



Review of the SADC Macroeconomic Convergence Programme for 2008

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Contents

1. Introduction	1
2. Macroeconomic Performance in Relation to MEC Targets for 2008	2
Macroeconomic Performance - 2008	3
3. Assessing the Likelihood of Meeting MEC Targets for 2012 and 2018	6
Reduced Capital Inflows	7
Slower Economic Growth	7
Challenging Balance of Payments	7
Larger Fiscal Deficits	8
Higher Public Debt	8
Inflation	8
4. Assessing the Viability of the SADC MEC Criteria and Numerical Targets	9
The Rationale for Choice of MEC Targets	9
Policy Convergence vs Convergence of Outcomes	12
5. Review of Indicators and Benchmarks for Macroeconomic Convergence	13
Inflation	13
Measures of Inflation	13
Choice of Convergence Targets	14
Fiscal Balance	14
Measures of Fiscal Balance	14
Choice of Convergence Targets	15
Public Debt	17
Measures of Public Debt	17
Current Account of the Balance of Payments	18
Conclusion	19
Definitions and Data	20
Decision	21
6. Consistency of the SADC MEC Programme with Other MEC Programmes	21
7. Sequencing of Regional Economic Integration towards Monetary Union	22
Economic Policy Implications of Monetary Union	25
8. The Potential Costs and Benefits of Monetary Union	27
Potential Benefits	28
Potential Costs of Monetary Union	30
9. Proposed Criteria for Admission to Monetary Union	32

List of Tables

Table 1: Macroeconomic Targets 1
Table 2: Other Macroeconomic Targets 1
Table 3: Proposed Revised Macroeconomic Targets 20
Table 4: Sequencing of Regional Integration 23
Table 5: Convergence Criteria in SADC, COMESA, WAMZ, WAEMU, CEMAC, ECCU & EU 35

Abbreviations

CAD	Current Account Deficit
CEMAC	Communauté Economique and Monetaire de l'Afrique Centrale (Economic and Monetary Community of Central Africa)
CET	Common External Tariff
CFA	Communauté Financière de l'Afrique
CM	Common Market
CMA	Common Monetary Area
COMESA	Common Market for Eastern & Southern Africa
CU	Customs Union
ECCB	Eastern Caribbean Central Bank
ECCU	Eastern Caribbean Currency Union
EMU	European Monetary Union
FDI	Foreign Direct Investment
FIP	Finance and Investment Protocol
FTA	Free Trade Area
LIC DSA	Low Income Country Debt Sustainability Analysis
MEC	Macro-economic Convergence
MU	Monetary Union
OCA	Optimum Currency Area
ROO	Rules of Origin
SADC	Southern African Development Community
WAEMU	West African Economic and Monetary Union (UEMOA in French)
WAMZ	West African Monetary Zone

Review and critique the relevance of the convergence criteria and numerical targets

1. Introduction

The SADC Macroeconomic Convergence (MEC) programme involves a commitment by Member States to meet a set of macroeconomic convergence criteria at three points in time over the period 2008 to 2018. The primary criteria were laid out in the Memorandum of Understanding on Macroeconomic Convergence, signed by Member States in 2002, and are as follows:

Table 1: Macroeconomic Targets

Year Indicators	2008	2012	2018
Inflation annual rate	<10%	<5%	<3%
Fiscal Deficit/GDP	<5%	<3%	<3%
Public Debt/GDP	<60%	<60%	<60%
Current Account/GDP	<9%	<9%	<3%

A secondary set of quantitative macroeconomic targets were laid out in the Regional Indicative Strategic Development Plan (RISDP) as follows:

Table 2: Other Macroeconomic Targets

Year Indicators	2008	2012	2018
Economic growth	7%	7%	7%
External reserves (import cover, months)	3	6	6
Central bank credit to govt (% of revenues)	10%	5%	5%
Domestic savings (% GDP)	25%	30%	35%
Domestic investment (% GDP)	30%	30%	30%

This paper has several objectives related to a review of the MEC criteria and performance against them, set out in the Terms of Reference as follows:

- Based on the performance of MEC programme up to 2008, assess the possibility of Member States meeting the targets for 2012 and 2018.
- Taking into consideration economic developments at local, region and international levels, and taking into account the structural and developmental

differences of the economies in the region assess the viability of the SADC MEC criteria and numerical targets. This should also take into consideration the objective of the MEC programme, i.e. macroeconomic policy convergence, preparation for a monetary union, etc.

- c. Propose the most feasible and flexible scenario of the MEC criteria and numerical targets (for 2012 and 2018) without compromising the overall credibility of the programme.
- d. Identify factors (macroeconomic policies, structural factors, institutional factors, etc) that are prerequisites to Member States' attainment of convergence in the agreed convergence indicators and targets.
- e. Assess the consistency of the MEC programme with other regional and supra-regional macroeconomic convergence programmes such as the EAC and AU.

The paper also considers some more general issues related to the process of regional economic integration, specifically:

- f. Outlining the advantages and disadvantages for the region of the proposed Monetary Union.
- g. Recommending whether it is a prerequisite to have a Customs Union and Common Market before having a Monetary Union.
- h. Propose criteria for entry into the MU and a mechanism of enforcement of the criteria and set targets.

2. Macroeconomic Performance in Relation to MEC Targets for 2008

Macroeconomic Environment

2008 has been a very difficult year for SADC economies, as indeed it has been for the whole world. As it stands, the global economy is experiencing a period of dramatic growth slowdown which in many countries has resulted in negative growth, and in some cases deep recession. International trade volumes have fallen sharply. It is widely acknowledged to be the most serious economic crisis since the 1930s. There is widespread uncertainty over how long the crisis will last, how deep it will be, and how robust the eventual recovery will be. Given the extent of global economic problems, there are likely to be dramatic changes in the way in which economic and financial systems operate in the coming years, in particular with respect to financial sector regulation, the role of governments, and the level of international capital flows. The process of globalisation that has underpinned rapid growth and increases in real incomes over the past few decades is likely to slow, and although it may not be put into reverse, many aspects of globalisation are likely to be reconsidered.

There are many implications for developing countries. Although most developing countries have not experienced systemic financial crises, cross-border financial flows have dropped sharply. Access to international financial markets has been curtailed as a result of rising risk aversion and the expectation of major fiscal deficits in the advanced economies that will divert available savings. Developing countries that have been financing investment needs and balance of payments deficits from those

markets are already finding that financial conditions have deteriorated and that finance is scarce and expensive. Portfolio capital outflows have undermined equity and bond markets and weakened currencies. Trade finance is contracting and foreign direct investment has dropped. The least developed countries, which have generally made little use of commercial financial markets, may face problems from reduced remittance inflows from migrants and pressure on donor-financed aid budgets. There will be increased calls on the financial resources of regional and multilateral lenders such as the IMF, World Bank and African Development Bank, whose resources are being expanded.

In the short term, however, for most developing countries, financial issues are likely to be dominated by trade and growth issues. Lower export volumes and prices are in turn leading to growth slowdowns and widening balance of payments deficits. Fiscal problems are also emerging. Policy responses to the crisis are constrained by uncertainty over how long it will last. While many countries have improved their macroeconomic and fiscal positions in recent years, and have benefitted from extensive reforms, these gains are now under threat. Fears of rising protectionism compound the concerns regarding trade and growth, and add to uncertainty about the timing and pace of recovery. On a global basis, there is a real danger that protectionism could undermine the potential gains from the fiscal stimulus packages being implemented in the advanced economies.

SADC economies cover a wide spectrum, from middle income countries with access to global financial markets to less developed countries dependent upon donor financing to fragile states. Trade patterns also vary considerably, although many SADC countries are dependent upon commodity exports of one form or another. All SADC economies will suffer from reduced growth, and most likely rising unemployment and poverty levels, while some will experience outright recession. Countries dependent upon mineral exports (notably Angola, Botswana, DR Congo, Mozambique, Namibia and Zambia) have already suffered from a sharp drop in export earnings. But even countries dependent upon manufactured exports and tourism are experiencing a similar, although perhaps not quite as large, deterioration in their balance of payments, given the widespread nature of the global recession. Fiscal deficits are expected to rise given the importance of commodity taxes and trade taxes in revenues, compounded by additional expenditure demands from social safety nets. Generally, SADC countries are experiencing or will experience a range of adverse economic developments: reduced export earnings and wider current account deficits; slower growth, rising unemployment and poverty; reduced financial inflows from FDI, portfolio investment and remittances; deteriorating fiscal positions and rising public debt; and uncertainty over donor aid flows. The only generalised positive development is lower inflation as oil prices fall, which will provide scope for lower interest rates to offset some of the adverse economic conditions.

Macroeconomic Performance - 2008

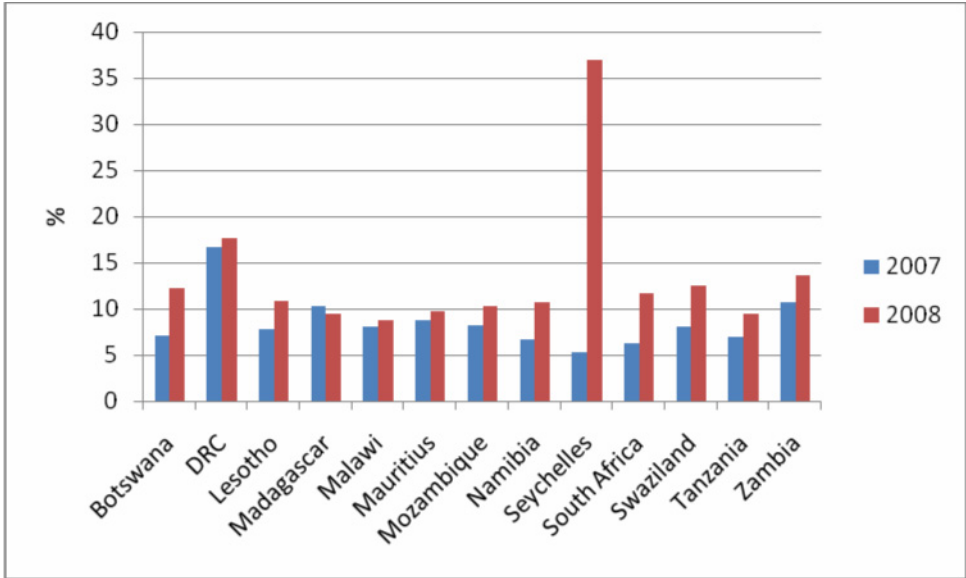
Notwithstanding the dramatic impact of the global financial and economic crisis, the impact was only really being felt towards end of year. Macroeconomic

performance in SADC in 2008 was largely dominated by earlier problems of food- and oil-price induced inflation.

With regard to the Primary Macroeconomic Convergence Indicators, performance was very good with regard to the **fiscal balance** and **public debt** indicators. This reflected many years of fiscal reforms and measures undertaken to implemented sustainable public finances, combined with the benefits of debt relief through HIPC and other initiatives. In 2008, all countries except Malawi and Zimbabwe met the SADC target for fiscal balance, and all countries except Zimbabwe and DR Congo met the public debt target.

