differences in the underlying capacity of those economies to cope with macroeconomic shocks, means that sovereign risks automatically become banking risks.

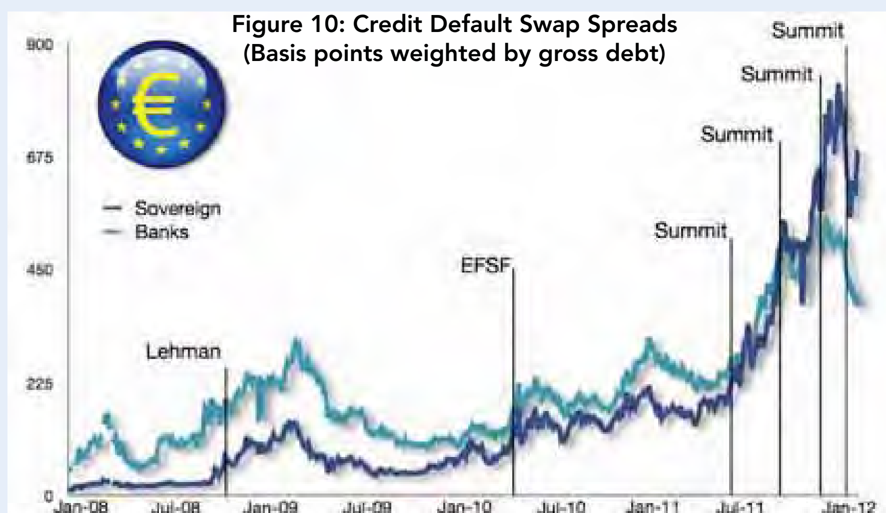


Figure 10: Credit Default Swap Spreads (Basis points weighted by gross debt)

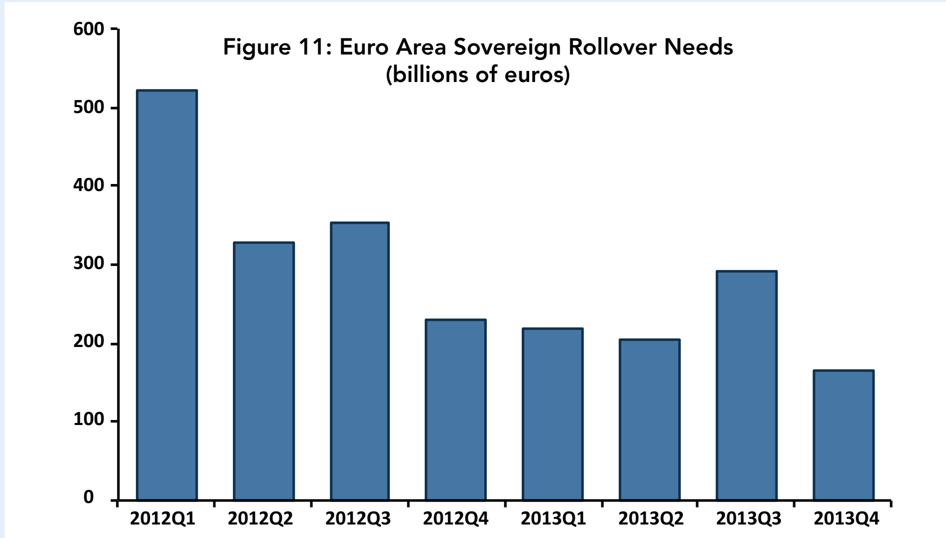


Figure 11: Euro Area Sovereign Rollover Needs
(billions of euros)
600
500
400
300
200
100
0
2012Q1
2012Q2
2012Q3
2012Q4
2013Q1
2013Q2
2013Q3
2013Q4

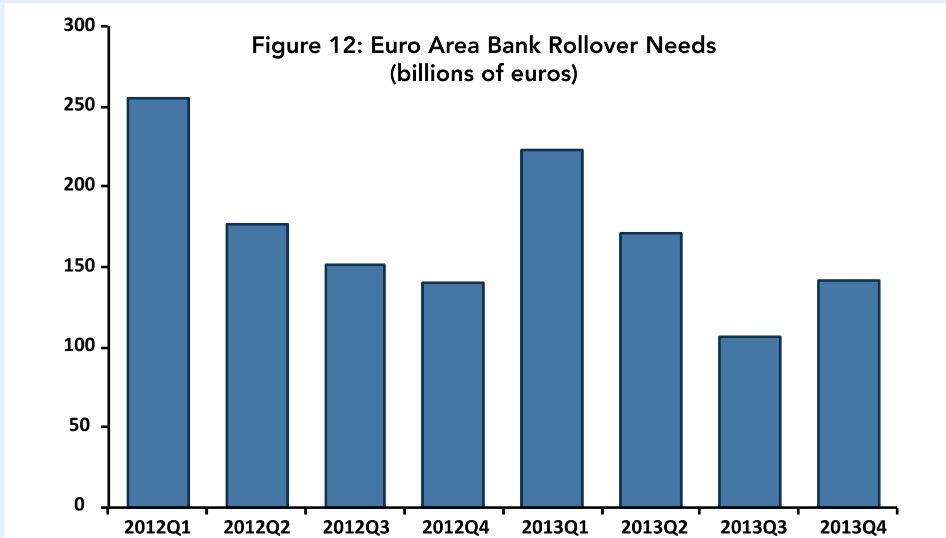


Figure 12: Euro Area Bank Rollover Needs
(billions of euros)
300
250
200
150
100
50
0
2012Q1
2012Q2
2012Q3
2012Q4
2013Q1
2013Q2
2013Q3
2013Q4

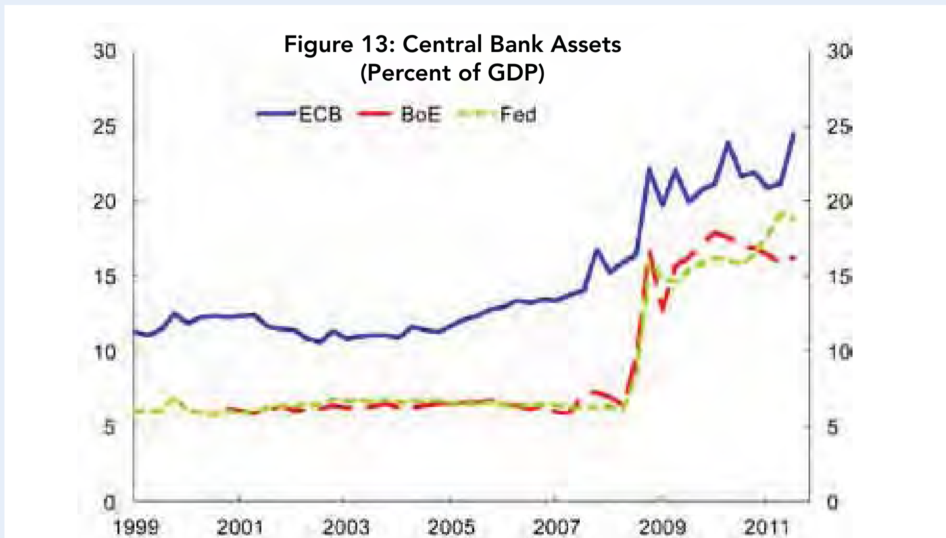


Figure 13: Central Bank Assets
(Percent of GDP)
ECB
BoE
Fed
30
25
20
15
10
5
0
1999
2001
2003
2005
2007
2009
2011

An increase in sovereign risks implies tighter lending conditions, both between banks and to households and firms, constricting credit and growth.

With very high actual (and perceived) funding risks, central bank support has been essential to stabilize financial markets. The European Central Bank (ECB) has responded with very accommodative monetary policy, interventions in the covered and sovereign bond markets of the periphery countries (the Securities Market Program), and extensive liquidity support, most notably through two Long-Term Refinancing Operations extending to three years. As a result the ECB's balance sheet has roughly doubled in size compared to 2008, broadly comparable to the expansion of the U.S. Federal Reserve and the Bank of England balance sheets (Figure 13).

Remaining Challenges: Fiscal and Financial Integration

We turn now to the policy challenges to address the adverse loop between banks, sovereigns and the real economies of euro area states. In its present form, Euro area policymakers lack the tools to break out of an escalating loop of rising risk premia, tight credit, fiscal austerity, and weakened real economies. This is what many have referred to as the problem stemming from an incomplete union.

Policy initiatives to complete the union should proceed along two dimensions. The first is risk sharing—that is, a mechanism for sharing the burden when negative shocks hit an individual economy and, correspondingly sharing the benefits of favorable shocks. The euro area started with no formal arrangement for risk sharing, but partial risk sharing has been introduced through the European Financial Stability Facility, a special purpose financial arrangement that can provide assistance to individual sovereigns through bonds it issues, backed by the guarantees of euro area sovereigns.

The second dimension is governance. If risks are to be shared, then there need to be safeguards to also prevent the buildup of large risks. This implies that fiscal governance is coordinated and centralized to some degree. Some steps have also been taken in this direction, in the form of the Fiscal Compact, which reaffirms most of the provisions of the Stability and Growth Pact and adds new terms aimed to limit the fiscal risks taken by individual euro area member states. Figure 14 provides a stylized illustration of these two dimensions.

How much more fiscal and financial integration should the euro area aim for? It is striking that EU budget transfers are very small compared with transfers between states via the U.S. federal budget (Figure 15). And with regard to the banking sector, a truly pan-European banking resolution authority would need resources sufficient to cover potential losses; in this respect, the size of banking sectors (relative to GDP) in most countries in the Euro area is much larger than in most U.S. states (Figure 16). This is compounded by the extent of cross-border banking assets – again much larger in the euro area than across the U.S. states with

Figure 14: Dimensions of Fiscal and Financial Integration

Figure 15: Gross Transfers
(Percent of state/member country GDP)

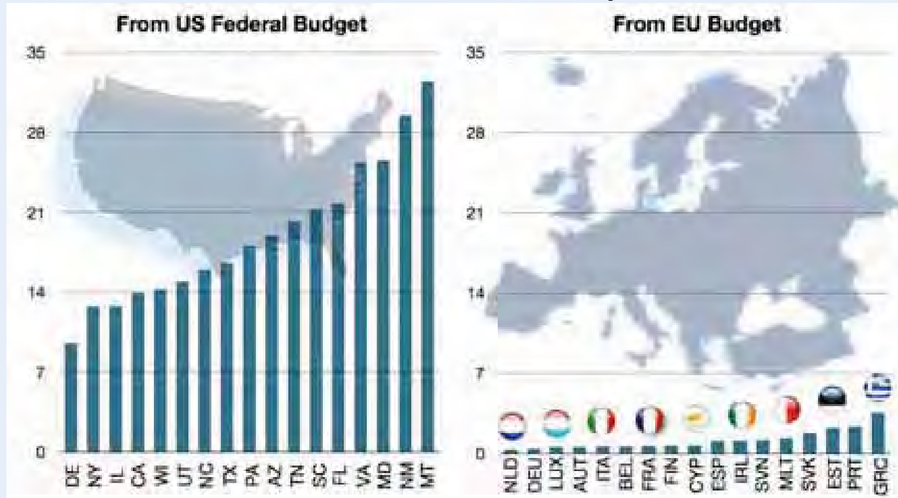


Figure 16: Banking Assets to GDP
(Percent of state/member country GDP)

substantial financial industries (even including Delaware, the favored domicile of U.S. financial institutions because of its securities laws).

Ultimately, the extent of risk sharing and common governance is the subject of political choices, and likely related to wider issues of accountability and legitimacy of centralized authorities. But the experience of euro area economies suggests that more integration would help make countries within the area more resilient and the currency union more stable.

Some Broad Lessons for East Africa

The brief discussion of the experience of European economic and financial integration presented in this chapter does not lend itself easily to drawing specific lessons for other countries and regions, including East African countries. For one, the euro area is still grappling with severe economic and financial strains and policymakers are in the process of constructing a more robust architecture. This will inevitably take some time. But more importantly, the underlying similarities

among countries in other regions may be very different from these European countries. Nevertheless, one clear lesson from Europe's experience is that macroeconomic imbalances matter. They may be masked and indeed exacerbated by capital market integration (large capital flows and yield convergence) but eventually need to be addressed. By contrast, countries in East Africa are at a very early stage on their path to integration, and the extent of capital market integration is arguably much less than in Europe in the late nineties at the inception of the single currency. Therefore capital flows leading to widening macro economic imbalances may not be the most relevant concern for East Africa, at least at this stage.

For Europe, the expansion of cross border banking without a common pan European resolution mechanism has left some sovereigns more vulnerable. Breaking these bank-sovereign links has become an important policy challenge. Again, for East African countries, although this experience is instructive, it is perhaps not a major current issue given the relatively small size of banking sectors in most countries in the region.

Notwithstanding the current strains in Europe, perhaps the most important lesson to draw from the European experience is the benefits of trade liberalization integration, which spans well beyond the euro area and the European Union. Indeed, Europe's trade has also increased with many countries in East Africa—in tandem with more integration within Europe.

Part II Fiscal, Monetary, Financial Sector Policies and Institutions

East African Monetary Union and Fiscal Policy: Current and Future Challenges[31]

Sanjeev Gupta and Jimmy McHugh[32]

Introduction

Recently, there has been an increased sense of urgency regarding the establishment of a single East African currency.[33] The East African Community (EAC) has established a high-level task force, which will prepare a draft protocol for the East African Monetary Union (EAMU) with the objective of establishing a regional monetary institute.[34] This high-level task force is also discussing legislation outlining the funding and operation of a future East African central bank. The EAC has also created a monetary affairs committee with a remit to harmonize monetary and exchange rate policies. In addition, EAC countries have set up a ministerial committee on fiscal affairs to complement the work of its Monetary Affairs Committee. In this regard, tentative steps have been taken toward greater regional fiscal coordination. Finance ministers now hold regular regional pre-budget and post-budget consultative meetings. Considerable progress has been made toward harmonizing excise taxes and value-added tax (VAT) rates, including the establishment of a regional double taxation agreement.[35]

East African monetary union will pose challenges for the design of fiscal policy. The monetary union will require a single centralized East African monetary authority operating within the context of at least five national fiscal authorities.[36] Each EAC member state faces unique developmental challenges, with each country often confronted by large country-specific economic shocks. Uncoordinated fiscal policies—in particular, large deficits and rapid debt accumulation—can weaken monetary and price stability objectives of a monetary union, unless certain enforcing mechanisms are put in place to prevent this from happening.

This chapter examines the current and future fiscal policy challenges inherent in the EAMU. To set the stage, the chapter reviews recent fiscal performance of EAC member countries, especially in the wake of the recent global financial crisis. The crisis and the concomitant disruption to global economic activity provide an informative backdrop to considering the design of the fiscal policy, in terms of both the preparatory stages for EAMU and the long-term arrangements that need to be in place once the currency has been introduced.

The chapter then examines the design of EAMU fiscal convergence criteria. Since 2007, EAC countries have been obliged to meet a comprehensive list of macroeconomic targets, including explicit objectives for the fiscal deficit. Nevertheless, the chapter highlights a number of areas where the current EAMU criteria could be fine-tuned. It further argues that the EAC will have to implement a number of complementary reforms. Three areas are identified. The first one pertains to the coverage, timeliness, and quality of fiscal data. The second covers the strengthening of public financial management systems in member countries and ensuring that such systems are harmonized across all countries. Finally, there is much scope for harmonizing tax and customs procedures to strengthen regional trade.

EAC countries will need to consider some unresolved issues that are prerequisites to the long-term success of the proposed single currency. For example, they will need to establish permanent fiscal rules, a multilateral fiscal surveillance regime to oversee the operation of those rules, and enforcement mechanisms.

[31]The authors would like to thank the participants of the Joint EAC Secretariat-IMF seminar on "Fiscal Issues in a Regional Context" held in Arusha Tanzania, February 27, 2012. Helpful comments were received from Nate Arnold, Hamid Davoodi, Salvatore Dell'Erba, Hui Jin, Stella Kaendra, Duncan Last, Gregoire Rota-Graziosi and Oral Williams. Malin Hu and Nancy Tinoza provided excellent research assistance. Errors and omissions are the responsibility of the authors.

[32]Deputy Director and Senior Economist, respectively, in the IMF's Fiscal Affairs Department. This chapter elaborates on a presentation at the conference.

[33]Article 5 of the EAC Treaty, signed in 2000, commits the participating states to establish a customs union, a common market, and ultimately a monetary union.

[34]This task force began working in early 2011. It comprises of a series of technical working groups covering areas such as macroeconomic policies, statistics, financial markets, and payments and settlements infrastructure.

[35]On November 30, 2010, EAC member countries signed the Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes and Income.

[36]Pending the inclusion of South Sudan.

Given the size and frequency of recent economic shocks, effective risk sharing may need to be an essential pillar of EAMU. Finally, important considerations arise with the overlapping membership of EAC member countries with other regional integration initiatives in Africa. The chapter finishes with some concluding remarks.

Overview of Regional Fiscal Developments

Macroeconomic policy management has strengthened within the EAC in recent years. Fiscal performance was particularly strong just prior to the crisis. Between 2003 and 2008, all countries kept their overall deficits including grants below 5 percent of GDP (Figure 1 upper panel and Table 1). By contrast, the deficits excluding grants were large in some cases, exceeding 26 percent of GDP, reflecting diversity among the EAC countries and a high dependence of some countries on external grants (Figure 1 lower panel and Table 1).

Prudent fiscal policies and relatively high growth rates, along with sizable debt relief operations,[37] reduced public debt ratios across the region (Figure 2 upper panel and Table 2). In 2003, the debt ratios in all EAC countries were in excess of 60 percent of GDP, and in the cases of Burundi, Rwanda, and Uganda, the ratios were 100 percent of GDP or higher. By 2008, headline debt ratios had fallen to 50 percent of GDP or less for all EAC countries, while the unweighted regional average was 36 percent. This improvement in overall debt ratios is mirrored in lower external indebtedness.

Debt relief operations created fiscal space in four out of five EAC countries[38] through lower interest costs (Figure 2 lower panel). The fall in debt servicing costs was greatest in Burundi, where interest payments fell from 11 percent of total expenditures in 2003, to about 2 percent in 2011.

Revenue performance has improved across the region, despite the absence of resource revenues until now. In four out of five countries, total revenues as a percent of GDP have increased during the past decade (Figure 3 upper left panel). Revenue mobilization was particularly impressive in Kenya and Tanzania. Between 2003 and 2011, both countries increased their total revenues by more than 5 percentage points of GDP (Figure 3, lower left panel). Tanzania enjoyed the strongest improvement in tax revenues from slightly less than 10 percent in 2003 to 15.2 percent in 2011. Over the same period, Kenya improved tax collection by 3.6 percentage points. The improvements were less dramatic in Rwanda and Uganda, where tax revenue increase was in the range of 0.8–1.9 percentage points of GDP. The exception is Burundi, where tax revenues as a percent of GDP did not show any increase (Figure 3 upper right panel).

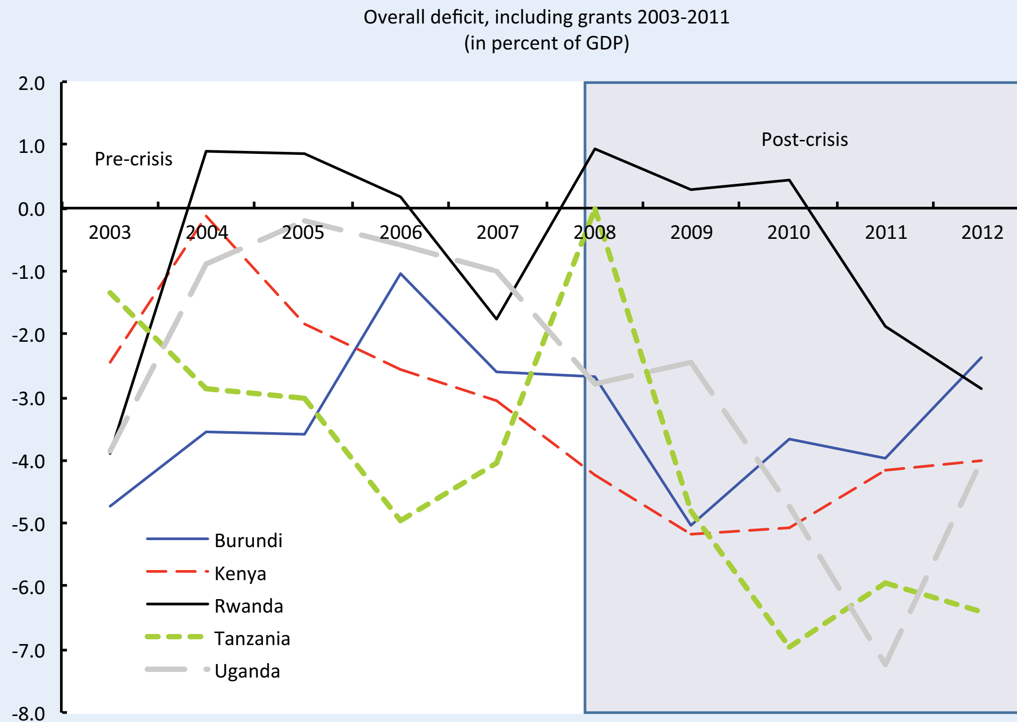
The composition of tax revenues changed, shifting from taxation of international trade and toward domestic sources (Figure 3 lower right panel). In 2003, international taxes accounted for, on average, 15 percent of total revenues. By 2011, this number had fallen to 9 percent. The biggest changes were in Rwanda and Burundi, where previously international taxes accounted for more than 20 and 24 percent of revenues, respectively. In 2011, those ratios had fallen to 10 and 8 percent. The relative contribution of taxes on goods and services have fallen slightly, by 4 percentage points, while taxes on income, profits, and capital gains have increased by 7 percentage points in the EAC.

