SUPPORTING MACROECONOMIC CONVERGENCE IN AFRICAN RECs

Jian Zhang
AFRICAN DEVELOPMENT BANK
AFRICAN DEVELOPMENT FUND

Supporting Macroeconomic Convergence in African RECs
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This Working Paper was prepared by Mr. Jian ZHANG, Principal Macroeconomist, Regional Integration and Trade Division (ONRI/2). It has benefited from comments from colleagues in the Bank and external experts, including Mr Michael Mah’moud, former Lead Economist ONRI, as well as from the ECOWAS, WAMI, COMESA, EAC, SADC, and CEMAC Economic Commissions or Secretariats. It has also benefited from the findings of related Bank studies on regional financial integration and on fiscal convergence. The paper was finalized with the editorial assistance of Nice Muhanzu and Aerina Kim.

While the views expressed are not official Bank positions, the paper has been used as a guideline in designing technical assistance to COMECA Secretariat towards the preparation of a Multilateral Fiscal Framework, and to ECOWAS Secretariat in Harmonizing Convergence Criteria. For further inquiries on this Working Paper, contact Mr. Jian ZHANG by calling +2167110 2756 or by emailing j.zhang@afdb.org
ABSTRACT

This Working Paper examines the concept of macroeconomic convergence and its implementation, which has become a key aspect of preparation towards monetary union in the African regional economic communities (RECs). The application of the concept follows the example of the European Union, where attainment of macroeconomic convergence was part of the conditions a candidate country had to fulfill before being admitted to the European Monetary Union (EMU). The paper, therefore, reviews the importance of the concept in the light of the EMU experience. However, an assessment of the performance of REC member countries against the targets shows that attaining the convergence targets consistently is a challenge for the member countries of the RECs. The challenges in this regard range from the way the concept is designed and applied to exogenous shocks affecting African countries, but there are also some challenges that are generally common to implementation of regional integration programs in Africa.

Based on the lessons from the experience of implementing macroeconomic convergence in Europe and elsewhere, the paper proposes certain revisions to the application of the concept. In particular, it proposes linking the roadmap in the implementation of convergence to progress in trade integration. Indeed, it is important to ensure a balance between the financial sector and the real sector program. The macroeconomic convergence achieves its highest relevance when it is mainstreamed into regional efforts towards development and poverty reduction.

The proposal also emphasizes the importance of fiscal policy and fiscal convergence in the application of the concept. While surveillance is important to enhance progress, given the cost-benefit calculus of financial integration programs in African contexts, and especially the fact that upfront incentives as well as implementation capacities are low, surveillances should be more for promotional purposes — identifying specific country challenges and supporting them to improve performance — rather than for sanctioning purposes. Other factors to improve performance include the degree of national and regional commitment and ownership, allowing for varying degrees of country preparedness and capacity, availability of mechanisms to cushion adjustment costs, availability of technical and financial support for capacity building and investments.

While African countries and RECs have the primary responsibility to ensure that the conditions for success exist, development partners also have a role to play. In this regard, the paper proposes what the Bank could do to assist based on its mandate and comparative advantage as catalytic financier, knowledge broker and partner. In particular, the Bank can leverage its ongoing support for regional integration and trade, and financial sector development as well as its operations in the sector departments. Specific areas where the Bank can make impact in capacity building and investments are proposed. However, support to the RECs should be based on a detail assessment of the individual REC programs and consultations with relevant stakeholders so that a REC-specific support program could be drawn up.
PREFACE

The African regional economic communities (RECs) comprise open economies with diverse natural resources but at different levels of development and macroeconomic conditions. For almost four decades, these countries have been trying to integrate their economies in an effort to quicken the pace of development. Many of the RECs have adopted financial integration programs aimed eventually at the establishment of monetary unions. They have, therefore, set macroeconomic convergence criteria as part of the determinants for establishing a currency union and have been monitoring their performance in this regard. So far, the formation of the monetary unions has remained elusive, although much progress has been made with regard to trade integration. Since convergence is so vital to monetary union, this working paper discusses its application in the African regional groupings.

The research is inspired by requests received by the Regional Integration and Trade Division from some regional groupings for technical assistance in reexaming their macroeconomic convergence criteria towards making them more relevant to their objectives, level of financial development and macroeconomic management capacity. This issue has become even more topical now with the recent developments in the Eurozone, whose model for financial integration has shaped the design of monetary integration in many African RECs.

The paper covers a number of pertinent issues in the design of macroeconomic convergence criteria and in the monitoring of country and regional performance, including the principles, indicators and data, the issue of fiscal and monetary cooperation, relevance to trade integration as well as the monitoring and surveillance mechanism. The paper has drawn from work done at the Division and the other areas within the African Development Bank as well as other African regional organizations, the European Union and international financial organizations. The author also received valuable comments from various experts in the Bank and African RECs and from other researchers.

We hope the publication of this paper will stimulate further discussion and research on the topic towards contributing to the improvement of financial integration in the African regional groupings.

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ACRONYMS AND ABBREVIATIONS

AACB Association of African Central Banks
AfDB African Development Bank
AGOA African Growth and Opportunities Act
AMCP Africa Monetary Cooperation Program
AMU Arab Maghreb Union
ASYCUDA Automated System for Customs Data
AU African Union
BEAC Bank of Central African States
BCEAO Central Bank of West African States
CEMAC Central African Monetary and Economic Community
CET Common External Tariff
CMA Common Market Area
COMESA Common Market for Eastern and Southern Africa
EAC East African Community
ECCAS Economic Community of Central African States
ECOWAS Economic Community of West African States
EMU European Monetary Union
ERM Exchange Rate Mechanism
EU European Union
FX Foreign Exchange

MDRI Multilateral Debt Reduction Initiative
MTEF Mid-Term Expenditure Framework
NEPAD New Partnership for Africa’s Development
PRSP Poverty Reduction Strategy Paper
RECs Regional Economic Communities
RFI Regional Financial Integration
SADC Southern African Development Community
UNECA United Nations Economic Commission for Africa
WABA West African Bankers Association
WAEMU West African Economic and Monetary Union (UEMOA)
WAMA West African Monetary Agency
WAMI West Africa Monetary Institute
WAMZ West African Monetary Zone
WTO World Trade Organization
I. BACKGROUND

The concept of macroeconomic convergence has become increasingly popular among economists in developing regions, particularly in Africa. This increasing popularity, buttressed by the experience of the European Monetary Union, reflects the perceived strategic importance of macroeconomic convergence in underpinning the move towards regional and continental monetary integration, and even broader economic integration\(^1\).

Macroeconomic convergence is regarded as important for preparation towards monetary and broader regional integration for a number of reasons: inflationary pressures generated by unsustainable fiscal deficits and monetary expansion can cause untenable current account deficits that can eventually undercut trade liberalization and stifle economic growth. Moreover, macroeconomic instability, reflected in unsound financial sector and external debt difficulties, limit the ability to address structural difficulties and promote growth. African regional economic communities (RECs) have, therefore, made the adoption of macroeconomic convergence programs a key aspect of their regional monetary and financial integration programs. However, the record for its implementation in African contexts of preparation towards monetary integration has not been impressive; raising the issue of what conditions could improve the record.

This Working Paper discusses the application of the concept of macroeconomic convergence in Africa, proposes an approach towards increasing its relevance, and makes recommendations regarding how development partners could support the ongoing efforts in the various RECs to achieve convergence. The paper is presented in five sections. Following a brief introduction of Africa’s monetary integration efforts in section one, section two discusses macroeconomic convergence, the relevance and implication of Euro-Zone experiences for Africa. Section three highlights the main findings from an assessment of the implementation of regional programs of macroeconomic convergence in Africa and the constraints encountered. A phased road map for Africa macroeconomic convergence is outlined in section four. Section five presents the major conclusions and recommendations.

II. RELEVANCE AND ISSUES

Across Africa, the various regional economic communities (RECs), which are the building blocks of the continental regional integration, have adopted programs to deepen economic and monetary integration. The roadmap for the various programs outlines a number of key targets and milestones to be met along the way. These milestones include target dates for deeper trade integration from a Preferential Trade Area through Free Trade, Custom Union, Common Market and, eventually, the Monetary and Economic Union. Currently, many of the RECs are at the stage of either consolidating the Free Trade Arrangements or preparing to launch a Customs Union.

