

**THE PREREQUISITES FOR PROGRESS TOWARDS A SINGLE CURRENCY
IN THE COMMON MARKET OF EASTERN AND SOUTHERN AFRICA**

MEDIUM TO LONG-TERM PERSPECTIVE STUDY

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Executive Summary

Prerequisites for progress towards a single currency in COMESA

Lessons from theory and experience

According to experience in other regions, there are gains to be had from cross-border economic policy coordination where national policies create externalities for neighbouring countries. However, policy unions are difficult to maintain, particularly if countries which are members of the union respond differently to the same external shocks. Where there are long-term relationships that are mutually desirable then some policy coordination may be sustained, but the wider the range of policy variables tied by international treaties, the smaller the likelihood of compliance. At the very least, the experience of other developing regions suggests (i) that the presence of a larger comparatively stable anchor economy increases the chances of success and (ii) that regional integration alone does not contribute significantly to regional growth and development, suggesting that regionalism should be part of an overarching strategy of global integration.

Monetary union is optimal amongst economies that: show a marked degree of real economic convergence, or which have flexible labour markets; permit capital and labour to move freely between countries; have workable mechanisms for transfers to struggling regions; react similarly and flexibly to shocks; or between which there is a high degree of trade openness. The consensus seems to be that for groups of countries which are not optimal currency areas, maintaining exchange-rate flexibility is best, while also introducing/preserving institutional agencies of restraint to limit inflationary policy.

There is a lack of agreement as to the precise nature of the relationship between economic policy coordination and economic convergence. In practice, any group of countries contemplating a policy union will require convergence in macroeconomic stability indicators as a prerequisite for admission in order to protect other members from adverse policy spillover effects. This implies that a set of credible Maastricht-type criteria will be an essential component of an agreement to coordinate policy, although it is possible that stability indicators will converge only as real economic convergence is occurring.

Progress towards the Monetary Harmonisation Programme (MHP) criteria

Average annual inflation of less than 10%

Inflation is the most basic symptom of macroeconomic instability. It is possible for measured inflation to appear low where there are price controls, while unofficial prices are behaving quite differently. Low inflation created by controls – in other words suppressed inflation - would not be an indicator of progress towards the conditions for monetary convergence. In the period 1995-1999, twelve COMESA members had average inflation which met the MHP criterion. Many of the countries which did not meet the criterion are involved in military conflict.

Budget deficit less than 10% of GDP

COMESA members have done even better with their budget deficits in meeting the MHP criterion: at least 16 out of the 20 countries for which data are available had budget deficits less than 10% of GDP in 1995-99. In fact, all but two of these had budget deficit to GDP ratios of 5% or less. This is of great significance, because the MHP criterion is clearly insufficient for eventual macroeconomic stability and monetary convergence. That such a large number of countries have gone beyond meeting the MHP criterion makes it feasible to consider reaching a considerably tighter criterion, which will undoubtedly be necessary in the longer-term.

Broad money growth less than 10% per annum

The monetary growth criterion for the MHP may be *inconsistent with the inflation criterion*. Whereas a majority of COMESA member countries met the inflation criterion in 1995-99, only three met the monetary growth criterion over the same period. The monetary growth criterion proposed in the 1995 Report may have been too stringent.

Central bank finance of government spending less than 20% of previous year's government revenue

As with the monetary growth criterion, the criterion for limiting finance of the government by central banks has a relatively weak correlation with success in controlling inflation. The criterion is probably inappropriate, and should refer to recent changes in such finance rather than to its absolute size. It is suggested, therefore, that a new criterion be created, namely that increases in central bank claims on the government *should not increase* by more than 5% of the previous year's revenue.

Positive real lending and deposit rates

In 1995-99, twelve COMESA member countries had positive real lending and deposit rates, and a further five had positive real lending rates, but deposit rates which were (by and large mildly) negative in real terms. The great majority of COMESA members were therefore meeting the interest rate criterion, or were quite close to it. This does not imply that the interest rate situation was satisfactory, however. Because of the wide margins between lending and deposit rates, some member countries have to have exceptionally high nominal and real lending rates in order to achieve positive real deposit rates. It is greatly preferable to meet this criterion by reducing inflation, than to have to achieve positive real interest rates by having high nominal rates.

Annual debt service as a percentage of export earnings to be less than 20%

Eleven member countries for which there are statistics had debt service ratios (annual debt service as a ratio of annual exports) below the MHP criterion of 20% during 1995-99. Most of the remainder have debt service ratios between 20% and 30%. It is possible that the statistics paint a more optimistic picture than they should. The numbers are for

debt service actually paid, and may therefore conceal unpaid debt service and the building up of debt service arrears. It should also be pointed out that a debt service ratio of 20% is a tremendous burden. Few countries can actually pay as much as 20% over an extended period of years. An external debt service ratio above 10% can be argued to be a major constraint on development.

Macroeconomic convergence in COMESA

Real economic convergence in COMESA is a necessary precondition for monetary harmonisation. There is no reason, *a priori*, to expect that convergence has taken place, as substantive moves towards facilitating intra-regional trade and factor movements are relatively recent. Two different measures of convergence were used for the period 1980 to 1998, and both show that there has been no convergence of real incomes across COMESA as a whole. If anything, the economies of member countries have *diverged*. Even within sub-groups of countries, there is no evidence to suggest that convergence clubs have emerged over the period considered.

The complete lack of progress towards a greater degree of economic similarity between COMESA members suggests that the region is currently *not* an optimal currency area. In order to foster greater regional symmetry, it will undoubtedly be necessary to implement more stringent economic policies. In preparation for the introduction of the euro, EU members adopted a set of criteria agreed to in the Maastricht Treaty. As these are theoretically consistent, they have been used as a starting point for developing a set of criteria for COMESA countries.

Maastricht-type criteria

Against a modified set of Maastricht criteria, which are prerequisites for a common currency, the performance of COMESA members varies:

- a large majority of COMESA countries have budget deficits which are already less than 3% of GDP, or are within reach of achieving that target
- very few COMESA countries meet the already too soft inflation criterion
- with respect to exchange-rate stability, there is still a long way to go
- external debt ratios remain a serious problem

An additional, important, criterion was raised in the review of the literature: it makes sense for a country to fix its exchange rate to that of its major trading partner/s. By this criterion, a common currency in COMESA is sub-optimal, because COMESA countries trade very little with each other.

Summary of progress

Overall, by all criteria, it can be concluded that progress has indeed been made towards policy convergence and monetary harmonisation. The progress made is mostly the result of either internal decisions, or IMF/World Bank conditionality, rather than explicitly in

order to meet commitments made towards COMESA and its MHP. Nevertheless, there are extremely significant benefits in prospect if further progress can be made towards macroeconomic equilibrium, whether or not this leads on to the creation of a common monetary area in COMESA. Further progress will require stricter macroeconomic targets than those proposed in 1995. These were probably appropriate at the time. It would have been pointless to propose targets which were apparently unattainable for most COMESA countries. That is no longer the case, however, so that stricter targets are now within reach for most members.

Flexibility

In order to meet the need for a degree of flexibility in the criteria for economies subjected to external shocks while at the same time preserving the binding nature of the MHP, it is proposed that the criteria be tightened and then applied to three-year moving averages rather than annual outcomes. This will allow slippage in one year to be compensated for over two, but will not allow adjustment to be dragged out over a long period of time.

Credibility

In order to attract foreign investment, and to encourage domestic investment, governments need to build credibility. It takes a long time to convince investors that a shift to a more stable policy regime will not be reversed, much longer than most developing countries can afford to wait. The role of external institutions in acting as agencies of restraint has been of limited effect, and COMESA is not yet in a position to develop an internal institution which will itself have sufficient credibility to be of benefit to member countries.

The most viable alternative would be for a number of COMESA countries to choose to lock in (to the extent possible) future macroeconomic stability by creating *irrevocable* links with one or more major currencies, the euro or the US dollar. This would not only allow them to import credibility from the rich economies but it would then be a relatively small step for them to link to the same currency, creating a common currency area. The link can be organised via a currency board arrangement, or by legally substituting a strong currency (usually the US dollar, but, for COMESA, preferably the euro) for the domestic currency.

It must be stressed that a country can only commit to an irrevocable link once it has achieved macroeconomic stability that approaches that of the country to which it is linking. If macroeconomic disequilibrium emerges, the link will have to be broken, with extremely severe implications for any future attempts to create credibility.

The common currency and links with other African organisations

If COMESA countries were to link to the euro, they would, in effect, also be linking to the CFA franc, creating a potential zone of over thirty countries all linked to the same currency.

Although relatively little progress has been made in other regional organisations in Africa, there is nothing in the criteria set out for the MHP that could be interpreted as being damaging to the interests of non-member countries or as currently conflicting with the objectives of other regional groups. It would be possible to create such conflicts, by raising tariffs against non-member countries or introducing investment subsidies, but, if policy towards non-COMESA countries remains unchanged, moves towards macroeconomic stability can only be of benefit to the rest of the continent.

Incentives and sanctions

In order to encourage compliance with COMESA treaties, a range of carrots and sticks are available. Although a mechanism of compensatory payments to smaller, poorer countries is inappropriate in a currency union (applying only in a customs union), for political reasons it is important that the benefits of regional integration be seen to benefit all members more or less equally. One means of spreading the benefits is the formation of a regional development fund, financing infrastructure investment and financed by a combination of regional governments, the private sector and donors.

Alternatively, the establishment of a COMESA stabilisation fund could be used to smooth out members' responses to exogenous shocks to their balance of payments, and leave individual COMESA governments with greater budgetary discretion than is currently available from the IMF, the World Bank and other donors. However, the financing of such a fund is currently beyond the reach of members, and the building up of sufficient reserves will require significantly more stringent economic policy.

It is equally important that sanctions for non-compliance with the MHP criteria be applied to defaulting members, a process that requires political will and the prior existence of something to lose by exclusion. As long as COMESA agreements are loose and the gains are small, there is no incentive to adhere to difficult undertakings where they conflict with other national interests. Exclusion from a regional development fund, if it could be established with sufficient finance to make a significant difference, could be used as a sanction.

Institutional reforms

It is difficult to be objective about progress with institutional reforms, but some progress has been made with the liberalisation of different financial markets, as 13 countries have accepted IMF Article VIII (under which current account transactions on the balance of payments are free of all restrictions). Only two countries have abolished exchange controls completely, although 15 have removed them in part. Many governments retain some control over interest and exchange rates.

Sub-groups within COMESA

An alternative possibility for monetary harmonisation is for sub-groups of COMESA member countries to have convergent policies, leading to macroeconomic convergence. It

would seem most likely that such sub-groups would be mainly geographical, and based on the largest and/or most dynamic economies in each sub-region. Currently, there is no evidence of convergence within these groups, but the report considers the potential for each by comparing basic macroeconomic statistics for the following sub-groups, with the possible "leading" economy listed first:

- Egypt, Sudan, Djibouti, Ethiopia, Eritrea (northern): promising
- Kenya, Burundi, Comoros, Congo, Mauritius, Rwanda, Seychelles, Tanzania, Uganda (central): some progress towards harmonising policy, but instability in the largest economy remains a problem
- Zimbabwe, Angola, Madagascar, Malawi, Namibia, Swaziland, Zambia (southern): least progress, and progress remains unlikely while Zimbabwe and Angola have internal difficulties.

Recommendations

The recommendations, in the final section of the report, are based on the belief that more progress will be made by COMESA member countries proceeding at their own speed, in pursuit of their own objectives of macroeconomic stability and the increased investment that should follow, than by COMESA endeavouring to get all member countries to move simultaneously towards the interim, and eventually the final, objectives of the Monetary Harmonisation Programme.

Individual countries which have achieved macroeconomic stability can lock in those gains (by establishing currency boards or by euro-isation/dollarisation). As the number of countries with such an external currency link increases, it will establish a de facto common currency. This should enable COMESA to achieve the objectives of a common currency, and eventually a common currency itself. This would be initially for a core group of countries, but with time for an increasing number, as further member countries satisfy the proposed criteria. Until macroeconomic stability is attained, however, countries should not make irrevocable commitments to fix their exchange rates, because the consequences of a policy reversal will be very harmful to long-run growth.

In summary, it is recommended that COMESA member countries, having once achieved macroeconomic stability (defined in the recommendations), establish currency board arrangements with a major non-regional currency, preferably the euro, before attempting to launch a new regional currency. In the interim, however, a series of macroeconomic targets will have to be met, and these should be tightened where appropriate in order to reduce the costs to all other members of one member's instability.

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1 Background

The treaty establishing the Preferential Trade Area for Eastern and Southern African States (PTA) was signed in December 1981, and became effective in September 1982. In 1988, the Council of Ministers directed the Secretariat to do a study of a PTA Monetary Union. In December 1989, an "historic decision" was made, that a monetary union should be established in the PTA. It was hoped that a monetary harmonisation programme would liberalise factor mobility, enabling economic adjustment in member states to be effected less painfully through price changes, rather than through changes in real output and employment under conditions of price rigidity [PTA, 1990]. This would require harmonisation of fiscal policy, monetary policy, external sector management and development policy.

A task force report in September 1991 [PTA, 1991] recommended that the PTA should adopt a gradualist approach, noting that most members had IMF programmes which they would not abandon for a PTA programme. This report set out the costs, mostly immediate, and the potential benefits, which were said to be mainly long-term. The report also argued that the benefits would be greater the higher the form of integration.

The task force report recommended a phased programme as follows:

Stage 1 1992-96, which would consolidate the existing mechanisms of the clearing house and PTA travellers' cheques, neither of which was at that stage being fully utilised.

Stage 2 1997-2000 could not start until Stage 1 was completed. Stage 2 would involve limited currency convertibility and an informal exchange rate union.

Stage 3 2000-24 would start with immutable fixed exchange rates, fluctuating within a given margin, with intra-PTA transactions fully convertible. Central banks would remain independent, but monetary and fiscal policy would be coordinated by a common monetary institution. Foreign exchange reserves would be pooled, and managed by the common monetary institution. Stage 3 could not start until Stage 2 was completed.

Stage 4 2025 onwards would involve a common currency issued by a common monetary authority, provisional upon the success of Stage 3, and COMESA members wanting at that stage to move to full monetary union.

A review of the implementation of the Monetary Harmonisation Programme in 1995 [COMESA, 1995] proposed a series of macroeconomic and institutional targets, as follows:

Macroeconomic targets

- budget deficit to be less than 10% of GDP
- central bank finance of budget deficit to be less than 20% of previous year's fiscal revenue
- interest rates, on both savings and borrowing, to be positive in real terms
- annual growth of broad money supply to be less than 10%
- annual debt service as a percentage of export earnings to be less than 20%
- annual rate of inflation to be less than 10%.

Institutional targets

- abolition of exchange controls, including accession to IMF Article VIII
- freely floating exchange rates
- liberalisation of interest rates
- use of indirect monetary policy instruments
- increased use of the Clearing House for intra-COMESA trade
- increased use of PTA travellers' cheques.

In October 2000, the COMESA Secretariat requested a further review of progress towards monetary harmonisation in COMESA, and a revision of the Programme "so that it more effectively and efficiently meets the needs of member States" [Terms of Reference, 2000]. This report is a response to that request.

It is very important that a theoretically or empirically consistent set of criteria be defined, against which prerequisites and benchmarks can be established for the MHP. Section 2 reviews the theoretical literature on monetary harmonisation and analyses the experience of other regional groups of developing countries which use a common currency. Each sub-section draws out the relevant lessons for COMESA.

Recent developments within COMESA are reviewed next: the progress of individual member countries in implementing the MHP, the extent of convergence between members and sub-groups of members, and the recent experience of members with a set of adapted Maastricht criteria (Sections 3-8).

The report also considers a range of supplementary policies which, if in place, would underpin the process towards monetary harmonisation, and further economic relations with other African regional groups and individual countries (Sections 9-14). The final section summarises the recommendations.

2 Literature review: lessons from theory and experience

There is a broad theoretical and empirical literature concerned with macroeconomic policy coordination and monetary harmonisation. This literature identifies several issues that are critical when discussing the readiness of a group of countries for policy coordination. If we are to have any confidence in the findings of this study, it is necessary that we begin with a solid theoretical framework and an understanding of experience with monetary harmonisation elsewhere in the world. In addition, there will be features not covered in this literature - unique to COMESA - which will need to be taken into account.

In essence, the argument is as follows. The desire for independent nation states to coordinate policy arises from four sources. First, it is essential as a means of achieving a common currency, which should reduce the costs associated with international trade and capital flows (both the direct costs of foreign-exchange conversion and the indirect costs of delays and uncertainty). Second, changes in macroeconomic policy in one country have spillover effects on others, possibly generating a need for adjustment, which would

not otherwise have arisen. Third, there is a desire to avoid beggar-thy-neighbour policies in the pursuit of higher employment. Fourth, smaller, poorer countries wish to enhance their growth performance. The theoretical prediction that poorer countries should catch up with richer ones (because, for example, they can take advantage of existing technological developments and larger markets without having to develop their own) is weakly supported in groups of countries where cooperation is occurring. There is evidence that “convergence clubs” exist, where countries with a lower GNP *per capita* grow more rapidly because they are members of a trade group, or because domestic policy gains credibility by being tied to the domestic policy of a country with a better economic reputation.¹

However, there are also costs attached to economic policy coordination: primarily a loss of the use of policy instruments for domestic stabilisation (in political terms, a “loss of sovereignty”). If countries do not fulfil the criteria for being an optimal currency area, an attempt to lock their currencies together may prove unsustainable. For policy coordination to create a net gain, it is necessary that there be some degree of “convergence” (explained below) between the participating countries. They must either fulfil certain criteria in terms of both the domestic policy stance and the structure of domestic institutions, or there must be a supranational body which has sufficient authority to enforce compliance. The international experience is mixed, in terms of both the feasibility of cooperation and the effectiveness of regional arrangements. These issues are explained more fully in the review which follows.

There are several potential starting points for developing a set of benchmarks in moving towards a single currency. It is useful to review the preconditions for exchange-rate coordination, especially in its most extreme form of a currency union. An alternative is to use the EU’s Maastricht criteria as a starting point, and to evaluate their applicability or otherwise to COMESA countries. The experience of other regional groups is important. Although reference will be made to monetary unions among richer countries, the experience of African groups, like the (Rand) Common Monetary Area and the CFA-franc zone in West Africa, is potentially more interesting, as are attempts at policy coordination between developing countries outside Africa, in, for example, the Caribbean or Latin America.

2.1 Macroeconomic policy coordination and the problems of spillover effects

This section reviews the desirability and form of multilateral macroeconomic policy coordination.

As globalisation progresses, links between countries increasingly mean that monetary and fiscal policies adopted in one country affect the economic performance of other countries. Much of the current literature on international macroeconomics deals with the international transmission of national macroeconomic policies (see Persson and Tabellini,

¹ In particular, the ability to finance budget deficits by money creation has proved disastrous in those African countries with their own central banks (see Table 24), so that there would be a credibility advantage in ceding monetary control to an external institution.

1995). Clearly inefficiencies (and worse) are possible: governments choose policies to maximise domestic objectives and ignore the externalities imposed on other countries, possibly generating sub-optimal equilibria. The current concern with international policy coordination (or cooperation) stems from a felt need to take into account international strategic considerations as well as domestic interests.

There are different levels of cooperation. In the simplest case, countries exchange information about, for example, policy targets and priorities, but decisions are taken autonomously. Alternatively, countries may agree to coordinate their responses on an *ad hoc* basis to particular problems, like a region-wide drought. More formal cooperation ranges from agreement on particular targets, like the exchange rate, through partial coordination to a full bargain covering all targets and policy instruments.

Regional cooperation is not straightforward. Even within a single country, there are often difficulties with policy coordination, not least because different agents have responsibility for oversight. In developed countries, fiscal policy is the collective decision of politically motivated representatives, while monetary policy is usually implemented by a single-minded institution, with a greater or lesser degree of distance from the direct political process. In African countries, fiscal policy may be determined by collective decision-making in parliament, although sometimes it is the preserve of a centralised decision-making body consisting of the President and Ministers of economic departments. Monetary policy is frequently subservient to the dictates of financing the budget deficit. In addition, some autonomy in domestic economic policy-making may be lost to the international financial institutions (IFIs). In the latter case, the IFIs usually also have objectives limited to the domestic economy, and ignore the externalities which structural adjustment programmes impose on other countries.

Changes in domestic *fiscal policy* are transferred to other countries (i) through changes in the terms of trade; (ii) where capital is internationally mobile, through changes in the after-tax/after-subsidy return on investment in different localities; and (iii) through changes in the demand for imports. Internationally there are no examples of tight fiscal policy coordination outside of federal structures (Persson and Tabellini, 1995:3), although the EU may be moving in this direction. Cooperation in fiscal policy would imply some harmonisation of tax rates and of expenditures on subsidies. Governments are generally reluctant to cede such powers to a supra-national authority. Only when there are long-term relationships between countries, which create incentives - based on reputations and institutions - to maintain the relationship, can some policy coordination be sustained. A country with a history of macroeconomic instability may find it very difficult to build a reputation for fiscal restraint, in which case international structures (external agencies of restraint), which have authority to enforce cooperation, may be advantageous. Alternatively, in situations where one country is dominant, compensating payments by the dominant country, in return for the prerogative of guiding regional policy, may be necessary to hold the participating countries together.