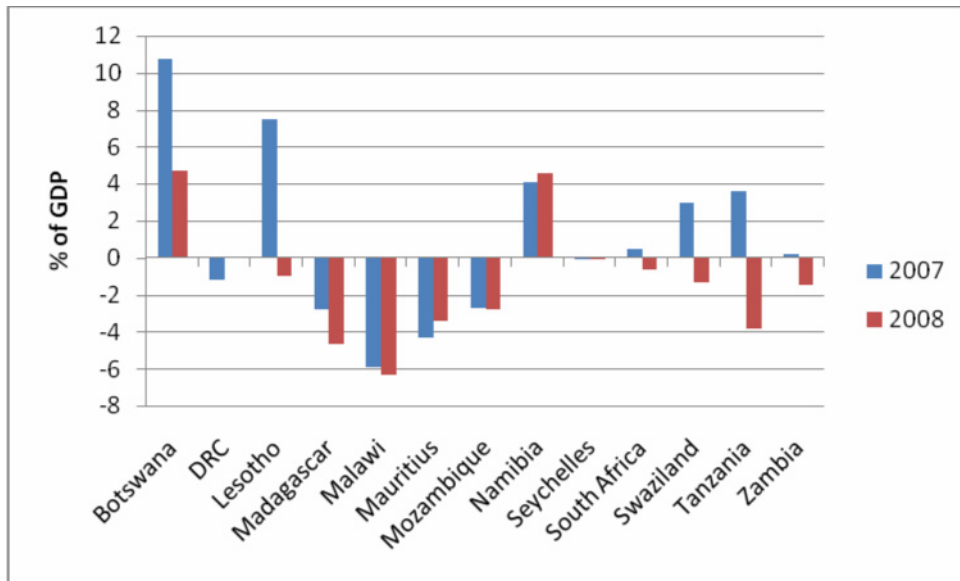
The main problem was in respect of **inflation**. Whereas in 2007 most SADC countries achieved single digit inflation, the upward pressure of rising food and oil prices pushed inflation up almost everywhere. In 2008, only three countries (Madagascar, Malawi and Tanzania) achieved single digit average annual inflation, and the lowest inflation rate achieved was 8.7%.

Figure 1: Inflation, 2007-8



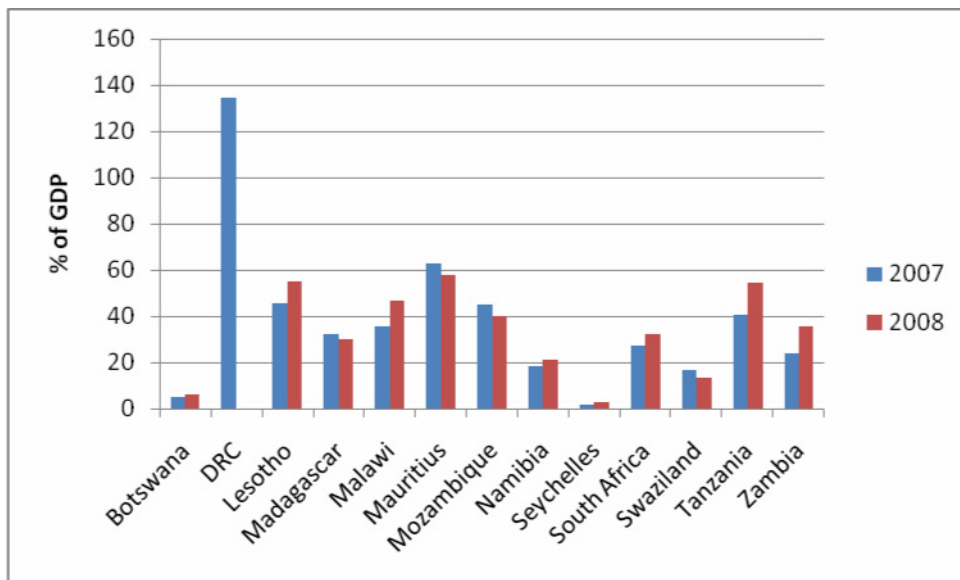
Source: National Authorities

Figure 2: Fiscal Balance, 2007-8



Source: National Authorities

Figure 3: Public Debt, 2007-8



Source: National Authorities

Current account deficits rose sharply, from an average of 4.4% of GDP in 2007 to 9.9% in 2008, largely reflecting higher import costs for food and fuel. Seven out of 15 SADC countries met the MEC target in 2008, compared to 10 in 2007.

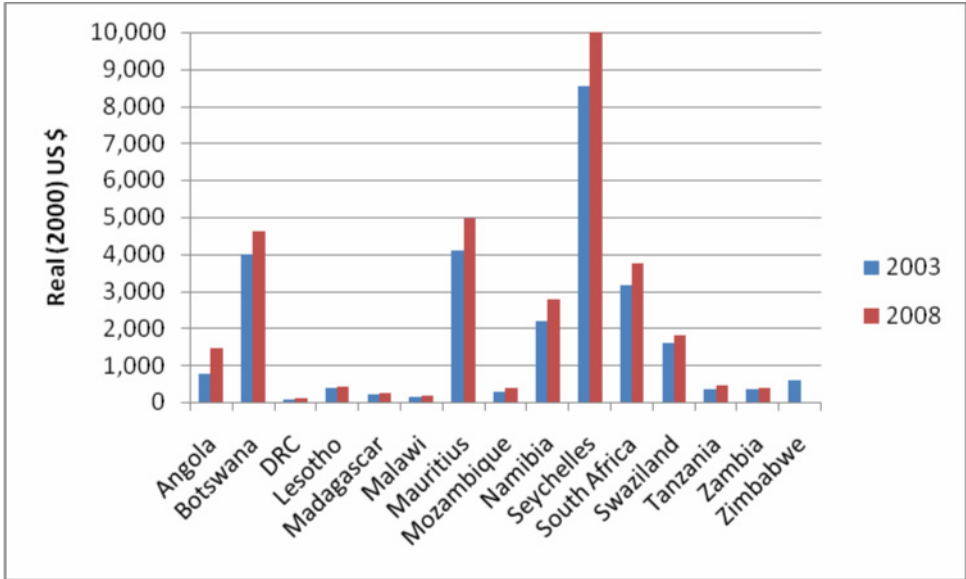
Economic growth has fallen somewhat in 2008; average real GDP growth (excluding Zimbabwe) fell from 6.6% in 2007 to 5.9% in 2008. However, only five of the 15 SADC countries met the 7% growth target in 2008, the same number of countries as in 2007.

Import cover (foreign exchange reserves) fell slightly, from an average of 6.4 months in 2007 to 5.4 months in 2008, reflecting deteriorating balance of payments conditions.

Investment rates improved from an average of 21% of GDP in 2007 to 24% in 2008, but remain low, with only two countries (Botswana and Madagascar) surpassed the SADC target in 2008. There was a similar story with respect to **domestic savings**, which also rose slightly (from 18% to 20% of GDP), but only three SADC countries met the MEC target in 2008. Data provision was quite poor for savings and investment, with nearly half of SADC members failing to provide data in 2008.

Real GDP per capita: while this is not a formal convergence target, one of the aims of macroeconomic convergence is to reduce the dispersion in real income levels throughout SADC. However, the region remains split between a group of middle income countries with income above US\$1000¹ (Botswana, Mauritius, Namibia, Seychelles, South Africa, Swaziland), and low income countries (DR Congo, Lesotho, Madagascar, Malawi, Mozambique, Tanzania and Zambia). Only one country has moved between groups, i.e. Angola, which has experienced rapid oil-driven growth and the benefits of the ending of the civil war. The countries with the largest increase in real per capita income between 2003 and 2008 are (in order): Angola, Mozambique, Tanzania, Namibia, Malawi and Mauritius, which suggests that there is no tendency for lower-income countries to grow faster.

Figure 4: Real Per Capita Incomes, 2003 & 2008



Source: IMF

3. Assessing the Likelihood of Meeting MEC Targets for 2012 and 2018

The period between 2008 and the next assessment date for meeting the SADC MEC targets in 2012 will be dominated by the fallout from the global financial and economic crisis, and the anticipated global recovery. At the time of writing (May 2009), there is still no clarity as to what form the recovery will take, and how fast it will

¹ At 2000 prices, using 2000 exchange rates.

be; however, the consensus expectation is that global economic growth will turn positive in the second half of 2009, but that the recovery will be weak and sluggish.

The medium-term impact of the global crisis on SADC countries will therefore be an important determinant of whether Member States will be able to meet the 2012 targets. The main expected medium-term impacts are summarised below.

Reduced Capital Inflows

The global crisis has been associated with an increase in the level of risk-aversion and sharply reduced cross-border capital flows. At the same time there have been many changes in the structure of global financial institutions, with bankruptcies, mergers and takeovers, as well as an increased ownership stake for governments in the financial systems of developed countries. The regulatory structure has been found wanting, and is likely to go through a period of considerable change as regulations are tightened and previously unregulated activities are brought within the supervisory net. As global economic recovery takes place and there is increased liquidity in the financial system, the availability of finance for developing countries should improve. However, it is unlikely that the situation will return to the “status quo” before the crisis, for several reasons. First, the level of risk aversion may well remain elevated, resulting in the reduced availability of funds for risky/emerging market borrowers, and the necessity of paying higher prices (interest rates). Furthermore, financial institutions with high levels of government ownership are more likely to demonstrate “home bias” and may be less willing to lend to or invest in developing countries. Finally, while there is uncertainty over the regulatory regime that will emerge from the crisis, there may well be higher capital requirements which could further constrain the availability of funds for developing countries. There will be greater reliance on multilateral financial institutions such as the IMF, World Bank and African Development Bank for access to finance.

Slower Economic Growth

The world economy is likely to contract in 2009 and forecasts indicate relatively slow – i.e. below-trend – growth in 2010. In contrast to previous recessions, world trade is projected to shrink in 2009 – in earlier recessions, trade has merely stagnated. As most SADC economies are highly export-dependent, this will create a drag on growth rates. Robust growth in the world economy and international trade is only expected in 2011. Even then, very high levels of public debt in major developed economies, leading to higher interest rates, combined with the process of rebuilding balance sheets of financial institutions, are likely to constrain growth in those economies, leaving emerging markets to bear much of the burden of driving global growth. Lower international capital flows – whether in the form of foreign direct investment or short-term portfolio flows – will constrain investment rates, which will further undermine growth, especially in countries with low domestic savings rates.

Challenging Balance of Payments

The slowdown in exports will exacerbate balance of payments problems, most likely leading to larger current account deficits in the short-term. Reduced capital flows will make such deficits more difficult to finance. Larger deficits will have to be financed

by drawing down foreign exchange reserves. However, most SADC countries have relatively low reserves and their ability to finance ongoing balance of payments deficits will be limited. If there are medium-term capital constraints, economies will have to adjust and current account deficits will necessarily be reduced. This process may involve weaker currencies – already happening in some countries – which will help to boost exports as the world economy recovers, and restrain imports, thus bringing current account deficits into line with the ability to finance them. Lower investment rates – impeding future growth – are also part of this adjustment process.

Larger Fiscal Deficits

Slower growth and lower levels of international trade are likely to reduce government revenues, while expenditures are likely to increase as governments face demands for larger social safety net provision. Hence fiscal deficits are likely to grow, posing financing challenges for governments. With reduced international capital flows, there will be greater reliance on domestic financing, in which domestic financial markets will have to play an important role, especially bond markets. Policy responses will need to include measures to encourage domestic savings, as well as fiscal reforms to improve revenue collection. Higher borrowing requirements may lead to higher interest rates, which can lead to a crowding out problem for private investment, but will help to encourage savings. Monetary financing of deficits would generate inflationary pressures.