The region has experienced substantial volatility in grant flows, an issue that complicates the design of EAMU macroeconomic objectives (Figure 4 upper left panel). In general, some countries in the region are heavily dependent on external assistance. In Burundi, external assistance accounts for more than 50 percent of total revenues, while in Rwanda, the ratio is 45 percent. Uganda's dependence on external assistance has fallen since 2006, when grants amounted to almost 9 percent of GDP and 38 percent of total government revenues. By 2011, these ratios had fallen to 2.3 and 17 percent, respectively. This decline was accompanied by an increase in non-tax revenue, rising from 11 percent of GDP in 2004 to 13 percent in 2011. Tanzania has received a broadly constant volume of grants as a percent of GDP. In contrast, grants have not figured prominently in Kenya. External assistance fell from just below 2 percent of GDP in 2002 to less than 1 percent just prior to the crisis. In terms of revenue composition, grants have typically remained below 5 percent of Kenyan total revenues.

[37]Burundi reached the completion point for Highly Indebted Poor Countries (HIPC) and Multilateral Debt Relief Initiative (MDRI) in January 2009, when it received US$1,495 million of debt relief in nominal terms. Rwanda reached a completion point in May 2005, receiving $620 million in debt relief. In 2000, Uganda received HIPIC debt relief amounting to $1.3 billion while in 2001, Tanzania received debt relief in 2001 amounting to US$3 billion.

[38]Kenya did not receive debt relief and it was not part of the HIPC initiative.

Figure 1. East African Community: General Government Deficits



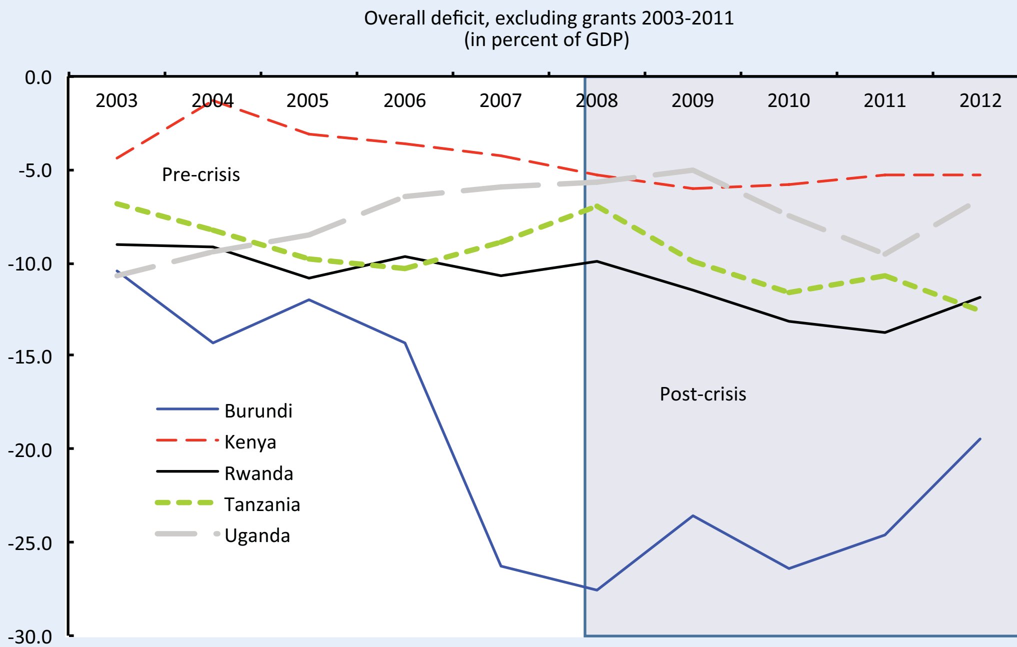
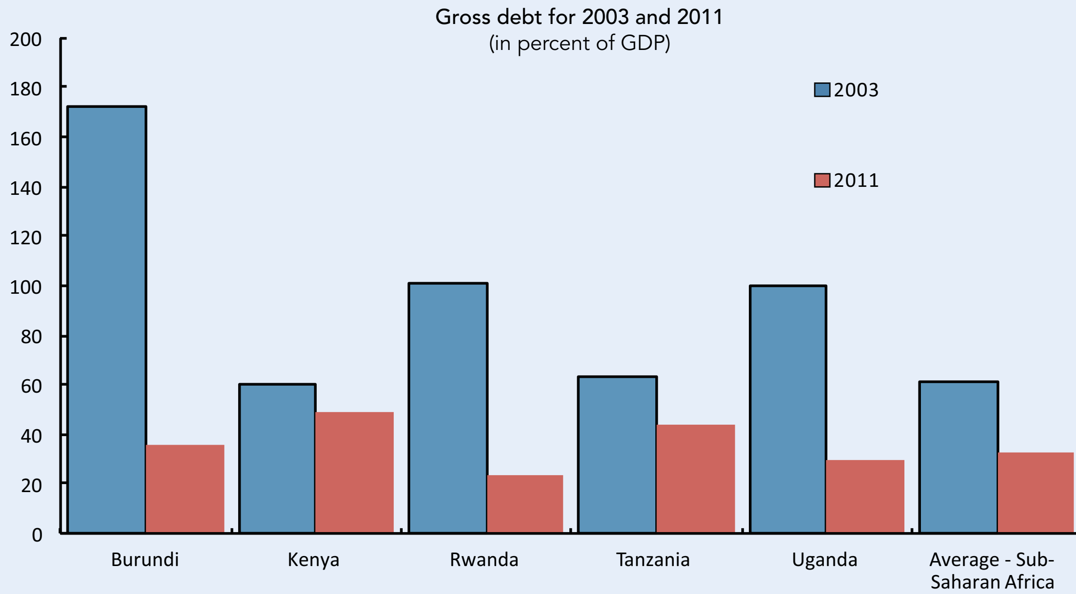
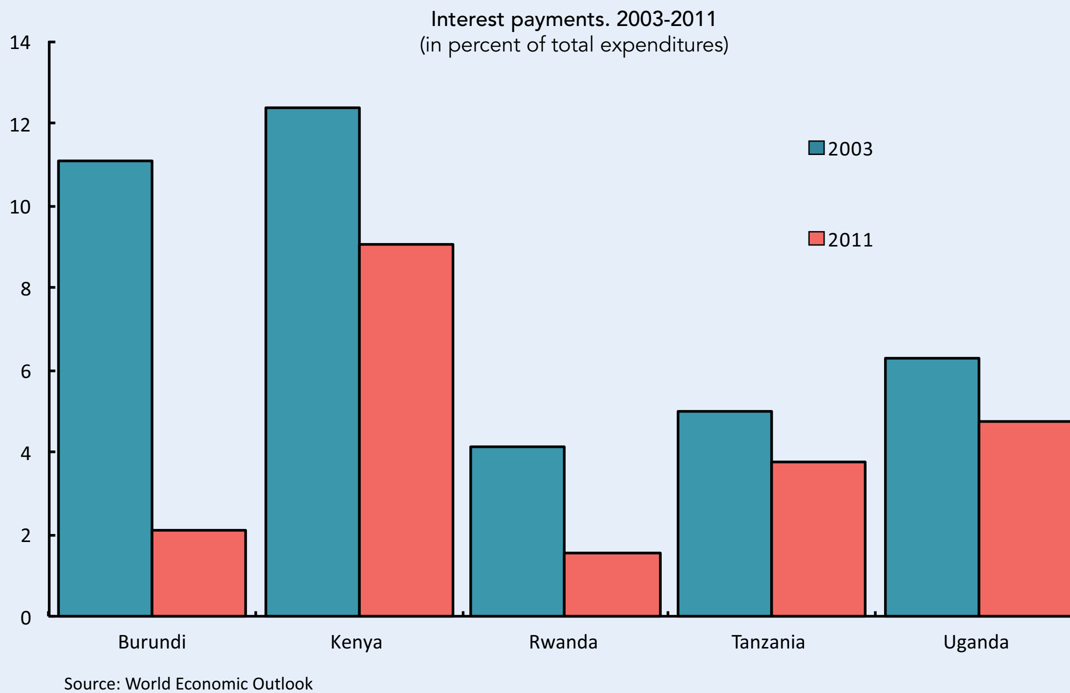


Figure 2: East African Community, Debt Indicators



Source: World Economic Outlook



Source: World Economic Outlook

Table 1. East African Community, Deficit Indicators
(Percent of GDP)

	2003	2005	2007	2009	2011
Overall deficit, including grants					
Burundi	-4.7	-3.6	-2.6	-5.0	-4.0
Kenya	-2.4	-1.8	-3.1	-5.2	-4.2
Rwanda	-3.9	0.9	-1.8	0.3	-1.9
Tanzania	-1.3	-3.0	-4.0	-4.8	-6.0
Uganda	-3.9	-0.2	-1.0	-2.5	-7.3
Overall deficit, excluding grants					
Burundi	-10.4	-11.9	-26.2	-23.5	-24.7
Kenya	-4.3	-3.1	-4.2	-6.0	-5.3
Rwanda	-9.0	-10.8	-10.7	-11.4	-13.7
Tanzania	-6.9	-9.9	-8.9	-9.9	-10.6
Uganda	-10.7	-8.5	-5.9	-5.0	-9.5

Source: World Economic Outlook

Table 2. East African Community, Deficit Indicators, 2003-2011
(Percent of GDP)

	2003	2005	2007	2009	2011
General government gross debt					
Burundi	171.96	137.0	132.0	35.3	35.3
Kenya	60.59	50.8	46	47.6	48.9
Rwanda	100.64	70.7	26.9	23.0	23.4
Tanzania	63.51	62.8	37.0	37.1	44.4
Uganda	99.57	75.3	23.3	22.2	29.2
Total external debt					
Burundi	170.32	131.2	111.3	20.7	21.2
Kenya	38.73	30.7	22.5	24.6	31.0
Rwanda	85.17	58.3	15.3	14.1	15.2
Tanzania	66.49	59.3	30.7	33.4	40.0
Uganda	63.75	47.9	12.3	20.1	25.0

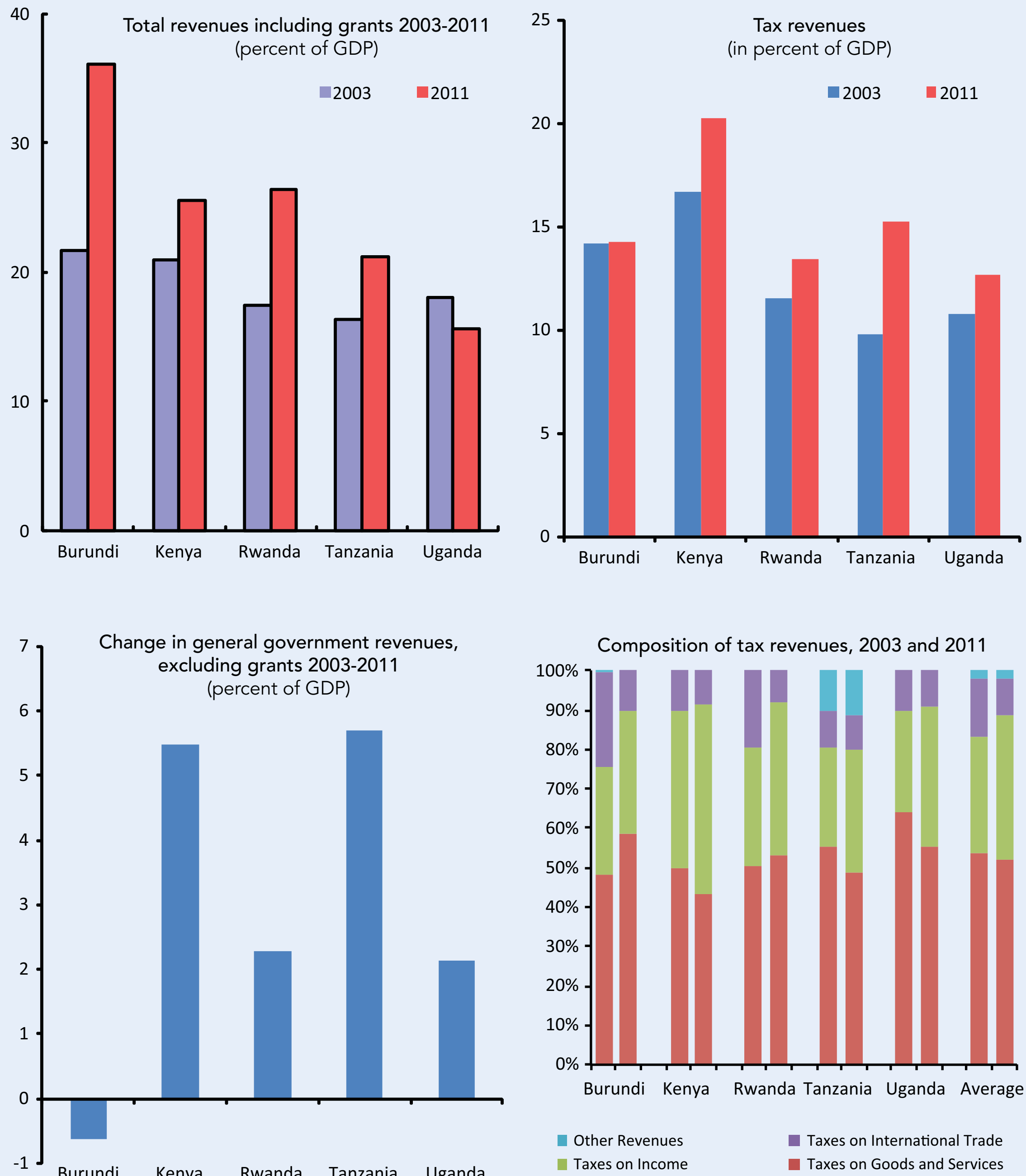
Source: World Economic Outlook

Strong revenue performance is reflected in higher public expenditure, particularly in social sectors (Figure 4). By 2011, public expenditure exceeded 20 percent of GDP on average. The increase was greatest in Burundi, partly reflecting higher external assistance. Across the region, expenditure on health and education, as a percent of GDP increased, with particularly large positive changes recorded in Burundi and Tanzania (Figure 3 lower panels).

The EAC and the Global Financial Crisis

Overall, EAC countries were less affected by the global financial crisis than advanced and emerging economies. Financial market linkages between advanced and low-income countries are generally weak, and this limited the scope for contagion. Furthermore, prior to the crisis, EAC countries had strengthened their policy frameworks, increased trade openness, and, as noted above, successfully reduced debt levels

Figure 3: East African Community, Revenue Performance



The global financial crisis generated only a modest slowdown in EAC growth rates. EAC growth rates declined from a pre-crisis average of 6.8 percent to 5.7 percent.[39] The slowdown was more muted than for all sub-Saharan Africa (SSA), where average growth rates declined from 6.5 percent to 4.4 percent. The slowdown was even more marked for sub-Saharan middle-income countries, where average growth decelerated from 4.7 percent to just 2.5 percent.

Nevertheless, the crisis emphasized the vulnerability of EAC countries to large adverse shocks. Although growth rates have held up well during the crisis, EAC countries have been affected through other channels, notably through higher food and fuel prices and deteriorating external balances. In Burundi, headline inflation rose from 4.1 percent in December 2010 to 13.3 percent by October 2011. In Kenya and Tanzania, a severe drought reduced agricultural and hydropower generation, pushing the inflation rate above 15 percent in both countries. In Uganda, the current account deficit deteriorated, due to weaker external demand, reaching 12.5 percent of GDP during FY 2012. This vulnerability and the need to respond to shocks will influence the design of the EAC fiscal objectives as well as the fiscal infrastructure following the adoption of the single currency.

Within the region, fiscal policy has played a key role supporting growth during the crisis, with general government deficits increasing in all countries (Figure 1). Increased fiscal space offered EAC countries some room to adopt countercyclical fiscal policies in 2009. In real terms government expenditures increased in all EAC countries (Figure 4 lower right panel). Furthermore, in Burundi, Kenya, and Tanzania fiscal deficits including grants were 5 percent or greater. As the crisis unfolded, the composition of expenditures within the EAC shifted toward public investment. Between 2008 and 2011, in all EAC countries capital expenditures increased as a percent of GDP. This partly reflects a longer-term trend of increased public investment as the tax base within EAC countries has strengthened.[40]

[39]The pre-crisis period refers to unweighted average growth rate from 2003 to 2007; the post-crisis period refers to 2008 through 2011.

[40]Between 2008 and 2011, capital expenditures within the EAC increased by 2.4 percent of GDP.

Africa, Growth Rates
(average annual percent change)

	2003-7	2008-11
EAC	6.8	5.7
SSA, All countries	6.5	4.4
SSA, Middle-income	4.7	2.5

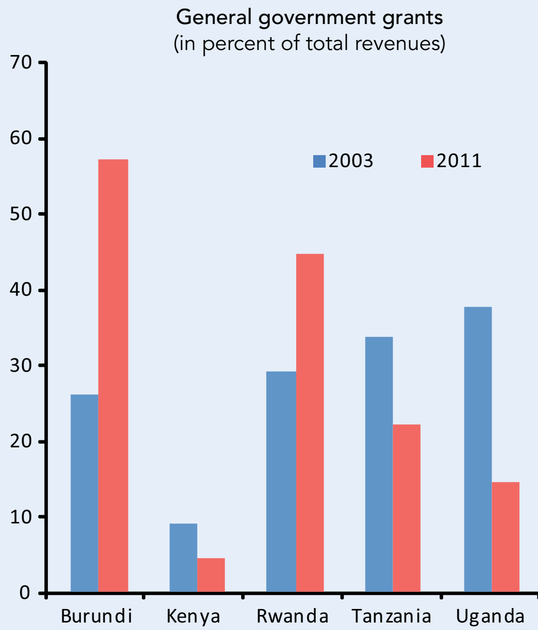
Source: World Economic Outlook

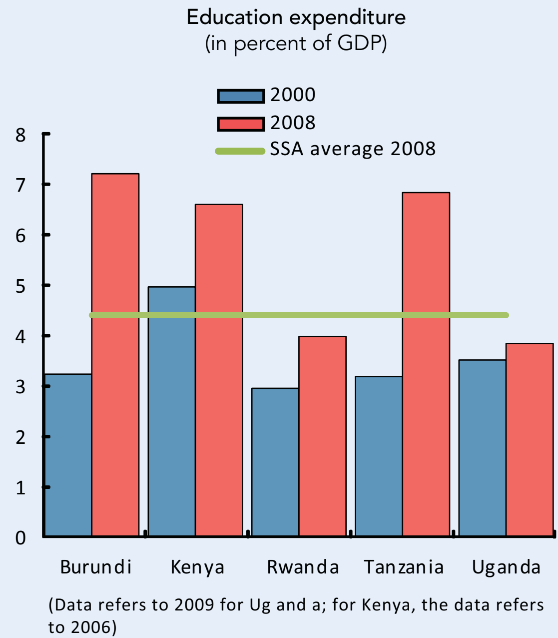
The Rationale for EAMU Fiscal Convergence Criteria

To fully benefit from monetary union, the EAC should meet the conditions for an optimal currency area (Mundell, 1961). In principle, countries should have a broadly similar economic structure. In the event of economic shocks, participating countries are affected in broadly similar ways and therefore a single harmonized policy response is appropriate. In practice, a complete harmonization of economic structure is not possible. Even within countries there are large regional differences, and shocks will always have a considerable asymmetric component. Therefore, a high degree of labor and capital mobility, coupled with price and wage flexibility, can provide a crucial supporting mechanism absorbing unfavorable asymmetric shocks. Furthermore, once a single currency is established, it should be bolstered by a risk-sharing system, such as an automatic fiscal transfer mechanism to redistribute resources to member states that have been negatively affected by economic shocks.

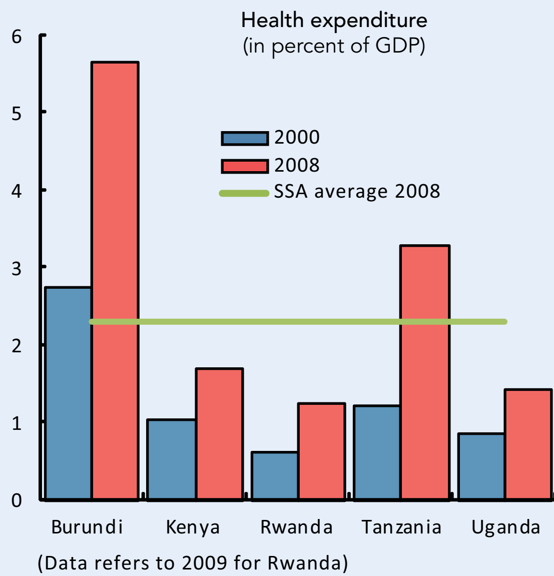
Countries embarking on monetary union must ensure that they have achieved sufficient real and nominal convergence to ensure the long-term stability of the single currency. Greater convergence is, to some extent, an endogenous process (Buti and Sapir, 1998). Monetary union encourages economic and financial integration. Capital flows to less-developed regions promote economic growth leading to a harmonization of per capita incomes. Nevertheless, the creation of a central bank and the elimination of national currencies are not sufficient. Countries must ensure that they are sufficiently prepared for dealing with the greater macroeconomic discipline demanded by a monetary union.