Changes in domestic *monetary policy* are transmitted to other countries through changes in interest rates and in real exchange rates. Cooperation will reduce the inefficiencies

which arise when there are conflicts between regional economies over stabilisation policies or growth targets. Monetary cooperation usually takes the form of a fixed exchange-rate regime,² where a smaller country makes a one-sided commitment to following the monetary policy of the dominant country, which chooses its monetary policy freely. Where shocks affect the two countries symmetrically, there is no need for any cooperative agreement; the one-sided peg is sufficient for a cooperative outcome (for example, prior to the launch of the euro, the Austrian schilling was pegged to the D-mark). If shocks affect countries asymmetrically, then they strain the whole mechanism, especially when they affect the central country (for example, the US and the Vietnam War under the Bretton Woods system, or German unification under the European Monetary System). In the presence of an agreement, the stronger country must take the smaller country into account, so usually only the smaller country is prepared to commit to a formal contract. A fixed exchange-rate contract is therefore only feasible in the case of extreme symmetry (and, possibly, extreme asymmetry, although the literature rarely deals with this case). Incentives to deviate from an exchange-rate peg are only small if (i) the central country has a lot of credibility; (ii) shocks are not asymmetric; and (iii) macroeconomic development in the participating countries is relatively parallel. These issues are dealt with in greater detail below.

Before examining more closely the economic issues of policy coordination, note that there are important *political issues* to be considered. It has been suggested that political factors actually dominate economic factors in the formation of currency unions (Cohen, 1993). It is possible to attach too much importance to regional harmonisation. Although the levels of demand, inflation and interest rates in one country affect economies elsewhere, a country can usually manage its own monetary and fiscal policies to offset many of the potential influences from abroad. There is a serious risk that economic summits and ministerial meetings can *slow down* the taking of painful decisions to make appropriate changes to domestic policies (Mooslechner and Schuerz, 1999:174). This occurs either because politicians feel that they can escape their responsibilities by blaming poor domestic performance on policies pursued abroad, or because they hope that coordinated foreign action will make domestic changes unnecessary, or because their actions are, in fact, bound by international agreements. Moreover, the attempt to pursue coordination in a wide range of macroeconomic policies is likely, even among developed countries, to result in disagreements that reduce the prospects for cooperation in more limited areas of trade, defence and foreign assistance (Feldstein, 1988:3). The collapse of, or non-compliance with, international agreements can lead to recriminations, souring foreign relations. It is better not to set up a policy union which is destined to fail.

In summary, there is consensus in the literature that economic policy coordination is desirable in an interdependent world where national policies create externalities for other countries (Hughes-Hallett and Mooslechner, 1999:169). However, policy unions are

²The institutional arrangements for a monetary union must include a common inflation target, a common inflation index, a common decision-making group to expand or contract the money supply, a mechanism for redistributing seignorage revenue, and a fixed exchange rate (Mundell, lecture, University of Oxford, 27 Oct 2000).

difficult to maintain, particularly if member countries respond asymmetrically to external shocks. Where there are long-term relationships that are mutually desirable then some policy coordination may be sustained, but the wider the range of policy variables tied by international treaties, the smaller the likelihood of compliance.

2.2 Exchange-rate coordination and adjustment

This section examines more closely the preconditions for currency union.

There is consensus in economic theory about the preconditions for exchange-rate coordination. Fixed exchange rates are *less* appropriate for countries dependent on the inflation tax; without factor mobility; subject to rigidities, so that shocks take years to work their way through the economy; and where shocks for core and peripheral countries are asymmetric.

The most extreme form of exchange-rate coordination is the formation of a currency union. Adopting a common currency means that a country cannot (i) devalue/revalue on its own, or (ii) control the quantity of money (De Grauwe, 1992).

The reasons for pegging are: (i) to reduce the costs associated with unpredictable volatility, both short- and long-term; (ii) to restrain domestic inflationary pressures; (iii) to import credibility from a low-inflation country; and (iv) to anchor price inflation for internationally traded goods, providing a guide for private-sector inflation expectations.

The costs of pegging include: (i) the loss of the exchange rate as a stabilisation instrument; (ii) the loss of control of the domestic money supply, and, consequently, loss of monetary instruments for stabilisation; (iii) an increased fiscal burden for higher inflation countries by reducing seigniorage revenue if disinflation is necessary (Gros and Vandille, 1995); (iv) the threat (and reality) of speculative attacks; and (v) if a common currency is adopted, the potential for conflict over, for example, the distribution of seigniorage, and common versus domestic stabilisation requirements.

Since the breakdown of the Bretton Woods system, very few fixed-rate regimes have actually remained intact. This is not only because of the costs of pegging, but because individual country reserves are dwarfed by the size of short-term capital flows. The latter magnify any weakness in a country's commitment to a fixed rate, leaving little room for manoeuvre, and increasing the likelihood of speculative attacks (Obstfeld and Rogoff, 1995:94). Even countries with a high degree of price stability have experienced large fluctuations in exchange rates. A fixed exchange rate is therefore very costly for a government to maintain when its promises not to devalue lack credibility. At the same time, developing and maintaining credibility has become increasingly difficult, as the 1992-93 European, 1994-95 Mexican and 1997-98 East Asian experiences showed. Even the EMU has had difficulty creating confidence in the euro.³

³ Note that a floating rate does not mean that a country avoids crises; South Africa, for example, endured a series of sharp exchange-rate adjustments in the 1990s.

A common money market - as distinct from fixed exchange rates - removes one of the main sources of uncertainty, speculative capital movements (Dooley, 1998:21). However, certain conditions must be fulfilled if there is to be a net gain from forming a monetary union. One relevant area of theory is that of optimal currency areas (OCAs), although this is criticised by some as “murky and unsatisfactory” (Buiters, 1995:1). There is no standard theory of OCAs, but several approaches follow Mundell (1961). The key insight of this body of theory is that countries or regions which experience high diversity in output and employment growth, in domestic institutions, or in preferences about optimal (acceptable) inflation and unemployment, need considerable labour market flexibility if they want to form a monetary union and avoid major adjustment problems.

Consider the following example. If there are two countries in a monetary union and an external shock shifts demand from one country’s goods to the other’s, the first country will run a current-account deficit and the second a surplus. In order to adjust, it is necessary for labour and/or capital to move from the deficit country to the surplus country, or for real wages to fall in the deficit country and to rise in the surplus country. If neither occurs, then the surplus country must allow some price inflation. Resisting this means that the current-account surplus, and therefore inflationary pressures, will persist. By contrast, the deficit country will have unemployment. If it cannot devalue, it must deflate to eliminate the deficit, but this will worsen the unemployment problem.

An alternative solution would be for the surplus country to increase taxation, and transfer the revenue to the deficit country. The deficit will then persist, but will be financed by the surplus country. These transfers between countries are known as “regional policy”. This is in effect what happens within the borders of one national unit (country), where transfers occur from more prosperous regions to ailing regions via the fiscus. Note that a significant degree of political cohesion is required if transfers to the deficit country are to be acceptable to the electorate of the surplus country.

Countries with a low degree of flexibility in the labour market and a relatively high degree of real divergence do not form an OCA. They are better advised to maintain some degree of exchange-rate flexibility, even if this carries economic costs, or face unemployment as they adjust to shocks (Soltwedel *et al*, 2000:37).⁴

It is possible, however, that in the case of extreme asymmetry, credibility gains are possible for a small country if it pegs to the currency of a large neighbour (its main

⁴The probability of asymmetric shocks depends on economic structures, their development over time, and on the degree of synchronisation of the business cycle across members of a monetary union. It is an important question as to whether currency union will affect economic structures and the synchronisation of business cycles. There are two views, both plausible on theoretical grounds. The first argues that tighter forward and backward trade linkages between members make both structures and cycles more symmetric, especially if shocks are common to all members or if trade is concentrated within a given industry (intra-industry trade is high) (Frankel and Rose, 1998). The second view makes the case that, in a common currency area, there are better opportunities for exploiting economies of scale, encouraging geographic concentration of industries and making it more likely that a given shock will have asymmetric effects on different regions because of increasingly different structures of production (Krugman, 1993). Empirical evidence on this question is inconclusive.

trading partner) with a credible anti-inflationary policy. This suggests either adopting the (stable) currency of a larger country under a currency board arrangement, as in, for example, Estonia (Burdekin and Langdana, 1995:24,25), or creating a supranational authority with currency boards. In this case, the smaller country effectively cedes macroeconomic policy-making to the dominant country.⁵

Soltwedel *et al* (2000:38) point out that differences occur not only between nation states but also between regions within national boundaries. In the EU asymmetric shocks are ‘much more pronounced’ at a regional level than on a national level; regional differences in economic growth rates are about twice those of national differences; and regional differences in unemployment rates in the struggling regions exceed those in the best-performing regions by a factor of more than 10. These unemployment problems are concentrated in the countries and regions in the periphery of the EU, where labour markets respond slowly to changes in supply and demand. Peripheral regions and countries are less likely to benefit from monetary union because they engage in little trade with the core members, profit less from the elimination of the exchange rate, and are less flexible in adjusting to shocks.⁶

In summary, monetary union is optimal amongst economies that exhibit marked differences if one - or a combination - of several conditions is fulfilled: there is wage flexibility; factors are mobile between countries; politically easy transfers are possible; or countries react similarly and flexibly to shocks. Alternatively, in groups of countries that exhibit marked rigidities and factor immobility, a degree of real economic convergence (explained immediately below) is necessary for exchange rate coordination. There is a possible and important exception: the case of extreme asymmetry, where a small country effectively hands over monetary policy to the control of its largest trading partner. The consensus seems to be that for groups of countries which are not OCAs, maintaining exchange-rate flexibility is probably best. They should also introduce or preserve institutional constraints on expansionary policy, such as guaranteeing the independence of the central bank, and/or reforming monetary institutions to focus on restraining domestic inflation (Harvey and Hudson, 1993). In other words, the exchange rate becomes an *indicator* and not the central target for monetary policy (Irwin and Vines, 1995:18; Obstfeld and Rogoff, 1995:74).

⁵A regional central bank, in which no single member has the final say, should in theory achieve the same result. However, even when a regional central bank is statutorily independent, governments might still look for ways to prevail upon its decisions by, for example, applying direct political pressure or influencing the appointment of members of the bank’s board (Beetsma and Bovenberg, 1999:300). The more countries involved in the union, the less incentive each individual member has to contributing to the credibility effect of a tight macroeconomic policy regime, preferring instead to focus on domestic imperatives and free-riding on the discipline of other members.

⁶It may be better for smaller groups/pairs of similar countries to form currency unions between themselves rather than joining a large group, if they are subject to external shocks on a regular (though unpredictable) basis. It was argued, for example, that although neither Finland nor Sweden is an obvious candidate for membership of the EMU (although Finland has, in fact, joined), together they appear to form an OCA (Jonung and Sjöholm, 1999:696).

2.3 Convergence

The convergence literature is confused and confusing. There appear to be different issues involved, and no consensus on any particular issue. For example, the literature refers to, but does not self-consciously distinguish between, convergence in two different contexts: convergence in real GDP *per capita* (i.e., a tendency for equalisation of income); and convergence in macroeconomic stability indicators.

Convergence in GDP per capita

This arises out of the prediction of neoclassical growth theory that poor economies might “catch up” with richer ones. If countries are converging, there would be a negative relationship between real income per head at the beginning of some time period and subsequent rates of growth (in real income per head). In other words, poorer countries will, on average, be growing faster than richer ones.

Most empirical studies testing the convergence hypothesis find no evidence of convergence occurring worldwide, or even among a very large sub-sample of the world’s economies (Romer, 1986). In fact, many poorer countries have experienced periods of negative *per capita* growth, so that the gap between rich and poor countries has been increasing. However, within smaller groups of countries (regions), like the OECD countries, or the US states, or Japanese prefectures, there is evidence of real economic convergence (Barro and Sala-i-Martin, 1991; Dowrick and Nguyen, 1989). The contrasting evidence has given rise to two related hypotheses:

(ii) *Convergence clubs*, which are a subset of converging countries (Baumol *et al* (eds), 1994), suggested as being those with similar initial human capital endowments. Moderately backward members of the club are able to take advantage of technological improvements in front-runners, and catch up. One version of this is that all countries which are open and integrated in the world economy are members of the convergence club (Sachs and Warner, 1995:41). Ben-David (1995) also argues that trade-based groups show higher convergence than randomly created groups.

(ii) *Conditional convergence*, where each country has its own long-run *per capita* income equilibrium, and grows more rapidly the greater the gap between initial income per head and this equilibrium (proxied by certain structural variables, like initial human capital endowments) (Barro and Sala-i-Martin, 1991; 1992; 1995). Other structural variables causing substantially different steady states include disparities in savings rates, fertility, and available technology (Barro *et al*, 1995:103), as well as differences in policies regarding economic integration (Sachs and Warner, 1995:41).

Convergence in macroeconomic stability indicators

There is a debate as to whether convergence in macro-stability indicators is a precondition for or a result of a fixed exchange rate regime. The literature deals almost exclusively with the EU and the conditions that make up the Maastricht criteria for

joining the European Monetary Union (EMU). As such, these convergence criteria provide a natural starting point for examining the international experience.

Clearly the criteria were envisaged by those who drew up the Maastricht Treaty as a precondition for monetary union in Europe (see Artis, 1992; Healey and Levine, 1993). Article 109F of the treaty sets out the following requirements for eligibility: (i) inflation rates must converge close to the average rates achieved by the three countries with lowest inflation; (ii) long-term nominal interest rates on government debt must converge to a level close to the average of those achieved by the three countries with lowest inflation; (iii) exchange rates must be stable (within the Exchange Rate Mechanism bands) for two years prior to EMU without any measures to stop the free flow of foreign exchange; (iv) the budget deficit-to-GDP ratio must not exceed 3 percent; and (v) the public debt-to-GDP ratio must not exceed 60 percent. However, it was argued that at least some of these criteria would be automatically satisfied on monetary unification, particularly interest-rate equalisation, and common equilibrium inflation in traded goods (Buiter, 1995:39,16).

The point of the criteria was to minimise the costs to other members of any particular country's joining the EMU. The inflation condition effectively ruled out sharp differences in indirect tax policies (Artis, 1992:303). The point of the exchange-rate criterion was to eliminate an "endgame devaluation" (a last devaluation push immediately prior to full integration in order to gain a competitive advantage or to amortise excessive public debt). The inclusion of the interest-rate criterion was a way of taking advantage of the forward-looking character of financial markets, because expectations about future inflation, exchange rates and fiscal policy are embodied in the interest-rate premium. The fiscal criterion was probably the most contentious, and a compromise was struck by allowing the 3 percent figure to be interpreted as a guideline. The basic argument for fiscal discipline turns on the analysis of Sargent and Wallace (1981). They argued that fiscal and monetary policy must be consistent. A country that continues to run an expansionary fiscal policy, and which has a growing government debt-to-GDP ratio, must, at some stage, monetise that debt, making a restrictive monetary policy impossible. The point of the deficit-to-GDP and debt-to-GDP ratios was, therefore, at least in part, to protect other members from having to service part of a country's debt directly or indirectly through European Central Bank monetisation (Buiter, 1995:42). Although fiscal criteria create an inherent contractionary bias in fiscal policy (Bean, 1996:25), countries with a strong preference for low inflation are likely to insist on such criteria because they will not want a union with fiscally more expansive economies.

There is a lack of consensus as to whether or not exchange rate coordination helped to foster convergence in macroeconomic stability indicators among EU members (reviewed in Bank of England, 1991a). There is also a lack of consensus as to whether monetary integration in Europe is good or bad. Prior to the launch of the euro, some argued for immediate monetary union among all members (for example, Buiter, 1995). Others argued that the prospects for a single European currency that delivers price stability were not good (Fry, 1991:502). Still others preferred to remain agnostic (Allsopp *et al*, 1995; Begg *et al*, 1995). Two years after the launch of the new currency, there remains a

decided lack of agreement as to whether or not it is successful and whether or not EU members outside the euro-zone, like Britain, should join.

Finally, there is no agreement on the issue of whether convergence in Maastricht criteria (or monetary union) can foster “catch-up” convergence - or in which direction causality flows if there is a causal link. The evidence for Europe seems to be mixed, with greater convergence occurring in some periods and not others (Neven and Goyette, 1995). Some countries, like Ireland, Spain and Portugal converged rapidly on the richer members. The Mezzogiorno (Southern Italy) remains relatively poor, despite having complete economic unification, including a common currency, with Northern Italy. Also it is argued that the costs of achieving forced convergence between West and East Germany have been high, and have required large transfers. Similarly, any reduction in income disparities between north and south in Italy appears to have required large transfers (Begg *et al*, 1995:10).⁷

A consensus is emerging that openness to trade fosters catch-up convergence,⁸ which in the EU preceded the process towards monetary union. The OCA literature implies that catch-up should precede convergence in macroeconomic stability indicators.⁹ As economies converge, structures of production and demand within individual countries diversify, increasing each country’s ability to respond flexibly to external shocks. With economic growth, governments become less dependent on the inflation tax. At the same time, financial and labour market institutions are either globalised or at least modelled on those in more sophisticated trading partners. This greater general macroeconomic stability creates a context for effective policy coordination. In addition to these macroeconomic issues, the cost savings from adopting a common currency are maximised if the participating countries are each others’ major trading partners. Indeed, some writers regard the extent of trade openness between potential members as at least equal in importance to OCA criteria (Anthony and Hughes-Hallett, 2000:122). This is significant for COMESA countries which trade very little with each other.

One of the mechanisms through which economic integration is supposed to foster convergence is that of greater freedom for investment to locate in lower-wage areas. In fact, a study of developing countries shows that investment is slow to move towards poorer regions or countries, preferring to agglomerate near richer markets (Puga and

⁷ Free trade, policy convergence and a common currency may be necessary for catch-up to occur, but these policies are not sufficient. If low income areas or countries do not have spare productive capacity, or are not able to attract investment (because of poor infrastructure, an undereducated labour force, or corruption), then they will not be able to raise output and so catch up.

⁸See, for example, Collier and Gunning (1999); Dollar (1992); Edwards (1993); and Sachs and Warner (1997). Some of these findings are disputed (Krishna *et al* (1998); Rodriguez and Rodrik (1991)). Trade policies are, to some extent, endogenous, so the direction of causation may not be obvious. Moreover, protection of manufacturing often produces high growth initially but slower growth in the longer run.

⁹An alternative view argues that the direction of causality between trade and the adoption of a common currency runs the other way: using data for 180 countries over 20 years, Rose (2000) shows that a currency union trebles trade, holding other things constant, making the case for monetary union stronger than is usually imagined.

Venables, 1999).¹⁰ The evidence for the EU is mixed, with some peripheral regions, like Ireland, experiencing an investment boom and others, like eastern Germany and southern Italy remaining poor. Even among the richer members, experience is not uniform, with Germany and France expected to enjoy a positive investment response to the reduction in exchange-rate volatility, while Italy and the UK are not expected to experience any permanent gains (Darby *et al*, 1999:C67).

In summary, there is a lack of agreement as to the precise nature of the relationship between economic policy coordination and economic convergence. In practice, any group of countries contemplating a policy union will require convergence in macroeconomic stability indicators as a prerequisite for admission in order to protect other members from adverse policy spillover effects. This implies that a set of credible Maastricht-type criteria will be an essential component of an agreement to coordinate policy, although it is possible that stability indicators will converge only as real economic convergence is occurring.

2.4 The question of sustainability

OCA models focus on static alternatives. In a dynamic situation, the balance of costs and advantages of membership may be narrow and uncertain, and a member could get to the point of wishing to leave, creating volatility for all members. If membership of the currency area increases a member's vulnerability to real shocks, or if the loss of the exchange-rate instrument reduces its ability to deal with them, the member may prefer to leave. The benefits of monetary union presuppose widespread use, especially those of reducing transactions costs and exchange risk (Collignon, 1999:8). Small currency unions are likely to collapse more readily, because both the benefits of membership and the costs of withdrawal are smaller. This has political as well as economic costs. Since both joining and leaving incur costs, "waiting" to join becomes a valuable option, increasing the sense of uncertainty for the union as a whole and reducing the benefits to countries which join at an early stage (Collignon, 1999:24).

There is the additional concern that the Maastricht convergence criteria were defined in nominal terms for one particular period, and that nothing is known about the ability to remain converged. In the EU, for example, if significant regional differences remain, either in economic structures or in some economic policies or in responses to external shocks, then it is inevitable that a common monetary policy will have different impacts in different places, potentially creating or exacerbating *divergence* in income (Hughes-Hallett and Piscitelli, 1999:337). Moreover, as EU governments' tax bases become more mobile, the Maastricht debt-to-GDP ratios may begin to look risky, suggesting either that tax increases will be necessary (Hughes-Hallett and McAdam, 1998) or that it might be prudent to lower the target ratio as fiscal coordination advances (Artis and Marcellino, 1998). This is the point of the Stability and Growth Pact of 1997, which indicates a target for time-averaged fiscal deficits of approximately zero in the medium term.