Higher Public Debt

To the extent that fiscal deficits are financed by increased borrowing, public debt is likely to rise. When combined with constrained international capital flows, this is likely to mean mostly domestic debt, which may be more expensive than foreign debt but has the advantage of not being exposed to currency risk.

Inflation

The collapse in commodity prices in the second half of 2009, combined with the global economic slowdown, means that inflationary pressures have abated globally. Inflation rates in most countries are falling. In the short-term, inflation pressures are unlikely to be a problem, except to the extent that they are generated by currency weakness pushing up import prices. Further ahead, the situation is more uncertain. The global response to the economic crisis has involved massive monetary expansion and debt issuance, which could in the medium-term lead to the re-emergence of inflationary pressures, although much depends on the policy response of central banks should this occur.

The medium-term impact of the global financial and economic crisis will certainly make it more difficult for SADC members to meet some of the 2012 MEC targets: the immediate outlook is for rising fiscal deficits, rising public debt, increased current account deficits, slower growth and declining foreign exchange reserves, combined with declining inflation. However, it is likely that the adverse trend will reverse prior to 2012, so at least MEC indicators should be moving in the right direction.

Looking further ahead to the next MEC assessment date in 2018, it is not possible to make any realistic assessment of global and regional macroeconomic conditions that far ahead. These may be unfavourable or favourable for the achievement of the MEC targets. However, even with favourable macroeconomic conditions, achieving the targets will be demanding: keeping inflation below 3% and fiscal deficits below 3% of GDP has never been achieved for a sustained period for most SADC countries and will require deep structural changes and building on policy reforms that are already under way in many countries. The necessary reforms include:

- improving the efficiency of product, labour and financial markets through enhanced competition and improving the effectiveness of the price mechanism;
- increasing economic flexibility through factor mobility and improved supply responses;
- higher levels of productivity through investment in education, skills and training, and addressing legal constraints;
- reducing cost levels and improving competitiveness;
- pursuing trade reforms, especially using tariff reform to bring down cost levels, and implementing trade facilitation measures to reduce the costs of international trade;
- fiscal reforms to simplify tax regimes and improve revenue mobilisation;
- investment in economic infrastructure; and
- taking advantage of the economies of scale and potential for cost-reduction offered by regional economic integration, and being prepared to forego national sovereignty in order to achieve greater regional integration.

4. Assessing the Viability of the SADC MEC Criteria and Numerical Targets

The Rationale for Choice of MEC Targets

The rationale for the adoption of the macroeconomic convergence as an objective in the SADC Finance and Investment Protocol (FIP) and the related targets appears to be based on three separate but related objectives:

- (i) improving the performance of the SADC economies and of the region as a whole; raising economic growth rates and per capita incomes, reducing poverty and achieving the Millennium Development Goals;
- (ii) deepening regional economic integration in general; and
- (iii) ultimately, achieving the highest form of regional integration, that is, monetary union.

It should be noted that objective (i) does not require macroeconomic convergence *per se*, but simply an improvement in macroeconomic performance. This in turn requires the adoption of growth-enhancing macroeconomic policies and, particularly in the case of those countries facing macroeconomic instability (now or in the recent past), the adoption of stabilisation policies to bring the situation under

control. More generally, objective (i) requires focusing on the progressive adoption of macroeconomic policies and an institutional framework that will support higher growth, including market-friendly policies to improve resource allocation and provide appropriate incentives; improvements in the investment environment to support higher and more productive investment by both the public and private sectors; and policies to boost trade. While macroeconomic convergence is not central to the adoption of stabilisation and growth-enhancing macroeconomic policies, it will nonetheless be a result, especially if stabilisation is effective in the “outlier” countries – those with high inflation, high budget deficits, unstable balance of payments, and low economic growth rates.

Many SADC Member States have experienced considerable improvements in their economic performance through the successful adoption of stabilisation policies over the past 25 years, and in some, the process is still ongoing. Even for those that have achieved macroeconomic stability, appropriate macroeconomic policies have to be maintained. But in almost all SADC states, even those with relatively favourable macroeconomic environments, growth rates are still too low to bring about the rapid reduction in poverty that will contribute to the widespread and meaningful improvement in living standards that remains an overriding objective.

In pursuit of higher growth, one of the key economic objectives of SADC is the pursuit of greater regional economic integration (objective (ii) above). This has a number of motivations. All SADC states except South Africa are small by global economic standards, with small domestic markets, and there are considerable potential benefits to be derived from trade liberalisation initiatives aimed at providing access to a much larger, integrated, regional market; these benefits include the welfare gains from increased trade and the efficiency gains that can be derived from economies of scale in production, although they may be offset by the costs of trade diversion.

Besides the obvious requirement of reducing tariffs on intra-SADC trade, the establishment of a single regional market requires the harmonisation of laws and regulations and the removal of bureaucratic impediments to trade that will lead to a reduction of transactions costs, information costs and regulatory-compliance costs, all of which increase the cost of doing business and undermine the competitiveness of individual SADC economies and of the region as a whole, in global terms. A truly integrated regional market will also make it easier to attract inward FDI, thus enhancing growth further. While the initial emphasis is on free trade in goods, this will have to be extended to free trade in services, the free movement of capital and, eventually labour, if true regional economic integration is to be achieved².

While regional trade integration is important, it should nonetheless be noted that the regional market is not large by global standards; indeed, South Africa accounts for two-thirds of the regional economy, and the economic size of the rest of SADC

² A fully integrated market will also embrace common regulatory requirements, standards etc. For example, if a product is approved for sale in one SADC country it should not be necessary to get a separate approval to sell it in another SADC country.

combined is less than one-half that of South Africa. This illustrates the importance of trade integration globally as a complement to trade integration within SADC.

The objective of an integrated regional market is linked to the objective of macroeconomic convergence, in a general sense. There cannot be a single regional economy if there is a wide dispersion of macroeconomic conditions. If inflation rates diverge widely between SADC states, for instance, then interest rates will also diverge and exchange rates will be volatile. Such differences will undermine market integration and generally lead to increased risk and uncertainty which will suppress investment. Regional integration therefore requires convergence of macroeconomic outcomes. And achieving similar inflation rates across SADC will require some degree of convergence in other macroeconomic policies, especially fiscal policies, although it does not necessarily require the adoption of common policies or identical policy frameworks³.

The importance of achieving economic conditions supportive of investment cannot be over-emphasised. At a general level, all SADC countries need higher investment rates for growth rates to be increased. But there is a specific link to the success of regional integration: trade liberalisation within the region will lead to changed economic opportunities. Increased import competition will render some productive activities in some countries uncompetitive, while at the same time the opening of export markets (especially the South African market) will give rise to new activities. For instance, manufacturing operations in some SADC countries, which have previously been protected by import tariffs, may find it difficult to compete with South African products in a newly liberalised environment. At the same time, many SADC countries have huge agricultural potential that can be used to boost agricultural exports to South Africa as well as an export-oriented agro-processing industry. All of this implies investment flows, which need to be supported by macroeconomic stability and a convergence of macroeconomic conditions within SADC.

However, while the development of a single regional market requires macroeconomic convergence in a general sense, this does not necessarily require the adoption of specific, rigid macroeconomic convergence targets; rather, it requires the adoption by Member States of sustainable, stability-oriented macroeconomic policy frameworks – which in most cases they are striving for anyway. Convergence “targets” may be useful as indicators of desirable levels for macroeconomic variables, but they are unlikely to be anything more than that, especially in the absence of any mechanism (other than peer pressure) for disciplining states that do not achieve the targets. It is also arguable that the adoption of uniform targets to apply to all Member States may be inappropriate, and that a more flexible approach with some variation in targets across countries may be more relevant.

³ For instance, countries still have a choice over monetary and exchange rate policies, even while focused on achieving low inflation.

Finally, it is worth noting that, for the purposes of regional integration, it is probably more important to focus first on tariff reduction and the elimination of legal, bureaucratic and institutional barriers to trade and investment, plus the adoption of stability-oriented macroeconomic policies, as these are likely to bring more immediate and substantial results than macroeconomic convergence alone.

The strongest rationale for a formal programme of macroeconomic convergence is in relation to objective (iii) above, SADC monetary union. This of course implies the adoption of common monetary and exchange rate policies, and imposes severe constraints on possible divergences in fiscal policies. Monetary union has a wide range of prerequisites if it is to be feasible, including a considerable degree of prior macroeconomic convergence, as well as a high level of intra-regional trade. Inflation and interest rates have to be very similar across Member States, and exchange rates have to be stable. It is also preferable that a single regional economy exists, implying macroeconomic stability, free trade, free movement of capital and labour, and properly functioning markets. All of these are necessary to ensure that Member States in a monetary union can undertake effective adjustment in response to inevitable economic shocks, given that the normal macroeconomic levers – monetary, exchange rate and fiscal policies – are no longer available.

SADC members have made a political commitment to eventual monetary union, through the African Union, which envisages regional monetary unions as building blocks for eventual Africa-wide monetary union. The merits of the proposed monetary union are discussed later in this report.

Clarity on the ultimate objective of the macroeconomic convergence programme is important, because it affects the choice of targets. If the objective is (i) or (ii) above, then the need for precise (and demanding) targets is reduced. If the objective is (iii), monetary union, then the need for more precise and demanding targets is clear.

Policy Convergence vs Convergence of Outcomes

The SADC MEC criteria focus on convergence of macroeconomic outcomes measured in terms of four key macroeconomic variables. The FIP also talks more generally about macroeconomic policy co-ordination. However, convergence of outcomes does not necessarily require policy convergence, although some policy convergence is implied; for instance, achieving fiscal and debt targets implies mobilising government revenues, restraining spending, and being cautious in taking on new debt, will apply to most countries. However, there are alternative, quite different paths to achieving low inflation. Essentially, countries can choose between using the exchange rate (through a fixed or managed peg) to anchor inflation, or an active monetary policy (through inflation targeting or money supply control). While these policies may have the same intended outcome, the implications for macroeconomic management are quite different. At present SADC countries cover the whole spectrum of monetary and exchange rate policies. However, there is no need for them to adopt common policies, unless as part of a formal programme in the run up to monetary union.

5. Review of Indicators and Benchmarks for Macroeconomic Convergence

Choosing indicators and benchmarks for macroeconomic convergence is not a straightforward task. Economic theory can assist, but ultimately offers little guidance on exactly which benchmarks should be chosen or what constitutes appropriate numerical targets. It is also quite possible for indicators and targets to get quite complicated, if they are to be comprehensive. One important point is that the optimal numerical values for three of the four existing MEC targets (except inflation) varies from country to country. Nevertheless, it may be preferable to have a small number of simple benchmarks, as these would be easier to monitor, more transparent, and less likely to be mutually inconsistent.

Inflation

Measures of Inflation

In principle, inflation is the key indicator of macroeconomic convergence, and is arguably the most important of the four chosen indicators. Low inflation cannot be achieved on a consistent basis in the absence of stability-oriented macroeconomic policies, and the achievement of low inflation therefore indicates that other policies are being implemented in a manner that is supportive of macroeconomic stability. More generally, high inflation is an indication of macroeconomic imbalances in an economy. Inflation is also relatively easy to measure, and in most countries data are readily available, at high frequency (monthly).