The RECs have also adopted monetary integration programs, which in a number of cases target the establishment of monetary unions, in line with the roadmap for regional integration. In the ECOWAS, the ultimate objective is to establish an ECOWAS monetary union. However, a stepwise approach has been adopted, involving, first, the establishment of a second monetary union (a single currency and a common central bank) by the West African Monetary Zone (WAMZ) and second, merging the WAMZ with the West African Economic and Monetary Union (WAEMU) when certain conditions are attained. The current target dates for achieving the two steps are 2015 and 2020. At the East African Community (EAC), the monetary integration program has set a target date of 2012 to launch a monetary union. The Southern African

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1. Regional integration is imperative for expanding economic opportunities in Africa, as bigger markets permit better exploitation of economies of scale, while factor mobility across borders and the coordination and harmonization of monetary and fiscal policies facilitate faster economic growth and greater welfare for participating countries.
Development Community (SADC) and the Common Market for East and Southern Africa (COMESA) also have monetary integration programs that are being fast-tracked, with target dates of 2016 and 2018 respectively, for the establishment of monetary unions. At the continental level, the Abuja Treaty envisages the establishment of a continental monetary union by 2021.

The process towards the establishment of regional and continental monetary unions is, therefore, being implemented concurrently with that of deepening trade or real sector integration, with the former aimed at enhancing the latter, while the latter also helps to translate and augment the benefits of the former. The process, therefore, also involves other related institutional and intra-regional cooperation in economic and financial sectors, which includes the adoption of macroeconomic convergence programs.

These components were inspired by the process followed by the European Monetary Union (EMU), which was promoted endogenously and evolved over a long period of preparation, followed by a carefully implemented transition period. Also significantly, the EMU was designed to be self-reliant, involving an elaborate framework of institutional and surveillance mechanism to ensure its stability and sustainability. Macroeconomic convergence was prescribed as part of the later or transitional arrangements towards the EMU, and its achievement was set as a precondition for membership in the monetary union. Formulated as part of the features for stability and sustainability, the regional macroeconomic convergence program was accompanied by a number of regional financial support arrangements and, at the country levels, by monetary and fiscal policy coordination plus other arrangements to balance public and private sector as well as real and financial sector integration. In particular, the Maastricht Treaty of 1991 stipulated that the transition to the final stage of monetary union was conditional on a number of “convergence criteria”, and that a country could join the union only if-

i) Its inflation rate is not more than 1.5 per cent higher than the average of the three lowest inflation rates among the EU member States;

ii) Its long-term interest rate is not more than 2 per cent higher than the average observed in these three low-inflation countries;

iii) It has joined the exchange rate mechanism of the EMS and has not experienced a devaluation during the two years preceding the entrance into the union;

iv) Its government budget deficit is not higher than 3 per cent of its GDP (if it is, it should be declining continuously and substantially and come close to the 3 per cent norm, or alternatively, the deviation from the reference value (3 per cent) should be exceptional and temporary and remain close to the reference value (Art. 104c (a); and

v) Its government debt should not exceed 60 per cent of GDP (if it does, it should diminish sufficiently and approach the reference value (60 per cent) at a satisfactory pace.

Apart from meeting convergence criteria consistently, EMU applicant countries were also required to be EU common market members. This implies that common market members have to meet convergence criteria through policy harmonization and coordination prior to entering Euro-Zone, thus enhancing the mutual benefits of the trade and financial integration.

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By setting constraints on the monetary variables, the convergence criteria limited the way monetary and exchange rate policies should be conducted in the

2. Interestingly, the preparation towards the EMU is different from those of the two oldest monetary unions in Africa, namely, the WAEMU and CEMAC, which have a long history dating to colonial days, but whose creation were underlined by political rather than economic reasons and, whose stability are guaranteed by the French Treasury. The lessons from the history of their establishment, therefore, have little relevance for other African countries trying to set up self reliant monetary unions (Maruping, 2005; Masson and Patillo, 2005).

3. Up to now, 16 of 27 EU Member States have adopted the Euro in line with the Maastricht Treaty. There are still 11 EU common market members that have not joined EU Monetary Union.
EMU accession countries, despite the importance of these policy variables in the stabilization process of an open economy. The Euro-Zone convergence criteria also aimed at reducing the possibility that fiscal policy may indirectly put pressures on monetary policy. The promotion of macroeconomic convergence during the transition phase was, therefore, supposed to condition and help potential member countries to be able to give up the benefits arising from independent monetary and exchange policies, while remaining competitive (economic convergence) within the union and enabling both the public and the private sectors to reap the benefits accruing from membership in a larger currency union. At the same time, achievement of macroeconomic convergence was supposed to protect the monetary union from being exposed to ‘contagion effects of macroeconomic instability or ‘moral hazard’ (public and private sector) policies and actions in individual member countries’ (AfDB, 2011).

At entry into the EMU, countries were subjected to a different set of convergence criteria. In contrast to the transition phase, ‘when the convergence criteria are comprehensive in nature and covered monetary, fiscal and exchange rate policies, as well as structural policies that were mutually consistent and supportive of enhancing the entrant country’s homogeneity with the existing members and ensuring its competitiveness within the union’ (AfDB, 2011), the convergence criteria for monetary union members include only fiscal policies that are designed to be consistent with the monetary and exchange policies pursued by the common central bank to ensure the union’s stability and sustainability. Convergence criteria, however, may also be complemented by certain union-wide rules relating to the financing of public deficits or other financing requirements. These rules and financing arrangements helped the achievement of the convergence criteria. Thus, the formulation of the convergence criteria reflect the phase of financial integration but also the availability of supporting financing facilities as well as the possibility of sanctions and built-in incentives in the surveillance and enforcement mechanisms. These features underline the relative success of the Euro-Zone Model, which has made the Euro much more stable than most of individual currencies, such as British Pound, Australian Dollars and many other convertible currencies; its stability has also attracted membership of many central and eastern European countries seeking to avoid financial instability (Wall Street Journal, 2009).

In the case of the African RECs, convergence criteria have been adopted in the very early stages of the process (the preparatory phase), even before countries are ready to make a transition to the monetary union.

III. PROGRESS ON MACROECONOMIC CONVERGENCE IN AFRICA: AN ASSESSMENT

Convergence Criteria set by African RECs

The convergence criteria adopted by the various African RECs cover monetary, fiscal and real sector variables, following the example of the EU. They are normally divided into primary or core criteria, which presage the monetary union rules and must be achieved on a sustainable basis, and secondary criteria, which are intended to facilitate the achievement and sustenance of the primary criteria. These criteria, whose precise definition and grouping vary slightly from one REC to another, generally reflect those recommended by

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4. In the absence of the exchange rate instrument and a centralised European budget, national budgets are the only available instruments for member states to cope with asymmetric shocks. In view of this, the general thrust of European convergence criteria was designed to be deflationary. Many member countries were required to cut budget deficits, to reduce public debt and to bring down inflation and interest rates to meet the criteria.

5. The WAEMU and CEMAC countries also have convergence criteria for their respective monetary union members.
the AACB’s African Monetary Cooperation Program (AMCP) as follows:

- **Primary criteria:**
  - Overall budget deficit (excluding grants) / GDP ratio < 3%;
  - Inflation rate < 3% ;
  - Minimization of Central Bank’s financing of budget deficit;
  - External reserves ≥ 6 months of goods and services imports.

- **Secondary criteria :**
  - Elimination of domestic arrears and non-accumulation of new arrears;
  - Tax revenue / GDP ratio > 20%;
  - Salary mass / total tax revenue ratio < 35%;
  - Public investments financed from internal resources / tax revenue ratio > 20%;
  - Maintenance of real exchange rates stability;
  - Maintenance of positive real interest rates.

- **Other variables** (considered by some RECs but not listed in the AMCP) include public debt, current account balance, domestic and external debt arrears, public wage bill, Government revenue, Government expenditure, GDP growth, national savings, and the Basel core principles.