¹⁰This study is concerned with trade liberalisation rather than monetary integration, but the findings are still of relevance in the context of reducing barriers to foreign capital flows.

In developing countries, convergence will require not only rapid economic growth in the poorest members but structural, institutional and policy changes, making it difficult to predict whether convergence, even if attained, will be sustainable.

2.5 Currency boards and dollarisation

This report has emphasised in its recommendations that COMESA member countries should attempt to *lock in* current and future gains in achieving macroeconomic stability in general, and in reducing rates of inflation in particular. It is argued that COMESA member countries should not rely on IMF/World Bank conditionality, nor on mutual agreement within COMESA, but should lock in macroeconomic stability through currency board arrangements or full dollarisation. Of these, currency boards are likely to prove more practical, in both economic and political terms.

The main theoretical advantages of establishing a currency board are to reduce uncertainty as regards the exchange rate, and to make it impossible for budget deficits to be financed by money creation (Berg and Borensztein, 2000b). Adopting a currency board should therefore provide low inflation, essentially little different from inflation in the currency to which the currency board is linked.

Other, less tangible, benefits of a currency board arrangement depend largely on the effect of locking in greater stability, which improves expectations, regarding future inflation, future availability of foreign exchange, the avoidance of macroeconomic instability and other aspects of the investment climate: "in Africa, government policies are frequently reversed. These policy reversals create credibility problems" (Oyejide, 1996a). A currency board should reduce these credibility problems. A further advantage is a reduction in transaction costs in international trade and finance.

Crucially, a currency board arrangement may increase inflows of foreign direct investment, which is one of the most important ingredients of future economic growth and development in poorer countries. Of course, a currency board may not *necessarily* result in improved expectations and therefore an improved investment climate, and there are other factors which affect inflows of foreign direct investment. Nevertheless, a currency board arrangement is one of the most direct steps that a government can take to try and improved expectations of future exchange-rate stability, which is one of the more important ingredients in attracting foreign investment.

The practical experience of at least some countries adopting currency boards in the 1990s suggests that they do indeed succeed in reducing inflation. For example, inflation in Argentina has been below 1% per annum since 1996. As recently as 1990, it was above 2000%. It took Estonia rather longer, but inflation fell steadily from 89% in 1993, to 3.3% in 1999.¹¹

¹¹ It is possible for countries using a currency board arrangement to have inflation faster than that of the anchor currency, as noted below. It is also possible for a country or some other authority at the sub-national

There is some evidence, from a wider sample of countries, that fiscal policy in countries belonging to an international common currency area has not been associated with fiscal discipline. Indeed, spending and taxes are higher inside currency unions, particularly for dollarised countries. Currency boards on the other hand *were*, however, associated with fiscal restraint (Fatas and Rose, 2000). The reason is that, provided the central bank of the anchor currency does not finance budget deficits in the currency board country, the inflationary financing of budget deficits becomes impossible. In other words, a currency board arrangement removes one of the mechanisms by which the pursuit of unsound policy is made relatively easy. Governments must still get other things right.

The disadvantages of a currency board system include not having an independent monetary and exchange rate policy, and the central bank not being able to lend without limit in a banking crisis. These disadvantages are mitigated to some extent if monetary and exchange rate policy have been successful, and if the adoption of a currency board system reduces the risks to which the banking system is exposed, most notably the risk of devaluation where banks have borrowed abroad. In addition, the stability provided by a currency board system may attract investment by large foreign banks, for which the risk of a banking crisis is negligible.

An alternative strategy is to go further by *replacing* the domestic currency with a major external currency (dollarisation or euroisation). These policies are being increasingly considered, with several countries adopting currency board arrangements in the 1990s, although Panama is the only sizeable country which has dollarised (Berg et al., 2000).

The main theoretical advantage of going full dollarisation is that the possibility of a speculative attack on the exchange rate is greatly reduced if not completely eliminated. Disadvantages (as compared with a currency board arrangement) of full dollarisation include the loss of seignorage (Fischer, 1982, 1993), and the political cost of abandoning a national currency (Berg and Borensztein, 2000b). It is also unlikely that COMESA member countries could earn sufficient foreign exchange without spending it on imports, in order to supply a local note issue of dollars or euros.

In comparison with full dollarisation, a currency board arrangement enables a country to retain its own domestic currency, which is important politically, and to retain the profits of the note issue (seignorage) which most COMESA member countries could not afford to lose. Against these advantages, the possibility of devaluation remains, as shown by speculative attacks on the currencies of Argentina and Hong Kong in the 1990s (Eichengreen, 1998; Hausmann et al, 1999). Choosing between the two alternatives depends, therefore, on whether it is believed that setting up a currency board arrangement will carry sufficient credibility, or whether lack of credibility makes dollarisation essential despite its relative disadvantages (Berg and Borensztein, 2000b). In countries with a long history of inflationary financing of budget deficits, the most important factor

level, to get into serious debt management problems without having its own independent central bank and currency. Examples include Liberia and New York City.

is to choose an exchange-rate regime which will make such inflationary financing as difficult as possible.

The alternative to devaluation under a currency board or dollarisation is driving down wages and prices, with deflationary consequences. It is possible for a currency board currency to become overvalued for reasons other than inflationary financing of budget deficits, for example because of excessive wage increases, or the appreciation of the currency peg against other major currencies. This happened to the CFA Franc by 1994, so that retaining the option of devaluation proved to have been valuable. Moreover, the devaluation is reported to have been successful. It can be argued that this is partly because a currency board arrangement should mean that budget deficits have been less than they would have been in economies with independent central banks, providing the credibility necessary to make a devaluation work as intended (Clement et al., 1996).

2.6 Developing country experience

Most of the literature reviewed above tends to focus on developed economies and the existence of a range of institutions is assumed. In developing countries, these institutions must first be formed and more sophisticated economic structures must evolve as part of the process of creating a framework for policy coordination. It requires high economic growth for poorer countries both to raise *GDP per capita* and also to diversify structures of production and demand. In the process, they tend to develop (copy) more sophisticated institutions, especially in labour and financial markets. Stagnating economies are unlikely to converge or to develop the institutions necessary for financial integration.

Several groups of developing countries have attempted more or less successfully to coordinate macroeconomic policy. The experience of those regions which are potentially of relevance to COMESA is reviewed briefly below.

The (Rand) Common Monetary Area (CMA)

The Common Monetary Area, based on the South African rand and formerly called the Rand Monetary Area, was effectively a recognition of an existing situation in which South Africa and its four very much smaller members all used the rand. Botswana left the arrangement in 1976, but has maintained very stable real exchange rates against the rand since then, and remains a member of SACU. The other three small members, Lesotho, Namibia (since 1990) and Swaziland, have set up central banks, but maintain a 1:1 rate of exchange of their domestic currencies to the rand, have no exchange controls on financial transactions with South Africa, and allow the rand to circulate in their territories alongside their domestic currencies.

The situation of the Common Monetary Area is extremely unusual. Firstly, there is the extreme dominance of South Africa. South Africa's GDP is more than 90% of the CMA total. The smaller members derive up to 80% of their imports from South Africa, and remain economically dependent on South Africa in several other ways: migrant labour working in South Africa, transit to international ports, foreign direct investment, etc.

Secondly, because the smaller members have always used the rand, or a domestic currency which is effectively equivalent to the rand, they have always had inflation rates and interest rates very close to those in South Africa. The CMA may offer an interesting precedent for small developing countries' adopting the currency of their major trading partner. The CMA shows how a situation of extreme asymmetry can actually be effective, permitting free movement of capital, imposing fiscal discipline on smaller members, and facilitating trade within a customs union.

West African Economic and Monetary Union (WAEMU)

The WAEMU forms half of the CFA franc zone. Like the CMA, it developed directly from a pre-existing colonial monetary arrangement, rather than being created by unifying previously independent monetary systems. Conditions in both parts of the zone are similar, but the WAEMU has progressed further in terms of additional regional integration measures and is therefore of more direct interest to COMESA. In the WAEMU, the common currency (the CFA franc) is issued by the regional central bank (the Banque Centrale des Etats de l'Afrique de l'Ouest). Although each member state has a central bank, which issues cash, monetary policy is conducted solely at the regional level by the BCEAO. The CFA franc is fixed against the euro, and the French Treasury manages an operations account in convertible currency for the BCEAO on which it can run overdrafts. This provides some flexibility for conducting monetary policy in the short run, by allowing the BCEAO to vary the money supply in response to shocks. In the longer term, the fixed exchange rate, and type limits on inflationary finance, mean that inflation rates in France (Europe) and the WAEMU should not diverge substantially (M'Bet and Niamkey, 1993 and 1997). The potential for speculative attacks against the CFA franc is, in practice, low, because capital movements from/to non-regional economies tend to be very small. Within the union, however, cash flows freely across national borders: data for 1996 show that more than 75 percent of the cash in circulation in the region is returned to a central bank outside of the country of issue (Rother, 1999:427). The dominant economy, Côte d'Ivoire, which is responsible for 40 percent of regional GDP, is the largest exporter of cash via migrant workers.

Because of its responsibility for regional monetary policy, it is important that the BCEAO is able to forecast a regional monetary aggregate. With simultaneous financial liberalisation and a move to market-oriented instruments of monetary policy, it is necessary that the reaction of macroeconomic variables to changes in monetary policy is both understood and forecastable. Work on money demand in the region (Rother 1998, 1999) shows that it is possible to sustain a common model upon which to operate policy across all seven members. However, there are sufficient differences in the behaviour of the determinants of money demand between Côte d'Ivoire and the smaller members to suggest that asymmetric shocks will lead to monetary instability.

It is also worth noting that investment, which is crucial for economic growth, has been particularly low in the WAEMU, averaging 15 percent of GDP from 1970 to 1995 - although this varies considerably across member countries. In spite of decades of regional integration, the CFA countries have experienced little economic diversification (industrial

development). A recent study making use of both time-series and cross-section data shows that openness to international trade, freedom of international capital transactions, freedom to compete in the domestic market, a competitive real exchange rate, and low dependency ratios are correlated with investment in the region (Vamvakidis, 1998:3). This suggests that integration in the world economy rather than regional integration *per se* is important in promoting private investment.

Within the WAEMU, it is recognised that there is already a structural polarisation of development between the two larger economies - Côte d'Ivoire and Senegal - and the other members - Benin, Burkina Faso, Mali, Niger and Togo - which may be entrenched by an effective single market. Development funds, out of which infrastructure or human capital investment in the poorer countries can be financed, are viewed as a mechanism for promoting a greater degree of convergence within the common market. The creation of structural funds may well prove to be decisive in securing internal credibility for the Union by ensuring that all members are perceived to benefit. This issue has also been critical for the European Union (EU) in gaining the continued support of weaker members. It has been suggested that additional donor support (which might not be available for financing direct intra-UEMOA compensatory transfers) could assist with financing regional developmental policies (Robson, 1997; Hernandez-Cato et al, 1998).

This experience is relevant for COMESA, the members of which are in many ways similar in economic structure to those in West Africa. If the potential for instability arises in the WAEMU, it is even more likely in COMESA. Goods and asset markets in COMESA were significantly more distorted in the 1980s, so that policy reforms will be more marked and less predictable - and COMESA does not have a major anchor economy (like France) which will offer credit to permit policy flexibility. Moreover, it is as well to bear in mind that global integration might be more important for African countries in the longer run than even sustainable regional integration. The issue of a mechanism for ensuring that all members are seen to benefit from regional integration is also important. This last issue will be developed later.

*CARICOM*¹²

The experience of the Caribbean countries, currently planning monetary union, is potentially instructive for COMESA, as it involves a group of small, poor, developing economies, dependent on primary commodities and tourism, which trade very little with each other but heavily with a large, predominantly developed common market (NAFTA).

There are three convergence criteria for entry to the proposed Caribbean Monetary Union (CMU), the so-called 3-12-36-15 criteria:

- the maintenance of 3 months' import cover in the foreign exchange reserves for at least 12 months

¹²Much of the material in this section follows Anthony and Hughes-Hallett (2000).

- the maintenance of a stable exchange rate against the US dollar for at least 36 months
- the maintenance of an external debt service ratio of no more than 15 percent of the value of exports

The explicit purpose of these criteria is the pursuit of macroeconomic stability in the region by importing it from the USA (and imposing it on potential members), rather than traditional requirements for forming an OCA. Moreover, the proposed CMU is viewed as a step towards enhancing economic integration by facilitating trade, rather than the result of closer economic integration. The process is therefore driven more by political objectives than by economic theory (or evidence).

In a recent paper, Anthony and Hughes-Hallett (2000) point out that there are five essential interrelations which should apply between members of a potential currency area, although one of these, that the extent of industrial diversification needs to be high, cannot be expected to apply to small undiversified primary-commodity exporters. The other four are all explained in the above review: (i) there needs to be a comparatively high degree of trade openness between members; (ii) economic structures - and the shocks to which potential members are subject - need to be broadly similar; (iii) the degree of mobility of capital and labour between potential members needs to be high, or, alternatively, wages should be flexible; and (iv) there should be a workable system of fiscal transfers between members to compensate those countries or regions that are not positively affected by the closer integration. They argue that the CARICOM countries satisfy none of these criteria, and that, in view of the fact that their external trade is dominated by the USA, they would do better forming a currency union with the USA than among themselves. (This would, in effect, mean adopting the US dollar, and leaving monetary policy to the US Federal Reserve Bank.)

The authors point out (2000:125-130) two further problems for the proposed monetary union. The first is that the new regional monetary authority will begin with no reputation, and will need to build credibility. This will be difficult,¹³ especially as governments tend to borrow more when there are limits to the extent to which they can monetise the deficit. The second problem is that of asymmetric incentives. One benefit of a monetary union, even if the region itself is not an OCA, is the advantage to more unstable economies of importing credibility from neighbouring countries which have already achieved it. While this provides a reason for weaker countries to join, those which already have macroeconomic credibility require another incentive.

Adopting the US dollar, or creating a currency board based on the US dollar, would solve both of these problems, providing immediately greater credibility than could be accumulated even over a lengthy period by CARICOM, and conferring an incentive on all member states to join and remain within the union. In fact, CARICOM is “dollarised”

¹³It has been difficult enough for the Euro, based on the old D-Mark which had credibility to spare, to establish itself as a strong currency.

to some extent already, so a currency board arrangement with the Federal Reserve will simply formalise what is already occurring.

These observations are relevant for COMESA because its members also satisfy few of the criteria listed above. Trade between members is low in value terms, and not one of the COMESA countries imports from more than nine of the others, while only three export to more than ten. Trade is oriented predominantly towards the EU. Both capital and labour are not free to move easily between members; for both economic and political reasons, there is no potential for fiscal transfers between members, and the economies are generally small and undiversified. In addition, a regional monetary authority will find it extremely difficult to build credibility, and the asymmetric incentive effect is likely to be strong. This makes the debates about whether Maastricht-type convergence criteria should precede monetary union, and whether they contribute to faster economic diversification and growth, of considerable relevance.

2.7 Summary

The following points emerge from this review of the literature:

1. There are gains to be had from economic policy coordination where national policies create externalities for neighbouring countries, but policy unions are difficult to maintain, particularly if member countries respond asymmetrically to external shocks. Where there are long-term relationships that are mutually desirable then some policy coordination may be sustained, but the wider the range of policy variables tied by international treaties, the smaller the likelihood of compliance.
2. Monetary union is optimal amongst economies that show a marked degree of real economic convergence, or which have flexible labour markets; permit capital and labour to move freely between countries; have workable mechanisms for transfers to struggling regions; react similarly and flexibly to shocks; or between which there is a high degree of trade openness. The consensus seems to be that for groups of countries which are not OCAs, maintaining exchange-rate flexibility is best, while also introducing/preserving institutional agencies of restraint to limit inflationary policy.
3. Although there is a lack of agreement as to the precise nature of the relationship between economic policy coordination and economic convergence, in practice, any group of countries contemplating a policy union will require convergence in macroeconomic stability indicators as a prerequisite for admission in order to protect other members from adverse policy spillover effects. This implies that a set of credible Maastricht-type criteria will be an essential component of an agreement to coordinate policy, although it is possible that stability indicators will converge only as real economic convergence is occurring.

4. Unless there is reasonable certainty that the policy union will be sustainable, the political and economic costs of failure are such that the union is better not attempted. At the very least, the experience of other developing regions suggests (i) that the presence of a larger comparatively stable anchor economy increases the chances of success and (ii) that regional integration alone does not contribute significantly to regional growth and development, suggesting that this should be part of a strategy of global integration.
5. An alternative strategy for achieving the necessary macroeconomic stability for monetary harmonisation is for individual member countries to establish irreversible links with a major external currency, rather than trying to establish monetary harmonisation through intra-regional agreements. In choosing between a currency board and full dollarisation, the currency board has certain advantages. It allows a country to retain the profits of the note issue, and to retain the option of devaluation. On the other hand, a currency board arrangement is potentially subject to speculative attack, and lacks the greater degree of credibility provided by full dollarisation. Choosing between the two alternatives depends, therefore, on whether it is believed that setting up a currency board arrangement will carry sufficient credibility, or whether lack of credibility makes dollarisation essential despite its relative disadvantages. In countries with a long history of inflationary financing of budget deficits, the most important factor is to make such inflationary financing impossible. In such cases, the important thing is to choose one or the other of a currency board or dollarisation, rather than neither.

These points need to be applied directly to the process of monetary harmonisation within COMESA. In order to do this, progress towards achieving the MHP criteria are reviewed in the following section.

3 Progress towards the Monetary Harmonisation Programme (MHP) criteria

3.1 Inflation (MHP criterion: less than 10%)

The level of inflation is a particularly important indicator of macroeconomic stability. Inflation statistics are frequently more comparable, more reliable, and more up-to-date, than other statistics. Secondly, intra-COMESA trade is more likely to grow if prices in trading partner countries are relatively stable. This is likely to mean that bilateral real exchange rates are also stable. In such circumstances, the delays associated with international trade do not create the high levels of risk associated with unstable prices and unstable exchange rates. Inflation is also the most basic symptom of other forms of macroeconomic instability, such as budget deficits financed by money creation, and excessive increases in the money supply. Indeed, all these indicators are closely interrelated.

It is possible for inflation as measured to appear low, where there are price controls. Official inflation figures in such circumstances can measure official prices while unofficial prices are behaving quite differently. Low inflation created by controls, in

other words suppressed inflation, would not be an indicator of progress towards the conditions for monetary convergence. Suppressed inflation was quite common in the 1970s and the 1980s, but has become less common with widespread economic liberalisation. Details of the degree of price control remaining in COMESA countries were not available from published sources.

It is encouraging that, in the period 1995 to 1999, twelve COMESA members had average inflation which met the MHP criterion of less than 10% per annum. It is also significant that in every single one of these countries inflation was lower in the recent period than it was in 1990-94. In eight of these cases, inflation has been reduced from more than 10% to less than 10% when comparing the two five-year periods. In other words, there has been a general improvement in the twelve countries, making the situation much more promising for eventual monetary harmonisation than it was five years ago.

Among the other countries, there are no statistics for Eritrea. The country has been at war since independence in 1993, and very little is known about its economy. There are no relevant data published which would make possible an assessment of its progress or otherwise towards monetary harmonisation within COMESA. Ethiopia and Eritrea signed a peace deal in December 2000, but talks were then stalled for two months. It was reported (in the *Economist* of 9 February 2001) that the two countries have agreed to create a UN-controlled buffer zone along the disputed border. It remains to be seen whether this will lead to a lasting peace, and the possibility of economic development in Eritrea. In the absence of economic statistics, there will be no further discussion of Eritrea in this report.

Of the eight countries which failed to meet the MHP inflation criterion, four are in situations of severe political tension, including war: Angola, Burundi, Congo and Sudan (henceforward the war-torn economies). The problems of macroeconomic instability in these countries are secondary to the problems of finding solutions to their political problems. To these countries could be added Zimbabwe. The country is not in a war situation, but the Zimbabwe government has become deeply involved in the war in the Congo. Other COMESA members also have military involvement in the Congo, but have managed to do so with less damage to macroeconomic equilibrium. In Zimbabwe, the government has not succeeded in meeting the cost of military involvement in a non-inflationary way, with severely damaging effects on inflation. It was 58.5% in 1999, and is estimated (by the EIU) to have been above 60% in 2000. It is forecast to remain above 60% in 2001.

That leaves three countries with inflation greater than 10% in 1995-99 for non-military reasons: Malawi, Tanzania and Zambia. Neither Malawi nor Zambia has made progress recently in reducing the rate of inflation. It was 44.9% in 1999 in Malawi. This was particularly disappointing as inflation had fallen from 83.5% in 1995 to only 9.2% in 1997. There has been marginal progress in Zambia, but inflation remains stubbornly above 20% despite many years of IMF programmes, and periodic attempts to impose cash budgets. Only in Tanzania has there been significant improvement in inflation.