Figure 4: East African Community, Expenditures and Grants

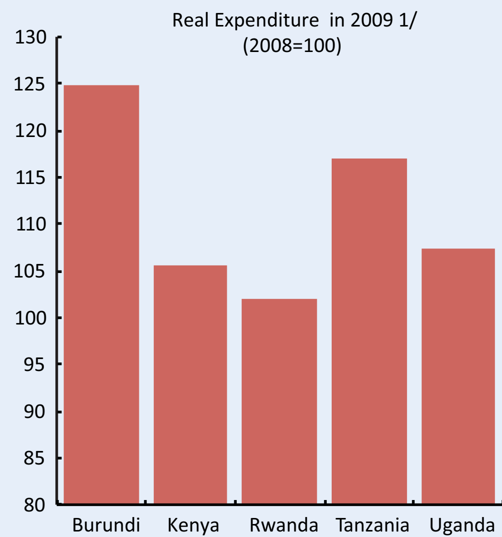




(Data refers to 2009 for Ug and a; for Kenya, the data refers to 2006)



(Data refers to 2009 for Rwanda)



Source: World Economic Outlook

Given its vulnerability to large shocks, EAC countries have recognized the importance of real and nominal convergence as essential perquisites for moving toward a single currency. In 2007, EAC states adopted a comprehensive set of macroeconomic targets, defining objectives for inflation, reserve accumulation, exchange rates, growth, current account balances, national savings, bank supervision, as well as fiscal objectives such as debt and deficits.

Fiscal policy raises a number of unique challenges in the context of a monetary union:

- Uncoordinated national fiscal policies can conflict with the objectives of price stability. Fiscal policies, pursued with only national objectives in mind, can create a negative externality on other members of the monetary union. Each member can in principle pursue policies that can affect the price level through changes in aggregate demand. The central bank could counteract these unilateral actions by tightening monetary policy for the monetary union as a whole. This could tighten monetary conditions in other member states, leading to lower investment and output and higher unemployment. In extreme cases, unilateral fiscal policies can lead to fiscal crises that threaten the credibility of the monetary union. In the event of a crisis, the central bank might come under overwhelming pressure to bail out spendthrift governments, thus fueling inflation and harming the stability of the union. Ultimately, these bailouts could threaten the continued existence of the monetary union.
- A related issue is opportunities for fiscal "free riding." For various reasons, a member state may pursue policies leading to large budget deficits and an unsustainable issuance of public debt. This flow of new debt could raise interest rates for the union as a whole, leading to detrimental consequences for region's investment and growth.

This means that a high degree of fiscal policy coordination is essential in a monetary union. The fiscal policy discipline demanded by a successful monetary union is onerous and difficult to achieve. Therefore, an extended period of preparation is inevitable, where the policies of individual member states are gradually molded together to form a coherent fiscal policy for the whole monetary union.

In practical terms, fiscal policy coordination is achieved through the adoption of numerical fiscal targets and a regional institutional infrastructure that oversees compliance toward achieving these goals. Fiscal targets should provide dependable indicators of the stability and sustainability of public finances as well as resilience to economic shocks. Normally, these targets comprise a stock objective that measures public sector indebtedness and a flow objective that assesses the state of current fiscal policies.

The rationale for a debt criterion is uncontroversial. Excessive debt levels and the inability to roll over debt at reasonable interest rates will ultimately be the fulcrum of any crisis leading to the destabilization of the monetary union. Furthermore, high levels of debt are an impediment to growth (Reinhart and Rogoff, 2010; Kumar and Woo, 2010; Cecchetti and others, 2011). Debt-servicing costs crowd out other expenditures. The debt objective can be defined in terms of gross or net debt. Coverage could comprise general government or potentially the public sector. The deficit or flow objective measures the current fiscal stance. As such, it measures how current policies will likely affect the future stability of the monetary union. The deficit objective also raises issues of definition. Should the target be general government overall balance, or should it exclude external grants? Should the flow objective reflect underlying economic developments, which would suggest a structural balance rather than the headline overall balance objective? These issues are taken up in the ensuing sections of the paper.

To achieve macroeconomic harmonization, countries must accurately communicate their policy intentions to other member states. For this purpose, a regional institutional framework would be required that can observe and report harmonized fiscal targets. This requirement opens up issues about data comparability, coverage, and quality. Furthermore, member states must understand the future fiscal objectives of their regional partners, which should be communicated within a medium-term policy framework.

EAMU Fiscal Convergence Criteria – Current Issues

In 2007, the East African Community Council adopted EAMU macroeconomic convergence criteria, coupled with an ambitious timetable that envisaged the introduction of a single currency by 2015 (Figure 5). These criteria established a three-stage process. The

initial preparatory stage was tentatively scheduled to last from 2007 to 2010, followed by an intermediate stage, lasting from 2011 to 2015, followed by the adoption of the single currency in 2015.

During the initial preparatory phase, countries embarked on a process of economic harmonization. EAC countries were obligated to achieve three primary objectives covering fiscal policy, inflation, and reserve accumulation. In turn, the primary fiscal objective comprises of two parts; the overall deficits (excluding grants) should be no greater than 6 percent of GDP, while the overall deficit (including grants) should be no greater than 3 percentage points of GDP. The preparatory phase also had an extensive list of secondary criteria, including a debt objective. The EAMU debt objective is qualitative rather than quantitative. Although there is no explicit target on debt, countries should have sustained reductions of domestic and external debt as a ratio of GDP.

During the second intermediate stage, fiscal targets will be tightened. The fiscal deficit objective (excluding grants) is reduced to 5 percent of GDP, while the deficit including grants will be reduced to 2 percentage points of GDP. The debt objective remains qualitative as before. There is no expectation of a reduction in the debt-to-GDP ratio, implying that EAC countries should have reached debt levels consistent with debt sustainability by the time countries reach stage two of the EAMU process.

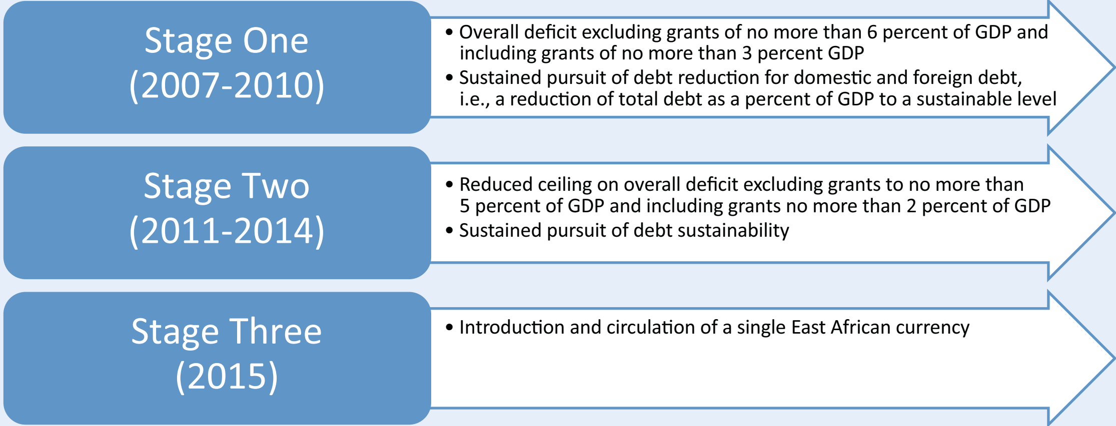
During the third stage, the new single East African currency will begin to circulate among participating states. The EAMU has not yet adopted any formal fiscal objectives for the period after the new currency has been adopted. This leaves open the question as to what the institutional framework for fiscal policy will be once the new currency has been introduced.

EAMU Fiscal Criteria – The Issues

The recent global financial crisis has highlighted a number of issues related to the EAMU fiscal targets that EAC member states could usefully revisit. Should the fiscal criteria be amended to allow some flexibility in the event of large shocks? Following the global financial crisis, fiscal deficits increased in order to support demand but at the cost of moving away from the convergence benchmarks. This also raises a question mark over the timetable for monetary union, since recent EAC deficits are now higher than the benchmarks specified in the initial stage of EAMU criteria. Should EAMU adopt a more flexible timetable?

The EAC could also usefully revisit the design of its fiscal convergence criteria. The most immediate issue concerns the headline fiscal objective: the deficit target. The current criteria specifies two deficit targets—one including grants, the other excluding grants. As explained below, there is a good case for simplifying the objective, focusing on the overall deficit, including grants, while monitoring the other target for surveillance purposes.

Figure 5: EAC Convergence Road Map



There is also a strong case for revising the criteria covering debt sustainability. The current criterion lacks specificity and could be strengthened by introducing numerical targets. If this revision is introduced, then the criterion would need a precise definition—should it be defined in terms of gross or net public debt?

Finally, EAC countries also must look beyond numerical macroeconomic objectives and examine institutional readiness for monetary union. In this regard, EAC countries need to improve data reporting, public financial management, and harmonization of customs, tax rates, and procedures.

Providing Credible Escape Clauses in the Event of Large Shocks

Currently, the EAMU road map has no explicit provisions for an escape clause in the event that an individual country is confronted with a large economic shock. Ideally, the criteria should not be excessively restrictive so that a countercyclical policy response aimed at stabilizing output is prohibited. Part of the reason lies in the inherent difficulty in designing escape clauses in developing and emerging countries where business cycles and output gaps are difficult to identify empirically.

In principle, any relaxation of fiscal objectives should occur only in exceptional circumstances. Excessive use of escape clauses threatens to undermine policy credibility and will weaken fiscal discipline. Therefore, it is essential that EAC countries establish comprehensive rules for exceptions to the EAMU criteria as well as procedures for assessing whether these exceptions are valid. In turn, this emphasizes the importance of strengthening regional multilateral surveillance to provide an objective basis for identifying the magnitude of shocks and when it is appropriate for EAMU states to deviate from the fiscal criteria.

Should the EAMU Deficit Target Be Revised?

What is the best fiscal deficit objective for EAMU? EAC countries have hedged their bets and decided to go with two fiscal objectives, the overall deficit including and excluding grants. The difference between the two deficit objectives, including and excluding grants, is 3 percentage points of GDP.

For most EAC countries, external grants are a large source of total revenues. Furthermore, grant flows have been extremely volatile. In the case of Burundi, external assistance has ranged from about 6 percent of GDP in 2003 to almost 25 percent in 2008. Grant flows to Rwanda have varied between 5 and 12 percent of GDP. As a practical matter, the majority of EAC countries would find it impossible to meet both deficit objectives simultaneously unless there is a sizable reduction in external grants. Therefore, under the current EAMU criteria for the initial stage, if grants are larger than 3 percent of GDP, a country would need to save the surplus resources with potential effects on domestic resource mobilization.

A plausible option would be to streamline the deficit criteria by focusing on a single target—the overall deficit including grants. This definition has the merit that it provides a direct link between current policies and aggregate demand as well as debt accumulation and therefore gauges the impact of fiscal policy on medium-term sustainability.

At the same time, the overall deficit excluding grants also imparts critical information about the fiscal stance. In particular, it illustrates the extent of economy's dependence on aid flows and extent to which external grants may crowd out domestic resource mobilization (Benedek and others, 2012). It should therefore be monitored during surveillance but should not be part of EAMU convergence criteria.

Should the EAMU Convergence Criteria Include a Numerical Debt Target?

The definition of the EAC debt objective is problematic. As noted earlier, this target is open to misinterpretation and it is unlikely to provide the transparency needed to ensure a sustainable reduction of debt levels. It is also anomalous given that other monetary unions such as the European Monetary Union (EMU), Eastern Caribbean Currency Union (ECCU), West African Economic and Monetary Union (WAEMU) and Central African Economic and Monetary Community (CEMAC), as well as proposed monetary unions—Southern African Development Community (SADC) and the Gulf Cooperation Council (GCC)—have explicit debt objectives that all participating states are expected to pursue.

A numerically defined fiscal objective would resolve this difficulty. Indeed, explicit debt limits are a common feature of other monetary unions, tending to range between 60 and 70 percent of GDP. The EAC member countries would need to collectively determine an appropriate numerical target. Debt sustainability needs to be assessed on the basis of current debt levels, the growth potential within the EAC, and an assessment of projected debt servicing costs.

A debt objective in the neighborhood of 60 percent of GDP may be high for EAC countries. They are likely to face limited access to international financial markets in the short term and greater vulnerability to external shocks as well as greater growth volatility. Furthermore, relatively low government revenue-to-GDP ratios in some countries also limit the capacity to service large public sector debt, despite substantial progress toward strengthening the domestic tax base in most countries. In addition, external grant flows have tended to be highly volatile. This suggests that a lower debt objective would be more prudent.

A related issue is whether the debt target should be uniform or country specific. Since EAC countries are likely to have different growth rates and face diverse interest rates, debt dynamics will vary across the region. This argues in favor of country specific debt objectives. Nevertheless, country-specific debt targets would create significant administrative and political difficulties that could, ultimately, undermine efforts to establish a single currency. Moreover, this issue is not unique to the EAMU. Other currency unions have faced a similar choice between a uniform and a country-specific debt objective. All have opted for a single debt target as the most effective basis for achieving and maintaining a single currency.

Should the Debt Target be Expressed in Terms of Gross or Net Debt?

The distinction between net and gross debt is significant. Changes in gross and net debt have differed during the economic crisis. Both definitions have their merits. Gross debt is the most common reference for assessing fiscal sustainability. Gross debt is a relatively straightforward measure of fiscal vulnerability. Coverage issues are comparatively easy to resolve; gross debt captures all liabilities, except those from equity, financial derivatives, and so on. In general, data for gross debt are easily available.

General Government Grants
(in percent of GDP)

	2003	2008	2011
Burundi	5.7	24.9	20.7
Kenya	1.9	1.1	1.1
Rwanda	5.1	10.9	11.9
Tanzania	5.5	6.9	4.7
Uganda	6.8	3.0	2.3

Source: World Economic Outlook

Conceptually, net debt is a preferable concept. Net debt adjusts for financial assets held by governments, for example, those acquired from natural resource revenues or government equity holdings in large domestic corporations. Net debt also resolves the inconsistency arising from the fact that governments receive a flow of income from their assets; something that is acknowledged in annual government accounts but implicitly ignored in gross debt calculations. However, the data reporting requirements for net debt are more stringent since governments must make assessments of the stock of available assets. Measuring financial assets is relatively straightforward. However, nonfinancial assets raise difficult issues of valuation. There is also the further complication that net debt should be consolidated across government entities.

There are alternative benchmarks. The EAC could, for example, adopt a target defined in terms of the present value of debt as a ratio of GDP. Alternatively, a debt service objective could be defined in terms of revenues, exports, or GDP. Unfortunately, these measures lack the simplicity and transparency of gross or net debt, expressed as a ratio of GDP.

Providing a Realistic Timetable for EAMU

In principle, EAC countries by now should have met the convergence criteria set out in stage one. Despite substantial progress, EAC countries still have some way to go to meet the fiscal deficit criteria (including or excluding grants). Therefore, the schedule set out in the road map should be considered to be indicative because member countries are still working toward meeting the initial stage of EAMU.

In recent years, EAC member countries have not met the stage one fiscal deficit objective on a consistent basis. In 2011, only one country—Rwanda—had met the 3 percent of GDP overall deficit including grants target. Tanzania recorded a deficit of 6 percent of GDP, while in Uganda the deficit reached 7.3 percent of GDP. Between 2009 and 2011, Burundi, Kenya, Tanzania, and Uganda all recorded overall deficits, including grants, in excess of 5 percent at least one year. In terms of the deficit target excluding grants, EAC countries are much further away from meeting the EAMU criteria. Only Kenya has managed to maintain an overall balance excluding grants below 5 percent of GDP on a consistent basis. In the case of Burundi and Tanzania, the ratio has been in excess of 10 percentage points of GDP since 2009.

EAC countries may wish to adopt a less rigid timetable for completing the fiscal criteria. In particular, the overriding objective should be that EAC countries develop the necessary degree of fiscal harmonization to ensure the ultimate success of monetary union.

Improving Fiscal Data Collection and Reporting

Timely and comparable fiscal data is a prerequisite for an effective macroeconomic harmonization process. This ensures that reported data accurately reflect the full coverage of government accounts. A broad coverage of fiscal data permits the identification of any emerging fiscal difficulties in a timely manner. It also ensures comparability of fiscal positions across countries.

Across the EAC, there are appreciable divergences in the coverage and timeliness of fiscal data. Burundi, Kenya, and Tanzania report central government data. Only Uganda reports general government data. Two of five members—Rwanda and Uganda—report fiscal data on a quarterly basis, which is not adequate for fiscal surveillance (others monthly). There are also large stock-flow discrepancies between deficit and debt. In the case of Kenya, these discrepancies can be as high as 5 percentage points of GDP.[41]

Improvements in the quality of fiscal data will help prevent the use of accounting stratagems to achieve the fiscal coverage criteria. Typically, these stratagems will inflate revenue performance or fail to report higher spending, for example, through public-private partnerships, treating privatization receipts as revenues, securitization, or the sale of future revenues.[42] Over the long term, such efforts tend to weaken fiscal performance and store up difficulties for the future.

The EAC has begun preparatory work to harmonize statistics. It has established a Committee on Statistics that is working with institutions such as central banks and ministries of finance. The committee has identified six priority areas including: (a) monetary statistics, (b) financial soundness indicators, (c) the Consumer Price Index, (d) government financial statistics, e) balance of payments, and (f) national accounts.

Strengthening Public Financial Management

Aligning and strengthening public financial management is an essential prerequisite for fiscal convergence. Strengthening public financial management (PFM) systems in EAC countries is an integral bulwark for ensuring good governance, promoting transparency and accountability, and increasing fiscal discipline.

Within EAC, there are substantial weaknesses in PFM systems. There remains a substantial outstanding reform agenda. This includes the need to strengthen legal frameworks and systems, reform budget preparation processes, and improve budgeting and accounting classification. Treasury systems remain weak, and more generally there is a need to upgrade cash- and debt-management procedures to modernize financial accounting and reporting systems, and improve expenditure control monitoring.

In addition to strengthening the PFM infrastructure at a national level, EAC countries will need to ensure that their national structures are aligned with partner countries. Inevitably, this will require appropriately revising organic budget laws to accommodate the requirements of the monetary union. In this regard, the EAC will need to establish a common legal and regulatory framework, and adopt international standards for accounting, reporting and auditing.

[41]Dippelsman and others (2012) reported that debt coverage can have a large effect on assessments of debt sustainability. Depending on the definition of the government, the debt-to-GDP ratios for a country at any given time can range from 40 percent to more than 100 percent. Debt statistics, for example, may include or exclude state and local governments and may cover all debt instruments or just a subset.

[42]For further details see Irwin (2012).

Harmonizing Customs and Tax Rates and Procedures

The EAC customs union, created in 2005, is a vital building block of monetary union. Nevertheless, much remains to be done to ensure that the customs union becomes fully operational. In principle, a customs union requires the establishment of a common external tariff, a dispute resolution mechanism, the elimination of internal tariffs, effective rules of origin, nondiscrimination, and the harmonization of customs and non-customs procedures. A particularly difficult issue will be the elimination of national exemptions from customs duties. To achieve these objectives, each country will have to amend national legislation to align it with the requirements of the customs union. This process is often time consuming because each member has its own legislative agenda, and meeting the requirements of the customs union can be seen as a lower priority.

The EAC will have to develop mechanisms for revenue sharing and the transparent accounting. Each country will need to properly record and account for payments made at customs houses and border points. The customs union will also demand the timely exchange of data, where each state has an IT system compliant with other member states. Furthermore, intelligence and tax information should be easily shared to ensure that enforcement activity is properly supported.

A harmonized tax system will facilitate the free movement of goods and capital and thus lay the basis for greater real convergence. Indeed, tax harmonization is an explicit objective of the protocol creating the EAC Common Market.[43] Within the EAC, there are different VAT rates, exemptions, and zero ratings. There are also divergent VAT registration thresholds. Furthermore, there are varying definitions of tax bases, different tax exemptions and rules on depreciation, and capital allowances.

Looking Beyond EAMU

Although the EAC has articulated a wide-ranging road map toward monetary union, thought needs to be given to the post-adoption period when the new East African currency would be in circulation. Three issues in particular deserve consideration:

- The nature of the post-adoption institutional and policymaking structure. The EAC will have to construct permanent fiscal rules to ensure fiscal discipline as well as establish an effective mechanism for multilateral fiscal surveillance.
- The mechanism to deal with asymmetric shocks. The EAC will also need to consider the appropriate response in the event that one or more member countries are confronted with a large unfavorable shock.
- The relationship between EAMU and other regional monetary initiatives. There is the unresolved question concerning the role of EAMU in the context of the wider move toward economic integration in Africa.

Post Adoption Policy Coordination Structures

To ensure the sustainability of the new currency, the EAC will need to develop effective macroeconomic policy coordination structures. Strong fiscal discipline will be essential if the future single currency is to succeed. This will require three components, establishing fiscal rules, undertaking fiscal surveillance to ensure that countries are adhering to those rules, and finally, introducing mechanisms for enforcing fiscal discipline.

A successful and sustainable monetary union requires a high degree of coordination between the supra-national central bank and the national-level fiscal authorities. Effective fiscal and monetary policy coordination, in particular constraints on debt and deficits, are essential prerequisites for successful monetary union. Therefore, binding and credible fiscal rules are essential.