### Convergence Performance in Selected African RECs

An assessment of macroeconomic convergence in the various African RECs shows that, while some progress is being made, performance is generally below the targets set by the REC financial integration programs, even considering only the primary criteria (see Table 1).

**Inflation:** Driven by ongoing economic reforms and despite the recent food, fuel and global financial crisis, inflation has been reduced considerably in the RECs over the past decade. However, inflation rates remain above the convergence targets set by the RECs. Inflation rates in 2010 are projected to go down to within single digits in all RECs, but even if these are achieved, the performance would not have been consistent as per the convergence criteria. During 2003-2009, in both WAMZ and the COMESA inflation rates remained above the single digit targets set by the convergence criteria. In SADC and the EAC, average 2003-2009 inflation rates were in the single digits, although, for EAC, this was above the very stringent 3 percent target set by the convergence criteria. Inflation convergence targets were, however, met in the three monetary unions, namely WAEMU, CEMAC and SACU.

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6. However, as grouped by the African Development Bank’s study (AfDB, 2011), they can also be looked at as composing fiscal and non-fiscal criteria as follows:

- Fiscal convergence criteria: Budget balance, Public debt, Domestic and external arrears, Public wage bill, Government revenue, Government expenditure, Public investment and Central bank credit to government;

- Non-fiscal convergence criteria: Inflation, GDP growth, National savings, Real interest rates, Basel core principles, Current account balance, and stable exchange rate

7. While the WAMI and COMESA convergence criteria closely follow the AMCP, the SADC and EAC have slightly different criteria: the SADC’s Regional Integration Strategic Development Plan, adopted in 2003, set the convergence criteria to include inflation, fiscal balance, public debt, and the current account balance, while the EAC has an elaborate criteria that include grouped into traditional criteria (current account deficit, budget deficits, and exchange rates); derivatives (interest rates, inflation rates, and foreign exchange reserves); derivatives of derivatives (real GDP growth) and means to the end (national savings, domestic and foreign debt, and Basle core principles).
Fiscal deficits: Over the past three years, fiscal performance has been impressive in the various RECs. The fiscal performance was, however, supported by increased flow of official development assistance (ODA). If grants are netted out, Africa's fiscal performance becomes less impressive. Besides, the overall achievement masks great variations across the RECs, as indicated in Figure 1-2. In 2010, the resource-rich CEMAC, with five out of its six member countries being oil exporters, was the best performer with a fiscal surplus approaching 6% of GDP reflecting rebounded fuel and commodity prices. The other RECs under discussion had negative fiscal balances and could not also meet their convergence targets. ECOWAS and EAC, whose members are mostly oil importers, had the least impressive fiscal performance, with their fiscal deficits, excluding grants, being close to -10% of GDP and far above the their convergence targets of 4 percent and 3 percent respectively. COMESA, SADC, SACU and WAEMU had median performance, with fiscal deficits ranging from -5% to -7% of GDP.

8. IMF data may be different from those of RECs’ Secretariats.
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African countries have made headway in maintaining high international reserves cover. However, achievement varies across the various RECs under study. CEMAC, SACU and WAMZ had the highest average reserve cover, with the averages meeting the convergence targets. Although convergence targets were not met by the WAEMU and the EAC countries, the countries generally achieved more than four months import cover.

External Debt: Generally, many African countries have benefited from the HIPCs, and their external debt positions have reduced substantially over the recent past. Therefore, the convergence criteria have been met in all RECs, except the WAMZ, whose performance is also reflected in the poor performance of ECOWAS.

External Reserves: Over the past few years, many African countries have made headway in maintaining high international reserves cover. However, achievement varies across the various RECs under study. CEMAC, SACU and WAMZ had the highest average reserve cover, with the averages meeting the convergence targets. Although convergence targets were not met by the WAEMU and the EAC countries, the countries generally achieved more than four months import cover.

Source: IMF.

9. IMF data may be different from those of RECs’ Secretariats.
The above brief review shows that progress remains limited for even the primary convergence targets to be achieved in the seven African RECs. Up to now, there has been no demonstrable progress in reaching consistent convergence within RECs, except for some signs of converging in CEMAC. The better convergence performance in CEMAC, as shown in Figure 4, reflects her deeper trade integration as a monetary and custom union, which is an incentive to member countries; the union’s resource base and the recent increase in fuel and commodity prices, which underlines the union’s fiscal performance and accumulation of reserves; and the regional implementation of the union’s multilateral surveillance programs supported by IMF. The two other customs unions, namely the WAEMU and SACU, which are less endowed and have not benefited so much from the recent increase in commodity prices have performed less impressively than CEMAC, but much better than the free trade area RECs on account of their advanced stage regional integration and better coordinated institutional arrangements (see Table 1-1).
IV. OPPORTUNITIES AND CHALLENGES FOR ACHIEVING MACROECONOMIC CONVERGENCE

Since the early 1990s, several African countries have been undertaking reforms to remove economic distortions in the real sector, including the adoption of market-based policies in the goods and tradable markets. They have also pursued financial sector reforms that have brought down inflation from the widespread double-digit inflation rates that prevailed in the pre-reform period. These reforms, which are largely supported by the Bretton Woods Institutions, have resulted in substantial policy convergence among African countries and provided the opportunity to enhance macroeconomic convergence. Beyond that, however, there are several challenges in meeting the indicated conditions for macroeconomic convergence (Maruping, 2005; ARIA III).

Multiple memberships: Most African countries belong to more than one REC, in many cases for political reasons or pressures rather than on the basis of economic cost benefit calculations. However, the macroeconomic convergence program is driven by economic consideration and parameters. Therefore, given the differences in the economic structures and monetary integration programs of the RECs, reflected in the variations in the design of the macroeconomic convergence criteria, countries face competing rather than complementary or harmonized macroeconomic convergence programs, resulting in wasteful duplication of efforts. At regional level, there is also the resultant burden of coordinating and harmonizing the implementation of convergence programs.

Slow implementation of agreed plans: Also, ownership of, and political commitment to, the monetary integration programs remain weak in some countries. This partly reflects inadequate internal and regional consultations to elicit strong political endorsement based on full information on the costs and benefits of the program. In other cases, socio-economic and political changes have resulted in deprioritization of the program, especially where socio-economic sacrifices are involved. Whatever, the reason, many countries are slow to implement the agreed macroeconomic convergence plans.

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Table 1: African REC’s Convergence Performance Assessment

<table>
<thead>
<tr>
<th>RECs</th>
<th>Price Stability</th>
<th>Government Financial</th>
<th>Position</th>
<th>FX Rate Stability</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Inflation</td>
<td>Fiscal Balance</td>
<td>External Debt</td>
<td>External Reserves</td>
</tr>
<tr>
<td></td>
<td>% Annual</td>
<td>% GDP</td>
<td>% GDP</td>
<td>% GDP</td>
</tr>
<tr>
<td>CEMAC</td>
<td>3.1%</td>
<td>5.6%</td>
<td>32.1%</td>
<td>4.5%</td>
</tr>
<tr>
<td>WAEMU</td>
<td>2.0%</td>
<td>5.7%</td>
<td>11%</td>
<td>8.1%</td>
</tr>
<tr>
<td>SACU</td>
<td>6.0%</td>
<td>&lt; 3%</td>
<td>7-1%</td>
<td>33%</td>
</tr>
<tr>
<td>EAC-5</td>
<td>9.1%</td>
<td>6.2%</td>
<td>2.7%</td>
<td>5.3%</td>
</tr>
<tr>
<td>SADC</td>
<td>8.2%</td>
<td>&lt; 10%</td>
<td>-1.1%</td>
<td>2.7%</td>
</tr>
<tr>
<td>COMESA</td>
<td>15.3%</td>
<td>5%</td>
<td>33%</td>
<td>3.4%</td>
</tr>
<tr>
<td>ECOVAS</td>
<td>7.5%</td>
<td>5%</td>
<td>33%</td>
<td>3.5%</td>
</tr>
<tr>
<td>WAMZ</td>
<td>12.8%</td>
<td>8.0%</td>
<td>3.4%</td>
<td>4.6%</td>
</tr>
</tbody>
</table>

**data source:** IMF.

10. Consumer Prices, (Annual average, percent change)
11. Overall Fiscal Balance, Excluding Grants, (Central government; percent of GDP)
12. External Debt to Official Creditors, (Percent of GDP)
13. Reserves, (Months of imports of goods and services)
Divergences in economic policies have also constrained the implementation of the macroeconomic convergence. Macroeconomic convergence should reflect the interactions among (i) national governments in the prospective union; and (ii) within each country, between national central banks and finance ministries (monetary and fiscal policy coordination) and domestic policy authorities and their private sectors (balance between financial and real sectors). Although regional macroeconomic convergence may be concerned with only the inter-country level, the internal balances are also important to ensure success at the regional level. It has been difficult to achieve macroeconomic convergence where there has been continuously glaring policy, implementation and information inconsistencies at the national level as well as lack of harmony between the domestic economic situation and the regional targets.