Nevertheless, the overall picture in COMESA as a whole is quite promising, and very definitely better than it was five years ago. It is particularly significant that inflation in Egypt, representing more than 50% of GDP in COMESA, averaged less than 5% in 1995-99, down from 13% in the previous five years. It can be argued, in addition, that low inflation (and other evidence of macroeconomic stability) has considerable credibility in Egypt. It has been achieved as a result of internal political decisions following the formation of a new government, rather than as a result of externally imposed (IMF) conditionality ("Egypt's 'home-grown' reforms spur growth and investment" *IMF survey 21 April 1997*).

Table 1: COMESA inflation (MHP criterion: inflation less than 10%)

Country	Average inflation (1990-94)	Average inflation (1995-99)	Meets Criterion	Fails Criterion	Progress if fails Criterion
Angola	n.a.	373.8	-	Yes	No
Burundi	8.1	18.6	-	Yes	No
Comoros	7.7	4.1 ^(c)	Yes	-	-
Congo	6425.0	371.2	-	Yes	Yes ^(b)
Djibouti	5.0	3.1 ^(a)	Yes	-	-
Egypt	13.2	4.7	Yes	-	-
Eritrea	n.a.	-	-	-	-
Ethiopia	12.3	-0.7	Yes	-	-
Kenya	32.0	7.6	Yes	-	-
Madagascar	16.4	9.0	Yes	-	-
Malawi	23.2	27.4	-	Yes	No
Mauritius	7.4	6.8	Yes	-	-
Namibia	12.4	7.8	Yes	-	-
Rwanda	11.5	6.4	Yes	-	-
Seychelles	2.1	0.7	Yes	-	-
Sudan	113.5	43.5	-	Yes	Yes
Swaziland	10.4	7.1	Yes	-	-
Tanzania	37.0	14.4	-	Yes	Yes
Uganda	23.3	4.8	Yes	-	-
Zambia	125.8	35.1 ^(a)	-	Yes	No
Zimbabwe	30	30.4	-	Yes	No
Total			12	8	3

Notes: ^(a) latest figure 1997; ^(b) inflation fell steadily from 1995 to 1998 (from 542% to 147%) but rose again to 333% in 1999; ^(c) latest figure 1998

3.2 Budget deficit as a percent of GDP (MHP criterion: less than 10%)

COMESA members have done better with their budget deficits than with inflation, in meeting the MHP criterion. No less than 18 out of the 20 countries for which data are available had budget deficits less than 10% of GDP in 1995-99 (see Table 3).

Table 2: COMESA budget deficits as a percentage of GDP (MHP criterion: less than 10%)

Country	Budget deficit as % of GDP (1990-1994)	Budget deficit as % of GDP (1995-1999)	Meets criterion	Fails criterion	Progress if fails Criterion
Angola	-	17.8 ^(a)	-	Yes	No
Burundi		2.9	Yes	-	-
Comoros	3.1	4.9 ^(a)	Yes	-	-
Congo	10.3	0.1 ^(b)	Yes	-	-
Djibouti	11.3	3.4 ^(a)	Yes	-	-
Egypt	1.6	1.0	Yes	-	-
Efdeficit. Eritrea ^(c)	-	-	-	-	-
Ethiopia	8.3	2.9 ^(a)	Yes	-	-
Kenya	2.7	0.6	Yes	-	-
Madagascar	1.6	1.0	Yes	-	-
Malawi	11.1	5.7	Yes	-	-
Mauritius	0.3	2.1	Yes	-	-
Namibia	3.4 ^(f)	4.0	Yes	-	-
Rwanda	7.3	4.7	Yes	-	-
Seychelles	3.3	12.4 ^(a)	-	Yes	No
Sudan	11.6 ^(e)	2.1 ^(a)	Yes	-	-
Swaziland	- 0.1	- 0.3	Yes	-	-
Tanzania	2.8	0.4	Yes	-	-
Uganda	4.0	2.0	Yes	-	-
Zambia	11.5	5.0	Yes	-	-
Zimbabwe	6.7	6.9	Yes	-	-
Total			18	2	0

Notes: budget outturns include grants; negative figure means surplus; (a) latest figure 1998; (b) 1995-96; (c) data not available; (e) 1992-94; (f) 1990-93

Moreover, all but two of the 18 had ratios of budget deficit to GDP of 5% or less. This is of great significance, because the MHP criterion is clearly insufficient for eventual macroeconomic stability and monetary convergence. Very few African countries have sufficiently deep financial markets to finance a budget deficit of 10% or more of GDP in a non-inflationary way. In addition, few African countries have sufficiently high savings ratios to allow the finance of a deficit of that size without crowding out the private sector from financial markets.

It should be noted that the statistics for the Congo do not cover the last four years, and may be fairly meaningless in the context of the current hostilities. Similarly, it has been reported that the Zimbabwe government has concealed military expenditure from the

IMF, and that the financing of parastatal deficits by the government has been treated off budget, so that the actual deficit may be a considerably larger percentage of GDP than reported in the official statistics. This appears to be confirmed by reports that the budget deficit has been projected at 23% of GDP in 2000, by the IMF. It may be, therefore, that only 16 countries met the MHP budget deficit criterion.

An important additional point is that 15 of the 18 countries, with budget-deficit-to-GDP ratios of less than 10%, reduced the ratio as compared with the previous five-year period (1990-94). Four of these countries (Congo, Malawi, Sudan, Zambia) had ratios above 10% in 1990-94, and therefore moved from not meeting the budget criterion into a position of satisfying it.

There were two COMESA member countries which did not meet the budget deficit criterion: Angola and the Seychelles. As already noted, Angola has long suffered from civil war, which explains both the high budget deficit and the high rate of inflation noted in the previous section. The performance of the Seychelles is disappointing, since the ratio increased from 3.3% in 1990-94, to 12.4% in 1994-98. Although the high budget deficit may be of concern, it appears to have had negligible impact on inflation, which averaged 0.7% between 1995 and 1999.

Overall, progress in COMESA member countries with reducing budget deficits in relation to GDP has been considerable in the second half of the 1990s. It is particularly encouraging that such a large number of countries have gone beyond meeting the MHP criterion. This makes it feasible to consider reaching a considerably tighter criterion, which will undoubtedly be necessary in the longer-term.

3.3 Broad money growth (MHP criterion: < 10% per annum)

It would appear that the monetary growth criterion for the MHP is *inconsistent with the inflation criterion*. Whereas a majority of COMESA member countries (12 out of 20 for which there are data) met the inflation criterion in 1995-99, only three out of 20 countries met the monetary growth criterion over the same period. A further 9 countries met the inflation criterion, but failed the monetary growth criterion: Burundi, Egypt, Kenya, Madagascar, Mauritius, Namibia, Rwanda, Seychelles, Swaziland and Uganda. The average rate of broad money growth in 1995-99 for these 9 countries was between 12.2% (Egypt) and 25.8% (Seychelles). In fact, 7 of the 9 countries had monetary growth over the period averaging between 10% and 20%.

This suggests that the monetary growth criterion proposed in the 1995 Report was too stringent. A possible explanation is as follows. If an economy has 10% inflation, and in addition has (say) 5% GDP growth, then one would expect that 15% money supply growth would fuel inflation. If in addition the country is monetising, then the rate of monetary growth could be even higher without accelerating the rate of inflation. Most African economies have depended historically on traditional agriculture, and in particular on subsistence agriculture in which by definition output is not marketed. They can therefore be expected to have monetary growth greater than the growth of GDP simply in

order to provide transactions balances for those entering the monetary economy, without that monetary growth generating additional inflation.

So long as the inflation criterion is maintained at 10% or less, this suggests that the monetary criterion should be about 20%, or possibly even 25%. Using a criterion of 20% or less, a further nine countries can be added to the three that meet the existing monetary growth criterion, with Namibia almost meeting the criterion. This would leave Seychelles, which had the very unusual situation of average monetary growth of 25.8% over 1995-99, while inflation remained at less than 1%.

For the future, this report will propose that the inflation criterion should be reduced gradually, at which point of course a more stringent monetary growth criterion than 20-25% will become necessary. Eventually, it is proposed that the COMESA countries will need to have an inflation criterion of 3% or less, in which case monetary growth of between 10% and 15% might become the appropriate criterion: 5% growth of GDP, 3% inflation, and 5% for monetisation.

In the presence of unstable and, more importantly, unpredictable money multipliers, it is necessary for countries to include both the inflation and money growth criteria. It is an open question as to which monetary aggregate can (or should) be tracked.¹⁴ A surge in the rate of growth of base money may be an early gauge of fiscal problems (because monetary statistics are available before government budget statistics), indicating monetisation of the government deficit. Inclusion of the money-growth criterion should therefore enable the authorities to ascertain quickly whether the economy is heading for macroeconomic instability.

Many African countries are now using money-based stabilisation measures (that is, control of the growth of the money supply as a means of suppressing inflation). This reflects the fact that, in the past, stabilisation problems have essentially stemmed from a lack of fiscal control and, therefore, of the growth of base money. However, for control of the growth of money to function effectively as an anchor for inflation, there needs to be a close and predictable relationship between these two variables.

Studies of changes in monetary aggregates in a range of African countries find that, in the long run, the behaviour of money is relatively stable, but real money demand is prone to very large short to medium term movements, especially in response to external trade shocks (Adam, 1999:264). In aid-dependent countries, balance-of-payments variability may be very high indeed. For this reason, the extent of volatility varies significantly between countries – and unpredictability has been exacerbated by different degrees of financial liberalisation.¹⁵ Stabilisation policies based on controlling the rate of growth of

¹⁴ It is probably best to consider this question on a country by country basis. Recently, there has been considerable research on money-demand functions in African countries, providing relevant analysis for a range of countries.

¹⁵ In Zambia, the long-run demand for currency is stable, although the ability to forecast the demand for currency in the short and medium term has declined with financial liberalisation, undermining the use of this monetary aggregate as a stabilisation strategy. In Tanzania, the relationship is considerably more predictable; in Zimbabwe, distortions mean that the effects of the ongoing liberalisation is unclear; and in

reserve money is likely therefore to have, at best, an imprecise link with inflation in the short and medium run, and it would be better to follow an inflation target.

There is, therefore, good reason for COMESA members to include both money-growth and inflation criteria as indicators of macroeconomic stability. While the growth of domestic credit can be linked directly with fiscal control, a target rate of growth of the growth of the money supply should be viewed as a necessary but not a sufficient condition for the control of inflation.

Alternatively, the upper limit for monetary growth might be set at the current inflation ceiling, plus the rate of growth of GDP, plus (say) five percentage points for monetisation. For example, a member country exceeding the monetary growth criterion, but with exceptionally high GDP growth, could argue for a higher limit to be applicable so long as rapid GDP growth continued.

Such a monetary growth criterion would have to be applied to a moving average, for example a three-year moving average. There would be some practical difficulty in that GDP growth figures are generally only available at least one year after the availability of inflation figures, and sometimes with a much longer delay. However, a monetary growth criterion could probably be applied without significant error by using actual GDP growth figures plus projections by outside bodies such as the World Bank, the IMF, or the Economic Intelligence Unit (which publishes growth projections for all of the COMESA member countries except Eritrea, and can be expected to publish growth projections for Eritrea in due course).

As regards the six countries in Table 4 which had monetary growth greater than the 25.8% of the Seychelles over 1995-99, there can be no doubt that their monetary growth was excessive because their inflation rates were also unacceptably high.

Uganda, liberalisation has led to remonetisation, which means that targeting the growth of the money supply is *more* suitable for stabilisation (Adam, 1999a:265, drawing on Adam, 1999b; Henstridge, 1999; Jenkins, 1999; Randa, 1999).

Table 3: Broad money growth (MHP criterion: < 10% per annum)

(annual percentages)

Country	Average money growth (1995-99)	Meets 10% Criterion	Fails Criterion	Progress if fails Criterion	Meets 20% criterion
Angola	316.1	-	Yes	No	
Burundi	14.6	-	Yes	No	Yes
Comoros	4.0	Yes	-	-	Yes
Congo	357.5 ^(b)	-	Yes	No	
Djibouti	-5.3 ^(a)	Yes	-	-	Yes
Egypt	12.2	-	Yes	Yes	Yes
Eritrea ^(c)	-	-	-	-	-
Ethiopia	6.5	Yes	-	-	Yes
Kenya	15.5	-	Yes	Yes	Yes
Madagascar	14.5	-	Yes	Yes	Yes
Malawi	39.5	-	Yes	No	
Mauritius	12.8	-	Yes	Yes	Yes
Namibia	20.1	-	Yes	Yes	
Rwanda	12.6	-	Yes	Yes	Yes
Seychelles	25.8	-	Yes	No	
Sudan	37.3	-	Yes	Yes	
Swaziland	16.0	-	Yes	No	Yes
Tanzania	12.4	-	Yes	Yes	-
Uganda	19.0	-	Yes	Yes	Yes
Zambia	52.6	-	Yes	No	
Zimbabwe	29.0	-	Yes	No	
Total		3	17	9	11

Notes: ^(a) latest figure 1998; ^(b) 1995 figure, later statistics not available; ^(c) data not available**3.4 Central bank finance of government spending (MHP criterion: < 20% of previous year's government revenue)**

As with the monetary growth criterion, the criterion for limiting finance of the government by central banks has a relatively weak correlation with success in controlling inflation. Half of the countries which had inflation of less than 10% over 1995-99 *were not successful* in keeping central bank finance of the government below 20% of the previous year's revenue (again averaged over 1995-99). Moreover, only five of the 11 countries which failed this criterion were making progress towards meeting it. As might be expected, four of the five countries making progress had inflation rates below 10% (inflation in the fourth country, Tanzania, was 14.4%). Rather less predictably, two other countries, which had inflation rates below 10% but did not meet the central bank finance criterion, were not in fact making progress towards meeting the latter.

One possible explanation for this apparent contradiction is as follows. Some or all of these countries may have accumulated central bank lending to the government in some earlier period, probably with inflationary consequences, but the flow of such lending may

have diminished in recent years with a beneficial effect on the rate of inflation. In other words, the criterion measures a stock, when it should probably measure a flow.

This explanation appears to fit the Egyptian statistics, for example. The stock of central bank claims on the government averaged Egyptian Pounds 26.8 billion over the period 1990-94, and averaged Egyptian Pounds 24.3 billion over the following four years. In other words, there was a net repayment by the government to the central bank over the period 1995-98. As a consequence, the average ratio of central bank claims on the Egyptian government to 20% of the previous year's government revenue fell quite sharply, from 4.7 to 1.7%. Egypt is thus shown in Table 5 as not meeting the criterion for central bank finance of government spending, yet the reason for this is an earlier period of inflationary finance. That probably explains why Egyptian inflation was below the MHP limit, while having central bank finance of government spending above the limit.

This suggests a criterion for the finance of the government by the central bank should refer to recent changes in such finance, rather than to its absolute size.

It would seem important to retain a condition related to central bank finance of the government, because such finance is pure money creation, and extremely inflationary if on a significant scale. Central bank finance of government spending has been one of the main causes for the extraordinary high rates of inflation and currency depreciation in COMESA countries in the past (see Table 24).

It is suggested, therefore, that a new criterion be created, namely that increases in central bank claims on the government *should not increase* by more than 5% of the previous year's revenue. Such a criterion should, it is suggested, relate to a three-year moving average. Short-term economic fluctuations may in some circumstances be prudently financed by central banks, provided that such finance is quickly reversed.

It is important to note that the criterion proposed in the previous paragraph would apply to reductions in net positive government balances at the central bank. Two of the COMESA member countries (Swaziland and Uganda) averaged net positive balances at the central bank during 1995-99. By definition, they met the central bank finance criterion in the 1995 MHP Report. However, it would be possible for them to *reduce* those net positive balances by *more than 5%* of the previous year's revenue, while maintaining an overall stock of central bank claims on the government of *less than 5%* of the previous year's revenue (including a situation in which the government maintained net positive balances). Such a government would then fail to meet the new proposed criterion. That would, it is argued, be correct. Even if a government has prudently accumulated financial surpluses, that does not mean that it would be prudent to run those balances down faster than the economy can absorb additional spending without creating excessive inflation. Running down net positive government balances at the central bank is just as inflationary as central bank "lending" to the government.

There are some apparent anomalies among the six countries which do meet the criterion in Table 5. It is almost certainly irrelevant that Congo meets the criterion, because the

latest figure available is for 1995. Another curiosity is Malawi, where inflation averaged 27% over 1995-99, and reached 45% in 1999, despite central bank claims on the government being only a fraction (0.4) of 20% of the previous year's revenue. Malawi's budget deficit was also of relatively modest proportions, 5.7% of GDP. The most obvious explanation is that the Malawian Kwacha, having been relatively stable from 1995 to 1997, depreciated very sharply in 1998 and 1999, from MK21.2 per US\$ at the end of 1997, to MK46.4 per US\$ at the end of 1999.

Table 4: Ratio of central bank finance of government to 20% of previous year's revenue (MHP criterion: ratio < 1)

Country	Ratio (1995-1999)	Meets Criterion	Fails Criterion	Progress if fails Criterion
Angola	2.0	-	Yes	No
Burundi	1.5	-	Yes	No
Comoros ^(f)	-	-	-	-
Congo	0.2 ^(c)	Yes(?)	-	-
Djibouti	None	Yes	-	-
Egypt	1.7	-	Yes	Yes ^(d)
Eritrea ^(f)	-	-	-	-
Ethiopia	5.4	-	Yes	Yes
Kenya	1.2	-	Yes	Yes
Madagascar	3.7 ^(e)	-	Yes	Yes
Malawi	0.4	Yes	-	-
Mauritius	0.6 ^(b)	Yes	-	-
Namibia ^(f)	-	-	-	-
Rwanda	3.3	-	Yes	No
Seychelles	3.1 ^(b)	-	Yes	No
Sudan	5.2	-	Yes	No
Swaziland	-3.0	Yes	-	-
Tanzania	2.3	-	Yes	Yes
Uganda	-0.9	Yes	-	-
Zambia	13.6 ^(e)	-	Yes	No
Zimbabwe	1.5	-	Yes	No
Total		6	12	5

Notes: ^(b) latest figure 1998; ^(c) 1995 figure, later figures not available; ^(d) there was very considerable progress from 1990 until 1997, but the ratios rose again in 1998 and 1999; ^(e) latest figure 1997; ^(f) data not available

3.5 Real interest rates (MHP criterion: real lending and deposit rate both positive)

The influence of the change in economic thinking towards economic liberalisation, which includes having positive real interest rates, shows up very clearly in Table 6. It was common to have negative real interest rates in the 1970s and 1980s. In 1995-99, twelve of the 20 COMESA member countries had positive real lending and deposit rates. A further five countries had positive real lending rates, but deposit rates which were negative in real terms. In three of these cases, deposit rates were only mildly negative (between -2% and -3%).

Of the remainder, real interest rates in Tanzania and Comoros were not heavily negative, and there was progress towards positive real rates. The real deposit rate in Rwanda was also only mildly negative (-2.6%), which suggests that the real lending rate (statistics not available) was probably positive.

Overall, only the two war-torn countries of Angola and Congo had heavily negative real interest rates during the period 1995-99 (both negatively more than 60%). The great majority of COMESA members were therefore meeting the interest rate criterion, or quite close to it.

Table 5: Lending and deposit rates (MHP criterion: positive in real terms)

Country	Real lending rate (1995-99)	Real deposit rate (1995-99)	Meets Criterion	Fails Criterion	Progress if fails Criterion
Angola	-64.6	-67.3	-	Yes	No
Burundi	11.5 ^(b)	^(c)	Yes	-	-
Comoros	-1.8	-	-	Yes	Yes
Congo	-60.2 ^(d)	-	-	Yes	Yes (?)
Djibouti	positive	positive	Yes	-	-
Egypt	7.1	3.0	Yes	-	-
Eritrea ^(f)	-	-	-	-	-
Ethiopia	10.8	6.4	Yes	-	-
Kenya	21.7	6.9	Yes	-	-
Madagascar ^(e)	12.5	- 2.2		No/yes	Yes ^(e)
Malawi ^(e)	3.1	- 9.7		No/yes	No ^(e)
Mauritius	12.9	3.6	Yes	-	-
Namibia	10.2	3.4	Yes	-	-
Rwanda	- ^(a)	-2.6	-	No/yes	No
Seychelles	14.8	8.5	Yes	-	-
Sudan	positive	positive	Yes	-	-
Swaziland	9.8	2.8	Yes	-	-
Tanzania	13.7	- 4.1		No/yes	Yes
Uganda	14.3	4.1	Yes	-	-
Zambia	9.6	- 2.5	-	No/yes	-
Zimbabwe	19.0	7.8	Yes	-	-
Total			12	8/5	4

Notes: ^(a) data on lending rates for 1995-1999 not available; ^(b) 1999 figure, figures for 1996-1998 not available; ^(c) statistics not available from 1989; ^(d) no statistics of deposit and lending rates, the only interest rate available is the real discount rate; ^(e) the lending rate meets the criterion while the deposit rate does not; ^(f) data not available

The interest rate situation was not satisfactory, however. Some COMESA member countries have to have exceptionally high real lending rates in order to achieve positive real deposit rates. This arises because of the wide margins in those countries between lending and deposit rates, and is a reflection of the relative inefficiency of their banking systems.