Effective fiscal surveillance will be critical to achieving macroeconomic policy coordination. EAC countries would need to identify imbalances early on and ensure that corrective actions are introduced promptly. To achieve this objective, the EAC will need to delegate responsibility for surveillance to a body that will regularly monitor fiscal developments and report findings to national authorities. The EAC has recently created a Fiscal Affairs Committee that could over time be transformed into an independent body responsible for EAC multilateral surveillance.

[43]Article 32 of the Protocol on the Establishment of the East African Community Common Market states: "The Partner States undertake to progressively harmonize their tax policies and laws to remove tax distortions in order to facilitate the free movement of goods, services and capital and to promote investment within the Community." Article 83 2 (e) of the EAC Treaty also requires EAC countries to harmonize their tax policies.

Enforcing fiscal discipline will also be imperative. The EAC will have to develop mechanisms whereby countries are obliged to take corrective actions in the event member states fail to maintain fiscal discipline. In political terms, enforcing multilateral fiscal rules can be difficult. Countries infringing fiscal rules can apply pressure on partner countries to relax them. To counter this pressure, the EAC will have to establish strong institutional capacity.

Fiscal Risk-sharing Mechanisms

The EAC has not yet articulated how the EAMU would deal with country-specific shocks once monetary union has been established. In other words, what fiscal risk mechanisms would be in place to confront potentially destabilizing shocks? The issue has become more acute given recent developments within the eurozone. Mechanisms to share risks and absorb the negative consequences of shocks would need to be developed. Since labor mobility is limited within the EAC, and structural rigidities will hamper rapid price adjustment, the impact of country-specific shocks is likely to be protracted and painful.

There is a wide range of potential fiscal risk-sharing mechanisms that could be established when the single currency is introduced. These options include a) a system of intergovernmental transfers, b) issuance of a supra-national EAC bonds, and c) the creation of an EAC fiscal stabilization fund. Regardless of the mechanism chosen, the EAC would also need to establish transparent governance structures.

The EAC could in principle develop a system of intra-governmental transfers, which could be made effective to address shocks faced by individual member states. Intra-governmental transfers have two broad objectives. First, transfers can help meet a redistributive objective, partially equalizing incomes across member states. Second, transfers can play a macroeconomic stabilization role, counteracting the negative effects of shocks. In the context of a monetary union, the stabilization objective is paramount, because it will discourage individual member states from undertaking fiscal policy measures that conflict with the price stability objectives of the EAC central bank.

Supra-national EAC bonds offer an alternative risk-sharing mechanism. If the EAC borrows collectively market access could be secured at sustainable interest rates when individual member states come under stress. The issuance of a unified EAC bond raises issues about legacy debt issued by individual member states. In the event of a debt crisis, which instrument would have seniority? This issue could, in theory, be resolved by the complete mutualization of the existing debt stock. Currently, EAC countries have different levels of indebtedness. This would raise a further complex subject of how the responsibility for servicing legacy debt would be allocated.

EAC countries could also create a regional stabilization fund. In the event of a country-specific shock, EAMU members could access the fund to provide resources to meet any fiscal shortfalls. The fund could then be replenished at a time when output returns to its long-run trend. The fund would need to be financed through initial contributions from member states. Such a fund would require strong governance structures that would ensure that the fund was run according to its objective of responding to shocks independent of political influence.

Monetary Union in the Context of African Economic Integration

Over the past decade, African countries have entered into a number of ambitious regional integration initiatives. The EAC's drive toward monetary union coincides with other initiatives to strengthen regional economic cooperation, including monetary integration. COMESA—the Common Market for Eastern and Southern Africa—has also expressed a desire to create a monetary union. Likewise SADC is also working toward monetary union. The memberships of COMESA and SADC partly overlap with the EAC, creating conflicting obligations for those who are members of two regional organizations. At some point, these countries will need to decide which organization they want to belong to.

Concluding Remarks

The recent global financial crisis highlighted many of the recent policy achievements of the EAC region. Fiscal policy management has improved over the past decade. Public debt ratios have fallen, revenue performance has improved, and the composition of tax revenues has shifted from international taxes to domestic sources. Despite the widespread disruption to the global economy, East African growth rates have remained broadly in line with those prior to the crisis.

This improved fiscal performance laid the basis for a robust response to the global crisis. In the pre-crisis period, EAC countries had built up fiscal space that provided the opportunity for countries to implement countercyclical fiscal policies. Public investment has increased, both as a share of total spending and as a percent of GDP. Important social sector expenditures have also increased as a percent of GDP.

At the same time, the crisis has emphasized the region's ongoing vulnerability to large economic shocks. Over the past two years, EAC countries have experienced large supply-side shocks from higher global fuel prices, and as well as a regional drought. Balance of payments difficulties have emerged, and headline inflation rates have picked up across the region.

East Africa's vulnerability to shocks had underscored the need to re-examine the design of EAMU convergence criteria. The current criteria have no formal flexibility in the face of large external shocks. As a consequence of the crisis, deficit levels in EAC countries are now some distance from meeting the objectives outlined in the initial phase of the EAMU road map. In this context, the EAC should consider formulating credible procedures for countries to relax the fiscal criteria in the event of large economic shocks. Furthermore, the current EAMU timetable has also been overtaken by events, pointing to the need to develop a more flexible approach to the timing for introducing the new currency, where the emphasis is on credible and sustainable convergence.

While the overall framework is broadly appropriate, there are areas where the EAC countries could usefully revise and strengthen the criteria. The criterion on the fiscal deficit excluding grants should be eliminated as a mandatory objective but should be retained for fiscal surveillance purposes, particularly to evaluate revenue mobilization efforts. EAC countries should also establish explicit ceilings on gross public debt as part of a broader regional debt sustainability framework. There is also a need to improve the institutional framework underpinning fiscal policy, in particular, data reporting and coverage, as well as public financial management.

EAC should look beyond the pre-adoption phase and consider the institutional framework once the single currency is finally adopted. EAC countries will need to give more attention to the institutional architecture needed to ensure the long term sustainability of the new currency. They will have to establish credible fiscal rules, multilateral surveillance structures, and enforcement mechanisms. There are also a number of unresolved issues, including the development of regional risk-sharing mechanisms. Overlapping membership of regional organizations could also pose difficult questions in achieving convergence.

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Monetary Policy Harmonization in the East African Community

Rogelio Morales[44]

Introduction

Formation of the East African Monetary Union (EAMU) is an expressed declaration of the five states making up the East African Community (EAC)—Burundi, Kenya, Rwanda, Tanzania, and Uganda. To this end, the EAC Secretariat requested that IMF staff study issues related to the transition from the current monetary frameworks for each partner state to a common framework for the EAMU. Specifically, it requested a study that provides an outline of a strategy for harmonizing national monetary policy regimes across the EAC. This chapter is based on that study.[45]

EAC partner states' interest in moving toward a monetary union has a historical precedent. The East Africa shilling was adopted in 1922 by countries ruled by the United Kingdom (Kenya, Uganda, and Tanganyika and, in 1936, Zanzibar). After independence, local currencies were introduced but they continued to be fully and freely convertible into the U.K. pound sterling in Kenya, Uganda, and Tanzania, and continued to benefit from explicit and implicit subsidies. The depreciation of the pound sterling against the U.S. dollar in late 1960s and early 1970s and slow progress in economic integration across EAC countries led to the disintegration of the sterling area in 1972. Following a period of divergence of inflation targets and interest rates, the East African Currency Area formally ended in 1977.

Harmonization of national monetary policy regimes requires an understanding of the envisaged end point, the "currency union model," and of the current monetary policy regime, the "initial conditions," each of which is discussed below.

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[45]The study was funded by the government of Japan. It was commissioned by the Monetary Affairs Committee of the EAC and prepared by IMF staff in collaboration with staff from EAC central banks. Three IMF departments participated in the study, the African, Legal, and Monetary and Capital Markets Departments.

A Currency Union Model

- **Decentralized model.** In principle, the EAMU Protocol envisages that participating national central banks (NCBs) would be subordinate to a new East African Central Bank (EACB). NCBs would implement monetary operations on behalf of the EACB in support of the monetary union regime. In anticipation, NCBs would benefit from conducting monetary policy using the same set of monetary tools.
- **Floating exchange rate.** The study assumes that the EAC maintains exchange rate flexibility under the new currency. Therefore, the EACB and NCBs will face the challenge of operating an independent monetary policy. This will require the use of a range of monetary policy instruments and operations to achieve the inflation objective—activities that would need to be harmonized across the NCBs with the view of preparing for operating in a decentralized system. Under a currency peg, the institutional challenges are greatly reduced because of the elimination of monetary independence.

Initial Conditions

- **Differences in policy frameworks.** Currently, monetary policy regimes and practices differ across EAC countries. Chiefly, the exchange rate regime is classified as floating in only three countries (Kenya, Tanzania, and Uganda), while policy interest rates are binding for monetary operations in three countries (Kenya, Rwanda, and Uganda). Kenya and Uganda are moving away from hard targets on reserve money.
- **Room to improve policy effectiveness.** Although the inflation record in EAC countries has improved over the past decade, low effectiveness of monetary policy has translated into double-digit inflation in most EAC partner states in 2012. These shortcomings, if sustained, would likely hamper the process of aligning national monetary policy regimes in a monetary union, and could lead to less than successful monetary management in the initial stages of the new currency.

Differences in initial conditions reflect differences in the macro institutional environment and in the monetary policy framework. An understanding of these differences will in turn help identify the needed harmonization policies and their sequencing.

Delving Further into Initial Conditions

Macro institutional Environment

- **Legislative history.** Legal frameworks for central bank operations reflect historical national priorities. Recent changes in national central bank laws have been driven by institutional initiatives for reform (Rwanda) and by broader political reforms, such as the new constitution in Kenya.
- **Extent of donor funding.** For both Rwanda and Burundi, foreign aid inflows are a significant source of both fiscal revenue and foreign exchange. In these countries, monetary policy is dominated by issues related to the management of the monetary and foreign exchange repercussions of these inflows.
- **Financial depth and development.** In Kenya and Uganda, countries with the highest degree of financial development in the region, the behavior of economic agents appears to have become more sensitive over time to changes in interest rates. Therefore, NCBs in these countries are giving more weight to interest rate changes in their policy decisions.

Monetary Policy Frameworks

- **Policy consistency.** Central banks' approaches to monetary policy design and implementation are continuing to evolve within the EAC, with mixed success in maintaining low inflation, in part owing to challenges in maintaining policy consistency in the presence of external shocks, imperfect interest rate signaling, and unclear communication of policy intentions.
- **Fiscal dominance.** Although central bank financing of national budgets is generally subject to defined limits in EAC countries, instances of exceptional financing can arise, usually when efforts to fund the budget using market-based instruments would result in what are regarded as excessive interest costs. Where central banks are required to provide ad hoc funding in excess of defined limits, monetary policy autonomy and effectiveness can be undermined.

Is There a Unique Timetable?

The timetable for strengthening the effectiveness of monetary policy, harmonizing legal frameworks, and developing common monetary policy practices and instruments would need to be consistent with the decision on the starting date for the monetary union. The study assumes that sufficient time is available in advance of monetary union to allow a sequencing of the preparatory reforms to monetary frameworks.

What Are the Lessons from Other Currency Unions?

Exchange rate regimes of existing monetary unions can be free floating, pegs, or an anchor currency. The euro and the South African rand both float, while the franc in the two CFA (Communauté Financière Africaine) zones is pegged to the euro and the Eastern Caribbean Currency Union is pegged to the U.S. dollar. Current plans for the EAMU are consistent with exchange rate float experiences, while the historical experience of the failed East Africa shilling is consistent with the exchange rate peg. Currency unions pegged to a hard currency generally predate independence.

Floating Exchange Rate Regimes

- The South African rand still serves as the anchor for the Common Monetary Area (CMA), formed by some members of the Southern Africa Customs Union: South Africa, Lesotho, and Swaziland. The arrangement functions as an effective currency board.
- The German deutschmark served as the effective anchor for the European Exchange Rate Mechanism (ERM) for several years in the lead-up to the euro. Tensions from diverging macroeconomic developments (growth, inflation, fiscal policies) and the understandable focus on developments of the Bundesbank led some countries to reconsider their commitment to the ERM until a common currency was adopted. The euro operates as a floating global reserve currency, with minimal intervention in support of the currency.

- The period between the adoption of a common exchange rate arrangement and monetary union exceeded ten years in both cases. The CMA was formed in 1986, 14 years after the formation of the Rand Monetary Area. In the case of the EU, the period between the adoption of an exchange rate mechanism and full monetary union was 20 years (1979–99).

Pegged Exchange Rate Regimes

- The CFA franc (CFAF) was pegged to the French franc from 1945 until 1999, when it was pegged to euro. At the time they created the CFAF, the main institutional characteristics that applied to both unions were a fixed peg to the euro and a convertibility guarantee by the French Treasury. The West African Economic and Monetary Union and the Economic and Monetary Community of Central Africa were created 49 years after CFA.
- The Eastern Caribbean Currency Union (ECCU) was formed by members of the Organization of Eastern Caribbean States in 1983. The Eastern Caribbean dollar pegged to the British pound from 1950 to 1976, and to the U.S. dollar thereafter. The launch of the ECCU in 1983 took place with limited advanced preparation. The member countries had the advantage of starting with common monetary policy frameworks—specifically, parallel pegs to the U.S. dollar. Reflecting this common starting point and the straightforward institutional demands of the pegged exchange rate regime, the currency union was launched despite limited financial and trade integration across member countries.
- The choice of a pegged exchange rate is to a large extent a function of historical and trade ties. The two CFAF zones and the ECCU are pegged to reserve currencies. The period between the adoption of a common currency arrangement and the monetary union is longer than in the case of floating exchange rates.

Experience shows that harmonization requirements are more pressing for floating union-wide currencies. The experience of other currency unions shows that harmonization can be supportive for the following reasons:

- Harmonization could contribute to the preparation of a floating common currency, to the extent that it helps to ensure macro stability in the transition and thus reinforce credibility.
- Harmonization can help "discover" the parity between currencies in the absence of an external anchor.
- Harmonization can support a smooth transition to a system of decentralized monetary operations. It can ensure consistency between centralized policies and decentralized operations, and can facilitate capacity improvement that ensures effective coordination between national central banks.

What Aspects of a Legal Framework Should Be Harmonized?

Harmonization of legal frameworks is necessarily a long-term undertaking that requires a substantial political commitment. Main areas of harmonization are:

- **Central bank–treasury relations.** Some jurisdictions have strong legal safeguards in place to protect their NCB against political influence while facilitating policy coordination with the treasury, other jurisdictions explicitly authorize the treasury to give the EAC central banks binding policy instructions. In the area of monetary financing, the EAC central banks' legal frameworks are less divergent. However, terms of temporary financing and the repayment modalities differ. Moreover, in practice, central bank financing of the government has at times been accommodated by resorting to a flexible application of legal restrictions.
- **Legal mandates.** The main divergences in the EAC central banks' mandates concern their legal powers, in particular regarding monetary policy instruments. Although all the EAC central banks may enter into credit operations, the legal framework diverges with respect to counterparties, maturity, collateral requirements, and the EAC central banks' creditor position. The EAC central banks' statutory objectives are similar but not synchronized. EAC central bank acts have different objectives and priorities, for example, regarding financial supervision. Also, the institutional allocation of powers over foreign exchange matters differs among EAC jurisdictions.
- **Legal safeguards.** Statutory autonomy is not always ensured in EAC jurisdictions. In most countries there is no explicit prohibition on

instructions, and only three have an explicit statement that the central bank has operational and financial autonomy. Although all EAC central banks appear to have budgetary autonomy, rules on profit determination and the treatment of unrealized revaluation gains, profit distribution gains, and recapitalization requirements and modalities lack clarity, compromising EAC central banks' financial autonomy. Individual autonomy of EAC central bank officials should be improved.

Harmonizing Some Aspects of the Legal Framework

Harmonization of legal frameworks could be a lengthy process involving political commitments. Because it requires a careful consideration and prior agreements involving the legislative bodies in individual countries, it does not seem advisable to initiate this process at an early stage. However, countries can still move toward best practices at their own pace ahead of changes in the law to reduce potential political influence on central banks and to improve financial central bank–treasury relations. Also, the introduction of an institutional framework should help enforce agreements across EAC countries in the process of harmonization:

- The EAC is considering implementing the East Africa Monetary Institute (EAMI), inspired by introduction of the European Monetary institute in the euro area four years before the move to a monetary union. The introduction of the EAMI would help moving from inter-country coordination to the discussion of supra-national considerations. The dedication of full-time staff to prepare the relevant analytical and technical work that would support informed decisions by designated authorities would be a major step that would raise awareness in public and private sector economic agents of the region of the implications of moving toward a monetary union.
- A strong track record of implementing binding decisions through the EAMI will enhance the credibility of the eventual EACB when the monetary union is in place. Visible progress in pre-union harmonization will highlight the efficacy of the eventual decentralized execution of monetary policy and liquidity management. EAC central banks could operate under the principles of autonomy and establishing clear common objectives, which in itself would contribute to institutional strengthening as agreements are enforced over time.

How to Address Different Monetary Policy Frameworks?

The path toward monetary union must take into account differences in existing national monetary policy frameworks and their effectiveness. EAC countries currently give different emphasis to monetary aggregates, exchange rates, and interest rates at the heart of their monetary policy frameworks (Figure 1),

Figure 1: Features of Monetary Policy Frameworks in EAC Countries

	Monetary Policy Framework		
	Exchange Rate Flexibility	Reserve Money	Policy Interest Rate
Burundi			
Rwanda			
Tanzania			
Kenya			
Uganda			

and these approaches would need to be harmonized under a single currency. The success of this regime change will, in turn, likely reflect the effectiveness of the pre-existing monetary frameworks in delivering low and stable inflation.

Some differences in monetary policy frameworks in EAC countries need to be underscored:

- **Choice of exchange rate regime:** No country in the region uses the exchange rates as a de jure nominal anchor. However, the degree of exchange rate flexibility is different across countries. Exchange rate regimes in Kenya, Tanzania, and Uganda have been classified as floating for the past four years for the *IMF Annual Report on Exchange Arrangements and Exchange Restrictions* (AREAER), unlike Burundi and Rwanda, which are currently classified as managed floating and stabilized, respectively. Moreover, Kenya allows the exchange rate to respond to market pressures to a much larger extent than other EAC countries, about 25 percent compared with 10 percent in Uganda in recent times, and 8 percent in Tanzania (Slavov, 2011).
- **Use of monetary aggregates and policy interest rates:** In November 2011, the Central Bank of Kenya (CBK) adopted a new monetary policy framework that gives more prominence to the policy interest rate. Under the framework, the CBK uses the policy interest rate to guide interbank rates to achieve the net domestic assets that are the CBK's operational target. The Bank of Uganda is moving to a form of inflation targeting "lite." Under this framework, the operating target would be a publicly announced central bank interest rate centered on the seven-day interbank rate. The central bank will refrain from direct central bank financing of the deficit. The Banque de la République du Burundi, the National Bank of Rwanda, and the Bank of Tanzania (BoT) operate under a money targeting framework.

Generally, countries show increasing reliance on interest rates as financial markets develop further and dependence on foreign exchange inflows declines. Recently, Rwanda and Burundi have committed to allowing greater exchange rate flexibility and promoting the development of their foreign exchange markets. Kenya and Uganda are moving toward a greater role for the policy interest rate, initially introduced as a signaling device.