Lack of national capacities: The national level requirements to plan, coordinate, monitor implementation of macroeconomic convergence programs are complex and can be resource-intensive. These requirements are beyond the capacity of many countries to meet, thus constraining their ability to implement the convergence programs effectively.

Lack of reflection of special country circumstances: Macroeconomic convergence need not mean full and symmetrical effort. Some convergence can be achieved by a commitment from each participating country for an effort within an overall framework. The targets need not be symmetric among the participants, and even if they are, asymmetry may arise from their different characteristics, transitory challenges (as in post-conflict countries), level of development and capacity to implement the macroeconomic convergence program. Therefore, the search for macroeconomic convergence should also investigate the asymmetry among countries and their implications for macroeconomic convergence and the extent to which policy or target bands or even variable geometry may be built into the design of the convergence framework. The macroeconomic convergence programs in the African RECs have not provided for special circumstances that can lead to weak performances.

Inadequate reflection of the private sector dimension: In many African countries the private sector remains weak and is still not well organized. Consequently, the private sector has not been fully involved and provided inputs at both the planning and implementation stages. More importantly, the macroeconomic convergence programs have not sufficiently reflected the private sector dimension, especially to ensure the necessary balance between the real and financial sectors. In particular, domestic and regional financial and investment constraints, which limit the ability of member States to achieve sound macroeconomic performance, are not always considered in the design of the macroeconomic convergence program.

Lack of adequate institutional mechanisms: African economies, especially the financial sectors, are highly vulnerable to exogenous shocks, including inadequate and erratic external resource inflows, natural disasters, unfavorable terms of trade and civil strife, which can impact on the soundness of the financial systems and macroeconomic performance. There is, therefore, need for appropriate mechanisms to be established to mitigate these external shocks.

Lack of Common Market Conditions/Structures: To minimise the disruptions of exogenous shocks, it is important that economic structures of countries in a regional grouping be significantly congruent, ensuring that the countries face the same vulnerability to asymmetric shocks. However, where incongruence in economic structures prevail, there should be a high level of wage flexibility amongst the member countries, such that asymmetric shocks could be absorbed, while considerable factor mobility across the regional grouping could also help ease the costs of asymmetric shocks. In addition, it is helpful if production and exports of member States are widely diversified and the countries are very open to trade and levels of intra-regional trade are high so as to enhance the benefits of the monetary integration efforts. These conditions normally prevail in a common market. Hence, the adoption of the EU macroeconomic convergence program at the Common Market. However, the African RECs do not
meet these common market criteria, and the lack of such appropriate conditions put a high degree of strain on the countries to meet the convergence criteria.

**Lessons Learned**

In the extreme case, as shown by the establishment of the existing African monetary unions, common currency areas could be established among countries whenever political commitments are high enough. However, for monetary cooperation to be effective, the experiences of the European Union and elsewhere suggest the significance of moving slowly and ensuring that a number of conditions are in place. These experiences also provide other useful lessons, the essentials of which may be briefly presented as follows:

- **Convergence of the economies**, through the use of convergence criteria, is a precondition for establishing a monetary union, and is important both for monetary union candidate countries and the union itself. Macroeconomic convergence prepares potential member countries to be able to give up the benefits arising from independent monetary and exchange policies, while remaining competitive (economic convergence) within the union to reap the benefits accruing from being a member of a larger currency union that would be established. It is also important for the stability of the monetary union once formed, as it will enhance national ownership of the monetary integration program and enable a smooth conduct of single monetary and exchange policies.

- The imposition and observance of convergence criteria enable the achievement of a high degree of homogeneity of the economies of member countries, thereby avoiding asymmetry of shocks. At the same time, the risk of contagion from macroeconomic instability in one member country is contained, as is the possibility of moral hazard whereby a member country may rely on bailout from other members and indulge in ‘irresponsible’ macro policies. However, as the current Greek case within the EMU has shown, observance of convergence criteria may be a necessary condition for this outcome but not a sufficient condition.

- Macroeconomic convergence is of limited value unless African countries see them as helpful in their own efforts to strengthen their domestic economies, and is mainstreamed into domestic policymaking. Progress in implementing convergence would be facilitated by raising political awareness about them and explaining their role and importance to both government officials and market practitioners. Building consensus in developing the convergence criteria and its prioritization and implementation modalities is important to enhance political commitment. In particular, political commitment at the highest levels of government will be required to introduce the necessary legislative and administrative changes, to establish and empower the policymaking authorities, and to foster a practice of putting macroeconomic convergence in a broader regional integration context.

- The design of macroeconomic convergence should take into account the interdependence of real-sector and financial-sector integration, which is important in enhancing their mutual benefits. Indeed, while the necessity to embed trade integration in the financial integration strategy is supported by how the EMU has evolved, the lack of trade integration in various African RECs, by minimizing intra-regional interdependence, may explain the slow progress towards monetary integration in those regions.

- Convergence criteria may also be complemented by certain institutional arrangements relating to the financing of public deficits or other financial requirements. In particular, experience indicates the importance of the existence of an institutional mechanism to help cushion the costs of adjustments and manage the distribution of the benefits of macroeconomic integration, especially when the region is affected by exogenous shocks. The proper design and consistent policy objectives of such an institution would enhance the sustainability of monetary integration in the context of the heterogeneity of, and varying, policy preferences among members to
a convergence agreement, as, for example, with an employment-inflation trade-off.

- Convergence criteria need not be fixed over time, but should be revised in step with the increasing commitment to monetary integration, the degree of real sector integration, the stage of monetary integration, as well as the supporting institutional mechanisms, which would determine the feasibility and usefulness of introducing the criteria as well as the incentives for its adoption by candidate countries or even their ability to cope with the required adjustments;

- Mobilizing resources towards the implementation of macroeconomic convergence (including for funding reforms in the financial sector, strengthening or establishing the relevant institutions, investing in supporting infrastructures, development of the necessary professional skills, and undertaking of assessments) – there is a mismatch between the requirements of standards compliance and the skills and resources needed to implement them.

V. ELEMENTS FOR FURTHER PROGRESS IN MACROECONOMIC CONVERGENCE IN AFRICAN REGIONS

The ultimate target of Africa’s monetary integration efforts, as reflected by the proposals of the African Union, is the establishment of an African common currency to be managed by an African central bank. However, an African Union Expert Group on Monetary and Financial Matters, including central bank Governors of the Association of African Central Banks, who reflected on the issue, advised that the establishment of a common currency should be “a result of a process that should include the reform of the economies; reduction of imbalances in the economy; and harmonization of differences among economic performances of African economies’. The experts further suggest that the monetary integration should be guided by a number of principles that include:

i) sequencing, a gradual, progressive and sequential approach;

ii) compatibility or ensuring coherence among the policies and convergence of macroeconomic performance of the candidate countries, including sound, healthy economies with high positive real growth rates, sustainable budget deficits, stable, low inflation rates, and sustainable balance of payments positions that will not constrain the development of the economies;

iii) flexibility that all countries need not join the common currency before it is launched. Once a critical mass (suggested by the WG to be 51 percent) of countries were ready, the common currency could be launched;

iv) consultation among stakeholders, including the political authorities (who take the decisions), the central bankers and experts at the ministries of finance (who will implement the decisions) and other beneficiaries (including private sector) to define a harmonized implementation path for monetary integration, leading up to the establishment of the common currency.