Table 7 shows the 10 COMESA member countries which have real lending rates above 10%, which imposes a heavy burden on business borrowers. Most of these countries have

margins of 9 percentage points or more between real lending and real deposit rates, and most have nominal lending rates above 20%. Unfortunately, high nominal rates, even if inflation is also high, impose exceptional risks on borrowers.

Table 6: High real and nominal lending rates, selected countries, 1995-99

(percentages, 5-year averages)

	Real lending rate (%)	Real lending less real deposit rate (% points)	Nominal lending rate (%)
Kenya	21.7	14.8	29.0
Zimbabwe	19.0	11.2	39.8
Seychelles	14.8	6.3	14.7
Uganda	14.3	10.2	20.9
Tanzania	13.7	17.8	33.2
Madagascar	12.5	14.7	31.8
Mauritius	12.9	9.3	20.4
Burundi	11.5	n.a.	15.2 ^(a)
Ethiopia	10.8	4.4	12.1
Namibia	10.2	6.8	19.4

Note: (a) 1999 only

A business borrowing at 25 percent, when inflation is expected to be 20%, faces an expected real cost of borrowing of "only" 4.2%. However, this business faces very much more risk than a business borrowing at the nominal rate of 4.2% with expected zero inflation. A business is fairly certain that its costs will rise with the level of inflation. Costs consist of a wide variety of goods and services, so that their average cost is fairly certain to rise with the general level of inflation. On the other hand, there is a great deal less certainty that the price of the producer's product will increase with inflation (because a typical producer's output consists of one or only a few products). The business therefore runs a risk that input costs will rise faster than output prices. Secondly, it has been established statistically that the higher the rate of inflation, the more variable it is. This means that a business borrowing at a high nominal interest rate faces the risk that inflation will actually be less than expected, while the business is committed to paying the high nominal interest rate.

It is therefore greatly preferable to achieve positive real interest rates by having low levels of inflation, than by having high nominal interest rates in order to offset a high level of inflation. Positive real interest rates have considerable advantages over negative real interest rates. The case has been made many times, and the achievement of positive real interest rates has been made a condition of IMF and World Bank lending. However, this does not appear to take into account the potential damage done to the business sector by a high nominal cost of borrowing. It imposes high risks. In addition, it has frequently resulted in the commercial banks buying Treasury Bills rather than lending to the private sector. In other words, lenders as well as borrowers are aware of the high risks involved in credit at very high nominal interest rates, regardless of what real rates may or may not

be. In turn, this suggests that achieving positive real interest rates, without also achieving low rates of inflation, may do as much economic harm as good.

3.6 External debt and annual external debt service

It is important that members of a common currency area have external debt within a given benchmark. The servicing of excessive external debt would put excessive strain on the foreign exchange jointly available to the group.

Table 8 shows that 11 out of the 20 COMESA member countries for which there are statistics had debt service ratios (annual debt service as a ratio of annual exports) below the MHP criterion of 20% over 1995-99. This includes Zambia where the statistics from the World Bank appear to differ from those provided by the EIU, although the most recent years give roughly the same debt service ratio of approximately 20% (see also footnotes to the table for Madagascar).

Three additional countries have debt service ratios between 20% and 21.5%. Most of the remainder have debt service ratios between 20% and 30%. Only Burundi (39.5%) has a higher debt service ratio.

It is possible that the statistics paint a more optimistic picture than they should. The numbers are for debt service actually paid, and may therefore conceal unpaid debt service and the building up of debt service arrears (this is known to apply to the Congo, which has not therefore been included in the countries meeting the MHP criterion). It should also be pointed out that a debt service ratio of 20% is already a tremendous burden. Few countries can actually pay 20% over an extended period of years, unless aid is provided specifically for this purpose. Even if foreign aid is available to pay foreign debt service, using it for this purpose means that it is not available for other uses. An external debt service ratio above 10% (say) can be argued, therefore, to be a major constraint on development.

Against this, six COMESA member countries were announced as having become eligible for external debt relief at the end of 2000 under the Highly Indebted Poor Country (HIPC) initiative of the IMF and the World Bank: Madagascar, Malawi, Rwanda, Tanzania, Uganda, Zambia (*IMF Survey* of 8 January 2001). Eligible countries qualify for debt relief in two stages. First a country has to establish a "satisfactory track record", normally of three years, under IMF and World Bank programmes. Thereafter, the country must implement a "full-fledged poverty reduction strategy". During the second stage, the IMF and the World Bank provide interim relief provided that the economy continues to meet conditionality. At the end of this second stage, a "floating completion point" is reached, and the remainder of the committed debt relief is granted. It appears, therefore, that the announced debt relief is some years in the future, and highly conditional.

Table 7: Annual debt service ratios (MHP criterion: ratio < 20% of exports of goods and services)

Country	Debt service Ratio (1995-99)	Meets Criterion	Fails Criterion	Progress if fails Criterion
Angola	21.5 ^(a)	-	Only just	No
Burundi	39.5 ^(c)	-	Yes	No
Comoros	2.2	Yes	-	-
Congo	1.2 ^(d)	-	Yes ^(d)	No
Djibouti	4.4	Yes	-	-
Egypt	16.3	Yes	-	-
Eritrea ^(f)	-	-	-	-
Ethiopia	25.4	-	Yes	No
Kenya	28.0 ^(b)	-	Yes	Yes
Madagascar	17.2 ^(e)	Yes	-	-
Malawi	24	-	Yes	Yes
Mauritius	8.6 ^(b)	Yes	-	-
Namibia	9.0	Yes	-	-
Rwanda	20.4	-	Only just	No
Seychelles	5.7 ^(b)	Yes	-	-
Sudan	8.9	Yes	-	-
Swaziland	2.8	Yes	-	-
Tanzania	17.3 ^(a)	Yes	-	-
Uganda	21.0 ^(b)	-	Only just	Yes
Zambia	19.4	Yes	-	-
Zimbabwe	25.2	-	Yes	No
Total		11	9	2

Notes: ^(a) latest figure 1998; ^(b) latest figure 1997; ^(c) latest figure 1996; ^(d) most debt service not being paid; ^(e) World Bank *African Development Indicators 2000* shows exceptionally high payment in 1997, which would give an average 1995-97 of 45.2%, EIU shows five-year average of 17.2%; ^(f) data not available

Table 9 shows the ratios of external debt to GDP for COMESA member countries, over 1995-99. The picture looks less promising than for debt service ratios, probably confirming that some countries are not paying the debt service owing. Alternatively, for some countries at least, such a high proportion of external debt is on concessional terms that annual debt service is a relatively low percentage of the debt outstanding. Whatever the reason, only four COMESA member countries met the criterion of external debt being less than 50% of GDP, averaged over 1995-99.

Of the 16 countries which did not meet the criterion, six were included in those added to the HIPC list of countries at the end of 2000. As noted above, however, the impact of this debt reduction scheme is not immediate. Moreover, of the 16 countries which failed the criterion, only five are making progress in reducing the debt to GDP ratio. Interestingly, three out of these five had relatively low ratios, between 50% and 100%. This means that a majority, 11 countries, not only had a debt to GDP ratio above 50%, but were not making progress in reducing that ratio. The average ratio for the 16 countries which failed the criterion was 110%, more than double the target, with eight countries under 100%, and eight above.

Table 8: Ratio of external debt to GDP (MHP criterion: less than 50%)

(percentages)

Country	External debt/GDP (1995-1999)	Meets Criterion	Fails Criterion	Progress if fails Criterion
Angola	166.0	-	Yes	No
Burundi	93.5 ^(b)	-	Yes	No
Comoros	90.8	-	Yes	No
Congo	208.2	-	Yes	No
Djibouti	57.8	-	Yes	Yes
Egypt	45.5	Yes	-	-
Eritrea ^(c)	-	-	-	-
Ethiopia	173.1	-	Yes	No
Kenya	70.0	-	Yes	Yes
Madagascar	110.4	-	Yes	Yes
Malawi	235.0	-	Yes	No
Mauritius	53.4	-	Yes	No
Namibia	6.6	Yes	-	-
Rwanda	71.3	-	Yes	No
Seychelles	29.5	Yes	-	-
Sudan	433.3	-	Yes	No
Swaziland	18.1 ^(a)	Yes	-	-
Tanzania	116.4 ^(d)	-	Yes	Yes
Uganda	60.4	-	Yes	Yes (marginal)
Zambia	198.3	-	Yes	No
Zimbabwe	66.8	-	Yes	No
Total		4	16	5

Notes: ^(a) latest figure 1997; ^(b) latest figure 1996; ^(c) data not available; ^(d) latest figure 1998

Progress in meeting the MHP targets is therefore mixed. It has been suggested that, in some cases, the criteria need to be modified. Recommendations are made later.

In order to ascertain whether the policy changes described in this section have had any impact on the process of convergence between COMESA member countries, the extent of convergence is measured in the following section.

4 Measuring macroeconomic convergence in COMESA

Theory and experience suggest that, while macroeconomic coordination by a group of countries may be desirable, it is difficult both to achieve and to sustain. Moreover, several features of the COMESA economies suggest that they do not necessarily form an optimal currency area. For example, high unemployment in many countries means that labour mobility is not an equilibrating option; indeed several economies exhibit marked rigidities, especially in labour markets. While these economies are generally reliant on primary commodity exports, some are mineral exporters while others export different forms of agricultural output. This means that asymmetric price shocks are likely, requiring asymmetric country responses. Budgetary pressures in all of these economies will inevitably cause domestic opposition to fiscal transfers between countries. Finally, there is diversity in the levels of economic and institutional development.

For these reasons, real economic convergence is probably a necessary precondition for monetary harmonisation in COMESA. This requires not only convergence in macroeconomic stability indicators but also some catch-up by the poorer economies of the relatively richer ones to increase diversity of production and demand, and thereby reduce the inevitable asymmetry in responses to external shocks. However, there is no reason, *a priori*, to expect that convergence has taken place in COMESA, as substantive moves towards facilitating intra-regional trade and factor movements are relatively recent. Moreover, there is substantial variation in countries' current macroeconomic and trade policy frameworks.

In this section, we examine the extent of real economic convergence in COMESA as a whole and in various sub-groups of member countries. In order to form these sub-groups, the largest economies in the northern, eastern and southern areas of the COMESA zone were identified together with those smaller economies which are most closely integrated with them. The idea is that, if convergence clubs do exist within COMESA, they are most likely to involve smaller regional units.

Real GDP *per capita* is used as the best available proxy for the level of development (Kuznets, 1966; Syrquin and Chenery, 1988). In this context, convergence in real *per capita* GDP is therefore an indicator of real economic convergence. There are problems attached to measures of convergence, and no consensus as to which measure is best. Two of the simplest measures are calculated below and the trends for both COMESA and the sub-groups are discussed.

Measure 1: σ -convergence

The most simple measure is σ -convergence, when the dispersion of cross-sectional income levels diminishes over time, with dispersion typically measured by the standard deviation of *per capita* income. In this case it is irrelevant whether a single economy shows convergence; what is important is how the entire cross section behaves. If countries which are initially very different are converging, it is expected that the standard deviation will be growing smaller.

To illustrate σ -convergence, the example of the European Union is considered below (not because it is assumed that the EU is a suitable model for comparison with COMESA, but so that readers unfamiliar with the methodology have a point of reference for comparison). Since the formation of the Common Market in the 1950s, the standard deviation of *per capita* income of all EU members has been falling - this is illustrated in Figure 1 for the period from 1960 to 1990 (Figure 1 is from Jenkins and Thomas, 1997). Some interruption to this trend is evident in 1982-4, when a degree of divergence occurred, but this was subsequently reversed.

The calculations for COMESA members for the period from 1980 to 1998 are plotted in Figure 2¹⁶. In contrast to the downward sloping pattern of convergence that is evident in data for EU countries, the pattern for COMESA essentially suggests that convergence in *per capita* incomes has not occurred over the 18-year period. The degree of dispersion is in fact higher at the end of the period than at the beginning which suggests that these countries may have actually *diverged* over time. The absence of convergence among the COMESA countries may be due to several factors, including asymmetric external shocks and different problems with indebtedness, but there are also uniquely domestic policy issues which have promoted or slowed growth over this period.

Figure 3 shows the convergence measure for the group of countries closest to Egypt (country groupings are shown in Section 14). Note that Djibouti and Eritrea are excluded due to lack of comparable data. Between 1980 and 1992, the standard deviation of per capita incomes generally increased; thereafter, some improvement in dispersion is evident. These trends also suggest that divergence rather than convergence has occurred.

The group of countries around Kenya is examined in Figure 4 (note that Rwanda is missing from the calculation due to a lack of comparable data). Again, an upward trend in the dispersion of incomes is evident. As with COMESA as a whole, this measure suggests a lack of convergence; and some evidence of divergence.

Finally, Figure 5 illustrates the dispersion measure for the Southern African group around Zimbabwe. The pattern for this group of countries is flatter, suggesting that the trend of divergence for this group may well have been less evident than in the other sub-groups of COMESA. Nevertheless, the degree of dispersion was higher at the end of the period than at the beginning, indicating a lack of convergence.

Measure 2: β -convergence

The second and perhaps more common measure of convergence is β -convergence. This occurs when, in a cross-section regression of (time-averaged) growth rates on initial levels of GDP *per capita*, the estimated β -coefficient on initial levels is negative. The underlying assumption is that each region has a steady-state growth path. A downward-sloping plot of average growth rates on initial GDP will indicate possible β -convergence: if the hypothesis of convergence is supported by the data, then those countries whose *per capita* income was below the average for all countries at the beginning of the period should, on average, grow faster.

To illustrate this measure, the example of the EU is shown in Figure 6 (from Jenkins and Thomas, 1997). The scatter plot shows the deviation from mean per capita income in 1960 (on the x-axis) and average annual growth between 1960 and 1990 (on the y-axis). It can be seen that the countries that were relatively poor at the start of the period (for

¹⁶ The data used in these calculations are GDP *per capita* adjusted to constant prices and converted into 1990 purchasing power parity dollars. Data are from the World Bank. Where there are gaps in the coverage of the data, estimates have been used to yield a complete time series. The poor quality of data available for some of the COMESA economies means that these calculations are at best broadly indicative.

example, Portugal and Greece) grew faster in real terms than their richer regional partners over the next 30 years.

Figure 7 shows that, using this second measure, there is no pattern of convergence among the COMESA economies over the period from 1980 to 1998.¹⁷ Indeed, nine of the 18 countries for which there are data experienced negative growth in this period, according to our measure of real per capita income. Of these, eight had below average income at the start of the period. The fastest growth was experienced by one of the relatively richer economies, namely Mauritius.

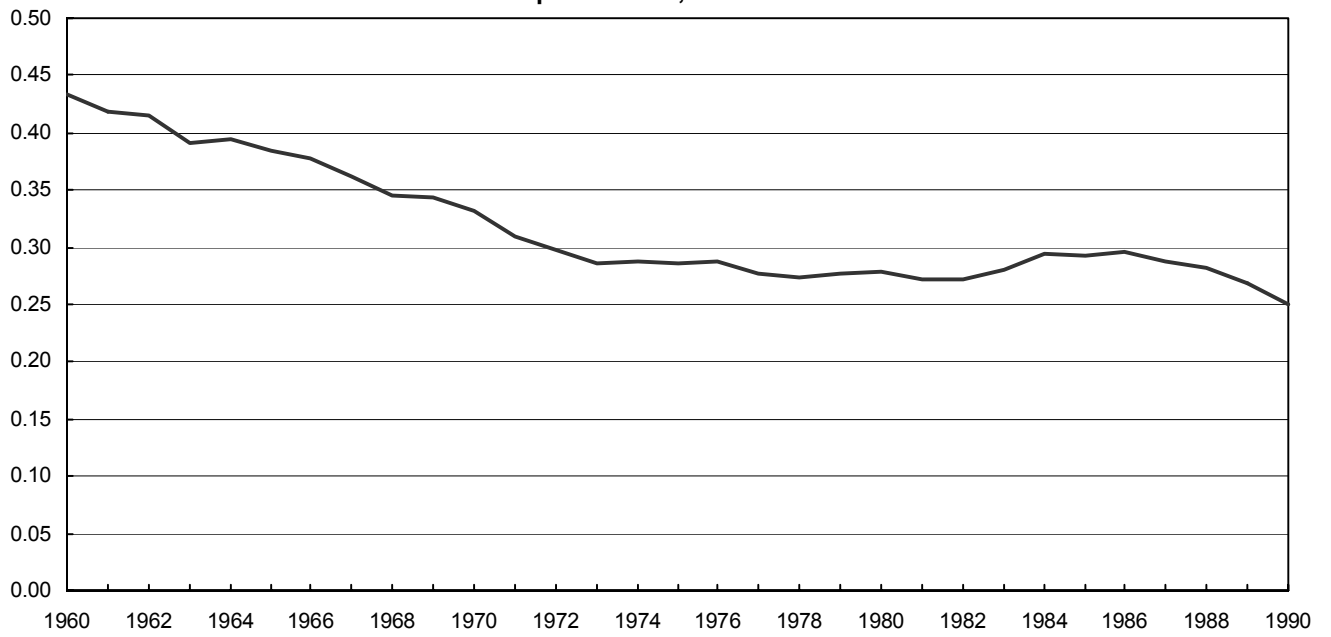
Figures 8 to 10 illustrate the patterns for the three sub-groups of COMESA economies. There is no evidence to suggest from these calculations that convergence has occurred within any of these groups. In the Egypt group (which perhaps has too few countries to offer a meaningful comparison), the poorest country at the beginning of the period experienced negative growth in contrast to its relatively richer partners. In the Kenya group, Mauritius outperformed its poorer counterparts by a considerable margin and the richest economy, Seychelles, also had one of the highest rates of growth. Nevertheless, Uganda and Tanzania, which began as the poorest countries in this group did show stronger growth than neighbouring Kenya. Finally, in the Zimbabwe group, the growth performance generally was very poor. Only two of the eight economies - both relatively richer than most of their regional partners - experienced positive average annual growth in per capita incomes in this period.

In conclusion, both measures of convergence tend to suggest that there has been no convergence of incomes in COMESA as a whole; if anything there has probably been divergence. Neither is there evidence to suggest that the regional sub-groups of COMESA members identified in this study have experienced convergence over the period considered.

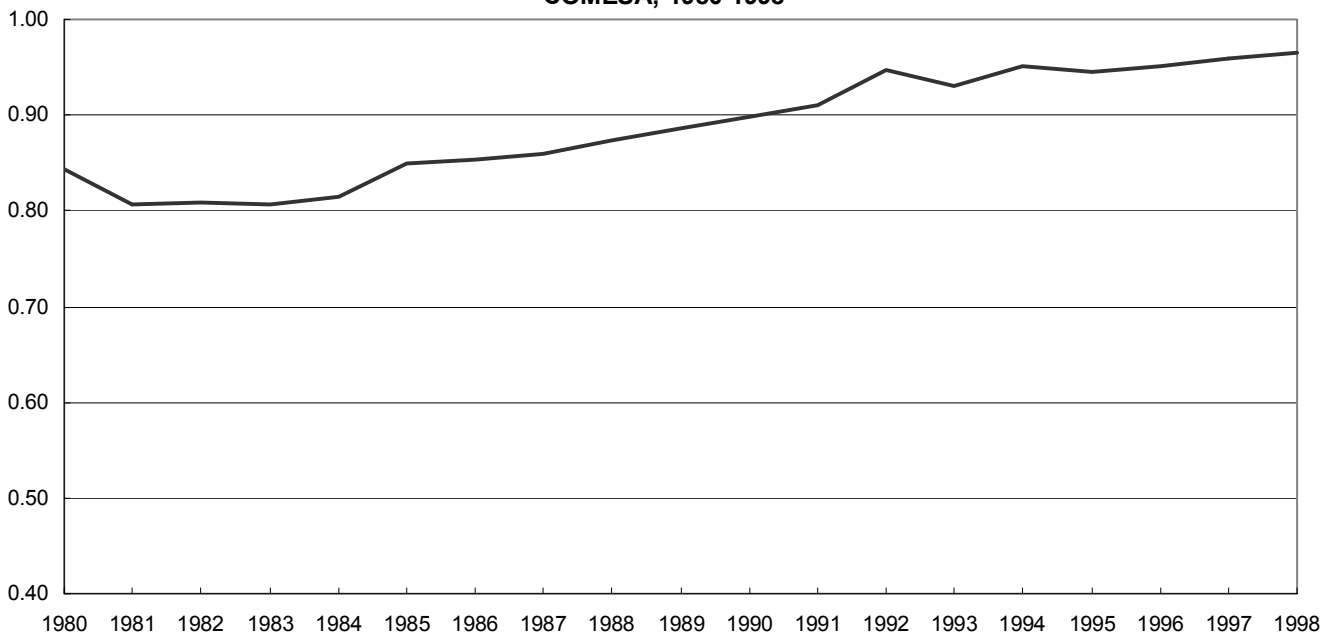
The complete lack of progress towards a greater degree of economic similarity between members in COMESA suggests that the region is currently *not* an optimal currency area. In order to foster greater regional symmetry, it will undoubtedly be necessary to implement more stringent economic policies. In preparation for the introduction of the euro, EU members adopted a set of criteria agreed to in the Maastricht Treaty. As these are theoretically consistent, they have been used as a starting point for developing a set of criteria for COMESA countries. Recent experience with these criteria is evaluated in the following section although some modifications, more appropriate for African countries, are proposed.