The choice of monetary policy frameworks in EAC countries is conditioned by the nature of central bank–treasury relations, the financial environment, and the structure of the balance of payments (Figure 2). The higher the fiscal dominance, the lower the reliance on market securities for monetary operations. Also, the higher the excess reserves, the lower the elasticity of market interest rates to changes in money market rates. Finally, the higher the share of foreign exchange flows that is channeled out of interbank markets, the lower the exchange rate flexibility. This highlights the interdependence between convergence and harmonization efforts:

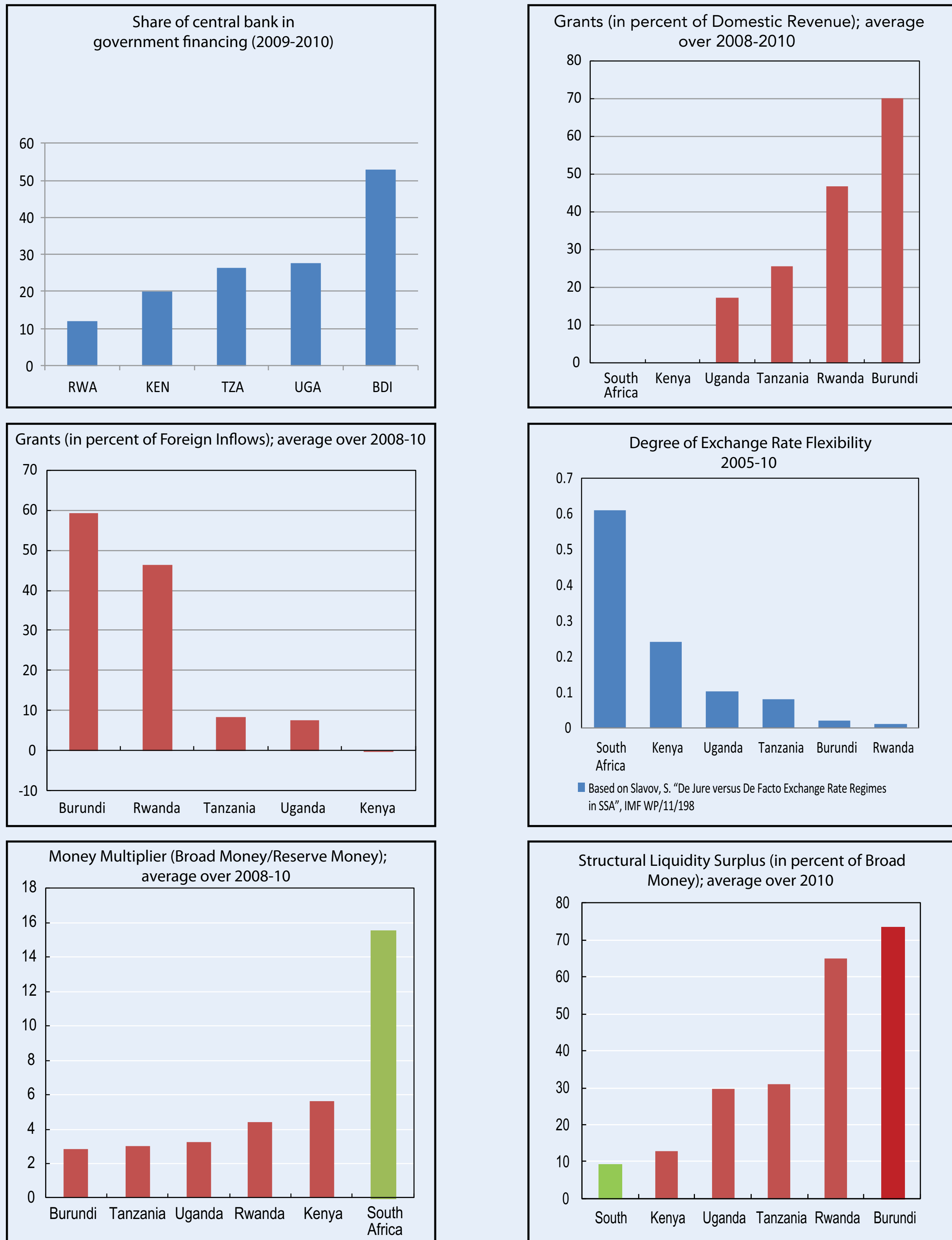
- **Addressing fiscal dominance.** Fiscal dominance appears much greater in Burundi than in the rest of the EAC countries. Significant central bank financing of the government limits the scope for relying on market instruments to conduct monetary policy.
- **Dealing with large foreign inflows relative to foreign exchange receipts and fiscal revenues.** These flows pose challenges for Burundi and Rwanda, including the extent of exchange rate flexibility.
- **Varying financial deepening and structural liquidity surpluses across EAC countries.** Liquidity injection operations through foreign exchange purchases, open market operations, and/or the overnight lending facility are more relevant in Kenya relative to countries with low financial deepening and high structural liquidity surplus.

Enhancing Monetary Policy Effectiveness

All EAC countries show room for progress in achieving low and stable inflation. Before the 2010–11 episode of food price inflation, all countries showed average inflation of about 10 percent, higher than the targets. Differences in policy frameworks do not seem to affect the level of inflation, although higher inflation volatility in Burundi and Rwanda may be associated with their greater exposure to external price shocks. Assessing the implementation of policy frameworks and the transmission of policy decisions across EAC countries will help understand the challenges to improve monetary policy effectiveness.

Apparent weaknesses in monetary transmission channels in EAC countries are partly explained by the following:

Figure 2: Macroeconomic Factors Conditioning the Choice of Monetary Policy Frameworks in EAC Countries

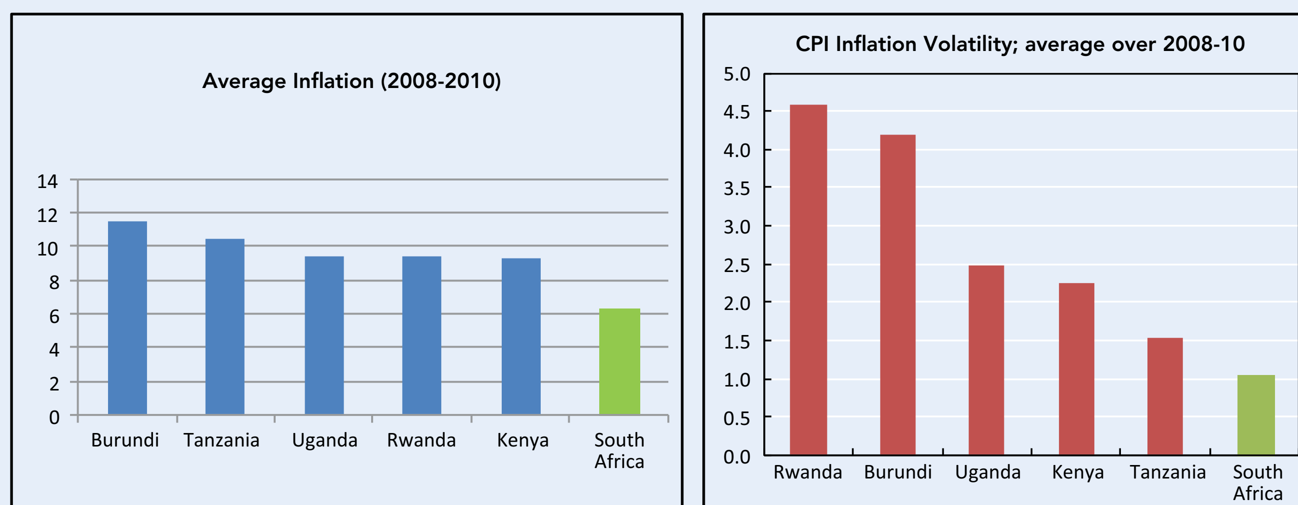


- **An accommodating policy bias,** inconsistent at times with the inflation objective. Monetary transmission is generally weak in low-income countries (LICs), including those in the EAC (Mishra, Montiel, and Spilimbergo, 2010). Exogenous reasons for this include limited financial intermediation and incipient money markets. However, an accommodating policy bias may also have hampered the impact of policies on market behavior. For example, Davoodi, Dixit, and Pinter (2012) find that reserve money and the policy rate often move in conflicting directions. In the presence of shocks, countries tend to maintain an accommodating bias long after evidence of demand pressures emerge. Andrle and others (2012) find that monetary policy in Kenya during the 2011 food inflation episode remained accommodating despite significantly low interest rates and diminishing global demand weakness. Stepanyan (2012) finds a similar pattern in EAC countries as a whole.
- **The pursuit of multiple objectives.** Anecdotal evidence shows this to be a factor that explains lack of consistency of monetary policy in EAC countries at times in pursuing low and stable inflation (Figure 3). Although pursuing low interest rates and increasing intermediation are valid goals, they could be better achieved by consolidating macro stability. In particular, central banks often use policy rates to try to persuade commercial banks to keep lending interest rates low, partly because of reservations about how significant interest rates are to helping achieve inflation goals. Also, the impact of high credit growth on inflation is often understated on the grounds that fast credit growth is required to enhance financial deepening and as such should not threaten stability.

Preliminary evidence suggests that, despite overall weak transmission, interest rates, credit, and the exchange rate are effective channels from policy decisions to prices and economic activity:

- Adapting methodologies to LIC-specific features of EAC economies suggests effective transmission. Incorporating high volatility of output, flexible wages, and an accommodating bias to a monetary policy model for Kenya still leads to features of monetary policy transmission common to emerging markets (Andrle and others, 2012).
- Combining different specifications of vector autoregression (VAR) models offers additional insights. Davoodi, Dixit, and Pinter (2012) find that the exchange rate and the credit channels from policies to inflation are active for Kenya, and that some transmission of monetary policies to activity through credit to the private sector in Rwanda appears to be present to some extent. Results are consistent with the particular features of EAC countries. Interest rates play an important role in transmission of monetary policies to inflation in Kenya and Uganda, while reserve money seems to play a more important role in Burundi and Rwanda.

Figure 3: Inflation and Inflation Volatility in EAC Countries



- A diverse two-way interaction between increased financial intermediation and monetary policy transmission is evident across EAC countries. Money multipliers and velocity become unstable with financial development, and less relevant for transmission, which is generally confirmed by studies conducted by EAC central banks and the International Growth Center (IGC). Velocity and multipliers are unstable in Kenya (Sichei and Kamau, 2010), and the money multiplier is unstable in Rwanda and Uganda in the short run. For Tanzania, the multiplier is stable in the long run, but not in the short run (Adam and Kessy, 2010), while velocity is generally stable (Adam and others, 2010).

Some Harmonization Steps to Enhance Monetary Policy Effectiveness

Given the mixed experience with alternative frameworks, a decision to adopt a common framework for the EAC appears premature. The benefits of moving to a common framework early in the game would probably not offset the transition costs. In fact, moving away from the countries' existing frameworks may risk delaying progress in achieving low and stable inflation in Burundi and Rwanda, while the conditions for upgrading their frameworks—in line with more modern practices around the world—may not yet be in place.

Nevertheless, the following are key elements of a strategy conducive to harmonization of monetary policy frameworks:

- The key priority for harmonization should be to achieve low and stable inflation. Recent experience with rapid acceleration of inflation in several EAC partner states shows that challenges remain in ensuring a prompt policy response when inflation escalates.
- A two-speed approach to convergence of monetary policy frameworks would facilitate moving ahead with harmonization plans. Countries where economic agents have revealed sensitivity to central bank interest rate decisions (Kenya, Uganda, perhaps Tanzania) may coordinate the adaptation of their frameworks to the new realities of the market, while countries for in transition to a more flexible exchange rate regime (Burundi, Rwanda) may not need to change their operational targets until progress with harmonization in other areas is well advanced.
- The choice of harmonizing operational targets in individual countries should also be addressed only when countries in the EAC region have consolidated macroeconomic stability. Differences in exchange rate regimes and in the use of market instruments are expected to continue for a while until the reliance on aid inflows declines substantially and the level of financial development across EAC countries becomes more closely aligned.

Figure 4: Features of Reserve Requirement Regimes

	Reserve Requirement Regime			
	Uniform Required Reserve Ratios	Reserve Base Includes Government Deposits	Lagged Reserve Base	Averaging
Burundi				
Rwanda				
Tanzania				
Kenya				
Uganda				

Addressing Diversity in Use of Monetary Policy Instruments and Practices

Major differences exist among EAC countries in the role of the policy rate, the design of liquidity absorption tools, and reserve requirement systems. By contrast, they face common challenges, namely, deficiencies in liquidity forecasting implied in government operations, the need for better analytical support to inform policy decisions by monetary policy committees, excessive government reliance on overdraft facilities, the need to develop interbank markets further, and effective use of policy interest rates. Main differences in the use of monetary policy instruments are:

- **Reserve requirements.** The reserve requirement system is not harmonized across countries (Figure 4). Required reserve ratios range from 3 percent in Burundi to 10 percent in Tanzania, applied uniformly to their deposit base (except in Tanzania, where the reserve ratio for government deposits is 30 percent). Eligible reserve assets consist of deposits at the central bank in all five countries, plus 10 percent of vault cash in Uganda for banks with more than 10 branches (5 percent for the rest). Average deposits are used for the computation of requirements in all countries except Tanzania. The maintenance period ranges from 7 days in Rwanda to 30 days in Burundi and Kenya. In Burundi and Tanzania, the reserve base is not lagged, which complicates banks' liquidity management.
- **Direct advances to governments.** In most cases, central bank advances are set as a percent of government revenues. Interest is charged on these advances except for by the Central Bank of Burundi and the Bank of Uganda (BoU). Governments use this facility intensively, exceeding legal ceilings occasionally.
- **Differing role of policy rates across countries.** The Central Bank of Kenya (CBK), National Bank of Rwanda (NBR), and BoU set the policy rate independent of market rates. The BoU defines the policy rate as the target around which the bank guides interbank rates. The CBK is moving in the same direction, but still emphasizes the policy rate's role as a signaling device.
- **Dominance of reverse repo of government securities and foreign exchange purchases.** These are the most widely used instruments to inject liquidity across EAC countries. Burundi uses collateralized seven-day loans instead of reverse repos. For other countries, the tenor of reverse repo operations ranges from 7 days in Kenya and Rwanda to overnight to 62 days in Uganda.
- **More cross-country diversity in mop-up instruments than liquidity injection (Figure 5).** All central banks use foreign exchange sales explicitly or implicitly to mop up liquidity, extensively in Burundi and Rwanda and less frequently in Kenya. The CBK, BoU, BoT, and NBR are also equipped with repo operations, while the BoU also uses term auction deposits.

Figure 5: Features of Main Monetary Policy Instruments

- **Lending standing facilities are in place, but no deposit facilities.** Access to overnight lending is unlimited in principle, but subject to collateral. In Kenya, Rwanda, and Uganda, interest rates charged for use of these facilities are set relative to the policy rate (policy rate plus 6 percent in Kenya and policy rate plus 4 percent in Rwanda and Uganda).

Harmonizing Some Monetary Policy Instruments and Practices

- An agreement on a schedule to set binding limits to central bank financing to the government—restricted to the provision of overdraft facilities based on uniform criteria—would help to introduce discipline in the implementation of monetary policy. Limiting central bank financing to the government will be increasingly important as the move to a monetary union approaches. Also, adopting uniform definitions of the relevant parameters for the extension of temporary financing will help diminish the NCB's scope for ad hoc arrangements to finance the government. Ideally, central bank financing of the government would need to be eliminated in a regional arrangement.
- As a general approach, the harmonization of existing instruments should be undertaken first. Harmonization should take place in areas that facilitate a smooth transition, to ensure that it does not interfere with the current national monetary policy frameworks in place. A plan to gradually harmonize the main features of reserve requirements should be introduced at this stage. Levels of reserve requirements can be harmonized after a period of accumulating experience under harmonized regimes. Harmonizing key features of standing lending facilities would also be feasible and desirable.
- Initiatives to harmonize and integrate market infrastructures should start early. Improving money market infrastructures (such as payment and settlement systems or the framework for repurchase agreements) will ensure that the capacity to inject/absorb liquidity is comparable across countries before taking more significant steps toward a currency union. Decisive steps toward integrating regional money markets would be supportive of harmonization efforts. This would require harmonization of capital account regimes, market infrastructures and practices, capital markets, and financial prudential frameworks.
- Harmonization efforts should build up from plans initiated at the early stage. A unique set of liquidity absorption tools can be identified, most likely repo operations, keeping in mind the impact on central bank balance sheets for each EAC member. Standing facilities' interest rates ideally should be aligned with policy rates and should harmonize tenors, amount, and room for discretion for central banks.
- EAC countries should exchange views regularly regarding their experiences with liquidity forecasting and preparation of the monetary policy committee meetings. In particular, a common approach to improving analytical support of the monetary policy committee, including full use of market indicators, and a continuous effort to upgrade communication mechanisms and information flows based on the regional experience, should help countries to acquire a better understanding of market reaction to policy decisions and will also be valuable in informing harmonization plans.

Sequencing Harmonization Policies

Several countries are in transition toward a more modern monetary framework, which also justifies harmonization. Although low inflation can be achieved under either framework as long as the policy stance is consistent, international experience shows that first, as financial markets develop, money demand becomes less predictable, and second, the markets will learn to respond to whichever framework is chosen. Therefore, a strategy to harmonize monetary policy frameworks in the long run focusing on achieving low and stable inflation with available tools will benefit from a concerted effort to pay increasing attention to market signals as markets develop, and on assessing the evolving role of interest rates with the view to gradually allowing for more exchange rate flexibility.

Several steps can be taken while improvements in macroeconomic convergence take hold. A critical number of steps could be taken at the outset, namely the implementation of the EAMI, the harmonization of features of some existing instruments, and the harmonization of the rules for central bank financing

of the government. This should be accompanied by decisive action to reduce inflation.

The strategy to harmonize the conduct of monetary policy will be influenced by the choice of the transitional exchange rate arrangement in the path to monetary union. If a "two-speed" approach is agreed upon, implementation of a transitional exchange rate arrangement would need to be delayed until the countries using a de facto exchange rate anchor felt comfortable allowing the exchange rate to float. This would be important in the context of a union-wide floating exchange rate (as assumed by the IGC), but not necessary under an exchange rate peg (Adam, Kessy, and O'Connell, 2012). Under a transitional float system, the greatest degree of harmonization of inflation and underlying policies needed, no commitment on exchange rates, but stronger commitment to fiscal and macro convergence. These requirements are consistent with variable geometries, with increasing exchange rate flexibility to be introduced over time.

Ongoing preparations to agree on a EAMU Protocol would lay the ground for harmonization plans. The EAMU Protocol under discussion will need to cover a number of issues related to harmonizing the conduct of monetary policy prior to introduction of a single monetary policy. Decisions to be taken are interdependent to a large extent:

- **EAC central bank model.** This chapter assumes that the EAC members have a preference for a decentralized model, resembling the EMU experience. The EU experience shows that a decentralized model requires more harmonization and development of more overall capacity than a centralized model. A more centralized model would require that EAC member countries operate under a supra-national authority, including during a transition to a formal monetary union. Although the EAMI could serve this role, a cost-benefit analysis must be undertaken, taking into account the advantages of using the existing infrastructure. The final decision would depend on political considerations and the policy framework that EAC members agree to implement.
- **Open market operations.** As argued before, harmonizing existing instruments early on will help national central banks to adapt to a common framework ahead of the introduction of the currency union. Other instruments (for example, central bank securities), could be introduced or harmonized later on. The EAMU Protocol should keep the options open since international experience suggests more flexibility is useful for monetary policy operations under a currency union.
- **Standing facilities.** Harmonizing standing facilities among EAC members would facilitate a common approach to the use of policy interest rates to influence the market interest rate profile. The Protocol does not need to be specific on the features of these facilities, and may keep open the possibility to introduce, for example, a deposit facility to provide a potential additional tool for the EACB.
- **Minimum reserves.** Although there are many differences across countries in the EAC regarding reserve requirement regimes, the EAMU Protocol does not have to be specific about the common features of minimum reserves under a currency union. Harmonization should have been carefully implemented before moving to a currency union, but the new EACB should have the possibility to make modifications if needed.
- **Operations with public entities.** Harmonizing practices regarding temporary central bank financing of government operations should be adopted at an early stage, followed by a more comprehensive agreement on limiting central bank financing to the government that may or may not be validated by changes in the legislation. However, following agreement among EAC members, the EAMU Protocol should be explicit in limiting financing to the government under all possible modalities and clear in the definitions to be used (national governments, public entities, etc.) to avoid loopholes that may weaken the perception of the degree of commitment to minimize fiscal dominance under a currency union.

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Promoting EAC Regional Financial integration

Ambassador Claver Gatete[46]

Progress in EAC Capital Markets Integration

Integrating East African Community (EAC) financial markets is identified as one of the key pillars for establishing the future monetary union. Its objectives include mobilizing domestic savings and investments; efficiently allocating resources, which contributes to accelerating economic growth; and increasing competition and innovation in the region, among others. EAC countries have made great strides in harmonizing their financial sectors, consisting of banking systems, insurance sectors, and capital markets, in the past couple of years. With that in mind, this chapter focuses on discussing progress in integration of EAC capital markets, challenges, and ways forward.

An initiative for capital market integration commenced in 1997, when the East African Securities Regulatory Authorities Association was established with a memorandum of understanding (MoU) signed between the capital market regulators of Kenya, Uganda, and Tanzania. Its objectives include technical cooperation, mutual assistance, and information sharing among the members. Rwanda and Burundi later joined the association in 2008 and 2011, respectively.

Implementation of the Common Market Protocol has made significant progress since then. Kenya, Rwanda, and Uganda liberalized capital regulations, and plans for the gradual removal of capital controls are under way in Tanzania. In Kenya, Rwanda, and Uganda, nonresidents have full access to capital markets, treated equally with residents for all transactions.

The Nairobi Stock Exchange, Uganda Securities Exchange, and Dar es Salaam Stock Exchange signed an MoU in 2004, establishing the East African Stock Exchanges Association (EASEA). The Rwanda Capital Advisory Council joined the organization in 2009. The EASEA established a Securities Industry Training Institute devoted to capacity building for the industry.

Integration of clearing and settlement infrastructure is ongoing within the EAC, with the aim of facilitating cross-border listings and trading. Kenya, Rwanda, and Uganda have adopted the EAC policy of recognizing EAC citizens as domestic investors with respect to taxation. Furthermore, Rwanda and Kenya implemented the policy of reserving a minimum of 40 percent of privatization of initial public offerings to EAC citizens. The process of integrating the Central Securities Depository is advancing the EAC toward one regional network of depositories.

All EAC countries operate debt markets, but they are at different stages of development. In Burundi and Rwanda, the maturity of government bonds ranges from two to five years, compared with two to ten years in Tanzania and Uganda. In Kenya, the most advanced financial market in the region, the maturity of government bonds extends from 1 to 30 years. Stock exchanges exist in all the EAC countries except Burundi, yet numbers of companies listed differ among the exchanges: 55 in Kenya, 15 in Tanzania, 13 in Uganda, and 4 in Rwanda.

Challenges

Domestic debt markets are shallow and narrow. The markets are characterized by short-term maturities, low savings rates, underdeveloped bond markets, illiquid secondary markets, and limited investor base, among others. Macroeconomic indicators clearly illustrate the shallowness of the EAC financial markets compared with middle-income countries (Table 1). Table 2 shows that the EAC securities markets are dominated by commercial banks.