The experts also suggest the need for supporting measures -- operational (such as ensuring the availability of statistics and analytical work to inform decision making at each stage) and strategies (timely establishment of appropriate institutions, including a mechanism to mitigate adjustment costs and differential impact of exogenous shocks on candidate countries; timely decisions on conversion of currencies and other preparatory and transition decisions) – to facilitate the establishment of the common currency.


15. The Expert Group suggested sequencing that should begin with implementation at the sub regions or sub-regional communities and build up to the continental level. Progress should reflect the preparedness of the countries, including the stage of regional integration and political commitment.

16. The experts suggested that ‘the target figures for budget deficits, inflation rates and others should not be considered as dogma; what is important is the trend, which will create healthy economies and facilitate the attainment of the principle of compatibility. The actual targets could be revised periodically to reflect the realities of African economies’
The recommendations made by the AU Expert Group are consistent with the lessons learned, as presented in this paper. It provides an outline and the essential elements that should constitute a framework for refining the program for monetary integration in the continent, including macroeconomic convergence.

Table 2: Monetary Union - A Generic Roadmap Towards Fusion Of Real and Financial Integration

<table>
<thead>
<tr>
<th>Economic Integration</th>
<th>Financial Integration</th>
<th>Fiscal Criteria/ Benchmarks</th>
<th>Financial Criteria/ Benchmarks</th>
<th>Structural and Trade Criteria/ Benchmarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stage 1: Free Trade Area (FTA)</td>
<td>Pre-condition: Macroeconomic Stability, Intra-regional tariffs and quotas on trade in goods abolished.</td>
<td>Budget balance, bank credit to government</td>
<td>Inflation, domestic credit</td>
<td>Regional trade and transport development plan, Regional trade facilitation programs; National: medium-term programs to improve business environment &amp; regional/global competitiveness, Wage bargaining mechanism, social safety nets</td>
</tr>
<tr>
<td>Stage 2: Customs Union (CU)</td>
<td>Stage 1: Preparatory</td>
<td>Regional convergence criteria and Multilateral Fiscal Surveillance Framework (MFSF); National: Budget System Laws (BLS), Treasury Single Account, fiscal rules, MTMEF, and MTFF; National Convergence Programs</td>
<td>National payments system (RTGS), Bank supervision &amp; regulatory framework (gradually increasing compliance with BCPIs, IAS &amp; IAS), property rights &amp; intra-regional capital flows</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Stage 2: Harmonization</td>
<td>Interest rate, External reserves, Central Bank Independence, Liberalization of intra-regional capital flows</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Stage 3: Co-operative</td>
<td>Regional assistance funds, PFM Assessment Programs (PFMAP), REI Investment Act (part of national tax reform) replicating ASEAN Investment Act Enhanced MFSF; MTEF, tax reform (including Investment code) consistent with MTFF &amp; MTSF, information on fiscal risks in annual budget</td>
<td>Exchange rate stability, Liberalization of intra-regional exchange controls, adherence to single intra-regional bank licensing authority</td>
<td>MTSF based on convergence criteria (World Bank Index of Doing Business, Global Competitiveness Index), removal of non-trade barriers to intra-regional trade, regional procurement system</td>
</tr>
<tr>
<td>Stage 4: Economic Union (EU)</td>
<td>Stage 4: Integration (completed)</td>
<td>MTEF (sectoral), Intrusive MTSF</td>
<td>Link national currencies to a basket of currencies reflecting regional trade pattern, with variations within prescribed limits</td>
<td></td>
</tr>
<tr>
<td>Stage 5: Monetary Union (MU)</td>
<td>Stage 5: Monetary Union (MU)</td>
<td>MTEF, Comprehensive MFSF (preventive, restorative and sustaining)</td>
<td>Choice of common currency and relative exchange rates for national currencies conversion</td>
<td></td>
</tr>
</tbody>
</table>

1. Refining the Design and Expanding the Context of Macroeconomic Convergence

The building blocks of regional integration in Africa are the AU-designated regional economic communities. The monetary integration programs of these RECs are also expected, eventually, to form the basis of the continental program. Refining the RECs’ macroeconomic convergence programs or frameworks towards enhancing their success should, therefore, also leverage both their respective financial integration (see Annex 4) and trade integration programs. A Bank Group study (AfDB, 2011) has suggested such a refinement, taking into consideration the stages of financial integration (and related actions at the levels of financial policy, financial infrastructure and financial institutions) and trade integration as well as the mechanisms in place.

The Bank Group study also suggests giving a prominent role to the dimension of fiscal management, which dominates monetary policymaking in African countries. In this regard, the macroeconomic convergence criteria at the different stages of financial integration should include indicators of good public financial management, including fiscal discipline, fiscal control, efficient resource allocation, and cost-effective service delivery, which would ensure that at entry point of the monetary union member countries possess a minimum standard of efficient PFM system in the interests of convergence and sustainability of the union. Indicators of such good public financial management include budget balance, debt stock, public arrears, and budget outcomes, which are already correctly included in the current macroeconomic convergence criteria of the various African RECs. However, as indicated above, the frameworks of convergence in these RECs would also benefit by their broadening to include broader criteria reflecting the stage of regional integration, financial and trade. The suggestions in this section are based largely on the study (see Box 2 below).

Free Trade Areas (FTAs)

Many of the RECs launched their macroeconomic convergence programs when they were at the FTA stage. The FTA, however, is the first level of formal economic integration. FTAs eliminate import tariffs as well as import quotas between signatory countries. While goods produced within the free trade area (and subject to the agreement) may cross borders tariff-free, rules of origin requirements must be met to prove that the good was in fact produced in the exporting country. Aside from a commitment to a reciprocal trade liberalization schedule, FTAs place few limitations on member states. No harmonization of regulations, standards or economic policies is required, nor is the free movement of capital and labor a necessary part of a free trade agreement. FTA signatory countries also retain independent trade policy with all countries outside the agreement. Intra-regional trade is unlikely to increase significantly under the FTA arrangement if member countries have similar production structures, and domestic and regional markets are too small to provide scale economies to commercial enterprises. Since economic diversification is a long-term process, FTAs members need to focus on exploiting export markets outside the region. The financial integration programs of the FTAs are also at the early stages, and would comprise mainly of the preparatory and harmonization programs: modernizing financial systems by implementing parts of international financial standards and exchange of information, and harmonizing and linking regional financial policies, institutions, and rules and regulations (see Table 2 above).

Therefore, macroeconomic stability is important not only for the monetary program but also to enhance the competitiveness of the economies. Supporting economic reform measures to ensure competitiveness would include (i) on the financial integration side, reducing fiscal fragility by limiting central bank financing of fiscal deficits, improving monetary and fiscal governance, and cooperating in cross-border financial supervision; and (ii) on the trade side, removing supply-side constraints through improving infrastructure in support of regional integration; modernizing monetary and fiscal systems and infrastructure, fostering implementation of various international standards and practices in the financial, fiscal and monetary sector that would ensure regional harmonization; and improving the business environment.
At this stage, political commitment to regional integration is still low and the incentives in the arrangement that could encourage high compliance are limited, given the low intra-regional trade and the absence of compensatory financing mechanisms. Therefore, ability to enforce compliance would still be weak. Sustainability of the mechanism, therefore, depends highly on a variable geometry approach, which would allow time for slow movers to catch up.

**Customs Union (CU)**
A customs union (CU) builds on a free trade area by, in addition to removing internal barriers to trade, also requiring participating nations to harmonize their external trade policy. This includes establishing a common external tariff (CET) and import quotas on products entering the region from third-party countries, as well as possibly establishing common trade remedy policies such as anti-dumping and countervail measures. A customs union may also preclude the use of trade remedy mechanisms within the union. Members of a CU also typically negotiate any multilateral trade initiative (such as at the World Trade Organization) as a single bloc. Countries with an established customs union no longer require rules of origin, since any product entering the CU area would be subject to the same tariff rates and/or import quotas regardless of the point of entry. In order to gain the benefits of a customs union, member countries would have to surrender some degree of policy freedom – specifically the ability to set independent trade policy. The returns to intra-trade liberalization would be larger if they took place in tandem with continued supply-side and other structural reforms to enhance market functioning and competitiveness.