Nevertheless, there are several problems with inflation measures:

- limited geographic coverage of price measurement in some countries (typically resulting in an urban focus and under-recording of prices in the rural areas, which is where the majority of the population lives in most SADC countries);
- household surveys are required to get expenditure data for the CPI basket composition and weights – this is expensive and difficult to do accurately, and often infrequent;
- the result is out of date CPI baskets in terms of composition and weights, and hence an inaccurate inflation measurement that does not reflect spending patterns;
- slow adjustment of the CPI basket and weights will usually result in the overestimation of inflation, as it does not reflect the substitution of cheaper goods and services for more expensive ones; furthermore, new types of goods and services that may not be quickly reflected in CPI baskets – such as cellphones and computers – may well have falling prices, even if prices in general are rising;
- the dominance of inflation baskets by food (reflecting actual expenditure patterns), the price of which tends to be volatile, hence making headline inflation volatile;
- good quality inflation forecasts are not widely available; and

- ideally a measure of core (underlying) inflation should be used for macroeconomic convergence purposes, which would avoid the problems of volatility. However, core inflation measures are not generally available in SADC countries (only South Africa and Botswana have publicly available core inflation measures). There are also different ways to measure core inflation (exclusion of specific items, trimming etc.), and no general agreement on which method is the most appropriate.

There is also a more general problem of inconsistent inflation measures across countries. This was resolved in Europe by the adoption of the Harmonised Index of Consumer Prices (HICP), which is used for monetary policy purposes, but which co-exists with other, country-specific inflation measures.

Choice of Convergence Targets

A year ago it was anticipated that the 2008 target of single digit inflation would not be especially onerous, and would be achievable by all SADC members except for Zimbabwe. In the event, few SADC countries will achieve this target, due to the rapid increase in food and fuel prices during 2007 and 2008 (discussed in a separate paper). Inflation is declining in most countries towards the end of 2008, and most countries should be able to achieve single digit inflation at some point during 2009; to that extent the upsurge in inflation in 2008 represents a spike for exogenous reasons rather than underlying policy imbalance. However it does represent the danger of relying on a target for a single year.

Looking further ahead, the 2012 target of 5% inflation is tough but manageable, and indeed some countries have already achieved inflation of this level at some point over the past five years.

However, the 2018 target of 3% would require a shift to a different level of macroeconomic performance – this level of inflation has not been achieved by any SADC country on a consistent basis. It is also important to note that there is considerable debate over the desirability of low levels of inflation, once inflation is below 10%. While there is general acceptance that high inflation (above 10%) has a negative economic impact, below 10% the empirical evidence is mixed, especially given that the tight fiscal and monetary policies needed to achieve such low inflation will, in the short run at least, have a negative impact on growth.

Nevertheless, if monetary union is the objective, a very low rate of inflation – price stability – is essential, as is a narrow spread of inflation rates between prospective members. Hence as an objective prior to monetary union, a 3% inflation rate is justified. Both of the monetary unions in the CFA franc zone (WAEMU and CEMAC) have adopted a maximum inflation rate of 3% as part of their convergence criteria.

Fiscal Balance

Measures of Fiscal Balance

Fiscal balance (the budget deficit) is an important contributor to macroeconomic stability, with excessive fiscal deficits being the main cause of persistent inflation. Fiscal balance is also closely linked to the question of debt sustainability.

While the quality of measurement of the fiscal balance is improving, due in part to improved government accounting systems and reduced usage of quasi-fiscal (off budget) expenditure, there are nevertheless a number of problems that make monitoring of performance difficult.

First, data are not always available quickly, and are often provided only with long time lags. Monitoring of fiscal performance against the SADC target is further hampered by a lack of timely GDP data (which is needed for calculating the fiscal balance as a percentage of GDP).

Second, forecasts of fiscal balance can be highly volatile and in need of frequent updating (for instance, in recent years, fiscal receipts from the SACU revenue pool have been very difficult to predict).

Third, there are inconsistencies in measurement of fiscal balance across countries due to different time periods (fiscal years), and differences in the basis of compilation of government finance data (some countries use the IMF's Government Finance Statistics 1986 Manual, while others use the GFS 2001, which have important differences⁴).

It is important to have consistency across countries over the treatment of key items, such as privatisation receipts, other asset sales, and government lending, and improvements in this area, as well as improved forecasting, are important.

One issue that has arisen in consideration of fiscal balance issues is whether donor grants should be included in revenues and fiscal balance calculations. Technically, donor grants are included as part of government revenues. In many SADC Member States, grants form an integral part of overall revenues, and without grants, many projects would not proceed and expenditure would be lower; hence a fiscal balance calculated without grants would not be meaningful. One way around this is to concentrate on the basic fiscal balance, defined as revenue excluding grants minus expenditure excluding foreign financed investment⁵.

An alternative measure of fiscal balance is the current balance, defined as revenues excluding capital receipts minus current expenditure (i.e. total expenditure excluding public investment). This is similar to the "Golden Rule" used by the UK Treasury.

Choice of Convergence Targets

Whether a particular level of the budget deficit is sustainable depends on many factors, including the composition of fiscal expenditure, e.g. the balance of recurrent (especially wages) and investment spending. Public investment expenditure may

⁴ The main changes in GFS 2001 are: (i) recording fiscal statistics on an accrual rather than cash flow basis; (ii) integration of stocks and flows; and (iii) preparation of government balance sheet, statement of government operations, and a statement on sources and uses of cash.

⁵ However, one problem with the basic fiscal balance measure is that it does not impose any limits on foreign financed capital spending, and hence has to be accompanied by limits on external debt. For further details on alternative fiscal indicators see IMF (2006) *Fiscal Adjustment for Stability and Growth*.

justify borrowing, to “crowd in” private investment, for instance on infrastructure, whereas borrowing to finance recurrent spending or interest payment may be excessive and unsustainable. Furthermore, it is appropriate for the fiscal balance to vary across the economic cycle, in a countercyclical manner. Hence focusing on one year of data only may not be appropriate. Interpretation of fiscal balance data needs to be supplemented with other information, such as the basic balance, current balance, government wage bill, and donor dependence.

The “Golden Rule” adopted by the UK Treasury reflects several of these issues. The Golden Rule states that “over the economic cycle, the Government will borrow only to invest. The golden rule will be met if the average annual surplus on the current budget expressed as a ratio to GDP, measured from the year in which the economic cycle begins up to and including the year in which the economic cycle ends is in balance or surplus”.

As with inflation, the convergence criteria for fiscal balance are much stricter if the objective of integration is monetary union, which is especially vulnerable to fiscal destabilisation. This is especially the case if the MU adopts a fixed exchange rate; the fiscal criteria for sustainability are stricter under a fixed exchange rate regime, as fiscal laxity can undermine the stability of the exchange rate peg. Even under a floating exchange rate regime, fiscal laxity will lead to inflation as the exchange rate adjusts. Furthermore, there are moral hazard incentives (the free rider problem) for such fiscal overspending, especially when capital markets are underdeveloped, in both fixed and floating exchange rate regimes.

In choosing appropriate fiscal targets, it is helpful to refer to convergence criteria adopted in other monetary unions, specifically the ECCU, the two components of the CFA zone (the WAEMU and CEMAC) and the EMU⁶. The fiscal (and other) criteria are shown in Table 5.

The choice of specific values for fiscal balance criteria also depend on broader objectives. In the ECCU, the fiscal criteria are derived from public sector investment targets, from which the fiscal targets are essentially derived as residual items. This is not ideal, as fiscal targets should be derived from the fundamental objectives of debt and fiscal sustainability. However, the debt-stabilising fiscal balance is likely to vary from country to country, whereas for purposes of simplicity and transparency, a common target is probably desirable.

Given the above it is difficult to comment on whether the SADC MEC fiscal targets are reasonable, as it depends on whether the focus is monetary union. If it is, the targets need to be tight, but probably defined differently. In particular, the fiscal position could be viewed in terms of the primary balance (revenues less expenditure excluding interest payments), or the debt-stabilising primary balance, which keeps

⁶ For the ECCU, WAEMU and CEMAC these are ongoing convergence criteria aimed at maintaining stability in an existing monetary union with a single currency. For EMU, the convergence criteria are those prior to a country joining the monetary union, so the purpose is somewhat different.

the debt-to-GDP ratio stable. Further work is however required on identifying appropriate targets for the primary balance.

Public Debt

Measures of Public Debt

In principle, the level of public debt is an important determinant of and contributor to macroeconomic stability, fiscal stability and balance of payments stability. The ratio of debt to GDP can be a useful “headline” indicator of indebtedness, but may not be sufficient for a proper assessment of debt sustainability, for a number of reasons. Debt in SADC, and sub-Saharan Africa more generally, is not homogeneous, as it varies by currency (domestic or foreign), source (commercial or concessional), and duration (short or long term). The macroeconomic impact of debt works through several channels, and depends on the type of debt. For instance, domestic debt does not have a direct balance of payments impact, but may have a crowding out impact in domestic financial markets, and vice versa for foreign debt. The economic burden of debt servicing depends on the currency denomination, the interest rate and term of debt. More generally, domestic and foreign debt have different risk profiles. A single debt indicator therefore needs to be carefully interpreted and supplemented by other data to capture these channels.

In Europe (Maastricht Treaty), a single indicator was adopted for public debt, and was arguably more appropriate as public debt was homogeneous, i.e. generally denominated in domestic currency and issued on commercial terms, and hence the debt service burden was closely related to total of debt outstanding. The benchmark of 60% of GDP that was chosen in Europe may have represented a suitable benchmark for debt sustainability there. In Africa, however, the most advanced analysis of debt sustainability stemmed from HIPC programme, which focused on debt sustainability (particularly in balance of payments terms), and not debt levels.

Hence the focus on debt levels alone in the SADC macroeconomic convergence criteria may be misleading. Debt of 60% of GDP could be sustainable if, for instance, most of this debt is concessional and export growth is strong. However it could be unsustainable in balance of payments terms if debt is denominated in foreign currency and export growth is low, or if it is domestic debt and interest rates are high.

The setting of a MEC criterion for public debt should in principle be derived from debt sustainability analysis. The level of sustainable public debt depends on a number of factors, including the level of real interest rates (which is inversely related to the sustainable debt level), the rate of economic growth (which is positively related), and the volatility of revenues (which is inversely related)⁷. As a result the sustainable level of public debt varies from country to country, and may also vary over time, depending on interest rates, the rate of sustainable economic growth, and revenue generation. One analysis for Kenya concludes that the level is around

⁷ See e.g. IMF (2003) “Public Debt and Fiscal Policy in Emerging Market Economies”, in World Economic Outlook, September 2003.

35% of GDP⁸. Other analyses suggest that for a typical emerging market economy the sustainable public debt level may be as low as 25% of GDP (IMF 2003).

The World Bank-IMF framework for Low Income Country Debt Sustainability Analysis (LIC DSA) uses a range of sustainability thresholds for External Debt, including: NPV of debt-to-GDP (40%); NPV of debt-to-exports (150%); NPV of debt-to-revenue (250%); Debt-service-to-exports (20%); Debt-service-to-revenue (30%). None of these relate directly to debt-to-GDP ratios as in the MEC criteria.