Stock markets also need to be substantially developed to encourage savings and improve the efficiency and productivity of investments. For now, secondary markets are very illiquid or do not exist in some countries. There are very few issuances of corporate bonds; bond markets are dominated by government bonds.

Sustaining a stable macroeconomic environment is imperative for financial markets to operate with more efficiency. A stable macroeconomic environment across the EAC also promotes cross-border investment, which complements development of financial markets. In addition, sustained economic growth increases people's wealth, which mobilizes regional savings and attracts private investments from inside and outside the region.

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Table 1. Financial Depth of EAC (In percent)							
Indicators	2005	2006	2007	2008	2009	2010	Middle-Income Countries
M3/GDP	26.53	28.49	30.42	28.76	31.40	33.26	60
Private Credit/ GDP	14.94	16.08	20.25	17.63	18.45	19.54	40–60
Deposits/GDP	21.17	23.11	24.75	23.81	28.87	28.22	40
Financial Assets/GDP	38.16	41.82	38.08	34.98	45.90	45.92	

Table 2. Bond Holdings by Commercial Banks (In percent)				
Burundi	Kenya	Rwanda	Tanzania	Uganda
65	53	83	30	77

Establishing effective regulatory frameworks and improving financial market infrastructure are also essential. Domestic debt markets in the EAC region still face difficulty in meeting international standards. Most EAC countries use the auction method to issue government bonds, and primary dealership is largely limited to commercial banks. Invitation to tender for bids is conducted by the open box system as opposed to wire service facilities such as Reuters and Bloomberg. This exposes auctions to operational risks.

The EAC needs to have more institutional investors (for example, insurance companies, pension funds, mutual funds, unit trusts) in its markets in order to have active financial markets. In addition, ensuring reliable and timely financial disclosure is still a big challenge in the region. Appropriate disclosure of information is essential in enabling proper evaluation and monitoring of soundness of investments. Introducing effective tax policies is also a crucial challenge. It is necessary that all incomes from savings and investments be treated fairly across the jurisdictions. We also need good linkages between the banking sector and capital markets. Sound financial intermediaries and liquid interbank markets are a key to sustained development of capital markets.

However, the low skill base in the capital markets needs to be urgently improved. We need more and well-trained professionals, such as dealers, brokers, fund managers, and security analysts, for well-functioning capital markets. Fund management services that create competition and develop the market are almost nonexistent in the region, and it lacks professionals who understand brokerage services, pricing of assets, and derivative market trading. It is difficult to develop capital markets without improving skills in these areas.

Way Forward

While each country in the EAC has its particular concerns and goals, there are a number of general issues that it needs to tackle as a region:

- Enhancing the ability of entrepreneurs to raise capital in the region
- Establishing an environment that will create confidence in both domestic and foreign investors, which would encourage inflows of investment capital
- Providing more capital formation opportunities for domestic investors
- Increasing the number of listed corporations through cross-country listings
- Removing impediments restraining the access of small and medium-sized businesses to capital markets

- Introducing more sophisticated standards, including international accounting standards (especially for legal and accountant communities)
- Ensuring the enforcement of laws, through adequately trained and financed investigators and prosecutors, as well as knowledgeable judges

Conclusion

The EAC countries have made great strides in developing domestic financial markets and accelerating integration, but they still have a long way to go. Infrastructure development is on a good course, yet more needs to be done. While capacity has improved, more skills are still needed in terms of debt management and legal, accounting, and other capital market professionals. Despite these constraints, the outlook for financial market development and integration is positive.

Part III Investment and Trade in the East African Community: Progress and Priorities

Improving the Investment Climate in the East African Community: Using the Doing Business Surveys to Prioritize and Promote Reform

Peter Ladegaard[47]

Doing Business Indicators—What They Are and What They Are Not[48]

Enabling private sector growth—and ensuring that poor people can participate in its benefits—requires a regulatory environment where new entrants can get started in business and where firms can invest and grow. Based on this premise, *Doing Business* has been designed as a series of annual reports benchmarking the regulations that enhance business activity and those that constrain it. The idea is that regulations should be designed to be simple and efficient in implementation. Accordingly, some *Doing Business* indicators give a higher score for more regulation, such as stricter disclosure requirements in related-party transactions. Some give a higher score for a simplified way of implementing existing regulation, such as completing business start-up formalities in a one-stop shop.

The coverage of *Doing Business* has grown gradually over the years. The first report, published in 2003, covered five indicator sets and 133 economies. The 2012 report covers 11 indicator sets and 183 economies. Ten topics are included in the aggregate ranking on the ease of doing business and other summary measures. In order to allow global coverage and enhance comparability, the indicators are built on the basis of standardized case scenarios with specific assumptions (such as the business being located in the largest business city of the economy) and, where relevant, assuming a limited liability company.

While *Doing Business* focuses on the quality of the regulatory framework, it does not cover all regulations. *Doing Business* covers 11 areas of a company's life cycle through specific sets of indicators that do not cover all aspects of regulation in the area of focus. For example, the indicators on starting a business or protecting investors do not cover all aspects of commercial legislation. *Doing Business* also does not attempt to measure all costs and benefits of a particular law or regulation to society as a whole. The paying taxes indicators, for example, measure the total tax rate, which is a cost to business, but leave out potential benefits of the taxes.

Doing Business assumes that entrepreneurs are knowledgeable about all regulations in place and comply with them. In practice, entrepreneurs may avoid legally required procedures altogether or may spend considerable time finding out where to go and what documents to submit.

Does Doing Business say something about the business environment?

Doing Business does not tell us everything about the business environment, but it can give an indication. To get a more in-depth picture of the total cost of regulation in one particular economy, tools such as the standard cost model (SCM) may be needed, and an even fuller understanding of the broader business environment and policy challenges may require data from sources such as the World Bank Enterprise Surveys.

Despite its simplicity, high correlation with other major economic benchmarks shows that *Doing Business* provides a good-quality measure of the business environment. The Organization for Economic Cooperation and Development's rankings on product market regulation show a high degree of similarity with the ease of doing business (the correlation is 0.72). Similarly, there is a high correlation (0.82) between the rankings on the ease of doing business and those on the World Economic Forum's Global Competitiveness Index.

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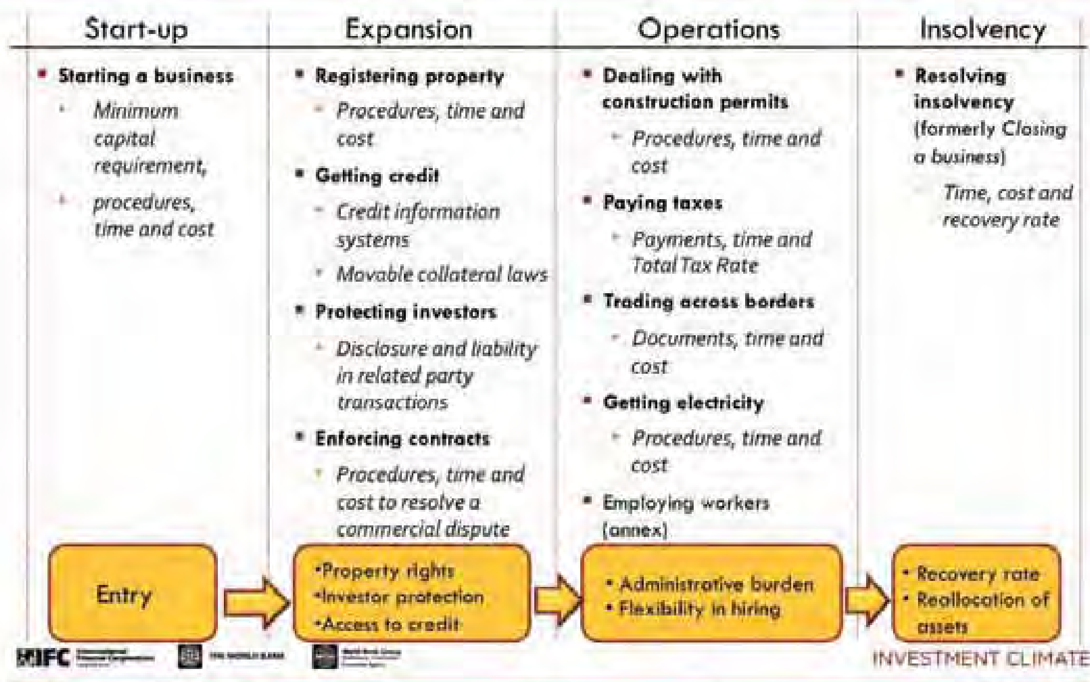
[48]All information about Doing Business has been collected from the Doing Business 2012 main report and the *Doing Business in the East African Community 2012* report, both available on the *Doing Business* website: www.doingbusiness.org.

What's new in *Doing Business* 2012?

2007	2008	2009	2010	2011	2012

• Starting a business
• Dealing with construction permits
• Employing workers
• Registering property
• Getting credit
• Protecting investors
• Paying taxes
• Trading across borders
• Enforcing contracts
• Resolving insolvency (formerly *Closing a business*)
	• Update of 2007
	• Add 3 countries
	• Reformer's Club, and 16 case studies
		• New "About DB" chapter
		• Trends analysis DB04-DB09
		  - Most popular reforms
		  - Most effective reforms
		  - Lessons learned
		• Add 3 new countries (Bahamas, Bahrain, Qatar)
		• Methodology change in Getting Credit (Legal Rights)
			• Business regulation and reform in the context of the global crisis
			• EWI and social protection
			• Worker Protection: Researching ILO core labor standards
			• Piloting a new infrastructure indicator
			• Add Cyprus, Kosovo
				• New metric on 5-year change at country level
				• Focus on reform results
				• Getting Electricity: added 36 countries and indicator level ranking
				• Methodology review for Employing Workers indicator
					• ***Getting Electricity*** **included in overall ranking**
					• **New metric on an economy's distance to the frontier**
					• **Illustration of variability of performance across indicators**
					• **Access to information data**
					• **4 case studies on regulatory reform**
					• **E-chapters for indicators**
					• **Threshold applied to the TTR in *Paying Taxes***



Africa among the fastest reforming regions in the world

Quantitative data and benchmarking can be useful in stimulating debate about policy, both by exposing potential challenges and by identifying where policymakers might look for lessons and good practices. For governments, the indicators typically result in a discussion exploring the relevance of the data to the economy and areas where business regulation reform might make sense, and a way to identify best practice peers from which inspiration and ideas can be obtained.

Over the past year, a record number of governments in sub-Saharan Africa changed their economy's regulatory environment to make it easier for domestic firms to start up and operate. In a region where limited attention was paid to the regulatory environment at the time of the first annual *Doing Business* ranking, regulatory reforms making it easier to do business were implemented in 36 of 46 economies (78 percent) between June 2010 and May 2011, up from an average of 56 percent over the previous six years.

Overall in sub-Saharan Africa, regulatory reform agendas have been broadening. Thirteen economies implemented reforms making it easier to do business in three or more areas measured by *Doing Business*—from business entry to exit—including post-conflict economies such as Burundi, Liberia, and Sierra Leone.

Globally, more efficient regulatory processes often go hand in hand with stronger legal institutions and property rights protections. Economies in sub-Saharan Africa are still most likely to have both weaker legal institutions and more complex regulatory processes. *Doing Business* shows a correlation between the strength of legal institutions and property rights protections in economies (as captured by getting credit, protecting investors, enforcing contracts, and resolving insolvency) and the complexity and cost of regulatory processes (as captured by starting a business, dealing with construction permits, getting electricity, registering property, paying taxes, and trading across borders).

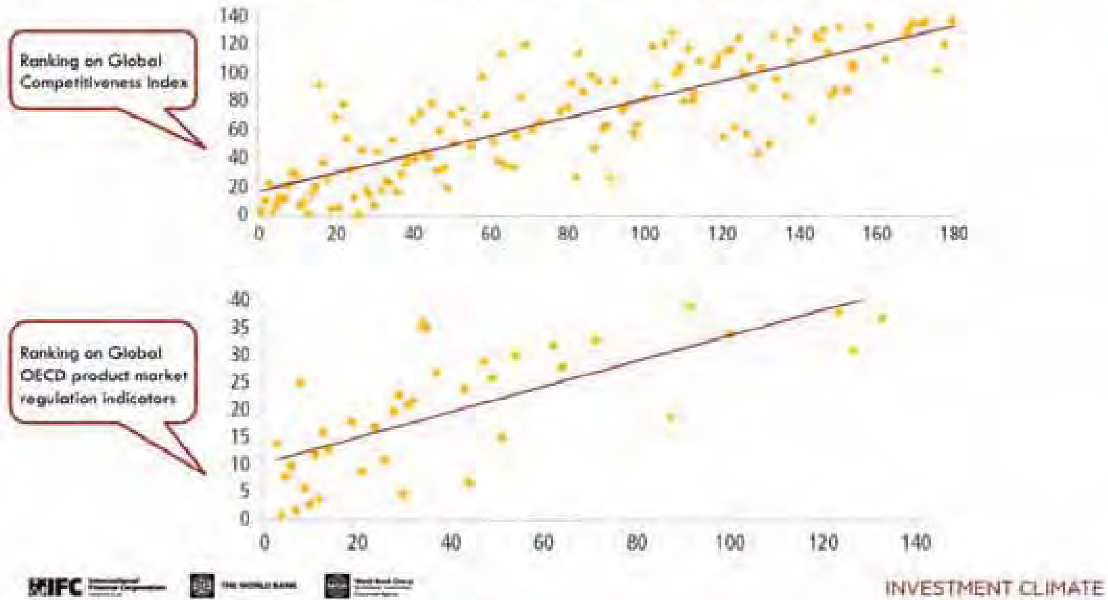
Insights from recent EAC Doing Business reports

Over the past year, all five economies making up the East African Community (EAC)—Burundi, Kenya, Rwanda, Tanzania, and Uganda—instituted regulatory reforms. EAC member governments implemented a total of ten regulatory reforms last year to improve the business environment for local businesses and encourage entrepreneurship in the region. All of the region's economies implemented reforms last year, compared with an average of 80 percent of the region's economies implementing reforms over each of the previous six years.

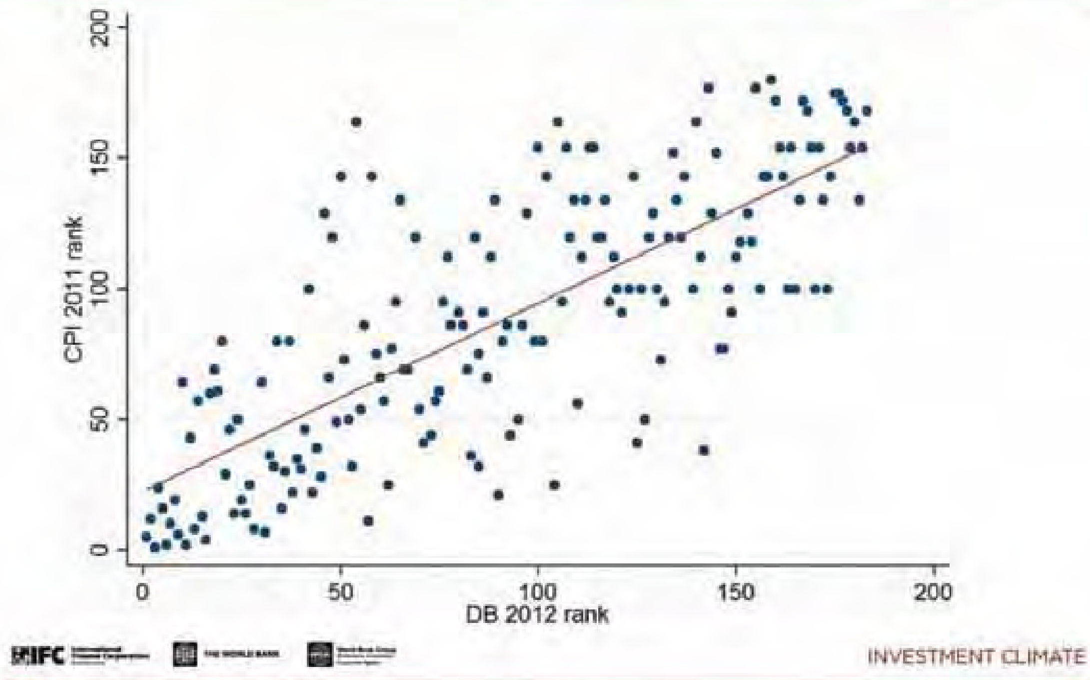
In 2010/11, the average economy in the EAC ranked 115th in the world in the ease of doing business. The fact that the EAC's global ranking remained the same as the previous year is an indication that critical obstacles to entrepreneurial activity remain and that other regions have picked up the pace with improvements. Compared with other regional blocs, the EAC ranks better than the Common Market for Eastern and Southern Africa (126th) and Organization for the Harmonization of Business Law in Africa (167th) but falls slightly behind the Southern Africa Development Community (114th). Yet performance across the EAC economies varies. Rwanda is ranked 45th globally in the ease of doing business, followed by Kenya (109th), Uganda (123rd), Tanzania (127th), and Burundi (169th).

Although EAC member states are at different stages of regulatory reforms, the possibility of getting closer to the best performers in the areas covered by *Doing Business* is not lost. The five EAC economies could benefit from sharing good practices in business regulation and linking reform initiatives on a regional basis. Rwanda is among the places where it takes the least time to start a business. Kenya has some of the most business-friendly regulations for dealing with construction permits. Ugandan courts resolve insolvency relatively efficiently. If each country were to adopt best practices of the region for each *Doing Business* area, East Africa would rank 19 on the ease of doing business, comparable to Germany.

Economies making ongoing efforts, often over decades, tend to perform well across all ten areas of business regulation. In many other economies, by contrast, the degree to which regulations and institutions are business-friendly varies fairly widely across different areas of regulation. This pattern shows up when comparing an economy's three highest rankings on *Doing Business* topics with its three lowest rankings. For example, Rwanda's top three rankings (on starting a business, getting credit, and paying taxes) average 12, while its lowest three (on dealing with construction permits, trading across borders, and resolving insolvency) average 135.



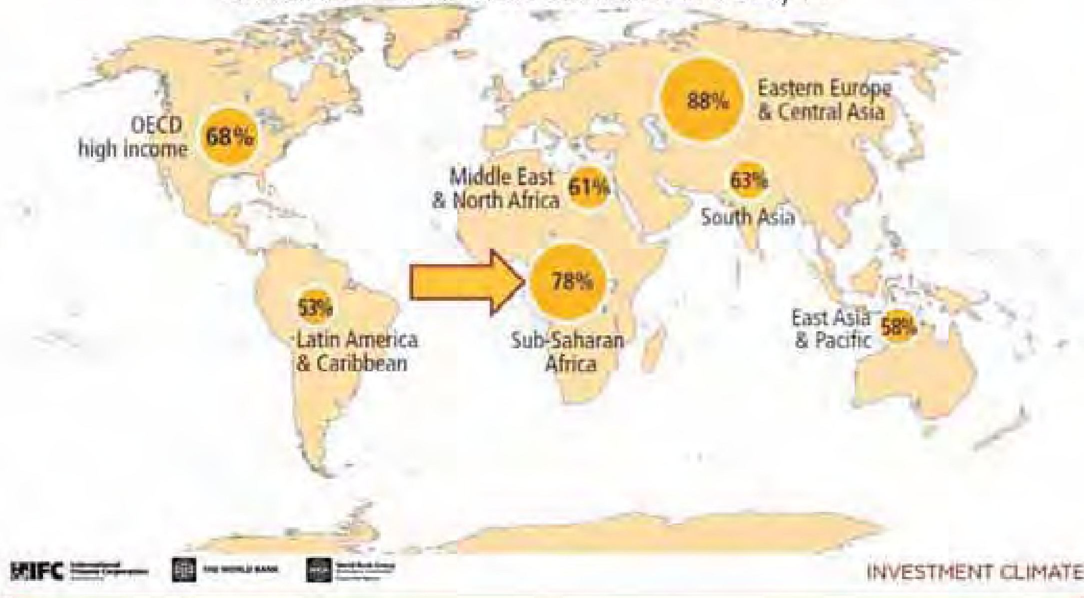
Strong correlation between Doing Business rankings and broader competitiveness indices
Improvements to business regulations and investment climate have become a central part of economies' broader competitiveness and growth agendas
Ranking on Global Competitiveness Index
Ranking on Global OECD product market regulation indicators
INVESTMENT CLIMATE



2011 Corruption Perceptions Index vs. 2012 Ease of Doing Business Ranks
CPI 2011 rank
DB 2012 rank
INVESTMENT CLIMATE

A record number of economies in Sub-Saharan Africa reformed business regulations in 2010/11

36 out of 46 governments in the region improved their economy's regulatory environment for domestic businesses in 2010/11