Enhancing the convergence of RECs would require the establishment of concrete institutional arrangements to facilitate the transition from national, monetary, financial and trade policies to the unified regional ones. The common market is also backed by strong political will at the highest levels. Therefore, it is possible and desirable to set up regional surveillance mechanism to enforce implementation of the convergence program. At the same time, member countries would be able to enhance implementation by mainstreaming the
REC's convergence strategy and targets into their national development plans and poverty reduction papers. Variable geometry approach would still help to accommodate the slow movers.

Coordination among member countries would also help the development of regional infrastructure (for both real and financial sectors) and the related supportive services such as the establishment of regional money-markets, measures to enhance factor mobility and establishment of regional safety net mechanisms.

3. Enhancing Surveillance

Any effective multilateral surveillance mechanism that is established by a REC must reflect the stage of regional integration as well as the capacity of the countries. In particular, it has to recognize that, at the regional level, despite progress in regional integration, intra-regional trade remains low, and that economic benefits of membership in the regional organizations are still very low while political costs and economic trade-offs involved in implementing the programs could be high. Moreover, many of the REC member countries, generally low income and possessing limited financial and technical resources, are aid-dependent, implying that their capacity to implement programs is largely determined also by availability of external support. For this reason, and coupled by complications of internal constraints, reflecting underdeveloped infrastructure, financial market fragmentation and inflexibilities, and possibly shifting political priorities, there tend to be mismatches (or long lags) between decisions and implementation of REC programs.

The macroeconomic convergence program should, therefore, be so designed as to make obvious some immediate benefits accruing to participating and well-performing REC member countries to offset, or at least to minimize, the trade-offs incurred in meeting the criteria. A priori elements in the design would include the following (AfDB, 2011):

i) **Enhanced national ownership**: Multilateral surveillance should be built upon the commitment of countries to make progress towards the attainment of regionally agreed convergence criteria by implementing appropriate policies and programs. National ownership, or buy-in, of the macroeconomic convergence program is, therefore, an essential precondition for its successful implementation. The precondition could be satisfied if the regionally agreed convergence criteria are approved not only by the each member country’s political authorities, including the Cabinet and the Parliament, and are given wide publicity for public record and discussions, The ;

ii) **Variable speed and variable geometry approach**: There are varying degrees of preparedness and capacity of countries to implement the macroeconomic convergence program, reflecting their structural or other constraints. Therefore, countries should be allowed time to make the necessary adjustments to fulfil the criteria.

iii) **Social safety nets**: The support of mechanisms that help REC member countries cope with adjustment and other costs is important in introducing flexibility in policymaking, thus enhancing their ability to pursue the necessary policies towards meeting the convergence criteria.

iv) **Promotional surveillance framework**: While in an established economic and monetary union, the surveillance mechanisms ‘police’ the compliance of member countries with the union’s programs and disciplines countries accordingly, in less integrated systems; the surveillance framework cannot include sanctions apart from postponing the entry of the country into the monetary union. Instead countries should be encouraged and provided necessary support to be able to comply with the convergence program, making the mechanism one of promotion rather than policing. In this regard, the surveillance mechanism should help to identify policy formulation and implementation, weaknesses/gaps in individual countries, and mobilizing financial and technical assistance to address the weaknesses and to meet
the adjustment and investment costs to member countries of implementing appropriate measures during the transition period. The surveillance findings and recommended action plans for the countries could be set up as in Annex 4.

v) Institutional Frameworks for Surveillance: The existence of institutional frameworks of various layers of authority at both the national and regional levels would help provide adequate surveillance for the implementation of the macroeconomic program. At the national level, the surveillance committee could involve such relevant institutions as the central bank, ministry of finance, ministry of trade, and infrastructure. At the REC level, the institutional framework could involve assessments by the REC monetary institute that would be reported to a hierarchy of committees of including those of technical committee of convergence, central bank governors, ministers of trade, ministers of finance, convergence council of central bank governors and ministers of finance, and the heads of state.

vi) Institutional Strengthening and Capacity Building: To ensure improved performance in the design of macroeconomic convergence and supporting activities at the regional level, and the design and implementation of national policies as well as credible national and regional surveillance mechanisms, the RECs and their member countries need to build up related capacities. In this regard, institutional capacity building as well as the building of skilled and knowledgeable human resources is as critical as the development of the physical infrastructure.

vii) Availability of external technical and financial support: The implementation of the program, including the surveillance mechanisms should, of course, be driven by the national and the REC institutions. However, the capacity of African RECs to carryout effective and thorough surveillance would also depend on the available human and financial resources, which is likely to be limited. Therefore, they need to be assisted with ODA's and packaged institutional strengthening and capacity building programs. In particular, the Bretton Woods Institutions and the African Development Bank could provide strategic technical support. Even so, international aid and technical support cannot and should not substitute for countries’ efforts to achieve their objectives for regional macroeconomic convergence.

4. Enhancing Partnership

Role of Member Countries: African countries could ensure success in the implementation of macroeconomic convergence by:

i) Ensuring country ownership by sensitizing the national stakeholders, political, technical and private and ensuring that the implementation of macroeconomic convergence is mainstreamed as part of the national policymaking, including in the sector and national strategies as the financial sector, trade sector, regional integration strategies and the poverty reduction strategy;

ii) Establishing the necessary preconditions and capacity for effective achievement of the macroeconomic convergence criteria, including for the implementation of sound and sustainable macroeconomic policies and development of the financial sector infrastructure and institutional reforms as well as policies and investments to support trade development and integration;

iii) Undertaking periodic assessments of its performance and identifying gaps and challenges of implementation, ensuring that the assessments are reviewed through national surveillance institutions, which would also make appropriate recommendations for drawing up programs to address gaps and weaknesses identified; and

iv) Mobilizing technical and financial support from external development partners to build capacity and enhance implementation of the convergence programs.
Role of Regional Organizations

The RECs have designated their secretariats or set up special institutions such as the WAMI and the planned COMESA Monetary Institute to coordinate the design and implementation of the macroeconomic convergence programs. These organizations not only undertake the analytical work and the assessments related to the macroeconomic convergence program, they also organize the meetings of the various committees in the surveillance mechanism. These organizations will continue to play this role. However, in some RECs, the macroeconomic convergence program and the trade development program are coordinated by separate institutions of the REC.

Role of the Development Partners

The technical and financial support of development partners is important for enhancing the achievement of regional macroeconomic convergence. The table below suggests various areas where donor assistance could advance macroeconomic convergence and the larger agenda of regional financial integration in the RECs. These areas include not only regional financial integration but also the support programs and cover investments, capacity building, advocacy and analytical work. However, each development partner will have to develop its specific areas of support for specific RECs.
<table>
<thead>
<tr>
<th>Area</th>
<th>Macroeconomic Convergence Program and Support Activities</th>
<th>Capacity Building</th>
<th>Advocacy</th>
<th>Financing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regional Framework</td>
<td>Sharpen Regional Action Plans</td>
<td>Strengthen regional secretariats capacity</td>
<td>Upstream analytical work</td>
<td>Adjustment &amp; development costs</td>
</tr>
<tr>
<td></td>
<td>Coordinated national Action Plans</td>
<td>Strengthen national coordinating body</td>
<td>Technical assistance &amp; monitoring</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Aligning RFI and regional trade integration</td>
<td>Ministries of commerce &amp; trade, finance, &amp; central banks</td>
<td>Assessment of costs &amp; needs</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Surveillance</td>
<td>Institution building,</td>
<td>Technical missions</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Implementation of regional support programs – trade regional payments system, infrastructure, etc</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Country Level Support/Financial Policies and Investments</td>
<td>Monetary policies</td>
<td>Institutional capacity building: strengthening country systems to design and implement macroeconomic policies</td>
<td></td>
<td>Financial sector reforms</td>
</tr>
<tr>
<td></td>
<td>Fiscal policies</td>
<td>Ad hoc workshops &amp; training facilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Investment policies</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Implementation of national support programs – trade, infrastructure, etc</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sector Level</td>
<td>Financial regulation</td>
<td>Supervisory bodies, central banks, national governments.</td>
<td>Policy dialogue</td>
<td>Equipment costs</td>
</tr>
<tr>
<td></td>
<td>Financial Infrastructure</td>
<td>National payment systems</td>
<td>Workshops/training institutions</td>
<td>Personnel recruitment</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Legal systems, property rights, Judiciary</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
VI. Implementing Bank Role