For present purposes, country-specific debt sustainability analyses are neither feasible nor appropriate. Where they have been done for individual countries (e.g. as part of IMF assessments) they could provide useful information, although for many SADC countries they use the LIC DSA framework which takes a different approach⁹. For purposes of transparency and consistency a single indicator that is easy to calculate and verify is more appropriate. Available literature suggests that the 2008 MEC target of 60% of GDP is probably too high, and that the 2012 and 2018 targets should be lower, with 40% a reasonable objective. However, the general problem remains that there is no a priori reason why a single cross-country indicator for public debt should be relevant or suitable for all individual SADC Member States.

It would also be helpful to supplement debt levels with other indicators, e.g. debt service (as a percentage of government spending or exports), or indicators based on the net present value (NPV) of debt, which takes into account debt levels, interest rates and maturity.

Current Account of the Balance of Payments

The current account deficit (CAD) is one of the most commonly used indicators of external stability and sustainability. However, while the CAD is important, it is difficult to define what is a sustainable level. The CAD is integrally linked with savings, investment and capital flows, through the national account identity

$$M - X = CAD = - \text{capital account} = I - S$$

(where M=imports; X=exports; I=investment and S=savings).

For instance, a country with low savings and high investment will have relatively high CAD, which may be good if it is due to a high level of productive investment based on long-term foreign financing. Whether a given level of the CAD is sustainable depends on various factors, including:

- the exchange rate regime (which affects how well the exchange rate can adjust to disequilibria);
- the level and trend of foreign exchange reserves;
- the level of external debt;

⁸ IMF (2008) "Kenya: Selected Issues", IMF Country Report No. 08/337.

⁹ The IMF/World Bank have conducted recent (during the last two years) LIC DSAs for Madagascar, Malawi, Zambia, Lesotho, Angola, Mozambique and Tanzania. While these include data on the ratio of public debt to GDP, no sustainability criteria are offered for this measure.

- the degree of access to international capital markets;
- whether the capital inflows used to finance the CAD are primarily short-term portfolio flows or long-term FDI;
- access to donor flows; and
- export (and import) volatility, and whether a CAD in a particular year is temporary or structural.

As a result the sustainable level of the CAD varies from country to country, as with fiscal balance and public debt. The ECCB criteria specify a CAD excluding grants of less than 5% of GDP, but IMF estimates of the sustainable CAD for the ECCU economies range from 9% - 20% of GDP¹⁰, with the relatively high figure reflecting strong FDI inflows into the tourism sector. In SADC, CAD sustainability has recently been an issue for South Africa, with a deficit in the range of 7-8% of GDP proving difficult to finance as credit conditions deteriorated in Q3 of 2008, causing the rand to depreciate rapidly.

Nevertheless, there is some concern that the SADC target of 9% of GDP is too high for a long-term sustainable CAD as a general target. The figure should therefore be progressively reduced to 5% of GDP over the period to 2018, although it is noted that some countries can sustain a higher level of CAD.

Conclusion

Of the four SADC MEC criteria, only the inflation target can be unequivocally stated as one that is largely invariant to country specific circumstances – i.e., it can be applied as a general rule across various different countries. For the other three – fiscal deficit, public debt and current account deficit – the sustainable level is country-specific. While a simple, single indicator is nonetheless better for transparency purposes, the resulting numerical target may be too strict for some countries or too lax for others.

All four variables are important components of macroeconomic stability. However, it is proposed that inflation be assigned a higher status than the other three indicators, for a variety of reasons:

- it is the only one for which a target value can be assigned that is not country-specific;
- it is of particular importance if the ultimate objective is monetary union; and
- inflation provides a broad indication of the degree of stability and consistency in macroeconomic policy implementation – i.e. it is a good indicator of outcomes.

Inflation should therefore be the primary MEC indicator, with targets that should be strictly adhered to if MU is the objective. Fiscal balance, public debt and current account deficit should be secondary indicators that are more flexibly interpreted.

¹⁰ IMF (2008) "Eastern Caribbean Currency Union: 2007 Discussion on Common Policies of Member Countries—Staff Report", IMF Country Report 08/94 (March).

The proposed values for the indicators are as follows:

Table 3: Proposed Revised Macroeconomic Targets

Year Indicators	2008	2012	2018
Primary			
Inflation Annual Rate	<10%	<5%	<3%
Secondary			
Primary Fiscal Balance/GDP	tba	tba	tba
Public Debt/GDP	<60%	<50%	<40%
Current Account/GDP	<9%	<7%	<5%

The main changes envisaged from the current indicators are:

Inflation: no change.

Fiscal deficit: change to primary fiscal balance (excluding interest payments); however, more work needs to be done on specifying a value for sustainable outcomes (which will be a surplus).

Public debt: it is proposed that the target values for 2012 and 2018 be changed from 60% to 50% and 40% respectively.

Current account: it is proposed that the target values for 2012 and 2018 be changed to 7% and 5% respectively.

Inevitably there is an element of arbitrariness in the choice of the target values. Furthermore, choosing a single figure to apply across all countries will ignore country differences, and as the figure has to provide a challenging target for all countries it will tend to be relatively stringent.

Definitions and Data

Improvements are required in data quality and consistency in definitions and measurement.

Inflation: Member states should work towards introducing core inflation measures. Consideration should be given to whether targets should be assessed over a longer period (such as 3 year moving averages) to avoid exceptional positive or negative impacts of exogenous developments.

Fiscal balance: there should be more consistent reporting, with a move to GFS 2001 standards; reporting should also ensure that interest payments can be separated out from general expenditure; reporting of primary balance should be supported by data on public sector wages as % of GDP and of spending; donor funds as % of receipts; current fiscal balance; and the basic balance excluding grants and donor funded investment projects.

Debt: should include all of the public sector (central and local government, and public corporations; public and publicly guaranteed debt (PPG)); attempts should also be made to identify other contingent liabilities.

Current account: donor grants should continue to be excluded from calculations, as they cannot be considered sustainable in the long run.

Decision

A workshop was held to review the above recommendations and the progress of the Macroeconomic Convergence Programme on 26-27 November, 2008 in Gaborone, Botswana (Annex 1). The workshop agreed on the following recommendations:

The indicators for the MEC programme should be as follows:

Primary Indicators: Inflation, fiscal deficit as percentage of GDP and public debt as percentage of GDP.

Secondary Indicators: Current account balance as percentage of GDP; real GDP growth; foreign exchange reserves; central bank credit to government; savings and investment; and per capita income. These should largely be for monitoring purposes.

In addition to the above secondary indicators, exchange rate stability and interest rate divergence should – subject to guidance from SADC Central Bank Governors - be monitored, especially as the region prepares for Monetary Union.

6. Consistency of the SADC MEC Programme with Other MEC Programmes

A number of Macroeconomic Convergence Programmes exist in sub-Saharan Africa. In addition to the SADC MEC programme, there are similar programmes in the Common Market for Eastern and Southern Africa (COMESA) and the West African Monetary Zone (WAMZ); all three programmes have an eventual common currency as their final objective. In addition, the two existing monetary unions in Africa in the CFA zone – the WAEMU and CEMAC – have macroeconomic convergence criteria aimed at underpinning the stability of their common currencies. Outside of Africa, the European Monetary Union (EMU) has MEC criteria for both existing members and as entry criteria for aspiring new members, while the Eastern Caribbean Currency Union (ECCU) has macroeconomic stability criteria for existing monetary union members.

There is considerable variation across MEC programmes in terms of both the specific variables included and the numerical values of the targets (see Table 5 for full details). The most commonly included variables are **inflation** and **fiscal deficit**; all seven MEC programmes include fiscal deficit criteria and six of them (excluding the ECCU) include inflation criteria. In most cases the inflation objective is 5% or less (WAEMU, CEMAC, COMESA and EMU), and the 2008 SADC inflation objective of less than 10% is therefore relatively high (and is matched only by the WAMZ target). Fiscal deficits vary in terms of the specific definition of the target variable – overall balance, balance excluding grants, basic balance and the current balance are all used. Most targets are in the range of 3%-4%, so the 2008 SADC MEC target is towards the high end (matched only by the COMESA Stage 1 target of 5%). The 2012 and 2018 SADC targets for inflation and fiscal deficit are more in line with those of other MEC programmes. Public debt is also commonly used, with specific targets in

SADC, WAEMU, CEMAC, ECCU and EMU, all either 60% or 70%, so the SADC target is in line with those used elsewhere.

Beyond these three criteria, there is no consistent pattern. Only SADC and WAEMU have targets for the current account of the balance of payments, while SADC and COMESA have GDP growth targets. Three programmes (SADC, WAMZ and COMESA) have targets for foreign exchange reserves; for WAMZ and COMESA this is a primary target, while for SADC it is a secondary target. SADC and COMESA both have investment targets, while only SADC has a domestic savings target. Several countries have secondary fiscal targets, such as the proportion of revenues spent on wages (WAEMU, WAMZ), revenue as a proportion of GDP (WAEMU, COMESA), public investment as a proportion of revenues (WAEMU, WAMZ), and the accumulation of domestic arrears (WAMZ). Three programmes (SADC, WAMZ, COMESA) have targets for central bank financing of fiscal deficits.

Perhaps the most striking contrast between SADC and other MEC programmes relates to exchange rates and interest rates. As discussed in more detail below, convergence with regard to exchange rates and interest rates is an important component of the run-up to monetary union. For the existing monetary unions (WAEMU, CEMAC and ECCU) this is not relevant, as they already share a common currency and union-wide interest rates. The EMU sets criteria for prospective members, relating to the convergence of nominal exchange rates and interest rates and being maintained within a prescribed range for a period of time. By contrast, WAMZ and COMESA have targets for *real* exchange rates and interest rates, although these are stability targets rather than convergence targets. Nevertheless, the fact that SADC is the only regional integration arrangement with a monetary union objective but without exchange rate or interest rate targets suggests that this gap should be reconsidered.

7. Sequencing of Regional Economic Integration towards Monetary Union

The process of economic integration between countries is generally conceived as comprising a sequence of stages involving progressively deeper integration, as follows:

Table 4: Sequencing of Regional Integration

Type of REI	Pre-requisites	Comments
Free Trade Area (FTA)	Free trade in goods and services between members (no tariff or non-tariff barriers)	requires internal controls for enforcement of rules of origin (RoO) no exchange control restrictions on current account transactions
Customs Union (CU)	FTA plus common external tariff (CET)	does not require RoO needs mechanism for customs revenue distribution
Common Market (CM)	CU plus free movement of labour and capital	no exchange controls on capital movements no work or residence restrictions on nationals from other Member States
Monetary Union (MU)	CM plus single currency and central bank	

This was, for instance, the integration sequence followed by the European Monetary Union, spread over a period of approximately 50 years. It is also the sequence envisaged by SADC in achieving a monetary union.

In answering the question of whether a Customs Union and Common Market are required as prerequisites for Monetary Union, the starting point is to appreciate what are the implications of MU. MU is the highest level of monetary integration that can be achieved between countries, and can be viewed as a process involving progressively greater harmonisation and linking of monetary and exchange rate policies by a group of countries. While the degree of monetary integration can cover a spectrum with many variations, four main 'stylised' stages can be identified; these stages can be characterised primarily by the nature of exchange rate policy, which in turn has implications for monetary policy as well as a range of other policies. The four stages are:

- (i) no monetary integration (floating exchange rates; no monetary policy harmonisation);
- (ii) weak monetary integration (linked exchange rates and capital mobility; partial monetary policy co-ordination);
- (iii) strong monetary integration (fixed exchange rates; monetary harmonisation); and
- (iv) full monetary integration (monetary union; single currency; single central bank).