¹⁷ Note that some members are missing due to a lack of comparable data. See the previous footnote on the source of data and definition of per capita income in this context.

**Figure 1: Standard deviation of log of per capita income:
European Union, 1960 to 1990**



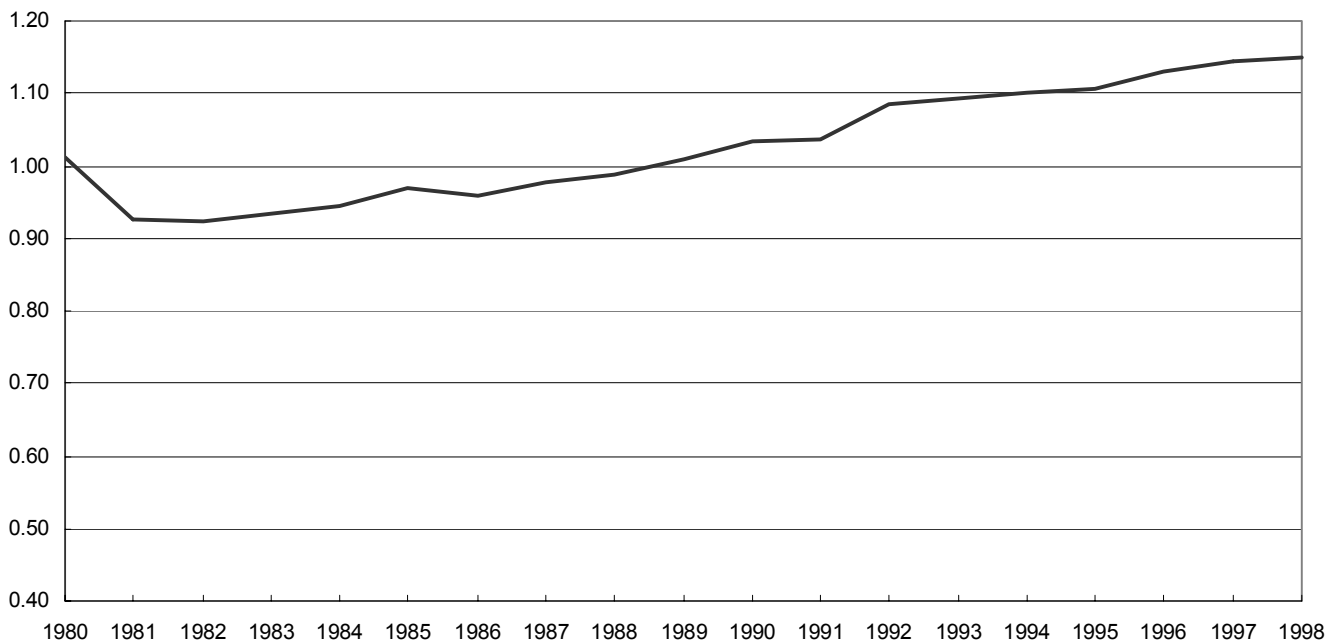
**Figure 2: Standard deviation of log of per capita income
COMESA, 1980-1998**



**Figure 3: Standard deviation of log of per capita income
Egypt group, 1980-1998**



**Figure 4: Standard deviation of log of per capita income
Kenya group, 1980-1998**



**Figure 5: Standard deviation of log of per capita income
Zimbabwe group, 1980-1998**

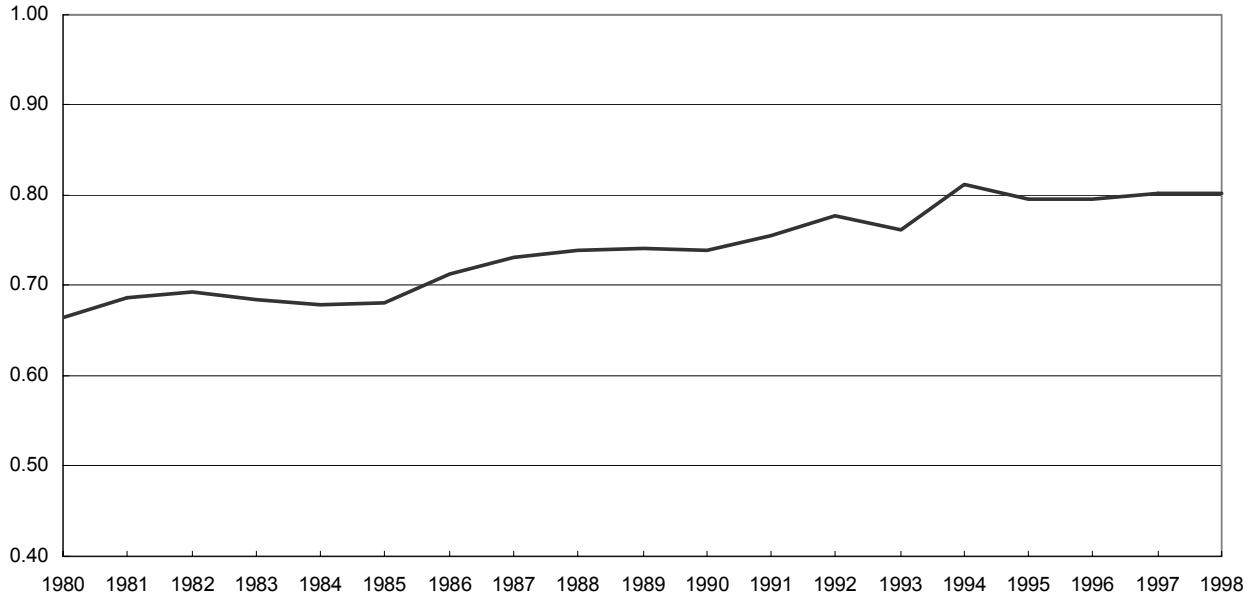
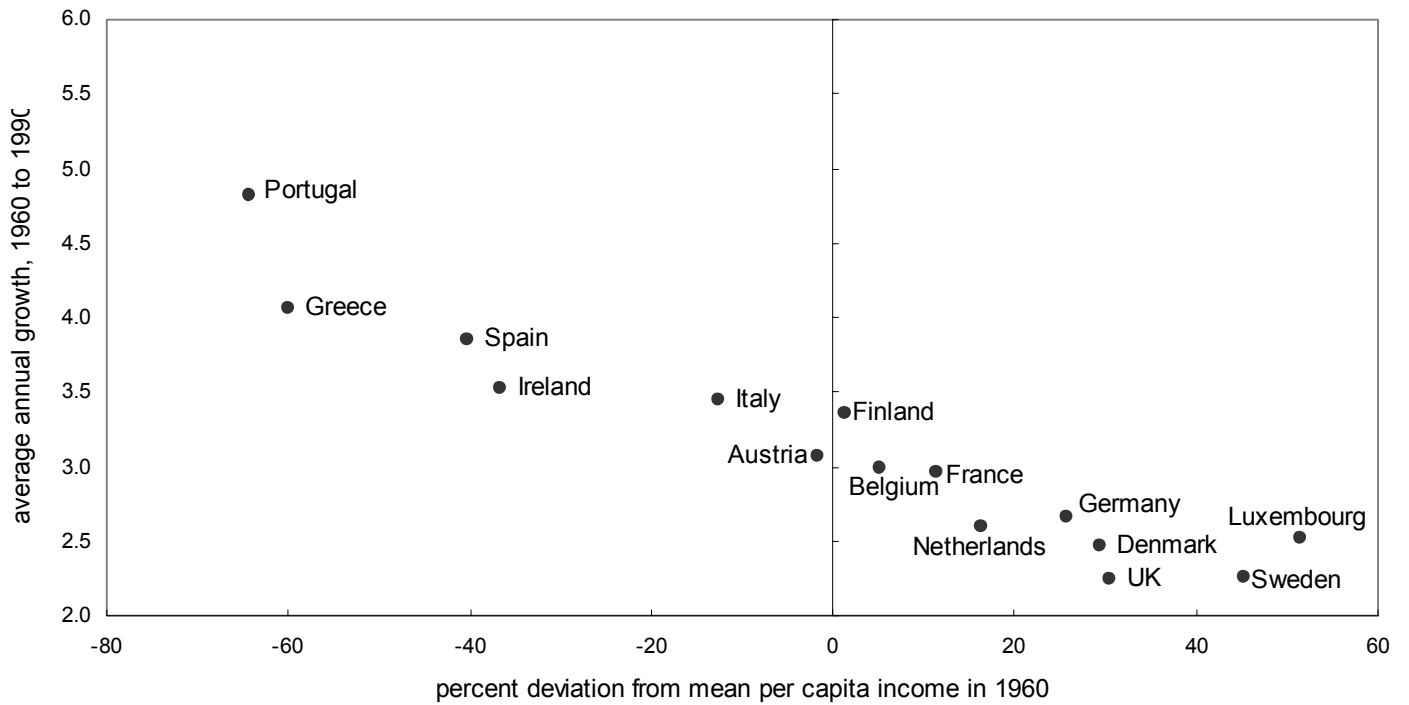
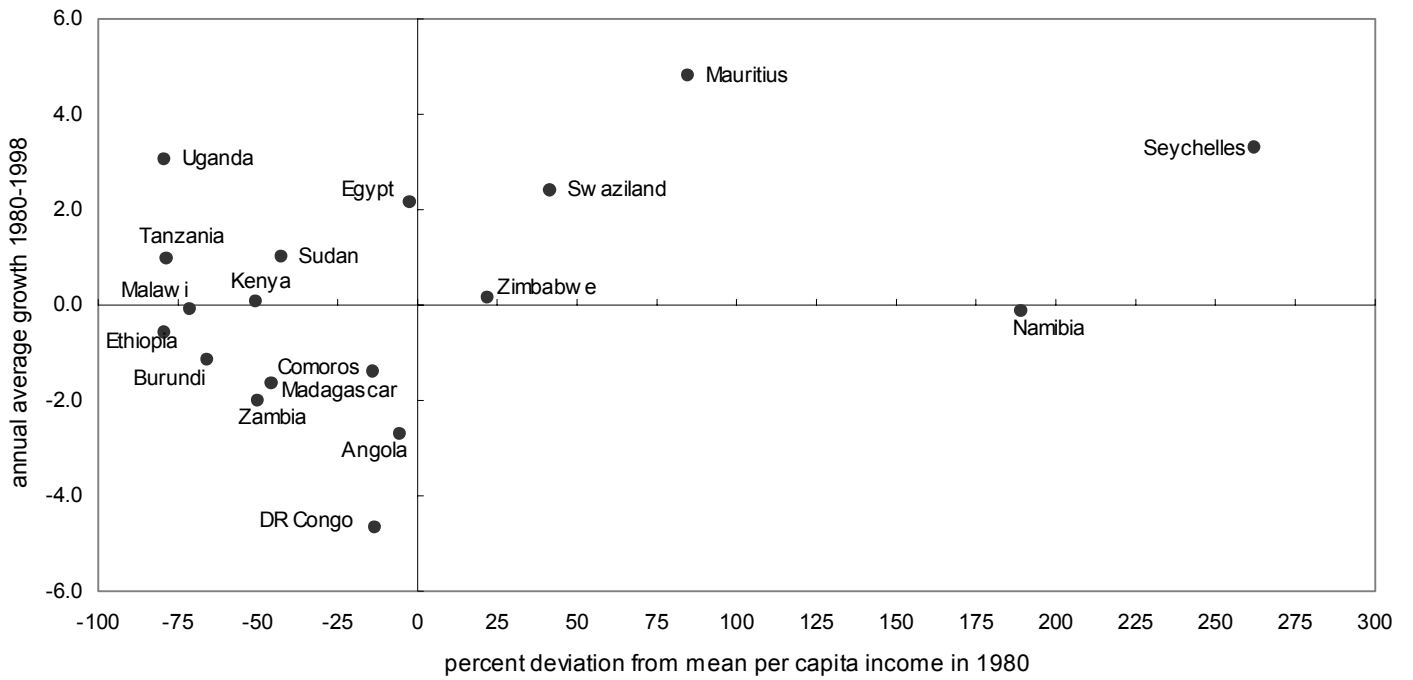


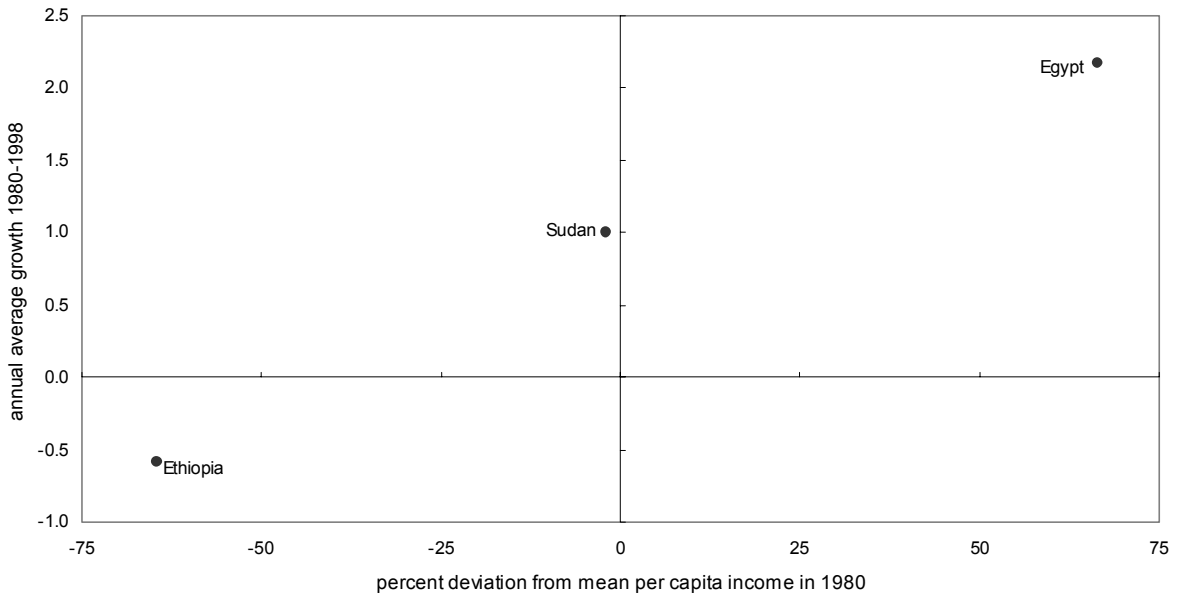
Figure 6: The relationship between initial per capita income and subsequent growth: European Union, 1960-1990



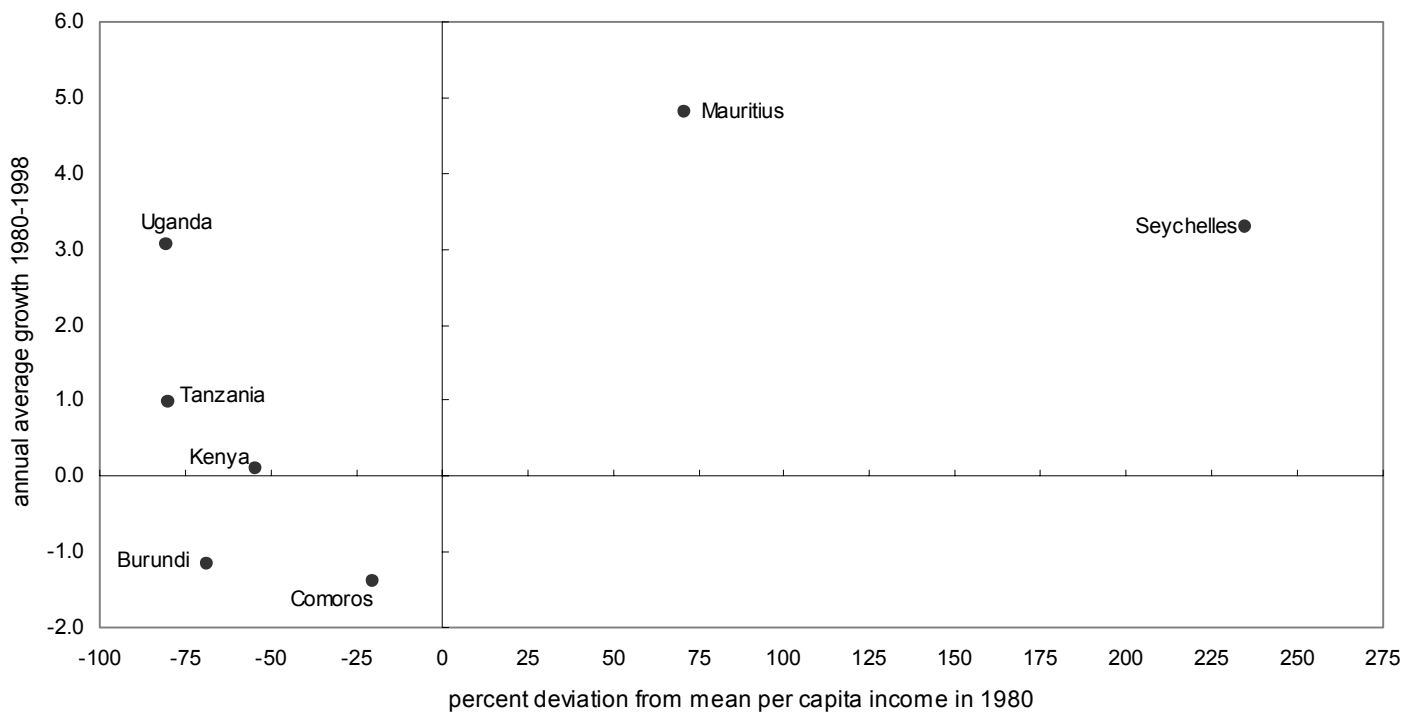
**Figure 7: The relationship between initial per capita income and subsequent growth:
COMESA, 1980-1998**



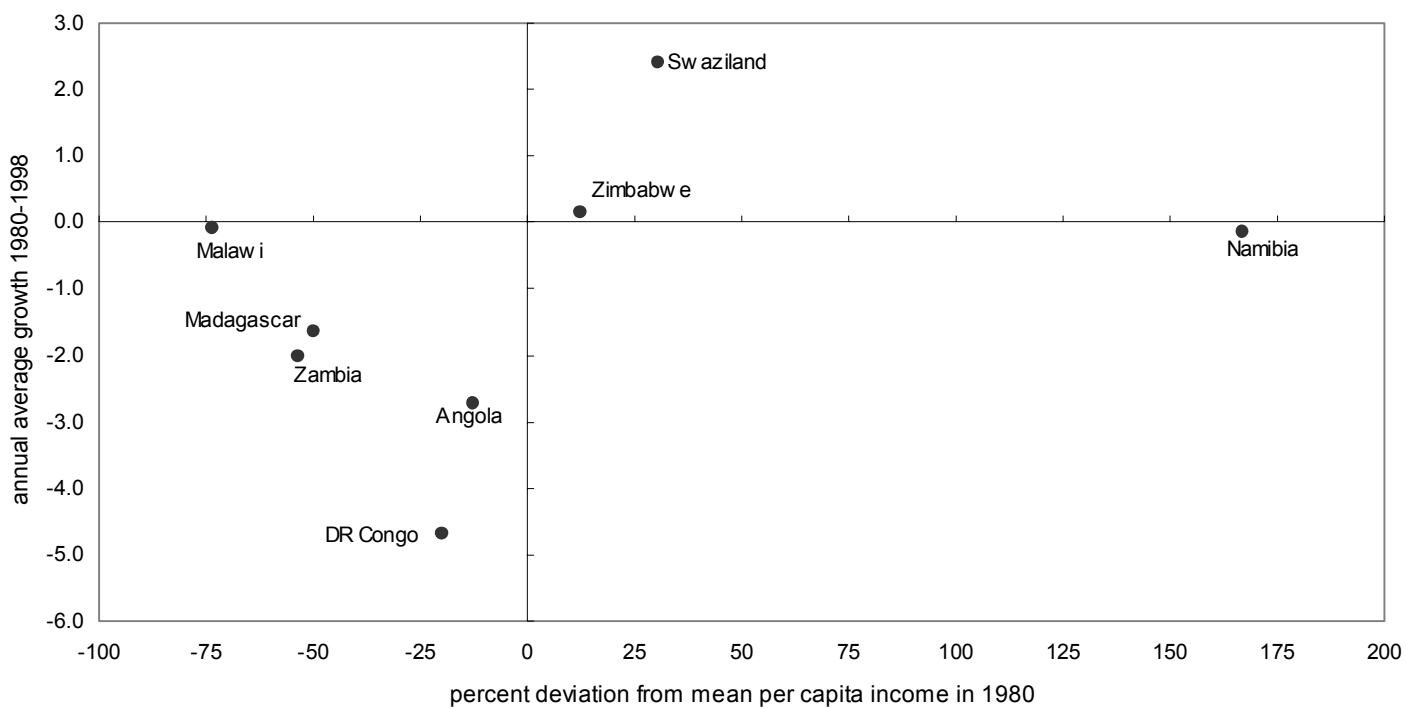
**Figure 8: The relationship between initial per capita income and subsequent growth:
Egypt group, 1980-1998**



**Figure 9: The relationship between initial per capita income and subsequent growth:
Kenya group, 1980-1998**



**Figure 10: The relationship between initial per capita income and subsequent growth:
Zimbabwe group, 1980-1998**



5 Maastricht criteria

5.1 Adaptation of Maastricht criteria to COMESA MHP

The Maastricht criteria are

- inflation rates must converge close to the average of the rates achieved by the three member countries with lowest inflation
- long-term nominal interest rates on government debt must converge to a level close to the average of those achieved by the three countries with lowest inflation
- exchange rates must be stable (within the Exchange Rate Mechanism plans) for two years prior to monetary union without any measures to stop a free flow of foreign exchange
- the budget deficit-to-GDP ratio must not exceed 3%
- the public debt-to-GDP ratio must not exceed 60%.