The Bank has undertaken some analytical work that should benefit the upstream work related to macroeconomic convergence, including redefining the criteria and drawing a roadmap for the broader monetary integration program. Beyond that, the Bank support could be directed at three levels: regional, country, and market/sector levels, in line with its study on Regional Financial Integration and on facilitating Multilateral Fiscal Convergence in the COMESA, whose suggested areas of Bank support in turn reflected Bank Group Regional Integration Strategy and the Financial Sector Policy (see Annex). The guiding principles of the Bank’s interventions in regional integration and the financial sector, which should also guide its support to the macroeconomic convergence programs, include: ownership, comparative advantage and mandate, selectivity and value added, complementarity and partnership, relevance and synergy as well as focus on development results (see Box 1 below). The Bank’s support to the macroeconomic convergence program should also reflect its defined triple role in the broader regional financial integration as a catalytic financier, knowledge broker and partner.

**Box 1: Suggested Guiding Principles for Bank Group Support to the Macroeconomic Convergence Programs**

The support of Bank Group to the macroeconomic convergence program would be guided by the principles similar to those that guide its financial sector and regional integration activities, which include the following:

**Ownership:** Bank interventions will be conditioned upon commitment of the beneficiaries, and will also seek to empower them to participate in the design of the programs/projects and to take the lead in managing their implementation. At the regional level, the Bank will also ensure ownership of the macroeconomic convergence programs by the RECs, and their member countries;

**Comparative advantage and mandate:** The Bank Group has limited resources in relation to the magnitude and complexity of macroeconomic and financial sector challenges. The Bank will concentrate its efforts and resources in areas where it has clear mandate and comparative advantage, as reflected by its track record and internal capacity, and where it expects to make impact. In particular, the Bank will also be able leverage a number of its activities, including its advantage as a strategic partner of the APRM, where it supports assessments on macroeconomic and financial governance; its work on regional financial integration and fiscal convergence as well as broader regional integration; its Mid-term Strategy, with the focus on infrastructure development and private sector promotion;

**Selectivity and value added:** The Bank will evaluate the specific impact of its operations, as well as their long-term sustainability, and ensure ‘best value for its money’. Furthermore, as a multi-sector institution with its focus on governance, infrastructure development and regional integration, the Bank will take a broad view of development and help to apply macroeconomic convergence and the broader regional financial integration program within a broader context of financial sector, regional integration and poverty reduction dimensions. It may, therefore, intervene in those areas which it considers necessary in the context of its own core strategy and where other institutions may not be involved or involved insufficiently. For example, in addition to the area of financial integration, where the Bank is building expertise, it can also add value in such supporting areas as capacity building and knowledge management, private sector development, and governance;

**Complementarity and partnership:** The Bank is one of many institutions and donor organizations that are actively pursuing strategies to support financial sector development and impact in African countries. Moreover, given its limited resources, the Bank cannot play a sole leadership role in this area and must foster strategic partnership with others, especially the Bretton Woods Institutions, which have the mandate, the resources, and technical capacities to assume that role. Partnerships are key to effecting co-ordination, efficient use of scarce resources, as well as mutual learning and knowledge exchange. Bank support will, therefore, be based on its ability to complement programs of other development partners that include, besides the Bretton Woods Institutions, the Bank for International Settlements, Financial Stability Forum and key bilateral agencies at the international level and the UNECA, AU, RECs and REC institutions, at the regional level;
Relevance and synergy: The Bank's interventions will be tailored to regional and countries' financial sector challenges, reform priorities and potential for progress. It will also be based on the need to create positive interactions with the rest of the Bank's portfolio, especially involving areas of the Bank's core mandate such as governance, infrastructure development, regional financial integration and the provision of technical assistance in which it has a clear mandate and comparative advantage. Within the financial sector also, interventions at regional, country, sector and institutional levels will be made coherent and supportive of each other; and

Focus on development effectiveness and results: The Bank Group will strive to achieve tangible results in the financial sector operations that it supports. Greater attention, therefore, will be paid to monitoring the implementation process closely; and providing necessary and timely technical support to ensure successful outcomes.

Source: Adapted from the African Development Bank Regional Integration Strategy (2009) and the Financial Sector Strategy (forthcoming, 2011)

However, the Bank's role and strategy in supporting macroeconomic convergence should be developed on the understanding that it is a relatively new player in providing assistance for financial sector programs,17 and that other institutions, such as the IMF, the World Bank, BIS and the European Commission, have been active in this area for a long time and have a clear comparative advantage.

Nevertheless, the Bank can make a useful contribution based upon its unique knowledge of African conditions, and experience in specific areas of the financial sector such as the assessments under the African Peer Review Mechanism. The Bank also has the advantage as the only multilateral institution (with the exception of the EU) that can provide direct financial and technical assistance to REC organizations to support the macroeconomic convergence program.

At regional level, the Bank has so far focused on assisting some of the REC institution charged with coordinating the macroeconomic convergence program and could continue to do so, including assessments, identifying weaknesses and helping to formulate programs to address them, as well as technical and financial support to the implementation of related capacity building and investment programs. At country-level, the Bank has identified its comparative advantage to include strengthening country systems for implementing macroeconomic programs and managing public resources with an emphasis on enhancing aggregate fiscal discipline and public debt management capacity. The Bank could also provide technical and financial support in implementing some of the investment support programs. At the sector level, the Bank could support the implementation of policies to help improve the functioning of the markets – financial, labor, goods and capital.

17. Notably, the adoption of the Financial Sector Policy in 2003 as well as the establishment of the Financial Reforms Division and the Regional Integration Division in 2006 enhanced the Bank Group role in the financial sector.
VII. CONCLUSION

Africa's regional financial integration agenda includes a macroeconomic convergence program, intended to achieve and maintain macroeconomic stability and laying the basis for eventual monetary union in the various RECs that form the building blocks of the continental regional integration agenda. In the concerned RECs, targets for key macroeconomic variables have been set out against a timeline. However, while most Sub Saharan African countries have recorded solid macroeconomic performance in recent years, reflecting strong economic reforms, the convergence targets have not been generally achieved on a consistent basis. The diversity of REC member countries also means that macroeconomic targets that may be considered realistic and appropriate for one subgroup of member countries may be unachievable and/or inappropriate for other subgroups of member countries.

Even so, the macroeconomic convergence criteria, as currently defined, miss an important dimension of the conditions for financial integration, and that reflects the need for corresponding progress on the real sector (or trade) integration. The external development partners, especially, the Bank could build the capacity of the RECs and provide other technical and financial support to enhance the relevance of the programs being implemented. While the Bank can provide such support in the context of its ongoing regional integration and financial sector activities as well as its sector operations, support to specific RECs should be based on detailed assessment of the challenges within the REC.
ANNEXES

Annex 1: SADC Macroeconomic Convergence Commitments

SADC member states’ commitments to macroeconomic convergence are outlined in their Finance and Investment Protocol (FIP):1

Principles. Regional economic integration and macroeconomic stability are preconditions to sustainable economic growth and for the creation of a monetary union in the region...In order to achieve and maintain macroeconomic stability within the region, [member states] shall converge on stability-oriented economic policies implemented through a sound institutional structure and framework... Stability-oriented policies include but are not limited to restricting inflation to low and stable levels, maintaining a prudent fiscal stance based on the avoidance of large budget deficits, monetization of deficits, and high or rising ratios of public and publicly guaranteed debt to GDP; avoiding large financial imbalances in the economy; and minimizing market distortions.