Under stage 1, no monetary integration, there is no attempt to link or co-ordinate the monetary policies of different countries, although of course national monetary policies may move in tandem if countries have similar economic structures and/or experience similar external shocks. Exchange rates would be freely floating (against each other) and countries would have national monetary policy autonomy.

Under stage 2, weak monetary integration, exchange rates are in some ways linked, perhaps by a managed float that constrains exchange rates within a predetermined range, or a crawling peg arrangement. Depending on the extent of capital mobility, such exchange rate linkages may impose restrictions on the independence of national monetary policies; however, if capital controls are retained, there may still be monetary policy autonomy.

Under stage 3, strong monetary integration, the exchange rates of national currencies are pegged to each other (either with adjustment permitted or, more strongly, with an irrevocable peg). If there is full capital mobility (no capital controls and well-developed national capital markets), a common monetary policy must be followed by all countries, for instance, with co-ordinated movements in interest rates. If monetary policy is not co-ordinated, the result will be unsustainable capital flows that would, in the limit, make the exchange rate peg impossible to maintain¹¹.

The final stage, full monetary union, is the culmination of the process of monetary integration. In a monetary union, all Member States make an irrevocable¹² commitment to the monetary union; adopt a common currency (which may be an existing currency or a completely new one), and a single central bank manages monetary policy. Individual Member States therefore have no autonomous monetary or exchange rate policy *vis à vis* other Member States of the union, although they do (collectively) *vis à vis* non-members.

It should be noted that the achievement of full monetary union does not prescribe exchange rate policy *vis à vis* the rest of the world; the exchange rate may be fixed (as in the case of the CFA franc, pegged to the euro, or the Eastern Caribbean dollar, pegged to the US dollar), or floating (as in the case of the euro).

SADC currently boasts a mixture of monetary integration arrangement. The Common Monetary Area (CMA) represents stage 3, with fixed peg exchange rates and a common monetary policy (but not stage 4 because there is not a single currency or central bank). Most other countries, however, are at stage 1, with floating exchange rates and no monetary co-ordination. Botswana lies somewhere in between, as it has a pegged exchange rate with a partial link to the CMA currencies.

¹¹ The inconsistency of a monetary policy target, and exchange rate target and capital mobility is often referred to as 'the impossible trinity'.

¹² In principle, monetary union treaties can be revoked, either collectively or by individual countries, but it is generally considered that such 'exit clauses' undermine the credibility which is necessary for the success of monetary union. The treaties underlying European Monetary Union have no provision for member countries to leave the union once they have joined.

Economic Policy Implications of Monetary Union

The ceding of autonomy in the fields of monetary and exchange rate policy is a crucial aspect of monetary union, and has many implications for national governments. There are major economic implications, as the range of economic policy instruments available to national governments is reduced, and hence other instruments and processes must bear the burden of adjustment to economic shocks. Thus the economic policy implications of monetary union need to be thoroughly examined beforehand. However, the implications go beyond relinquishing monetary and exchange rate policy, as other policy instruments are also affected, for reasons discussed below.

Economic policy instruments enable policymakers to respond to the various shocks that economies face; if, as in a monetary union, key policy instruments have to be common across a group of countries, then these policy settings are more likely to be suitable for individual countries if they are subject to similar shocks. If they are not, the common policy will not be generally suitable to differing national economic circumstances. For small open economies, such as those in the SADC region, the most important economic shocks are likely to be external shocks, such as those resulting from changes in terms of trade. The monetary and exchange rate policy stance adopted in a monetary union is more likely to be suitable for countries that have similar trade structures and which are relatively diversified (thus reducing their vulnerability to shocks emanating from the global market for one or a small number of commodities). A member of a monetary union that is subject to large, idiosyncratic shocks will find that it does not have access to the exchange rate and monetary policy adjustment mechanisms that would otherwise be available to it, and hence may have trouble in responding to shocks unless other effective adjustment mechanisms are available, with the result that national income is more volatile than it would be otherwise.

As an example, the appropriate response to a significant rise in oil prices is quite different for oil importers and oil exporters. For the latter, terms of trade have improved and there has been an increase in real national income, and both current account and fiscal balances are likely to improve. For oil importers, the opposite implies. Adjustment policies to the shock are quite different in each case. In particular, then oil exporter would expect a real exchange rate appreciation, while the oil importer would expect a real exchange rate depreciation. Hence a common policy will not be optimal for all members, and it is quite possible that it would not be optimal for any members.

While monetary union is formally about exchange rate and monetary policies, there are also implications for other policies, particularly fiscal policy. The traditional Optimum Currency Area (OCA) literature argues that in a monetary union, members should have additional flexibility over fiscal policy in order to compensate for the loss of policy instruments (monetary and exchange rate policies) with which they can respond to economic shocks. However, this argument is not widely accepted, for two main reasons. First, using fiscal expansion to compensate for negative shocks can quickly lead to problems of public debt sustainability. Second, budget deficits in

one country may have negative externalities for other members of the monetary union, if additional borrowing and recourse to capital markets pushes union-wide interest rates upwards. The benefits of expansionary fiscal policy accrue to the individual Member State, but the costs apply to all members of the MU; hence there is a moral hazard problem. This is potentially a problem in any monetary union with centralised monetary policy decision-making and decentralised fiscal policy decision-making. Such concerns led to the adoption of limits on budget deficits under EMU, and hence, in principle at least, constraints on the use of fiscal policy as a stabilisation policy by EMU Member States. In addition, in a monetary union with a fixed exchange rate *vis à vis* the rest of the world, there are additional dangers in that fiscal overspending by one (or more than one) country may undermine exchange rate stability.

The adoption of fiscal limits has however been quite controversial. Some have argued that the case for strict budgetary limits is weak, for the following reasons. First, there will only be negative externalities if capital markets are inefficient. If they are efficient, only the country with high budget deficits and borrowing needs will pay higher interest rates, through an increased (default) risk premium, as markets will correctly evaluate that there is no increased risk on debt issued by other member countries, whose interest rates will therefore remain unchanged. Second, the existence of an effective common central bank, preventing the monetisation of budget deficits, will ensure that union members face a “harder” budget constraint than in independent sovereign states where deficits can potentially be monetised. Third, it is argued that such limits are in any case unenforceable. The difficulties faced by the European Commission in responding to the breaching by France and Germany of fiscal constraints imposed by the EU’s Stability and Growth Pact under the Maastricht Treaty, and the consequent watering down of the initial limits, illustrates this problem. While there is some merit in these arguments, in the case of developing countries (unlike the EU), capital markets are unlikely to be well enough developed to price the risk of default efficiently, making the “free-rider” problem much more likely.

In such a situation, none of the three main levers of macroeconomic policy (monetary, exchange rate, fiscal) is fully available to national governments within a monetary union. This gives rise to an adjustment problem: how to respond to economic shocks, especially divergent shocks across monetary union members (common shocks can be dealt with by monetary union-wide monetary and exchange rate adjustments)?

Within a monetary union, much greater reliance is placed upon labour and capital mobility to support economic adjustment. There should be no restrictions on capital movements between union members, and labour should be free to move from low growth/low income areas of the union to high growth/high income areas; in other words, all monetary union residents are treated equally with regard to employment and residence across the union. Furthermore, there should be no restrictions on trade flows within the union, and prices should be flexible and able to adjust easily to differing economic conditions. It is also important that financial systems are robust, in order to avoid financial crises that can themselves disrupt economic activity, affect

monetary policy and have fiscal implications if rescues of financial institutions are necessary.

Macroeconomic policy management therefore becomes potentially more difficult in a monetary union, because:

- (i) differences in economic structure may result in Member States having different objectives with regard to the setting of union-wide monetary and exchange rate policy; and
- (ii) the range of available policy instruments available at national level is reduced, and a greater burden of adjustment falls on labour and capital markets in particular, and efficient markets (with price flexibility) more generally.

In these circumstances, it is sometimes considered necessary for MU to come at the end of a progressive sequence of integration involving the liberalisation of goods and factor markets, with the minimisation of barriers to the movement of goods, services and factors of production between Member States. This is certainly the accepted theoretical approach, and would suggest that a customs union is necessary (because a FTA requires internal barriers to enforce ROO), as is a common market (involving the removal of barriers to the movement of factors of production) prior to MU.

However, in practice this may not be the case. In the case of the Eastern Caribbean Currency Union (ECCU), the adoption of a single currency and a single central bank in 1983 was not preceded by the full sequencing of prior integration¹³. ECCU Member States have intra-union free trade and a CET through their membership of a regional customs union, CARICOM. There are also no exchange controls on capital movements. Nevertheless, there are restrictions on labour mobility within the union, and the effect of financial regulations is to restrict capital movements. Plans are underway to establish a full Economic Union for the Organisation of Eastern Caribbean States (OECS), whose membership is almost the same as the ECCU, which would remove these remaining restrictions on factor mobility.

In conclusion, the conventional linear sequencing from free trade area to customs union to common market to monetary union is not an absolute pre-requisite. However, there is more likelihood that a monetary union will be successful if this sequencing is followed.

8. The Potential Costs and Benefits of Monetary Union

The discussion regarding the proposed SADC monetary union (and indeed the proposed African monetary union) has generally been conducted on the basis that a MU is desirable *per se*, and should therefore be pursued as a policy objective. It is primarily a political project. However, there is little evidence that the costs and benefits of MU have been properly considered from a technical point of view. This is

¹³ One reason for this is that the ECCB/ECCU evolved from an earlier currency board arrangement with its origins in the colonial era (much like the CFA zone in Africa).

unfortunate, as the conclusion of the theoretical literature regarding monetary integration differs from that on trade integration, and does not necessarily conclude that monetary integration is unequivocally beneficial. In this section we briefly review the potential costs and benefits of monetary integration leading to monetary union.

Potential Benefits

The potential benefits of monetary integration/union can be classified into four main areas:¹⁴

- (i) providing an 'agency of restraint' that will reduce the ability of governments to pursue irresponsible and destabilising macroeconomic policies;
- (ii) acting as a bulwark against currency speculation and contagion effects that could add to exchange rate volatility;
- (iii) supporting the exploitation of economies of scale in the financial sector, with accompanying efficiency benefits; and
- (iv) the traditional Optimal Currency Area (OCA) benefits, i.e., the potential gains to trade from reduced transactions costs and exchange rate uncertainty.

Within SADC, the 'agency of restraint' argument is potentially important for those countries that have a history of profligate public finances and macroeconomic mismanagement; they may gain from delegating macroeconomic policy to a supranational monetary authority, and indeed, monetary union could be an indirect way of achieving central bank independence. The benefits could therefore include monetary stability and enhanced credibility. Even though the quality of macroeconomic policymaking in the region has improved considerably in recent years, a well-designed monetary union could help to 'lock-in' these gains. Another dimension of the agency of restraint argument is that monetary union prevents exchange rate adjustments from being used as a 'quick fix' to achieve improvements, with the resulting benefit that efforts are focused on long-term structural fundamentals, such as productivity.

The potential 'bulwark against currency speculation and contagion' benefits are unlikely to be significant for most SADC countries. In all cases except South Africa, SADC currencies are 'below the radar screen' of international speculators, reducing exposure to contagion problems. To the extent that a common SADC currency would be viewed as a 'super-rand' by international markets, the smaller SADC countries might find themselves even more exposed to speculation and contagion, as international currency market developments that have until now affected only the rand would be spread immediately to the other countries as well.¹⁵ While there would be complete exchange rate stability within the monetary union, the degree of international exchange rate volatility could increase.