Not all of these criteria are suitable for application to the COMESA situation, and modifications are proposed.

For example, convergence to the average of the three lowest rates of inflation within COMESA would not necessarily provide the stable conditions suitable for the creation of a common currency, and might require excessive deflation. It is proposed that the Maastricht inflation criterion should be adapted for COMESA as follows. To meet the criterion, a country should have inflation in the most recent three years equal to or less than twice the average rate of inflation of those three countries with the lowest rates of inflation in COMESA, provided that that average is less than 3%. If the average of the three countries with the lowest rates of inflation is more than 3%, then the criterion should be for a country to have inflation within three percentage points of that average.

At present, the three lowest rates of inflation over the most recent three years are in Ethiopia (-0.2%), Egypt (3.9%) and Uganda (4.5%), which gives an average of 2.7%. It seemed appropriate to omit the lower inflation rates of Comoros, Djibouti and Seychelles, because their economies are so small in relation to the rest of COMESA that they should probably not be used as a benchmark for convergence. Given that the average is less than 3%, the inflation criterion adapted for COMESA is taken to be that a country should be within twice the average rate of these three countries (that is, equal to or less than 5.4%).

Similarly, as there is not an exchange rate mechanism comparable to that in the European Union, a more appropriate condition for COMESA would be either stability in comparison with the leading economy in COMESA (currently Egypt), stability with the currency with which two COMESA countries are already in a common currency area (Namibia and Swaziland are in a common currency area with the South African rand), or stability with one of the major non-regional currencies such as the United States dollar. As it happens, Egypt has pegged its currency to the United States dollar for some years, so it is proposed that the criterion for exchange rates should be *real* stability against the United States dollar for a period of at least three years, and therefore by implication

stability against the Egyptian Pound (so long as it stays stable against the US\$). It is proposed that stability should be defined as annual average exchange rates being within 5% of the exchange rate at the beginning of the period, for at least three years.

A third criterion concerns the interest rates on long-term government debt. This would be difficult to apply to COMESA countries, because of the absence of active markets in long-term government debt in most of the member countries. It is proposed, therefore, not to apply this criterion to COMESA in this report. In the future, if markets in long-term government debt do develop, it might be appropriate to propose the following guideline. COMESA member countries should endeavour to achieve interest rates on long-term government debt (ten years maturity or more) within three percentage points (say) of the average on long-term government debt in the European Union.

Statistics for government borrowing are not readily available, apart from those for the lending of commercial banks and other financial institutions to the government. It is proposed, therefore, to adapt the Maastricht criterion regarding government borrowing to be that total public debt (defined as external debt plus government claims on the banking system) should not exceed 100% of GDP, with the external component being less than 50% of GDP.

For the purposes of this study, therefore, the performance of each country in COMESA will be compared with the following criteria, adapted from the Maastricht criteria, in addition to the criteria proposed in the 1995 review of the Monetary Harmonisation Programme:

- inflation rates must be less than or equal to twice the average of the three lowest inflation rates over the last three years within COMESA, provided that this average is less than 3%, and within three percentage points of the average if it is greater than 3%
- average annual exchange rates must be within 5% of the exchange rate at the beginning of the period over the most recent three years against the United States dollar, with no current account exchange or other government controls propping up the external value of the currency
- the budget deficit must not exceed 3% of GDP
- total public debt, domestic (as defined above) and foreign, should not exceed 100% of GDP.

5.2 Inflation (less than or equal to twice the average of the three lowest rates of inflation in COMESA, averaged over the three most recent years)

Very few COMESA countries meet this criterion. Apart from the three benchmark countries, which meet the criterion by definition, only the three very small economies of Comoros, Djibouti and Seychelles had inflation rates below the modified Maastricht benchmark of 5.4%, together with that of Rwanda (5.3%). That makes only seven countries meeting this criterion, compared with 12 which met the MHP target. A further five countries, however, had single digit inflation over 1996-99, and may therefore, be within reach of the adapted Maastricht criterion.

In the longer run, even a benchmark of 5.4% is probably too high. COMESA member countries which aim to become globally competitive, and also to have stable exchange rates, will need to have inflation rates of 3% or less, in order to be comparable to inflation rates in the industrialised countries with which they do much of their trade. Such low inflation rates are also necessary in order to attract the additional investment that is badly needed, as well as to reduce barriers to international trade. In the longer run, therefore, even more stringent criteria may be required for inflation (see recommendations).

Table 90: Modified Maastricht criteria: inflation

(less than average of three lowest inflation rates 1997-99: Ethiopia, Egypt, Uganda: 5.4%)

Country	Current position (1997-99)	Meets criterion	Fails criterion
Angola	197.4	-	Yes
Burundi	15.7	-	Yes
Comoros	4.1 ^(b)	Yes	-
Congo	218.5	-	Yes
Djibouti	3.5 ^(a)	Yes	-
Egypt	3.9	Yes	-
Eritrea ^(c)	-	-	-
Ethiopia	-0.2 ^(b)	Yes	-
Kenya	6.8	-	Yes
Madagascar	6.9	-	Yes
Malawi	27.9	-	Yes
Mauritius	6.8	-	Yes
Namibia	7.9	-	Yes
Rwanda	5.3	Yes	-
Seychelles	0.7 ^(b)	Yes	-
Sudan	26.6	-	Yes
Swaziland	7.1	-	Yes
Tanzania	12.2	-	Yes
Uganda	4.5	Yes	-
Zambia	35.1 ^(a)	-	Yes
Zimbabwe	36.3	-	Yes
Total		7	13

Notes: ^(a) 1995-1997; ^(b) 1996-1998; ^(c) data not available

5.3 Exchange rate stability (stable against the US\$ for the past three years)

This criterion is that the annual rate of change in the real exchange rate should be within five percentage points up or down. In order to test this, average annual exchange rates from IFS over the period 1997-99 were used. Observing actual exchange rates is not, unfortunately, a perfect test of exchange rate stability. It is possible that a nominal exchange rate has been maintained constant against the dollar by various controls, or by aid inflows. To some extent, therefore, Table 11 below should be read in conjunction with Table 16, noting in particular the extent of exchange control liberalisation. It is also possible to maintain an exchange rate by foreign borrowing, although that is less likely to be possible for most African economies.

The one really positive finding is that the largest economy in COMESA, Egypt with more than 50% of COMESA GDP, has maintained a stable rate against the US\$ since 1994. There was a small depreciation during the first nine months of 2000, but well within the 5% target (note however that Egypt maintained some exchange controls on the capital account). On the other hand, the only other three economies which met this criterion were the three small economies of Comoros, Djibouti and Seychelles which together account for only 1.2% of total COMESA GDP (see Table 23). In addition, Rwanda is very close to the target.

Three other currencies have depreciated by less than 20% per annum over 1997-99: those of Ethiopia, Kenya and Mauritius. A further two have depreciated by just over 20%: Tanzania and Madagascar. Excluding the war-torn economies of Angola, Congo, Burundi and Sudan, the average increase in the cost of the United States dollar over 1997-99 was 36.8%. On this criterion, therefore, there is still a long way to go. Put differently, *progress with budget deficits and inflation has yet to show up in exchange rate stability.*

Table 101: Exchange Rate, local currency per US\$

(Maastricht criterion: stable against the US\$ for the past three years^(a))

Country	1997	1998	1999	Meets criterion	% change 1997-99
Angola	229,040	392,824	2790,706	No	+1218.4
Burundi	352.35	447.77	563.56	No	+59.9
Comoros	437.75	442.46	461.77	Yes	+5.5
Congo	131345	160666	410000	No	+212.2
Djibouti	177.72	177.72	177.72	Yes	0.0
Egypt	3.39	3.39	3.39	Yes	0.0
Eritrea ^(e)	-	-	-	-	-
Ethiopia	6.71	7.12	7.94	No	+18.3
Kenya	58.73	60.37	70.33	No	+19.8
Madagascar	5,090.9	5,441.4	6,283.8	No	+23.4
Malawi	16.44	31.07	44.09	No	+168.2
Mauritius	21.06	23.99	25.19	No	+19.6
Namibia	4.60	5.53	6.12	No	+33.0
Rwanda	301.53	312.31	333.94	Nearly	+10.7
Seychelles	5.03	5.26	5.34	Yes	+6.2
Sudan	157.57	200.80	252.55	No	+123.7
Swaziland	4.60	5.48	6.12	No	+33.0
Tanzania	612.12	664.67	744.76	No	+21.7
Uganda	1,083.0	1,240.3	1,454.8	No	+34.3
Zambia	1,314.5	1,862.07	2,388.02	No	+81.7
Zimbabwe	11.9	21.4	38.3	No	+221.8
Total				Yes 4/No 16	

Notes: ^(a) criterion used is rate of change within 5 percentage points either way.

Source: annual average exchange rates from *International Financial Statistics*

5.4 Budget deficit (less than 3% of GDP in most recent three years)

Budget deficits in the Maastricht criteria for the European Union are emphasised for two reasons. Firstly, budget deficits are one important way of determining whether

macroeconomic convergence has taken place. Secondly, if a member country were to run a large budget deficit, it would be financed from the integrated EU financial markets, driving up interest rates at the expense of other member countries, and enabling the country with the large deficit to capture more than its share of the EU's financial savings.

At present, COMESA financial markets are hardly integrated at all. Nevertheless, with a common currency and no exchange controls within COMESA, it would be possible for a member country with a large deficit to have much the same effect as within the EU, probably by borrowing from other members' financial institutions. As argued above, the MHP budget deficit criterion, at 10%, is not nearly strict enough for the establishment of a monetary union. A particularly important reason derives from the shallowness of financial markets in most of the COMESA member countries, which would make it difficult (if not impossible) to achieve non-inflationary finance of budget deficits as large as 10% of GDP.

There has been a history in Africa of budget deficits financed by money creation on a large-scale, leading to extreme inflation and currency depreciation (see Table 24). It is encouraging, therefore, that a (narrow) majority of COMESA member countries already meets the Maastricht budget deficit criterion, with budget deficits less than 3% of GDP. Moreover, of the nine member countries which fail the criterion, only three have budget deficits which are more than 10% of GDP. These are

- Angola because of the war
- Seychelles, which has had access to large-scale non-inflationary finance making possible an average rate of inflation below 1% (IFS shows the budget deficit being financed almost exclusively by foreign finance)
- Congo, also at war, almost certainly exceeds the target, but figures for the most recent years are not available.

Of the six remaining countries which fail the criterion, five have budget deficits which are 5% or less of GDP. The average for the six countries is 4.8% (but note that the country in this group which has a budget deficit greater than 5% of GDP is Zimbabwe, and that the reported figure of 6.9% is probably an underestimate).

Overall, this is an encouraging picture, with a large majority of COMESA countries having budget deficits which are already less than 3% of GDP, or are within reach of achieving that target.

Table 11: Maastricht criteria: budget deficits

(budget deficit less than 3% of GDP in three most recent years)

Country	Average of last three years	Meets Criterion	Fails Criterion
Angola	14.6 ^(a)	-	Yes
Burundi	4.4 ^(b)	-	Yes
Comoros ^(e)	-	-	
Congo	^(d)	-	Probably yes
Djibouti	3.8 ^(a)	-	Yes-
Egypt	1 ^(c)	Yes	-
Eritrea ^(e)	-	-	-
Ethiopia	2.5 ^(a)	Yes	-
Kenya	1.0	Yes	-
Madagascar	1.0 ^(c)	Yes ^(c)	-
Malawi	2.3	Yes	-
Mauritius	1.7 ^(b)	Yes	-
Namibia	4.2 ^(b)	-	Yes
Rwanda	4.7 ^(b)	-	Yes
Seychelles	15.8 ^(a)	-	Yes
Sudan	1.8 ^(c)	Yes	-
Swaziland	- 0.3 ^(c)	Yes	-
Tanzania	-0.3	Yes	-
Uganda	2.0 ^(f)	Yes	-
Zambia	5.0	-	Yes
Zimbabwe	6.9 ^(c)	-	Yes
Total		10	9

Notes: ^(a) 1996-1998; ^(b) 1997-1999; ^(c) 1995-1997; ^(d) figures for the latest years not available; ^(e) data not available.

5.5 Government debt (external debt less than 50% of GDP; total debt less than 100% of GDP)

The adapted Maastricht external debt criterion is identical to the MHP criterion (see Table 9 above); an additional table is not provided here. The adapted Maastricht criteria also include a limit on total government debt, namely that it should be less than 100% of GDP. The picture for total debt is rather better than for foreign debt. This is because a number of countries have foreign debt less than 100% of GDP, and relatively few African countries have significant domestic debt. Their financial markets are underdeveloped, and, as already noted, a number of countries have managed to reduce the growth of central bank lending to the government (although some of them had large outstanding stocks of central bank lending from earlier periods).

As a consequence, 12 countries met the total debt criterion, and another (Zimbabwe) had a ratio of total debt to GDP of 101%. Of the seven other countries which failed to meet the total debt criterion, four were in war situations. The only two countries without a war problem which failed to meet the criterion were Madagascar and Zambia. As already noted, the main problem with countries at war is political not economic. If peaceful

solutions can be found, then the debt problems of these countries can be tackled. It is unfortunately only too common for countries to run up large debts during wartime, creating lasting economic problems even when the wars are over.

Table 123: Maastricht criteria: total central government debt

(less than 100% of GDP)

Country	Most recent year	Meets Criterion	Fails Criterion
Angola	156.7 ^(a)	-	Yes
Burundi	197.3 ^(b)	-	Yes
Comoros	90.8 ^(c)	Yes	-
Congo	>210.0	-	Yes
Djibouti	57.9 ^(c)	Yes	-
Egypt	79.0	Yes	-
Eritrea ^(f)	-	-	-
Ethiopia	168.8 ^(b)	-	Yes
Kenya	79.0	Yes	-
Madagascar	119.4 ^(b)	-	Yes
Malawi	116.0	Yes	-
Mauritius	79.9 ^(b)	Yes	-
Namibia	9.0 ^(d)	Yes	-
Rwanda	60.6 ^(b)	Yes	-
Seychelles	98.8 ^(c)	Yes (just)	-
Sudan	251.8 ^(b)	-	Yes
Swaziland	20.0 ^(b)	Yes	-
Tanzania	98.6	Yes (just)	-
Uganda	60.3	Yes	-
Zambia	160.9 ^(c)	-	Yes
Zimbabwe	101.0 ^(c)	-	Only just
Total		12	8

Notes: ^(a) 1999; ^(b) 1997; ^(c) 1998; ^(d) 1996; ^(e) 1995; ^(f) data not available

6 Additional criterion: the extent of intra-COMESA trade

In the literature review, it was argued that one of the essential interrelations that should apply between members of a potential currency area is that there needs to be a comparatively high degree of trade openness between them. In other words, this is viewed as a prerequisite and not a result – although the result is likely to be even greater intra-group trade.

One of the underlying reasons for wishing to create a common currency area in COMESA is that it will reduce the costs and risks of intra-COMESA trading. A frequently quoted research finding is that the costs of currency exchange within the EU were estimated to cost approximately 0.5% of GDP (De Grauwe, 1992). However, intra-EU trade is a high proportion of the total trade of European Union members, so that reducing its cost is significant in relation to member countries' GDP.

In contrast, intra-COMESA trade is a small proportion of COMESA member countries' total trade. Using the IMF's *Direction of Trade Statistics Yearbook 2000*, the imports of COMESA members from each other in 1999 were 4.0% of their total imports, and exports to other COMESA countries were 6.5% of their total exports (see also Musonda, 1997). In these circumstances, cost reductions through the elimination of the need for currency exchange would be very much smaller than in the EU.

The gains from risk reduction might be greater. Exchange rate fluctuations in COMESA are much greater than exchange rate fluctuations were in the EU, prior to the introduction of the euro. In addition, currency futures markets, which might be used to reduce exchange rate risks, are less developed, or non-existent, for COMESA currencies.

Intra-COMESA trade is shown in Table 14 (only formal bilateral trade valued at more than US \$0.5 million in 1999 is recorded). The level of intra-COMESA trade is relatively small, even among groups of neighbouring countries which might have been expected to trade significantly with each other.

Table 13: Intra-COMESA trade 1999

(US\$ millions)

Exports of	Ang	Bur	Com	DRC	Dji	Egy	Eri	Eth	Ken	Mad	Mal	Mau	Nam	Rwa	Scy	Sud	Swa	Tan	Uga	Zam	Zim	Tot
Imports of																						FTA
1. Angola	X																			1	7	8
2. Burundi		X							6					2				5		7	2	23
3. Comoros			X						4	1		1										6
4. DRC				X					1					1				6		35	9	52
5. Djibouti					X	4		51	3													58
6. Egypt						X		14	79		7					37		3			3	143
7. Eritrea							X															
8. Ethiopia					6	1		X	18							2		4				31
9. Kenya						10		1	X	10		10				2		10	1	2	5	51
10. Madagascar									1	X		6										7
11. Malawi									7		X	2						4		26	80	119
12. Mauritius									8	10		X					6				5	30
13. Namibia													X									
14. Rwanda		1			5			1	51			1		X				5	2	2		68
15. Seychelles									3	2		10			X							15
16. Sudan						24			51							X					4	79
17. Swaziland																	X					
18. Tanzania				1		1		1	111		2	1					12	X	2	18	6	155
19. Uganda						1			335		2	1						8	X		2	349
20. Zambia									4		4		1				7	4		X	76	96
21. Zimbabwe						1		2	9	7		6					11	2		17	X	61
Total FTA	0	1	0	7	6	43		70	691	30	15	38	1	9		41	36	51	5	108	199	1351
Total exports	4361	55	48	1134	140	3535		451	2192	220	462	1696	1278	77	108	700	790	587	367	785	1888	20874
FTA/total exports (%)	0.0	1.8	0.0	0.6	4.3	1.2		15.5	31.5	13.6	3.2	2.2	0.1	11.7	0.0	5.9	4.6	8.7	1.4	13.8	10.5	6.5
Trading partners	0	1		3	1	8		6	16	5	4	9	2	3		3	4	10	3	8	11	

Source: IMF Direction of Trade Statistics

Of the 20 COMESA countries covered by the IMF's *Direction Of Trade Statistics*, not one imported significantly (more than \$0.5 million) from more than 10 of the other COMESA countries. Ten of them imported from five COMESA countries or fewer.

Table 14: Number of trading partners within COMESA

(trade of more than US \$0.5 million in 1999)

	Imports from COMESA	Exports to COMESA		Imports from COMESA	Exports to COMESA
Angola	2	0	Mauritius	5	9
Burundi	6	1	Namibia	-	2
Comoros	3	-	Rwanda	8	3
DRC	5	3	Seychelles	3	-
Djibouti	3	1	Sudan	3	3
Egypt	6	8	Swaziland	-	4
Eritrea ^(a)	-	-	Tanzania	10	10
Ethiopia	5	6	Uganda	6	3
Kenya	9	16	Zambia	6	8
Madagascar	2	5	Zimbabwe	9	11
Malawi	5	4			

Note: (a) no data for Eritrea

The picture is only slightly more promising for exports. Kenya exported more than US\$0.5 million to 16 COMESA countries, and Zimbabwe to 11. On the other hand, 11 countries exported to only five other members, or fewer.