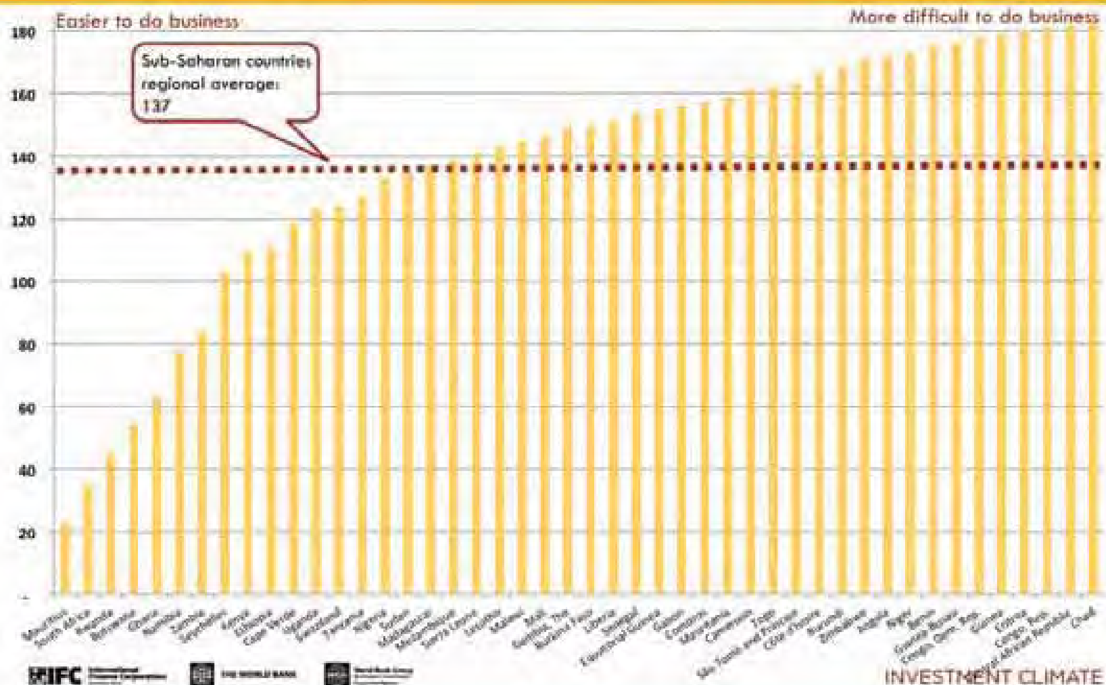


4 of the economies improving the most in the ease of doing business in 2010/11 are from Sub-Saharan Africa

	Change in ranking DB11 to DB12	Starting a Business	Dealing with construction permits	Getting electricity	Registering property	Getting credit	Protecting investors	Paying taxes	Trading across borders	Enforcing contracts	Resolving insolvency
Morocco	115 → 94 (-21)		√				√	√			
Moldova	99 → 81 (-18)	√				√				√	√
Macedonia, FYR	34 → 22 (-12)		√		√	√					√
São Tomé and Principe	174 → 163 (-11)	√	√		√				√		
Latvia	31 → 21 (-10)	√		√	√						√
Cape Verde	129 → 119 (-10)				√	√					√
Sierra Leone	150 → 141 (-9)					√			√	√	√
Burundi	177 → 169 (-8)		√				√	√			√
Solomon islands	81 → 74 (-7)	√			√		√				√
Korea, Rep.	15 → 8 (-7)	√						√		√	
Armenia	61 → 55 (-6)	√	√			√		√			√
Colombia	47 → 42 (-5)	√						√			√

INVESTMENT CLIMATE

Sub-Saharan Africa rankings on the ease of Doing Business 2010/11



Economies in Sub-Saharan Africa on average have weaker legal institutions and more expensive regulatory processes than other regions

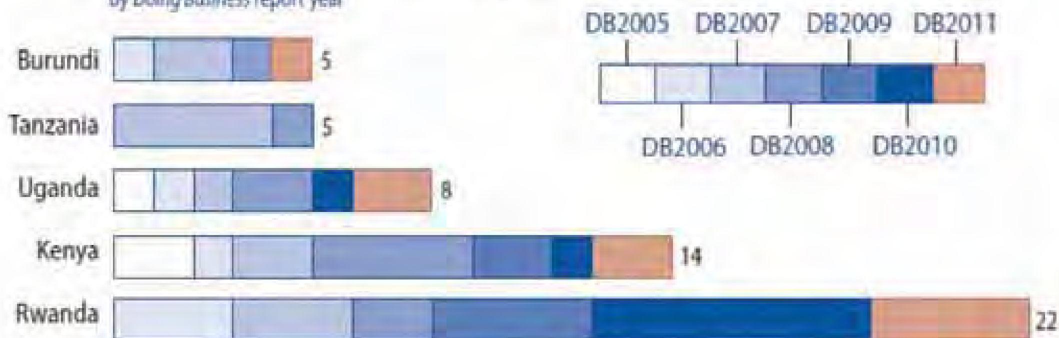
Change in EAC economies' rank according to Doing Business 2012

EAC countries	DB 2012 rank	DB 2011 rank	DB 2010 rank	Change in DB rank
Rwanda	45	58	70	Steady, significant improvements
Kenya	109	98	94	Continued drop – others are reforming faster
Uganda	123	122	129	Slight improvement
Tanzania	127	128	125	Slight drop
Burundi	169	181	181	Rapid improvements from low base

Analysis of a five-year DB change score in Doing Business indicators between DB2006 and DB2011 shows positive scores for all EAC economies.

IFC THE WORLD BANK INVESTMENT CLIMATE

54 Reforms among countries in the East African Community since *Doing Business 2005*



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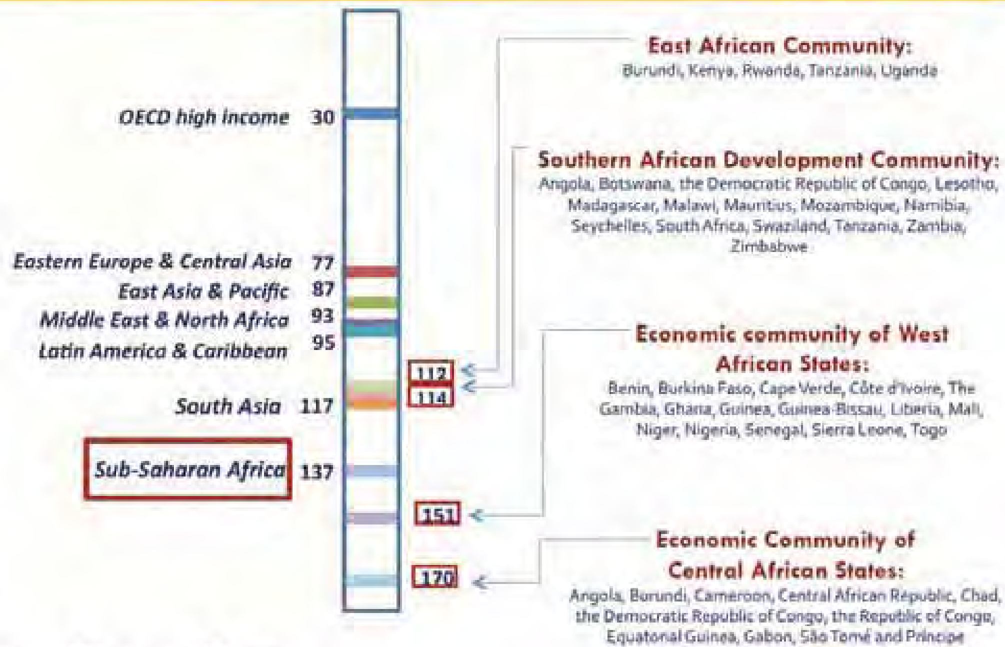
East and Southern African economies rank on average higher than the regional average on the ease of doing business



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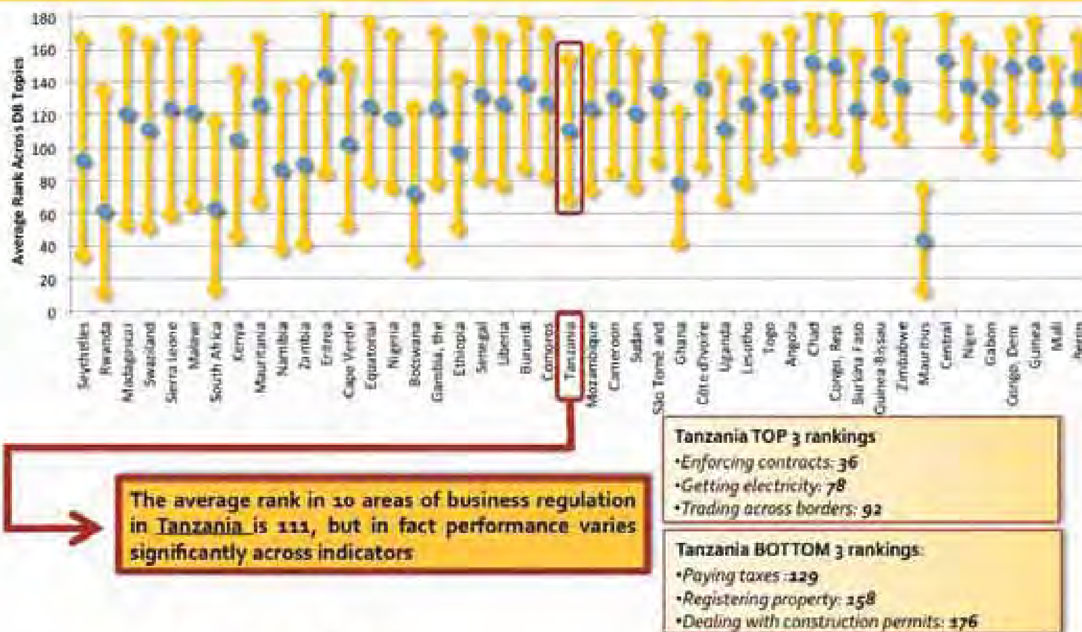
Most Sub-Saharan African countries have a high degree of variability among the different areas of regulation



IFC THE WORLD BANK INVESTMENT CLIMATE

Several Sub-Saharan African economies rank highly in numerous areas of business regulations

Indicator	World's top ranked	Sub-Saharan Africa's top ranked
Starting a business	New Zealand	Rwanda (8) Mauritius (15)
Dealing with construction permits	Hong Kong SAR, China	South Africa (31) Kenya (37)
Getting electricity	Iceland	Mauritius (44) Rwanda (50)
Registering property	Georgia / Saudi Arabia	Ghana (36) Sudan (36-41)
Getting credit	Malaysia / South Africa / U.K.	South Africa (1) Rwanda (8)
Protecting investors	New Zealand	South Africa (10) Mauritius (13)
Paying taxes	Maldives	Mauritius (9) Botswana (25)
Trading across borders	Singapore	Mauritius (21) Seychelles (33)
Enforcing contracts	Luxembourg	Tanzania (36) Cape Verde (37)
Resolving insolvency	Japan	Botswana (28) Namibia (56)

INVESTMENT CLIMATE

The EAC business environment can be comparable to that in Japan

Topic	East African Community best practice according DB 2011
Starting a business	Rwanda (9)
Dealing with construction permits	Kenya (35)
Registering property	Rwanda (41)
Getting credit	Kenya (6)
Protecting investors	Rwanda (28)
Paying taxes	Rwanda(43)
Trading across borders	Tanzania (109)
Enforcing contracts	Tanzania (32)
Closing a business	Uganda (56)

If each East African country were to adopt the region's best practice for each Doing Business indicator, East Africa would rank 18th instead of 117th bringing the community closer to the global top performers such as Japan.

INVESTMENT CLIMATE

Beyond indicators: Supporting a better investment climate in the EAC

A full implementation of the EAC's integrated common market will bring together the region's mostly small and fragmented economies, creating economies of scale and increasing competitiveness. However, economic activities within and across borders are still being impeded by regulatory constraints. This is the raison d'être for the World Bank Group's EAC Investment Climate Program (EAC ICP), which offers technical support to the EAC Secretariat, the five partner states, and other stakeholders through its three pillars, each built around two main activities:

Pillar One: Streamlining and Harmonization of Commercial Laws

Activity 1 - Harmonization of Commercial Laws: This component reviews and supports the drafting of five selected EAC commercial laws/regulations subject to harmonization under the EAC Common Market Protocol. In the process, the program transfers best practice in cross-border legal reform that enables the EAC to adopt and sustain a high-quality harmonization process.

Activity 2 - Tax Harmonization and Simplification: This component develops an EAC regional tax incentive regime/or policy, provides technical assistance to tax officials in the EAC to develop a rational regional tax incentive policy, helps write a "best practice" EAC Tax Procedures Code, simplifies tax administration processes in countries, and identifies and recommends areas for improved efficiency to reduce time and money spent by the tax authority and businesses. These activities support the formalization of small and medium-sized enterprises across the EAC region and aim at an average 10 percent reduction of businesses' tax administrative compliance costs in the EAC region.

Pillar Two: Benchmarking and Peer-to-peer Networks

Activity 3 - Common Market Scorecard: This component designs and establishes an EAC Common Market Scorecard to map and compare member states' implementation of the EAC's Common Market obligations. Based on European Union (EU) and Association of Southeast Asian Nation (ASEAN) experiences, the aim is to publish annual scorecards of key decision and implementation measures by EAC member states and institutions. A Reference Group of EAC and member states' officials, EU, ASEAN, and the United Nations has been established, and a draft methodology is being developed. In addition, annual EAC *Doing Business* reports are compiled to compare national *Doing Business* indicator performance by the five EAC countries.

Activity 4 - Network of Reformers: Leveraging the Network of Reformers Initiative that has been implemented over the past three years under other East Africa programs, this component builds on an existing cadre of public and private sector reformers in EAC and neighboring countries.

Pillar Three: Regulatory Management and Transparency

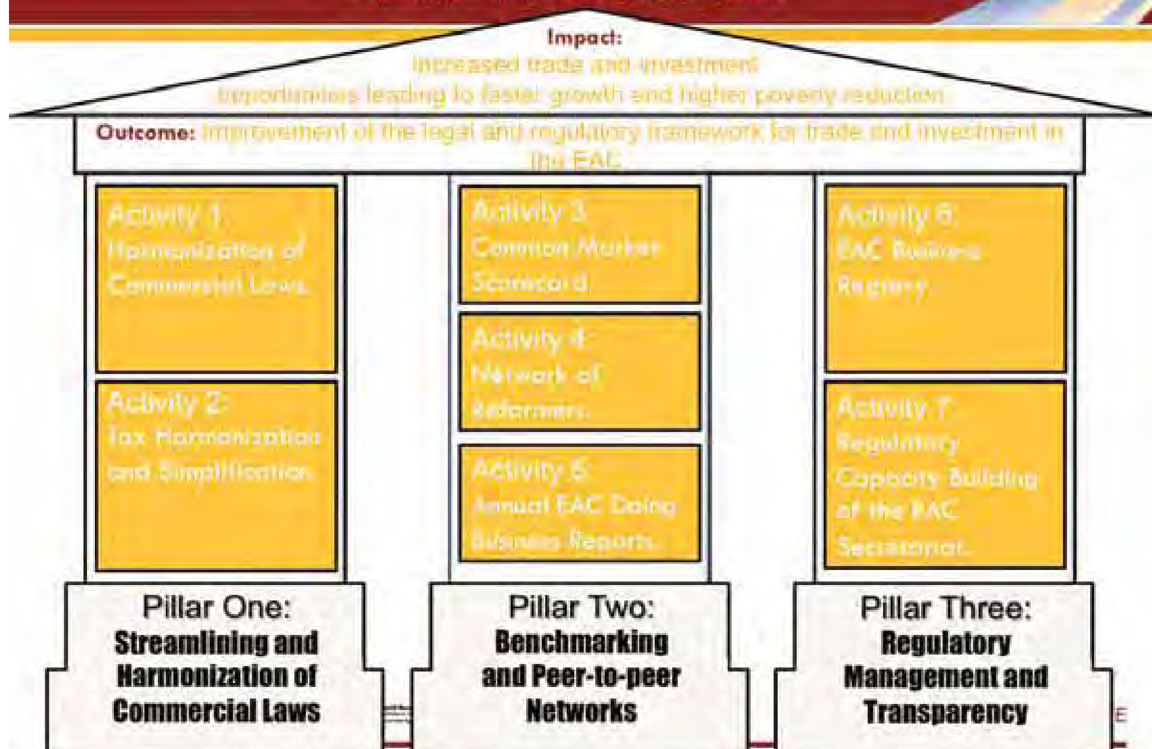
Activity 5 - EAC Business Registry: Enabling an EAC business registry is likely to encourage cross-regional business activities from both regional and international investors. The purpose of this work stream is to undertake a feasibility study for an EAC regional information-sharing platform to enable exchange of national business registration information between regulators and businesses and to connect EAC regulators and entrepreneurs.

Activity 6 - Regulatory Capacity Building of the EAC Secretariat: This work stream will support the training of EAC Secretariat officials in key regulatory quality tools (regulatory impact assessment, notice and comment, public consultation, etc.), as well as develop options and recommendations for institutional measures that will help create better mechanisms for regulation making in the future by improving basic procedures, institutions, and tools to ensure a high-quality legal and regulatory environment.

Business Regulation in the EAC: A Scorecard for monitoring implementation of the Common Market Scorecard

- Purpose: Strengthen the implementation and monitoring process of the EAC Common Market Protocol by scoring Member States' commitments against actual delivery.
- Approach: Tracking the degree of finalization of the EAC Common Market Protocol and tracking the level of implementation of decisions reached by state parties to the protocol.
- Main Data points: The EAC Common Market Protocol and associated documents (Annexes); EAC Council of Ministers decisions; Economic indicators on regional integration.
- Governance: Independent publication of the WBG authored in close collaboration with the EAC Secretariat.

INVESTMENT CLIMATE



Doing Business in East Africa: A Personal Perspective

Ali A. Mufuruki[49]

Time to Coordinate Our Efforts, Compare Notes, and Work Together

The organizers of this conference wanted me to give a private sector perspective on trade and investments in the East African Community (EAC)—progress and priorities ten years on.

This is an important subject and I came prepared to share with you data and statistics on progress and challenges, opportunities and risks, as they have played out in the past decade and finally to propose what needs to be done to promote trade and investments in the region over the next ten years and beyond.

But I had the good fortune of sharing a dinner table with a group of fellow delegates from the region last night, and our dinner conversation made me question very strongly the usefulness of what I was going to present.

I realized there was another, hopefully better way to tell the same story. So I dumped a big chunk of my original speech and came up with what I am going to say now, a series of personal stories—stories about living and doing business in East Africa.

I realize this is not fair to the organizers nor to those who are lined up to discuss my presentation, and I apologize profusely for any inconvenience caused by this last-minute change on my part.

Investment Decisions in East Africa

I set up my first business outside Tanzania precisely ten years ago, the same year that the EAC was promulgated. As I think back on what drove me to that decision, I can tell you with confidence it was not because of the coming into force of the EAC trade arrangements and the rosy prospects they promised for businesspeople in the region.

My retail business that I had set up three years earlier in Dar es Salaam needed to expand, and Tanzania was not enough. Ten years ago, Dar es Salaam and by extension the whole of Tanzania did not have a single modern shopping mall, and modern retail works best in shopping malls. So we had run out of options in Tanzania and started looking beyond our borders.

The most obvious destination was Nairobi, Kenya, because of its more developed retail infrastructure, but the franchise we were holding was already taken by a Kenyan business group, so it had to be Uganda.

Setting up shop in Uganda was much easier than I had thought. Even small investors like me were received warmly there. Business registration happened in record time, my Tanzanian staff and I got our resident and work permits without ever setting foot in the labor or immigration offices as would have been required in Tanzania. Hiring of local staff went quickly without incident , thanks to a business lawyer , and the Uganda Revenue Authority was very supportive in ways I never expected.

For example, the customs department at Entebbe airport remained open till well after midnight on a Saturday in order to complete the clearing and release of our shipment after we informed them that if we didn't get our goods out that day we would not be able to make our launching dates a week later.

The Uganda Investment Authority played a crucial coordinating role in making sure we got every permission, every assistance we needed to get started.

If you think such generosity was being extended to me because I am an East African, you are terribly mistaken. I found out soon enough all investors coming into Uganda were receiving the same treatment.

While this does not mean that the EAC and my East Afrikaans were not factors at the time, I wanted to put this into proper perspective.

We went to Uganda looking for markets, not neighbors or even friends. However, we ended up making friends and some money. We appreciated the good neighborliness even more and the possibility of a common future, but this came later, much later.

Uganda worked for us on its own merit first out of our own pressure to grow and as an investment destination

[49]Chairman, Infotech Investment Group Ltd. of Tanzania.

that can deliver good outcomes for all those who choose to invest there, not so much because it is an EAC member state.

As a matter of fact, when we tried to move company goods from Tanzania to Uganda in 2005, we faced so many problems and holdups at the border crossing points between Kenya and Tanzania and Kenya and Uganda that we ended up abandoning the cargo and making fresh purchases from abroad.

The chief finance officer of our business is a Ugandan and works out of our Kampala office. You may find this difficult to believe, but every time he comes to Tanzania for routine checks of his department or board meetings, we must make sure he has what is called a CTA or Certificate of Temporary Assignment. It costs $200 and expires after three months.

Our difficulties are caused by a Tanzanian law that requires a resident permit holder to be either on a payroll and hence paying taxes or in a dependent situation as a spouse of a resident permit holder. Our CFO cannot meet any of these conditions, so we are stuck.

One day last year he came in a hurry and had no time to process his CTA. He was supposed to stay overnight in Dar, then visit Arusha for one day to check our branch there before heading back home the same day. As fate would have it, immigration raided our Dar office that day and arrested him for working illegally. He avoided jail and deportation only after we submitted a written apology and committed to have him on the next flight back to Kampala.