¹⁴ See P. Honohan and P.R. Lane 'Will the Euro trigger More Monetary Unions in Africa?', *World Bank Working Paper no.2393*, (2000).

¹⁵ At present, only Botswana, Lesotho, Namibia and Swaziland are directly affected by changes in the international value of the rand through an exchange rate peg.

There could be benefits for the financial sectors of SADC countries, many of which are small, relatively undeveloped, and prone to bouts of financial instability. Monetary union, through the creation of an integrated capital market, would help to achieve economies of scale and hence efficiency gains. Monetary union also requires high, and preferably unified, standards of financial sector supervision. Given the high administrative costs of bank supervision, capital market regulation and the operation of securities exchanges, and the scarcity of supervisory and managerial resources in some countries, common international (regional) standards and the sharing of resources could help to improve the quality of prudential regulation and supervision. It could also boost capital market efficiency, resulting in enhanced financial stability and accompanying economic gains. There may also be gains from the process of distancing regulators from political pressures.¹⁶ Monetary union would also provide a more stable environment for investment flows. Most SADC countries are net recipients of inward foreign direct investment, much of which flows from South Africa to the smaller SADC countries¹⁷. Exchange rate volatility between the South African rand and other SADC currencies outside of the CMA adds to the risk and uncertainty facing South African investors in the rest of SADC, and thus may reduce investment flows in the region. Monetary union would therefore provide a more stable environment for direct investment flows within SADC, and could therefore boost investment and growth.

Under point (iv) above, the balance of benefits depends very much on the structure of the economies involved. The extent of potential savings from the reduction in transactions costs and the reduction in uncertainty with respect to exchange rates depends on the extent of (actual or potential) trade between members of the monetary union; the more trade there is, the greater the potential benefits. In contrast, the more the individual members are subject to idiosyncratic or asymmetric shocks, the greater the problems or losses that may result from forgoing national control over monetary, exchange rate and fiscal policies. At present, intra-SADC trade is relatively small. While the smaller members of the Southern African Customs Union (SACU) are heavily dependent upon South Africa for imports, and to a lesser degree for exports, this is less so for other countries. For the region's largest economy, South Africa, its largest trading partner is the European Union, and trade with SADC countries accounts for a relatively small proportion of its total trade. Trade flows within the SADC area are much smaller than trade flows with the rest of the world, in contrast to the euro area where the opposite applies. While there may be some potential for further growth in intra-SADC trade, more general analysis for Africa as a whole does not indicate a major unexploited potential for intra-Africa trade. This

¹⁶ Problems with the supervisory framework for the financial sector were recognised as one of the issues contributing to the near-collapse of the CFA franc zone in the mid-1990s. Subsequent reforms have included the establishment of a two sub-regional banking supervision agencies, to prevent such problems from recurring.

¹⁷ South Africa accounts for 50% of foreign direct investment inflows into the other SADC countries (SADC, *Regional Indicative Strategic Development Plan*, p.24 (SADC, Gaborone, 2003).

suggests, therefore, that the potential benefits for trade from monetary union are limited.

Potential Costs of Monetary Union

The main potential disadvantages of monetary union have been discussed earlier and are also laid out in the OCA literature; they relate to reduced national policy autonomy and constrained ability to react and adjust to economic shocks. As noted above, national governments in a monetary union do not have access to monetary policy or exchange rate policy to respond to economic shocks, and fiscal policy is highly constrained. Hence the traditional levers of macroeconomic policy management are no longer available to national governments, and are only available at a regional level. Trade policy is also not available, as tariff policies etc. are set at regional level. The burden of adjustment of national economies therefore falls on capital, labour and product markets – which requires very efficient markets.

The lack of macroeconomic policy instruments at the national level may add to economic instability, as governments are constrained in their ability to respond to shocks. Hence macroeconomic outcomes may be less stable in a monetary union, and incomes more volatile.

These tensions have been apparent in the euro zone, where a single “one size fits all” monetary policy operates. During the early 2000s, different members of the euro zone experienced quite different economic growth cycles, with France and Germany experiencing slow growth, while Portugal, Ireland, Greece and Spain (PIGS) experienced much faster growth. Not only was it difficult to find a monetary policy that suited all members, but the fact that the single euro interest rate was too low for the PIGS encouraged a property boom that eventually collapsed. Another outcome of the lack of national policy autonomy in the euro zone is illustrated by the experience of Italy. Traditionally, Italy has made up for its lack of competitiveness and slow productivity growth by devaluing the lira; now, this is not possible, and Italy is suffering from slow growth due to declining competitiveness in the euro zone, which is inevitably causing tensions over its membership, although it may have the intended and beneficial outcome of forcing structural reform on the Italian economy.

There is also a potential problem of profligate fiscal policy in a monetary union, given the moral hazard/free-rider problem whereby the benefits of fiscal expansion are felt at the national level, whereas the costs are shared regionally.

The balance of costs and benefits is difficult to assess in advance. However, it is possible to point to the characteristics of national economies that will tend to favour benefits over costs. These characteristics include:

- (i) similarities in economic structure, level of development, level of openness to international trade, and types of external shocks that Member States are subject to;
- (ii) high levels of trade between Member States;
- (iii) more diversified economies within the monetary union; and
- (iv) flexible product, capital and labour markets.

These indicate some of the economic pre-requisites for credible and successful monetary union between countries: similar economic structures (in terms of openness, trade patterns and diversification), and a willingness to remove restrictions on capital and labour movements between union members. The political feasibility of liberalising restrictions on factor mobility is enhanced if member countries are at similar levels of development and income levels. Similar levels of per capita incomes are also important in that countries would tend to have similar levels of institutional development as a result, and more generally a convergence of interests, which could otherwise be a reason for friction between potential members. Finally, there should be free trade within the union, price flexibility, and a robust financial system with common prudential rules and supervision. If sufficient of these factors are not present then monetary union could be disadvantageous: countries could find themselves unable to respond with suitable policies when economic adjustments are needed, resulting in lower growth, lower incomes and greater poverty. There is nothing inherent in monetary union that guarantees it to be a 'first best' policy in economic terms.

In addition, for a monetary union to be successful the central monetary authority needs to be very strong and independent from national influences when setting monetary policy and in dealing with fiscal imbalances. Also on the institutional front, the supervision of financial institutions and markets should be regional rather than national.

SADC economies are of course quite different in economic size and structure, with South Africa being relatively industrialised and diversified while most other countries are small and relatively undiversified with dependence on a small range of primary product export commodities, which vary considerably across countries; as a result, the structures of GDP vary a great deal. Furthermore, most SADC countries have concentrated export structures. Hence, most SADC members are highly vulnerable to shocks, and the nature of that vulnerability is likely to be quite different between countries. In these circumstances, nominal exchange rate flexibility is likely to be a potentially important adjustment mechanism. Furthermore, alternative adjustment mechanisms, especially well-functioning markets with price flexibility, and capital and labour mobility between countries, are limited. Therefore, it is unlikely that at present SADC qualifies as an OCA in terms of the conventional criteria.

While trade integration almost certainly makes sense for SADC, through the pursuit of a free trade area or customs union, it is not clear that monetary union is a good objective. There are exceptionally wide disparities in incomes and development levels in SADC that in themselves pose a barrier to monetary integration, which could amount to a "policy straitjacket" that inhibits governments' abilities to respond to differing economic, social and political circumstances. More generally, the very diverse development levels in SADC may well be an obstacle to economic integration, with resistance among the better off members that it will prove expensive for them – similar to concerns expressed in Europe with its eastward expansion and recent admission of 10 new members.

While macroeconomic convergence is an important component of the process of monetary union, there is scope for debate about how much convergence has to occur prior to the union taking place, and how much can follow afterwards. With regard to macroeconomic indicators that are primarily monetary in nature, such as inflation, interest rates and exchange rates, there are strong arguments that convergence should come prior to monetary union, as otherwise convergence will be forced, abruptly, as the union takes effect. As noted above, theoretical arguments in the OCA literature suggest that more general macroeconomic convergence and economic similarities are pre-requisites for a monetary union to be successful. However, it has been argued that for other criteria, especially structural factors, convergence may follow monetary union; in other words, convergence may be endogenous, as the existence of a monetary union will tend to alter the characteristics of an economy. From this perspective it is less important that some of the convergence and optimal currency area criteria are met prior to a monetary union being established, as membership of the union will induce convergence and institutional and structural changes that will help countries inside the union to find new methods of adjusting to economic shocks.

There is some experience from monetary integration experiences that supports the latter view. In the Common Monetary Area (CMA), there are major dissimilarities between the economies of South Africa on one hand and Lesotho, Namibia and Swaziland (LNS) on the other. Nevertheless, reviews of the benefits and costs of CMA membership conducted by LNS have generally confirmed that membership has had positive economic effects. The one OCA criterion that the CMA does meet is that there is a very high level of intra-regional trade, at least for the smaller members, so that they benefit from reduced transactions costs by having a fixed currency peg. Similarly, in the ECCU (which is a true monetary union, unlike the CMA), membership is also considered to have brought benefits, primarily from the independence of the common central bank from political pressures, for instance to monetise fiscal deficits. In neither case have the pre-requisites identified in the OCA literature been fulfilled. However, in the ECCU, rigidities have been identified that are constraining growth, and it is increasingly being held that economic growth would be faster if these rigidities – particularly those that are restricting factor market integration – were removed.

Overall, the technical case for establishing a monetary union between SADC members has not been established. There are very high risks that costs would outweigh benefits and a monetary union would have negative economic impacts; certainly, a political motivation for monetary union should not be taken as the reason to do so.

9. Proposed Criteria for Admission to Monetary Union

As noted above, a convincing case for establishing a SADC monetary union has not been made. Nevertheless, if this policy is pursued, strict macroeconomic convergence and entry criteria will be necessary. Besides this, there are institutional requirements such as the establishment of a common central bank.

Dealing first with the common central bank, it is essential that it is constituted in such a way as to be insulated from national political pressures as far as possible. One of the most challenging aspects of governance to be determined will be decision-making processes. This is difficult in any circumstances, but is particularly difficult given the mismatch in the sizes of national economies¹⁸. One of the first collective decisions that will need to be made is whether the single currency will have a floating exchange rate vis a vis the rest of the world, or will maintain some kind of peg.

With regard to entry criteria, three considerations are paramount. First, entry criteria have to be strict. A monetary union can be destabilised by inappropriate policies on the part of one Member State – especially inappropriate fiscal policy – but the ability of the collective organisation to discipline errant members, whether through moral suasion, fines or expulsion, is very limited. Hence it is important to ensure that, as far as possible, potentially destabilising members are not admitted in the first place. Political pressures should not dominate economic criteria.

Second, the entry criteria must be quite broad. Once the monetary union is established, members will have an irrevocably fixed exchange rate between them, will have a single interest rate with monetary policy determined collectively, and will have constraints on fiscal policy. It is also important that there be little dispersion of inflation rates, or else competitiveness problems will arise in high inflation countries, which cannot be compensated. Hence the prior convergence and entry criteria must encompass exchange rate stability, interest rates, inflation, fiscal balance and public debt¹⁹.