Indicators and data. Macroeconomic convergence in the region shall be measured and monitored by the following indicators: the rate of inflation, the ratio of the budget deficit to GDP, the ratio of public and publicly guaranteed debt to GDP, taking account of the sustainability of such debt; and the balance and structure of the current account. Data shall be provided in accordance with international standards as defined by the IMF.

Fiscal and monetary cooperation. Member states shall formulate, implement and maintain fiscal and monetary policies that are transparent, consistent, and contribute toward the achievement of macroeconomic stability within the region; and formulate and implement fiscal and monetary policies that are sustainable and minimize negative spillover effects into other member states.

Monitoring and surveillance: An annual review of macroeconomic convergence programs by a peer review panel (comprising Ministers of Finance and Central Bank Governors), which shall issue a communiqué explaining its assessments. The first round of convergence reports was prepared in 2005–06 and tabled before ministers of finance and investment in mid-2007.2 An overview update was prepared by the SADC secretariat in April 2008.

1 These were first laid out in a memorandum of understanding in 2002 and reiterated in the RISDP in 2003. Their inclusion in the FIP, which all member states signed in 2007, makes them legally binding in theory. In practice, however, implementation of SADC protocols has been patchy. There are also few references to the convergence criteria in national policy documents.

2 See http://www.sadc.int/tifi/macroeconomicpolicies_convergence/reports.php

Source: IMF.
In general terms convergence can be defined as the narrowing of international differences in the development of certain economic variables. As a requirement for a system of stable exchange rates, a distinction must be made between nominal convergence, which is the convergence of the development of costs and prices and their underlying determinants, real convergence of working conditions and living standards and the convergence of economic institutions or structures.

Real convergence is one of the fundamental objectives of a fully integrated REC, but it is a long-term process and it is not a necessary condition for a successful movement to an economic and monetary union. In a monetary union inflation rates must be similar, so it is important to insist that countries demonstrate that they are willing and able to converge on this parameter before the union is finalized. This demonstration involves getting inflation rates aligned, without strain. The strain would show up in indices of competitiveness, in unemployment and in external balance.

Lack of strain implies some conditions, on underlying economic variables, such as fiscal and external balances. Convergence of price performance can only be maintained when such underlying factors do not put pressure on prices to diverge again. This does not mean that fiscal and current account balance are required, but rather that they must be consistent with internal and external equilibrium. If a region is far away from its non-accelerating inflation rate of unemployment (NAIRU) or its fundamental equilibrium exchange rate, this cannot be sustainable and some sort of adjustment toward equilibrium will take place.

For instance, a prolonged overvaluation of the real exchange rate associated with a current account imbalance is not sustainable. Such a situation will lead to lower exports, higher imports and the gradual de-accumulation of reserves. These will all lead to lower demand and put downward pressure on prices. Current account deficits will be easier to finance in a fully integrated union with free capital flows, but this will be at the cost of higher interest payments.

This does not rule out an economic and monetary union, but it has implications for the costs of adjustment. An economy cannot continually diverge from its NAIRU because automatic stabilizing mechanisms will eventually produce adjustment. The further from equilibrium a country is and the longer this lasts, the more painful the adjustment will be. The transition from high to low inflation also involves reducing nominal interest rates and reducing fiscal deficits. It is arguable that this transition should be made before joining monetary union.

Fiscal balance may not be required for all countries, or a full convergence of public debt positions. But it is generally accepted that a situation of prolonged fiscal deficits and a rising debt to GDP ratio is not sustainable. The increasing burden of servicing the public debt reduces fiscal flexibility. If countries are not in a monetary union this burden may put upward pressure on real interest rates, and may ultimately lead to monetary financing or inflation tax as methods of reducing the real debt stock. Individual countries within the union have fewer financing options, which explains the need to ensure some level of comparable fiscal adjustment before the union starts.

Annex 3:

### Regional Financial Integration: A Generic Roadmap for Regional Financial Integration

<table>
<thead>
<tr>
<th>Stage of RFI</th>
<th>Domestic measures</th>
<th>Regional measures</th>
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</thead>
<tbody>
<tr>
<td>Preconditions</td>
<td>Macroeconomic stability Bank soundness</td>
<td>Agreement to establish FTA; Regional secretariat to advance and implement regional agenda; Exchange of information and regular meetings between monetary and financial authorities; Regional committees to delineate areas and modalities of integration process; Bilateral and regional agreements to offer technical assistance to 'less developed' members to upgrade their financial system;</td>
</tr>
<tr>
<td>Stage I: Preparatory</td>
<td>Improve national payment systems (RTGS) to reduce payments delays and transfer costs. Strengthen bank supervision and regulatory framework ('partial' compliance with BCPs); Improve accounting standards (IFRS); Improve core elements of legal system (land and corporate registries, property rights, contract enforcement);</td>
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<tr>
<td>Member countries begin to take steps to modernize their financial systems by implementing parts of international financial standards and initiate exchange of information among themselves regarding the program being made.</td>
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<td>Stage II: Harmonization</td>
<td>Expand payment systems to include electronic fund transfers, security deposit systems, and payment switches; devise cost-effective systems for small transfers; Further strengthen bank supervision and regulation by 'large' compliance with BCPs, IAIS, &amp; IAS; Remove intra-regional exchange controls; Liberalize foreign capital inflows; Strengthen stock exchange (if it exists) rules and regulations, and implement supervision (IOSCO) principles; Substantially complete the modernization of the financial systems, making them market-based; Central bank autonomy and reinforced supervisory authority; Remove barriers to entry of regional and foreign banks to improve competition; Develop national credit information systems.</td>
<td>Agreement on relevant convergence criteria (voluntary compliance); Establishment of (advisory) surveillance and monitoring mechanism; Regular meetings between country regulators and supervisors; Harmonization of policies regarding inward capital flows; Liking national payments systems (REPSS&lt; TARGET); Establish private financial sector consultative bodies (association of bankers, accountants, stock exchanges, etc.); Regional physical infrastructure development bodies;</td>
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### Regional Financial Integration: A Generic Roadmap for Regional Financial Integration

<table>
<thead>
<tr>
<th>Stage of RFI</th>
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<th>Regional measures</th>
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<tr>
<td>Stage III Cooperative</td>
<td>Gradually liberalize exchange controls vis-à-vis the rest of the world;</td>
<td>Agreement to establish customs union;</td>
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<td></td>
<td>Implement regionally agreed convergence criteria;</td>
<td>Regional FDI regime;</td>
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<td></td>
<td>Coordination of monetary and exchange rate policies</td>
<td>Establishment of comprehensive convergence criteria (mandatory) and its monitoring with MDBs/IFIs support;</td>
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<td>Full harmonization of regulatory, supervisory, and accounting standards;</td>
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<td>Single bank licensing, cross-border participation of regulators and supervisors in bank supervision;</td>
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<td>Development of a centralized credit information system;</td>
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<td>Development of region-wide securities market infrastructure and regulations;</td>
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<td>Stage IV</td>
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<td>Fully effective customs union;</td>
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<td>Stage V</td>
<td></td>
<td>Unified stock exchange;</td>
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<td></td>
<td>Exchange local currency for a regional currency; Reserves in common</td>
<td>Adoption of broad legal system (e.g. OHADA treaty in by WAEMU countries);</td>
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<td>Partial pooling of reserves;</td>
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<td>Regional bond market</td>
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<td>Regional central bank</td>
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<td>Regional common currency</td>
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Source: AfDB: Regional Financial Integration in Three African Subregions, 2009
### Annex 4:

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<th>Assessments (Observations)</th>
<th>Recommendations</th>
<th>Ongoing programs envisaged by authorities</th>
<th>Additional programs and reforms to be supported by development partners</th>
<th>Possible institutions that can provide support</th>
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<td>Macroeconomic policies</td>
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<td>* Fiscal</td>
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<td>Financial Infrastructure</td>
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<td>Trade Policies</td>
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<td>Trade Infrastructure</td>
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<td>Other Regional Issues</td>
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SUPPORTING MACROECONOMIC CONVERGENCE IN AFRICAN RECs

Jian Zhang