We took all this in stride and learned our lessons. For purposes of our business, we treat Tanzania and Uganda as the two separate and different countries they still are. We are still waiting for the promise of genuine integration that our leaders made to us so many years ago.

The Kenyan Perspective

At around the same time in 2002, again as the EAC was being launched, a Kenyan company called Nation Media Group, made a significant investment in Tanzania. Like us, Nation was looking to expand its market and Tanzania was the natural next step after having invested a year or two earlier in Uganda.

I became the first chairman of this Nation subsidiary and served a total of eight years until the end of 2010.

So many stories of Nation's investment experience in Tanzania have been told in the media that there is no point in repeating them here. Overall, Nation rates its investments in the region and even in Tanzania as a big success, and that is very true.

But working for that success did not come as easily as one would have expected.

For reasons I still do not understand, Kenyans seem to get singled out for harsh treatment in our country. This notwithstanding the fact that Kenya has been and remains our single biggest trading partner. These countries are of extreme importance to one another, they should be in each other's prayers every day, but the reality on the ground couldn't be more different. The contradiction is most baffling.

In 2006, the entire management team of the company was sensationally deported to Kenya on suspicion of working illegally. As it turned out this was not true, yet it took us five years of negotiations to get those red stamps in their passports reversed. For five years, those young people had to put their journalistic careers on hold and could not travel to many countries because of the ugly entries in their passports.

Last year, the government of Tanzania refused to renew the work permit of the company's Kenyan CEO and, strangely, ordered that a Tanzanian be hired to take his place. This is a private business enjoying investment protection under Tanzanian laws. The company has remained without a CEO for the past seven months as the search continues. So much for economic integration in the EAC.

Living in East Africa

You know by now that I am a Tanzanian with business interests in Kenya and Uganda and hopefully soon in Rwanda. What you may not know is that I have been married to a Kenyan citizen for the past 19 years. We have four children and our eldest turned 18 last month.

Suddenly we are faced with a big decision. Our daughter is about to go to college this coming fall and we are asking ourselves what citizenship she should adopt permanently now as required by Tanzanian law.

I wish we didn't have to worry about these things ten years after the EAC was launched and I hope that my little talk today will inspire some positive thoughts on how we can move this enterprise forward a bit faster,

because that is what the people of this region want and deserve.

EAC after all is not a community of nations, it is a community of the people of this region. What we want is a widening of the space we require for our development and well-being. We want to trade not Kenya against Tanzania, not Uganda against Rwanda or Burundi, but with one another and the rest of the world. Is that too much to ask?

Economists are projecting that the population of EAC will grow from 130 million today to 184 million in 2025 and 320 million by 2050.

Economically, the EAC is projected to move from being the tenth largest economic entity in the world today to eighth position in 2025 and fifth by 2050, behind India, China, the United States, and Pakistan, in that order. Our combined gross domestic product (GDP) will be in the region of $2 trillion!

This is without doubt a fantastic future, and some in this room may live to see it.

What no one can say for sure, however, is what the economic status of the East African people will be amid all this fantastic growth.

We have seen enough examples of countries whose GDP grew but their people were left poor due to bad planning and coordination, among many other failures.

We should try our best to avoid the traps that so many other emerging economies in similar circumstances have fallen into. It is my considered view that a closer working relationship between the public and private sectors of our region, one built on trust and a conviction that there is no contradiction in such collaboration, is the best way forward.

Thank you for listening to me.

Part IV Policy and Institution Building Priorities: The Second Decade

Policy Priorities for the East African Community

This chapter is a summary of discussion among five panelists and a few conference participants on policy priorities facing the East Africa Community (EAC).

Antoinette Sayeh[50]

It is a pleasure to join this panel. I want to ask each of the panelists to speak to the issue of policy priorities and to identify those that they feel most critically need to move ahead, and also to speak to challenges of implementing the integration agenda and why they have not seen as much progress as one would like to see. I think some of that has to do with political economy, so I think it is a good idea to also talk about implementation from a political economy angle, and to talk about how the realism of some of these priorities may be constrained by political economy issues and how we can change that. This is what I have heard over the past couple of days from both the ministers and honorable governors.

Robinson Njeru Githae[51]

In the interest of short time I will just speak on a few important policy issues. The first one is inflation. We need policies that will give us a stable and low inflation rate, so that we can get back to a level that we have been used to, a single-digit inflation rate. If we do not, all the gains that we have achieved so far are likely to be eroded.

The second priority is interest rates. Again, if you look at the region you will find out that interest rates over the past four months have increased to levels which are unsustainable, and I think we need to come up with policies which will ensure that we get low and stable rates, because the swings in the interest rates do not help businesspeople to plan. They also do not help government as they make borrowing costly.

The third priority is a stable exchange rate. Again, if you look at the region, you find that over the past four months there were swings in the exchange rate. This also has an effect on inflation, so in my view we need to come up with policies to stabilize the exchange rate, because the effect on inflation is high; this is even more important because all these countries import significant quantity of fuel.

Then, the fourth policy decision that we need to make is how we can attain a sustained (inclusive) and high growth rate. You find that although the growth rate is high, especially in comparison to the euro zone, we need to increase it in the long run along with increased per capita growth. If we do not do that a very large portion of the population will be left behind and our goal of achieving poverty reduction (similar to a middle-income region) may not be reached.

Then, the last priority issue is obviously integration of the financial and monetary and fiscal sectors. Again, we need to come up with policies to achieve that, even more so if we want a monetary union; now is the time to start coming up with these policies.

Finally , another issue came up during some panel discussions , on the issue of attitudes of all toward the East African Community. Again, we need to come up with the policies that first of all will help us start thinking as East Africans, policies that will make us start looking at things from an East African point of view, and we need to stop looking from our individual country's point of view, so that whatever actions we take benefit the region, which is good for all of us. I think this is what is called a "win-win" situation. And this means that some of the attitudes, we must change them, some of the fears in my view are unfounded, we must remove them, and we take what I call a leap of faith. And obviously, the last thing is that our political leaders have committed themselves to a federation.

Enock Bukuku[52]

I would like to single out the four pillars of EAC integration as policy priorities. These are: Customs Union, Common Market, Monetary Union, and Political Federation.

In terms of implementability, I would like to emphasize the establishment of regional supranational institutions to support integration as a policy priority. These include EAC institutions such as a common statistical agency, a competition and enforcement agency, a strengthened

[50] Director of IMF's African Department.

[51] Kenya's Minister for Finance.

[52] Deputy Secretary General of the East African Community.

Court of Justice, railways, research policy think tanks, and Bureau of Standards. In addition, policy priorities should be the creation of the Single Customs Territory of the EAC and the creation of a single regional financial market. The EAC partner states should meet their commitments to the Common Market Protocol as soon as possible, and not wait for the completion date of December 31, 2015, which will lead to a full-fledged common market. Harmonization of economic policies in this regard should also be a policy priority with the aim of economic integration. In this regard, harmonization of fiscal and monetary policies is a necessary step for a monetary union.

Jacques Morisset[53]

First, I am new to the region, so I cannot speak from experience of this region. But I would like to step back and think about the double question of the priority issues and at the same time think about those issues in terms of political economy.

Regional integration for me is where all members find some mutual benefits and I think this is the principle that we should keep in mind. So, we need to define actions, and identify actions from which everybody will win and that is what we have discussed over the past two days. A lot has been discussed on policy environment, business environment, investment climate, which I think is great. Every country, every member, needs to improve its business environment. The question in my mind is to ensure that integration promotes business.

A lot has been discussed on common fiscal rules and common monetary rules. Again, ask yourself, will everybody win or lose? We know that the economic cycles will be different, even more so in the future, because some countries have discovered oil and some natural gas, while some do not have either. So, it is a question: Are the mutual benefits the same for everybody?

One area where I am sure that you have mutual benefits is geographical and economic connectivity. For me, if you have to choose a single priority, connectivity is the most important. What does connectivity mean for EAC? It means trading among yourselves, leading to a boom in intraregional trade. Will it be enough? The EU ambassador mentioned that the EAC's GDP is the size of the GDP of the Slovak Republic, and about one-fifth of the GDP of London. If you think along these lines, is it better for Kenya to have a bilateral agreement with Rwanda or with London? The point is that regional integration should go with global market integration and the beauty is that the two go together. If Rwanda can export (more easily) to Kenya, then it can export (more easily) to the rest of the world – it is a "win-win" situation. I want to make the point that global integration and regional integration go together; they are not substitutes. Let me come up with a list of actions for better connectivity. For me, one investment that you have to make in terms of connectivity, I would say, is the ports. You have two ports in East Africa which are among the worst performers in the world.

The second one, which everybody has been working on, is the corridors. What do I mean by corridors? It means not only physical infrastructure, such as railways and roads, but also soft infrastructure, such as better border posts.

The third one, which has been addressed by the private sector this morning, is labor mobility. Actually, I would qualify that a little bit, you already have labor mobility. The problem is that you are crowding out quality, so people with skills do not move, so I think you need to address that. People are already moving, but the ones moving are not the most educated ones. In addition, education and skills need to improve and I think a lot can be done to address the deficit of education.

My fourth point is virtual connectivity, such as services and capital market integration. Already a lot has been done, but you need to do more.

My concluding point is that connectivity will have a huge impact, because it will shift the economic geography in the future. You can think of two models. You can think of the China model, where you bring many people to the coastal area (the first model). The other model is the European model. You have many landlocked countries in Europe, which are relatively populated and are economically developing, so you need to think about it, what model you want to follow – it will be also be related very much to what you want to trade. If you have low-value manufacturing, where margins are very small and distance matters, you will need to be close to a port. If you trade commodities, or agribusiness, you may want to be closer to the source.

[53] Lead Economist, World Bank.

Robert Mathu[54]

It is an honor to be the last one of the discussants at the conference. I think previous speakers have more or less touched on each and every item that is of priority in terms of policy on integration of East African community. I will point out just a few that I feel are of priority and some may have already been mentioned by my colleagues.

First, the whole purpose of integration is to improve the welfare of the citizens of this region; so integration is very important because the aim is to take advantage of economies of scale. So, the first priority should be to accelerate the implementation of all actions that have been identified. I will give a simple example: we have the Common Market Protocol, but with regard to the capital markets, we still have some outstanding issues.

The second one, and this is why I was referring to the citizens of the region, is to encourage the citizens to participate in wealth opportunities (such as privatization), so that they can benefit in the emerging wealth brought about by many things, including innovation, and global trends. I am mentioning this specifically because of experience.

We have to have a policy of carrying along our citizens, and to be able to encourage them to participate we need to be able to have a policy of identifying which sectors of the economy are likely to perform well over the next decade: technology, that is the next hot thing, resources are coming up, social media is coming up, we need to make sure that our citizens are involved at the right time. We want our pension funds, as institutional investors and private investors, to participate in investment opportunities that enhance growth.

Another policy priority that I would like to point out is infrastructure and I am specifically referring to Information and Communication Technology (ICT). With regard to financial services, we should say that the Internet has been a blessing for us. So we should move fast enough, so that other sectors of the economy take advantage of this, to add more dollars into citizens' wallets. Today, as we speak, we must be able to undertake an audit as to what has been the impact of the ICT development in East Africa on our investors in terms of bringing down the cost of transactions and also access to the market. When we talk about access, we mean how fast an investor in Mwanza can buy a mining stock in Uganda within a very short time and close the transaction.

The other policy priority is support for small and medium enterprises (SMEs). As we integrate our countries in the EAC, we must also make sure that we manage growth for our economies, and we know that close to 80 percent of our economic activities are concentrated in the SME sector, mainly domestic businesses. Entrepreneurs must be supported through access to grants and technical knowledge, and our governments should be setting up institutions and agencies that will support the SMEs.

Investor protection is also important, because it is needed for financial integration and because infrastructure is one of the growth-drivers of our economies, but it is also important to consider mobilizing capital markets to invest in public infrastructure.

Finally, financial inclusion—I strongly feel this is one of the priorities, so we have to give our citizens the knowledge that this is an important area. Finally, I am glad to say that the integration environment among our citizens has shifted from negative a few years ago to very positive now. This conference is a good example.

[54] Executive Director for Rwanda Capital Market Authority and Chairman of the East African Securities Regulatory Authority.

Comments from Some Conference Participants

Louis Kasekende[55]

How do we inoculate trust among each other and how do we arrive at changing the mindset from national to regional thinking? We may need a broker to build trust among ourselves as the EAC is witnessing what is happening in Europe. East Africans need to see integration as our own agenda from which we can attain a win-win situation. One of the quick wins is M-Pesa which is advancing without policymakers playing a major role. We need a functioning, well-regulated payment system for both high-value and retail payment systems.

Benno Ndulu[56]

I want to make several points:

- We need to show to our citizens that our actions produce win-win policies. This is not automatic.
- Connectivity should be promoted as Jacques underscored.
- Without building a strong grassroots constituency for integration, we will make the same mistake of creating a union which is unstable. Years later we will realize stability did not materialize since win-win policies were glossed over.
- Labor and land issues need to be resolved. Building trust may need a broker.
- Financial integration is broader than the monetary union. We have agreed to implement some activities that would enable integration of our markets, such as integrating the payments system, convertibility of currencies, and common platforms for capital markets. These are what we can do before reaching a single currency.
- Our monetary union protocol will guide us in the establishment of our monetary union. We need to remind ourselves that 2012 is the deadline for the completion of the protocol and not the date when a single currency will commence.

Claver Gatete[57]

On financial integration, we seem to have too many regulators in the region (for NBFI, capital markets, insurance, pensions, and microfinance); there are macroprudential issues that cut across the financial sector, with central banks attending all financial subsectors meeting. This enables oversight of the entire risk framework. We should have one regulator/supervisor for the entire financial sector instead of regulators scattered all over (e.g., microfinance, banking, insurance, pensions). We should emulate Australia.

The payments system is the key and we need to link both the retail and the high-value payment system to enable transfer of funds across the region.

[55] Deputy Governor, Bank of Uganda.

[56] Governor, Bank of Tanzania.

[57] Governor, Central Bank of Rwanda.

Closing Remarks

Antoinette Sayeh[58]

Honorable ministers, central bank governors, Secretary-General of the East African Community (EAC), Canadian High Commissioner, distinguished invitees, ladies and gentlemen. I was very pleased to participate in this important event on extending EAC integration in its second decade.

I want to again thank the Canadian International Development Agency (CIDA) for their generous support. The contributions of the many presenters, discussants, and participants also deserve our thanks.

High-level conferences provide excellent opportunities to address tough policy challenges, and this conference was no exception. Over the past two days, we touched on a number of the most important issues facing the EAC as it seeks to further strengthen integration in its second decade.

- A first issue was how to ensure strong, broad-based growth in EAC countries. Apart from the important ingredient of sound macroeconomic management, this raised questions of how to effectively implement the EAC customs union and common market to promote regional investment and trade.
- A second theme was how to promote closer integration of the EAC's financial markets. E-banking has been an area of success, but the more traditional banking and capital markets remain segmented.
- A third theme was budget management. We noted, in particular, the lessons from the eurozone area on the fiscal requirements for effective monetary union.
- And last, we discussed the question of how to harmonize monetary and exchange rate policies during the transition to monetary union.

On the question of growth and its key drivers, we know that macroeconomic fundamentals matter a great deal: low inflation, fiscal discipline, a competitive economic system, to name a few. But so do structural reforms, such as a better business environment and better-quality of fiscal and monetary institutions. In fact, achievements of the EAC's first decade are in large part due to getting these fundamentals right. These macroeconomic gains need to be preserved and further consolidated.

That said, I think there was general agreement that the remaining exceptions to the customs union should be tackled and that the common market should be implemented in a decisive manner. Closer integration of trade and investment was frequently described as offering "win-win" outcomes.

There was also agreement that stronger regional financial integration was needed, in parallel with moves to make the financial system more inclusive. The absence, so far, of close financial integration across the EAC increases the cost of doing business and limits the scope for a full common market. The rapid growth of M-pesa or e-banking is one regional success story, but more is needed to foster the growth of regional financial markets and ensure that they are soundly supervised.

On budget policies, there was clear recognition that the planned move toward monetary union needs to be preceded by steps to ensure sound national budgets and debt management. This raises important questions of how to subject national budget policies to what Professor Collier described as "supra-national" discipline. As members of a common currency area, national governments would need to be subject to binding limits on fiscal deficits and public borrowing. The eurozone area is moving to strengthen this discipline under stronger regional institutions, but does not necessarily provide an off-the-peg model that can be adopted by the EAC. Similarly, the federal arrangements adopted by the United States are far removed from the actual situation today in the EAC. This is an area where further thought is clearly needed, and where EAC member governments need to consult among themselves and with their populations to develop an EAC model. This model would need to provide strong central discipline while also recognizing important national differences, such as between resource-rich and other EAC countries. This is not a straightforward task, and needs to be done carefully if monetary union is to be a success. While Professor Collier suggested that this was perhaps a task for the next generation, others are clearly keener to make early progress, stressing that "careful does not need to be slow."

[58]Director of IMF's African Department.

On monetary and exchange rate policy harmonization, I saw definite interest in setting out a clear work plan and timetable. The challenge here will be to align this work program with that on fiscal integration. For effective monetary union, progress on harmonizing financial policies should not be de-linked from fiscal harmonization. Again, this brings us back to the need for decisions within the community on what pace of reform can be achieved.

In concluding, let me say that the IMF will continue to provide the technical and analytical support that the EAC and its member countries needs in these areas. We cannot and should not provide a standardized model for regional integration. But we are eager to discuss your priorities and engage with you on how these can be achieved, drawing on international experience. We would like to help you get to where you would like to be tomorrow.

John Moore[59]

I would like to emphasize the need to do the things we can do now and do not let impediments get in our way. To this end, we need to improve financial literacy and educate the public in the EAC on integration as underscored by many conference participants.

At CIDA, we are happy to provide funding for this conference. I found both days of the conference extremely stimulating and want to thank the IMF and the EAC for all their hard work. We are glad to be a small part of this conference.

Richard Sezibera[60]

I would like to thank everyone for a productive and informative conference over the past two days and would like to thank CIDA and the IMF for organizing the conference as well as the media, civil society, and all panel members. I would also like to thank EAC ministers of finance and governors who attended this conference, given their busy schedules.

I take away the following key messages from the conference:

- Removal of non-tariff barriers (NTBs) is critical to EAC integration, as well as taking steps toward a functioning customs union.
- Having a functional common market, especially on free mobility of labor, capital, goods, and services, is a challenge to all partner states.
- Cross-border infrastructure that makes the EAC work, and liberalization of airspace, is needed. Meeting on NTBs is scheduled for March 2012, and the chairperson of the summit is committed to removal of the NTBs.
- Financial integration and fiscal integration are needed as we move toward a monetary union. The EAC is working with the World Bank on a financial sector development and regionalization project that includes financial literacy, financial inclusion, harmonization of laws, mutual recognition of supervisory agencies, and bond market developments.
- A monetary union protocol should not be equated with a single currency. By December 2012, we will have an agreement on a monetary union protocol that will lay out clear benchmarks and a road map for financial and monetary policy integration, ultimately leading to a single currency. This is a work in progress, as is our customs union and common market.
- Involvement of the people of East Africa is vital to the integration agenda. Creating a framework for dialogues between sectors and members of civil society and private sector is crucially important in advancing the EAC's integration agenda.

Mustafa Mkulo[61]

I will be brief. As the host of the conference, I would like to thank all who found time to come to Arusha. I am glad to see the commitment of all ministers of finance to forge ahead with the integration agenda. EAC countries have established macroeconomic stability. During this conference, we learned the importance of common infrastructure, learning the lessons from eurozone countries, financial regulation, establishment of common statistics, and harmonization of monetary policies.

I would like to challenge the Secretariat to organize more conferences like this one, that are educational and invite as many people as possible to attend them.

[59]Director, Canadian High Commission, Dar es Salam, Tanzania.

[60]Secretary General of the East African Community.

[61]Former Tanzania Minister of Finance.

Integration is a win-win policy. Experience of the North American Free Trade Area shows that regional integration requires continuous fine tuning.

John Moore
Director and Head of Cooperation CIDA-Tanzania

Financial integration and fiscal integration are needed as we move toward a monetary union.

Dr. Richard Sezibera
Secretary General, the East African Community

An important challenge facing the East African Community is to advance the customs union and common market.

Naoyuki Shinohara
Deputy Managing Director, International Monetary Fund

We need to show to our citizens that our actions produce win-win polices. This is not automatic.

Professor Benno Ndulu, Governor, Bank of Tanzania

We need to link both the retail and the high-value payment system to enable transfer of funds across the East African Community. This is key to financial integration.

Ambassador Claver Gatete, Governor, National Bank of Rwanda

As East Africans we need to see integration as our own agenda from which we can attain win-win policies.

Dr. Louis Kasekende, Deputy Governor, Bank of Uganda

Trade always has winners and losers, but a common infrastructure (railroads, ports, power, and financial integration) is a win-win policy.

Professor Paul Collier, Oxford University

An important challenge is how to attain sustained, high, inclusive growth.

Robinson Githae, Kenya's Minister of Finance

To achieve middle-income status by the end of this decade, per capita income in the EAC needs to grow at an average rate of 5½ percent a year, 2 percent faster than seen recently.

Catherine McAuliffe, Sweta Saxena and Masafumi Yabara
African Department, International Monetary Fund

High-level conferences provide excellent opportunities to address tough policy challenges and this conference was no exception.

Antoinette Sayeh
Director of African Department, International Monetary Fund