Third, the entry criteria encompass both convergence of macroeconomic outcomes and convergence of macroeconomic policies. In particular, prospective members must adopt managed exchange rates, with the objective being to progressively reduce the variability of exchange rates between member currencies. The counterpart of this is that the nature of monetary policy will change, and the target of monetary policy will become the achievement of exchange rate stability rather than an inflation target. This in turn will require a nominal anchor for prices in the embryonic monetary union, and a decision will be needed as to whether this is to be achieved through an exchange rate peg (so that the embryonic common currency is pegged to an external currency or basket of currencies) or through an active monetary policy (based on inflation targeting or control of monetary aggregates) combined with a floating exchange rate vis a vis the rest of the world. But prospective members will no longer be able to pursue active monetary policies at the national level.

¹⁸ The essence of the problem is this. In economic terms, the SADC monetary union will be union between the currencies of the 14 smaller countries and the SA rand, given that SA accounts for two-thirds of SADC GDP. But political expectations are likely to be that governance of the proposed SADC central bank will be on a one-country-one-vote basis. This raised the question, will South Africa be prepared to hand over the formulation of its monetary policy to SADC?

¹⁹ These were essentially the Maastricht criteria used in the run up to EMU.

While determination of the exact numerical values for prior convergence will require further work, the essence of the criteria will be as follows:

Inflation: must be low (approaching price stability) and with limited divergence between prospective MU members.

Interest rates: long-term benchmark real interest rates (e.g. on government bonds) should have limited divergence between prospective MU members.

Exchange rates: variation in exchange rates between member currencies should be progressively reduced over a period of years, and should approach fixed rates towards the end of the convergence period.

Fiscal deficit: low and stable.

Public debt: low and stable.

Table 5: Convergence Criteria in SADC, COMESA, WAMZ, WAEMU, CEMAC, ECCU & EU

	SADC	WAEMU	CEMAC	WAMZ	COMESA	ECCU	EMU
Inflation	Average annual inflation Stage 1: <10% Stage 2: <5% Stage 3: <3% (PRIMARY)	<3%	<3%	<10% (PRIMARY)	Average annual inflation Stage 1: ≤5% Stage 2: ≤3% Stage 3: ≤3% (PRIMARY)	None	No more than 1.5 percentage points higher than the three lowest inflation EU member states (as at May 2008, this was 3.2%)
Fiscal	Deficit (% of GDP) Stage 1: <5% Stage 2: <3% Stage 3: <3% (PRIMARY)	Primary Basic fiscal balance (revenue excluding grants minus expenditure excluding foreign financed investment) in balance or in surplus Secondary Ratio of govt. wage bill to tax revenue < 35%; Ratio of domestically financed investment spending to tax revenue > 20% Tax-to-GDP ratio > 17%	Basic fiscal balance (revenue excluding grants minus expenditure excluding foreign financed investment) in balance or in surplus	Primary Fiscal deficit < 4% of GDP Secondary Govt. wage bill < 35% of tax revenue; Domestically financed investment ≥20% of tax revenue; No accumulation of domestic arrears	Primary Fiscal deficit excluding grants (% of GDP) Stage 1: ≤5% Stage 2: ≤4% Stage 3: ≤3% Secondary Domestic revenue ≥ 20% of GDP	Government current surplus of 4-6% of GDP Overall fiscal deficit <3% of GDP	Entry: Budget deficit < 3% of GDP Ongoing (Stability Pact): close to balanced budget or surplus over economic cycle; fines for persistent deficits over 3% of GDP

	SADC	WAEMU	CEMAC	WAMZ	COMESA	ECCU	EMU
Public Debt	<60% of GDP (PRIMARY)	Total public debt < 70% of GDP Non-accumulation of domestic and external payment arrears.	Total public debt < 70% of GDP Non-accumulation of domestic and external payment arrears.		"Sustainable level" (SECONDARY)	Total central government debt < 60% of GDP Debt service payments < 15% of current revenue	General government debt: < 60% of GDP. If above the target, the ratio must be falling and approaching the reference value at a satisfactory pace. None
Current Account of BoP	Stage 1: <9% of GDP Stage 2: <9% of GDP Stage 3: <3% of GDP	CAD excluding grants < 5% of GDP	None		"Sustainable level" (SECONDARY)	None	None
Real GDP Growth	≥7% (SECONDARY)				≥7% (SECONDARY)		
Exchange Rate		Not applicable - already have common currency	Not applicable - already have common currency			Not applicable - already have common currency	Applicant countries should have joined the EMS exchange rate mechanism (ERM II) for 2 consecutive years and should not have devalued its currency during the period.

	SADC	WAEMU	CEMAC	WAMZ	COMESA	ECCU	EMU
Interest Rates							Nominal long-term interest rate must not be more than two percentage points higher than in the three lowest inflation member states
Foreign Exchange Reserves	Months of import cover Stage 1: ≥ 3 Stage 2: ≥ 6 Stage 3: ≥ 6 (SECONDARY)			≥ 3 months (PRIMARY)	Months of import cover of goods and non-factor services Stage 1: ≥ 4 Stage 2: ≥ 5 Stage 3: ≥ 6 (PRIMARY) $\geq 20\%$ of GDP		
Domestic Investment	$\geq 30\%$ of GDP (SECONDARY)						
Domestic Savings	% of GDP Stage 1: $\geq 25\%$ Stage 2: $\geq 30\%$ Stage 3: $\geq 35\%$ (SECONDARY)						
Central Bank Financing	% of previous year's tax receipts Stage 1: $\leq 10\%$ Stage 2: $\leq 5\%$ Stage 3: $\leq 5\%$ (SECONDARY)			$\leq 10\%$ of previous year's tax receipts (PRIMARY)	Zero (PRIMARY)		
Real Interest Rate				$> \text{zero}$ (SECONDARY)	$> \text{zero}$ (SECONDARY)		

	SADC	WAEMU	CEMAC	WAMZ	COMESA	ECCU	EMU
Real Exchange Rate				Stable (SECONDARY)	Stable (SECONDARY)		

Source: IMF WP 03/163; Wikipedia (http://en.wikipedia.org/wiki/Convergence_criteria); West African Monetary Institute; COMESA.

Annex 1



SUMMARY AND RECOMMENDATIONS OF THE MOBILISATION WORKSHOP FOR THE REVIEW OF THE SADC MACROECONOMIC CONVERGENCE PROGRAMME HELD ON 26-27 NOVEMBER 2008, GABORONE SUN, GABORONE, BOTSWANA

BACKGROUND

A workshop to facilitate the process of reviewing the Macroeconomic Convergence (MEC) Programme was held on 26-27 November at Gaborone Sun, Gaborone, Botswana. Participants **deliberated** on the following issues:

- (i) Definitions of the Macroeconomic Convergence Indicators;
- (ii) The Template for Reporting Macroeconomic Convergence Indicators;
- (iii) Country Presentations: Macroeconomic Developments in 2008 with respect to macroeconomic Convergence Indicators;
- (iv) Review and critique of the relevance of the convergence criteria and numerical targets;
- (v) Roadmap to the Monetary Union; and
- (vi) Implications of the rising food prices and power/energy shocks; and the financial crisis on the Macroeconomic Convergence Programme.

The following is a summary and recommendations which the participants made during the workshop:

A. PROGRESS ON MACROECONOMIC CONVERGENCE AND IMPACT OF EXTERNAL SHOCKS

Based on the figures presented by Member States (MS), the picture is that there is deterioration in several MEC indicators for 2008. However, this is more pronounced in inflation, current account balance and GDP growth where MS are unlikely to meet the targets as stipulated in the MEC programme. The following are some of the observations on the country presentations.

1. Current developments have largely been dictated by external factors where MS have no direct control, i.e. volatile food and fuel prices and slowdown in

the global economy influenced by the credit crunch in the USA and Western Europe.

2. While these external shocks have affected all Member States, their impact has varied from MS to MS.
3. As a result of the volatility in food and fuel prices and global economic slow down, economic growth in most MS has been subdued generally.
4. Due to rising food and fuel prices in the first half of the year, inflation in all MS has taken an upward turn.
5. In general, it was observed that future investment may be put on hold, especially relating to mineral sector following slowdown in world demand for such commodities.
6. The current account of the balance of payments in most MS worsened partly because of rising food and fuel prices (for net importers of food and fuel) and importation of intermediate goods for production and construction projects.
7. For some MS other challenges have been related to shortages of skills as a result of brain drain and impact of HIV/AIDs, Malaria and Tuberculosis on the workforce; thus impacting negatively on productivity.
8. For those MS in the SACU region, they expect reductions in SACU receipts, with the potential of exerting pressure on their budgets.
9. In order to mitigate the impact of shocks on their economies most MS have responded by adopting a number of strategies, which include:
 - a. introduction of subsidies and transfers in the short run to minimize the impact of rising food and fuel prices on the populace, especially the poor. This has exerted pressure on MS budgets.
 - b. diversification of economies in the long run to make them more resilient against external shocks.

Finalization of MEC Country Reports

Participants agreed that MS should firm up their reports especially where there are data gaps and submit the finalized reports to the Secretariat for consolidation by end of February 2009 just in time for the next Subcommittee's meeting.

B. RELEVANCE OF THE INDICATORS, CRITERIA AND NUMERICAL TARGETS OF MEC

In general participants agreed that the focus of MEC Programme should be to pursue and consolidate efforts aimed at achieving macroeconomic stability in the region. This will form a solid foundation for the Monetary Union. As such the following recommendations were made:

1. Set of Indicators

The indicators for the MEC programme should be as follows:

Primary indicators: Inflation, fiscal deficit as percentage of GDP and public debt as percentage of GDP.

Secondary Indicators: Current account balance as percentage of GDP; real GDP growth; foreign exchange reserves; savings and investment; and per capita income. These should largely be for monitoring purposes.

In addition to the above secondary indicators, exchange rate stability and interest rate divergence should be monitored especially as the region prepares for the Monetary Union. However, before adopting these two as such, the Central Bank Governors have to provide their guidance.

2. Definitions of Indicators

The current definitions of MEC indicators provide a basis for harmonising the reporting of the indicators and monitoring of the MEC programme. However Mozambique expressed concerns regarding fiscal deficit particularly the inclusion of social security funds. Mozambique also expressed reservations with regard to public debt definition as presented with the inclusion of arrears to pension funds and arrears to suppliers of goods and services. Participants agreed that where MS have deficiencies in reporting a particular indicator to the level of the definition, the concerned MS should provide a foot note indicating the limitation. Further, the Secretariat should mobilise resources to support those MS to build capacity in that area.

3. Numeric Targets

The current numeric targets should be maintained and MS should be encouraged to strive to meet them (especially those of the primary indicators).

4. Data Collection and Reporting

MS should report data to the SADC Secretariat. MS should designate two officers (one from Ministry of Finance and one from Central Bank) for this purpose. Where a MS does not supply data on MEC indicators, internationally published database should be used with a foot note. To ensure consistency, MS should coordinate data production and reporting by involving economic management institutions, i.e. Ministries of Economic Planning and Development and Finance; Central Banks; and National Statistical Offices. The SADC Secretariat should coordinate data collection efforts with the CCBG Secretariat. The SADC Secretariat should mobilize resources and convene a workshop to discuss economic statistics.

5. Statistical Reforms and Capacity Building

The SADC Secretariat should mobilize resources to carry out statistical reforms in MS that need reforms in this area. Further, the resources will also be used for building capacity in the area of analysis of MEC indicators (including use of the Template) and forecasting of MEC indicators.