A partial exception to this is that the members of the former East African Community (Kenya, Tanzania and Uganda) have continued to trade quite extensively. Some 20.3% of Kenya's exports went to Tanzania and Uganda in 1999. However, this trade was overwhelmingly one way only. The value of Tanzanian imports from Kenya was US\$111 million, but the value of Tanzanian to exports to Kenya was only US\$1 million. The bilateral deficit in Uganda was even larger, with imports worth US\$335 million from Kenya, and exports worth only US\$10 million to Kenya. The perception that Kenya was deriving most of the benefits was a major reason for the collapse of the East African Community in the 1970s. Meanwhile, despite sharing a common border, (formal) trade between Tanzania and Uganda was negligible (1% of their total foreign trade). Trade within these three East African countries, therefore, really only amounts to Kenya having developed export markets in Tanzania and Uganda. Meanwhile, it is reported that Tanzania is leaving COMESA.

Elsewhere in COMESA, formal intra-COMESA trade is relatively small. By definition, therefore, any cost reductions through the elimination of the need for currency exchange would also be extremely small. It would be a benefit, but not one that would on its own justify the setting up of a single currency. The benefits derive from the macroeconomic stability that would be necessary to set up a single currency, and would be locked in by it, together with the increased investment that should follow. Moreover, if it is advisable

that exchange-rate coordination occur between countries which trade extensively, then a common currency in COMESA is at best premature.

The low level of intra-COMESA trade is consistent with findings regarding intra-regional trade in other parts of Africa: "It is safe to say that [regional integration arrangements in Africa] have not been particularly successful. In fact, the studies indicate that the least significant stimulus for trade liberalisation is membership in a regional integration arrangement" [Oyejide, 1996a].

7 Institutional reforms

It is rather more difficult to be objective about progress with institutional reforms, than with such identifiable issues as the rate of inflation and whether real interest rates are positive or negative. Many issues are not clearcut, and definitive information is difficult (and sometimes impossible) to obtain. The one issue on which information is definite is whether countries have agreed to the IMF Article VIII, under which current account transactions on the balance of payments are free of all restrictions.

It should be pointed out that using indirect monetary instruments, liberalising interest rates, removing exchange controls, and floating the exchange rate, *are only means to an end*. They may be necessary in order to get the benefits of a freely functioning market economy, and the efficiency that comes from opening up an economy to the rest of the world. However, they can be mismanaged.

For example, freeing up financial markets while not reducing a large budget deficit can lead to damagingly high interest rates and the crowding out of private sector borrowing. Alternatively, if a large budget deficit is not reduced or financed in a non-inflationary way, there is a severe risk of a downward spiral. At worst this leads to a combination of rising inflation and accelerating depreciation of the exchange rate (if it is freely floating). It can be argued that this is exactly what has happened in some COMESA countries in some recent years, for example Zambia and Zimbabwe.

That said, some progress has been made with the liberalisation of different financial markets. Moreover, evidence from Table 2 above is that a clear majority of COMESA member countries now have annual inflation rates below 10%. This is *prima facie* evidence that the liberalisation of financial markets has been combined with relatively sound fiscal policy in many cases. This is confirmed by Tables 3 and 12.

The overall picture in Table 16 is quite positive. It is estimated that 14 member countries are using indirect monetary instruments, one has moved in that direction (Sudan), another has announced that it will (Ethiopia), and only three appear to be using controls. This degree of liberalisation is fairly remarkable, given the very small size of the financial markets in most COMESA member countries.

Closely related to the use of indirect monetary instruments is the liberalisation of interest rates, where eleven countries are estimated to have met the criterion, two countries have

moved partly in this direction, and only three countries still have controlled interest rates. The case of Namibia and Swaziland is slightly different, in that they are members of the Common Monetary Area (CMA, the other members are Lesotho and South Africa). They therefore have interest rates very close to those obtaining in financial markets in South Africa (because money can flow freely within the CMA).

Thirteen countries have accepted IMF Article VIII. Two further countries have announced their intention to adopt it, leaving only six countries which still have controls on current account transactions. However, several of the countries which have acceded to Article VIII retain controls on capital account transactions. The severity of exchange controls varies considerably among the different countries. This is difficult to summarise, so that Table 16 records such cases as "partly", with indications in some cases as to how much or how little of capital account controls have been retained. In summary, only two countries have abolished exchange controls completely, with a third (Zimbabwe) having reintroduced controls in 2001. Fifteen countries, have partly liberalised, of which two countries are classified as having liberalised only a little, and a further five classified as having mostly liberalised (including Namibia and Swaziland, which have the same exchange controls as South Africa for transactions outside the CMA). Only the two remaining countries are classified as not having liberalised exchange controls.

Exchange rate regimes are also quite difficult to classify. The degree of change in institutional arrangements can be seen by the relatively small number classified as having a "conventional peg", as that was the most common arrangement previously. Only six countries are in this category, of which two have extremely stable pegs (Djibouti and Egypt), while one (Zimbabwe), has resorted to frequent devaluations. Namibia and Swaziland are pegged to the South African rand, which in turn floats independently. On the other hand, there are nine countries which have been classified in Table 16 as having freely floating exchange rate regimes, although it is not possible to be certain that there is no government interference. Many African countries have irregular receipts and payments of foreign exchange, making it unlikely that a completely free market can provide a relatively stable exchange rate. That is no doubt why four countries can be classified as having a "managed float". It is possible that there is a grey area between this classification and the "independent float" classification.

In any case, *it is debatable whether a freely floating exchange rate is the optimum strategy for achieving monetary harmonisation in COMESA*. It has been argued that stable links to major currencies (probably the euro or the US dollar), possibly leading to irrevocable links, may be a more promising strategy. If that argument is accepted, then Djibouti and Egypt, classified in Table 16 as "stable peg", may represent the direction in which other COMESA countries should ultimately move. Until countries manage to reduce their inflation to rates comparable with that of a chosen link currency, however, floating rates may be preferable. Great damage can be done by trying to maintain a fixed nominal exchange rate when inflation is higher than that of major trading partners.

Overall, most of the COMESA member countries have made significant moves towards liberalisation of their financial markets. The main exceptions are the retention of

exchange controls on some capital account transactions, and some continued government interference in exchange rate determination. Many governments also retain some control over interest rates. This is not surprising, given the small domestic financial markets of many COMESA member countries (and the considerable government control over interest rates retained in the major industrialised countries). Perhaps more important, the freeing up of financial markets in COMESA has been accompanied by relatively sound fiscal policy, as demonstrated by progress with success in reducing budget deficits and rates of inflation. As already noted, the main exceptions to these generalisations concern the war-torn economies.

Table 15: Progress with MHP institutional reforms

Country	Use of indirect monetary instruments	Liberalisation of interest rates	Acceptance of IMF Article VIII	Exchange control liberalisation	Freely floating exchange rate (independent float)	No. of 'yes' (out of 5)
Angola	Yes	Yes	No	Partly	Yes	3
Burundi	Yes	Yes	No but intends to	No	Managed float	2
Comoros	No	No	Yes	Partly	Conventional peg	1
Congo	No	Not known	No	No	Yes	1
Djibouti		Yes	Yes	Yes	Stable peg	3
Egypt	Yes	No (partly)	No	Partly	Stable peg	1
Eritrea	-	-	-	-	-	-
Ethiopia	No, but soon	No (partly)	No	A little	Managed float	0
Kenya	Yes	Yes	Yes	Mostly	Managed float	3
Madagascar	Yes	Yes	Yes	Partly	Yes	4
Malawi	No	No	Yes	Partly	Managed float	1
Mauritius	Yes	Yes	Yes	Mostly	Yes	4
Namibia ^(a)	Yes	As in South Africa	Yes	Partly, as South Africa	Peg to SA rand	2
Rwanda	Yes	Yes	Yes	Partly	Yes	4
Seychelles	Yes	No	Yes	A little	Basket peg	2
Sudan	Partial	Islamic banking	No	Partly	Yes	1
Swaziland ^(a)	Yes	As in South Africa	Yes	Partly, as South Africa	Peg to SA rand	2
Tanzania	Yes	Yes	Yes	Partly	Yes	
Uganda	Yes	Yes	Yes	Mostly	Yes	4
Zambia	Yes	Yes	No, but intends to	Yes	Yes	4
Zimbabwe	Yes	Yes	Yes	Controls reintroduced 2001	Conventional peg	3
Total	14	11	13	All, 2 Partly, 16 No 2	9	

(a) Swaziland and Namibia do not have control over exchange rate policy or interest rate policy. These policies are set in South Africa.

8 Summary of MHP and Maastricht criteria met by COMESA member countries

Table 17 below summarises the current situation, as to how many of the MHP and adapted Maastricht criteria had been met as at the end of 1999. There are 16 criteria covered in this report, and 20 member countries for which there are data. Each criterion has been given equal weight in Table 17.

Just under half the criteria have been met, 148 out of a possible 320. If Angola, Burundi, Congo and Sudan (the war-torn countries) are excluded, the score is 133 out of 256, or slightly more than half. Twelve of the COMESA member countries meet half or more of the criteria. If the war-torn countries are again excluded, this means that three-quarters of the remainder meet half or more of the criteria.

It has been argued above that the MHP budget criterion (B) is too weak, so that although it is encouraging that 18 out of 20 countries met this criterion, the more relevant figure for the future is that only 10 countries met the much stronger Maastricht criterion for budget deficits (H). On the other hand, it has also been argued that the criterion for monetary growth (C) is much too restrictive, so that it may not be particularly relevant that only three countries met this criterion.

For all its limitations, Table 17 paints a relatively optimistic picture. Progress has been made towards policy convergence and monetary harmonisation.

Table 16: Summary of MHP and Maastricht criteria

(* indicates a country meets the criterion)

	A	B	C	D	E	F	G	H	I	J	K	L	M	N	O	P	Total
Angola												*	*			*	3
Burundi		*			*							*	*				4
Comoros	*	*	*			*			*	*	*			*			8
Congo		*		*												*	3
Djibouti (a)	*	*	*	*	*	*			*	*	*	*	*	*	*		13
Egypt	*	*			*	*	*	*	*	*	*						9
Eritrea	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Ethiopia	*	*	*		*			*	*								6
Kenya	*	*			*			*		*		*	*	*			8
Madagascar	*	*				*		*				*	*	*		*	8
Malawi		*		*				*		*				*			5
Mauritius	*	*		*	*	*		*		*		*	*	*		*	11
Namibia	*	*			*	*	*			*		*		*			8
Rwanda	*	*							*	*		*	*	*		*	8
Seychelles	*				*	*	*		*	*	*	*		*			9
Sudan		*			*	*		*								*	5
Swaziland	*	*			*	*	*	*		*		*		*			9
Tanzania		*		*		*		*		*		*	*	*		*	9
Uganda	*	*			*			*	*	*		*	*	*		*	10
Zambia		*		*								*	*		*	*	7
Zimbabwe		*			*							*	*	*			5
Total	12	18	3	6	12	11	4	10	7	12	4	14	11	13	2	9	148

Notes:

A inflation less than 10% 1995-99

B budget deficit less than 10% of GDP 1995-99

C broad money growth less than 10% per annum 1995-99

D ratio of central bank finance of government less than 20% of previous year's revenue 1995-99

E average lending and deposit rates positive in real terms 1995-99

F ratio of external debt service less than 20% of exports of goods and services 1995-99

G ratio of external debt to GDP less than 50% 1995-99

H budget deficit less than 3% of GDP in three most recent years

I inflation less than twice the average of three lowest inflation rates in COMESA 1997-99 (5.4%)

J total central government debt less than 100% of GDP

K exchange rates table against the US\$ for the past three years (within five percentage points)

L use of indirect monetary instruments

M liberalisation of interest rates

N acceptance of IMF Article VIII

O exchange-control liberalization

P freely floating exchange rate

9 Flexibility of macroeconomic targets

The targets proposed by the 1995 review of the Monetary Harmonisation Programme (MHP) are referred to extensively in this report. Considerable progress has been made towards meeting them, although the evidence available suggests that this is mostly the result of either internal decisions, or IMF/World Bank conditionality.

There is no evidence of progress having been made in order to meet commitments made towards COMESA and its MHP. Nevertheless, there are extremely significant benefits in prospect if further progress can be made towards macroeconomic equilibrium, whether or not this leads on to the creation of a common monetary area in COMESA.

This suggests that further progress will require stricter macroeconomic targets than those proposed in 1995. These were probably appropriate at the time. It would have been pointless to propose targets which were apparently unattainable for most COMESA countries. That is no longer the case, however, so that stricter targets are now within reach for most members.

This is crucial, because the 1995 targets would not be adequate for achieving monetary harmonisation. For example, it is not likely that budget deficits ranging as high as 10% of GDP can be financed in a non-inflationary way, because of the shallowness of capital markets. Strongly related to this, annual rates of inflation are unlikely to be held down to 10%, and are still less likely to be held to lower levels, while budget deficits can range as high as 10% of GDP. Most COMESA countries do not have sufficiently deep financial markets for such large budget deficits to be financed, and even if it were possible, the private sector would be seriously crowded out at the expense of private sector investment. Countries enjoying large inflows of grant aid might be able to keep inflation down despite high levels of budget deficit, but that is not sustainable. Moreover, it would create a higher degree of dependence on donor conditionality than is likely to be politically acceptable over an extended period.

This suggests that stricter targets should be adopted by COMESA member countries. One readily available model is provided by the Maastricht criteria. These have the advantage of having been implemented in the recent past, which suggests that they are both practical and effective. There is no evidence at the time of writing that the creation of the euro will be reversed. There has been much criticism of the weakness of the euro against the US dollar, but this has not destroyed the project.

On the other hand, the Maastricht criteria were developed and implemented for a group of developed, industrialised economies. It may be, therefore, that the very different structure of the COMESA economies will require some adaptation of the Maastricht criteria. For example, COMESA economies are subject to price fluctuations, extremes of climate (drought and floods) in agriculturally dependent economies, and other exogenous shocks. For these reasons, COMESA countries need to maintain large financial reserves, and to be particularly prudent in good years in order to be able to cope with bad years.

It is for some of these reasons that the Terms of Reference, in requiring the development of a series of fiscal, monetary and macroeconomic targets to effect progress towards monetary harmonisation, also require that these targets show a sufficient degree of flexibility. This is necessary in order to leave some discretion for individual COMESA member states in dealing with exogenous shocks. Similarly, while acknowledging the need to establish mechanisms for enforcing budgetary discipline, the Terms of Reference require that any proposals be formulated in such a way as to allow COMESA member states to retain the option of (some) budgetary flexibility.

The dual need to develop stricter criteria than in the 1995 Review, and at the same time to provide some flexibility to individual COMESA governments, is clearly difficult to address. Flexibility could so easily be interpreted to mean that the rules need not be obeyed, giving scope for governments to destabilise their economies by failing to maintain the necessary prudence. At worst, COMESA member governments might justify the relaxation of policy, or unwillingness to adjust to negative shocks, by referring to flexible COMESA targets. This is a particular danger for those governments which have had a degree of macroeconomic discipline forced upon them by the IMF and the World Bank (and the other major donors). Governments which have adopted policies because of such external pressure, rather than because of internal conviction, are very likely to abandon those policies whenever they can. For example, temporary improvements in export prices, and consequently in government revenue, can and have been used to abandon IMF programmes, while temporary negative shocks like droughts have been used in the same way.

On the other hand, the reality is that COMESA member countries do suffer from exogenous shocks, and these in turn do require some degree of flexibility in macroeconomic management. The more diversified economies of the European Union are very much less affected by exogenous shocks than African economies. Furthermore, EU economies have much greater access to credit. Raising interest rates by a percentage point or two, or even less, can attract large amounts of short-term finance to EU economies, in most circumstances. In contrast, much larger increases in interest rates may not succeed in attracting adequate capital inflows to COMESA economies, which therefore have much less capacity for using credit to cope with exogenous shocks.

One possible solution, which is recommended here, is to set macroeconomic targets using moving averages. Such moving averages would have to be over a long enough period to provide the necessary flexibility, yet would have to be short enough to prevent macroeconomic disequilibrium developing to the point where recovery would be impossibly difficult, or would have unacceptable costs. It is proposed here that three-year moving averages should be used. This would allow some flexibility in dealing with short-term economic shocks. It would provide time for longer-term adjustment than would be required if sanctions were to apply to failure to meet policy targets in a single year. It would, of course, also require that macroeconomic policy targets be exceeded in good years, in order to allow scope for failure to meet them in bad years, and in order to restore moving averages to their target levels after they have been exceeded. A period significantly longer than three years, for the calculation of targets based on moving

averages, would provide excessive scope for the optimism of politicians, or, put less kindly, their unwillingness to face short-term costs, even if they are necessary for longer-term stability.

The use of a three-year moving average, for such targets as budget deficits as a percentage of GDP, monetary growth, inflationary finance and inflation rates, would also help to prevent governments from failing to adjust when shocks turn out to be longer lasting than at first assumed. The textbook answer to a negative balance of payments shock, for example, is to finance it if it is temporary, and to adjust if it is not. However, this advice is essentially useless, because at the time of a shock a government cannot by definition know whether it will be temporary or not. Some financing of a deficit may be justified, but some adjustment is also necessary at an early stage, as a precaution against the shock proving not to be temporary. If a government has also to meet a three-year moving average target, it will not be possible to exceed macroeconomic policy targets in a second or third year. On the contrary, any exceeding of a policy target in one year will have to be followed by doing better than that target by a similar amount in the following years (unless some flexibility has been provided by doing better than that target in the year before the shock).

10 Macroeconomic stability and credibility issues

10.1 Role of macroeconomic stability

Sustained macroeconomic stability is needed to make the COMESA free trade area work optimally, and in order to encourage investment. Of the two objectives, investment is a much higher priority. Intra-COMESA trade is currently a very small percentage of the total, so that easing constraints on trade cannot at this stage make much difference. Investment, on the other hand, is essential for faster growth. Increased investment would in due course increase the importance of intra-COMESA trade. Because of the low level of domestic savings – which means that resources available for domestic investment are limited – attracting foreign investment is crucial for COMESA countries.

At present, Sub-Saharan Africa in general, and COMESA countries in particular, have mostly a very poor record in attracting foreign direct investment. It can be shown that Sub-Saharan Africa's share of global inflows of foreign direct investment are roughly equivalent to Sub-Saharan Africa's share of global GDP (Harvey, 1999). However, the bulk of these inflows are for mining projects. If a natural resource is profitable enough, foreign investment can be attracted even in the most unfavourable circumstances. An example of this is the relatively large inflows of foreign direct investment into Angola (see Table 1), despite a vicious and prolonged civil war. Direct foreign investment is attracted because the oil is mostly offshore or in the Cabinda enclave, and therefore relatively immune from attack by anti-government forces.

Table 17: Foreign Direct Investment (DFI) into COMESA, 1998

Country	DFI (net)	GNP	DFI/GNP
Angola	360	4098	8.8
Burundi	1	872	0.1
Comoros	2	197	1.0
Congo	1	6210	0.0
Djibouti (a)	5	497	1.0
Egypt	1076	85580	1.3
Eritrea(c)	0	768	0.0
Ethiopia	4	6453	0.1
Kenya	11	11934	0.1
Madagascar	16	3677	0.4
Malawi	1	1778	0.1
Mauritius	12	4161	0.3
Namibia	n.a.	n.a.	-
Rwanda	7	2017	0.3
Seychelles	52	514	10.1
Sudan	371	9220	4.0
Swaziland	80	1342	6.0
Tanzania	172	8063	2.1
Uganda	200	6764	3.0
Zambia	72	3158	2.3
Zimbabwe	76	5911	1.3
Total	2519	163214	1.5

World Bank (2000) *Global development finance: country tables 2000* (World Bank, Washington DC)

Macroeconomic equilibrium in itself is not sufficient, particularly for the longer-term needs of investors. COMESA countries also need to create a belief that macroeconomic stability *will be sustained in the future*. Investors of the type most needed by COMESA countries, namely those with a relatively long-term perspective, need to have confidence that macroeconomic stability will be sustained for a long time into the future, long enough for them to earn a sufficient rate of return on their investments. This applies to both foreign and domestic investors. It is just as damaging for economic development if domestic savings are invested abroad, as if there are no inflows of foreign investment.

Macroeconomic stability is not the only factor needed to attract increased investment. Other factors are important, such as adequate infrastructure, low levels of corruption, and functioning public services. In other words, macroeconomic stability, and a belief that it will be sustained, is necessary if not sufficient.

10.2 Credibility based on a good track record

One strategy is for a government to have a good track record, over a sufficiently long period for investors to believe that it will be continued. Such a belief almost certainly requires that political and other institutions function transparently, with little or no scope for their being managed other than in the public interest. Unfortunately, even a good track

record sustained over a lengthy period of time may not establish lasting credibility, because it can be quickly damaged. Moreover, even those countries with an impeccable record over an extended period can have their credibility damaged by events in other African countries.

Even more unfortunately, many COMESA member countries have had periods of unsound macroeconomic policy. Clearly, it is much harder for a country to establish credibility, that macroeconomic policy will be sound in the future, if it has had a history of poor economic management and macroeconomic disequilibrium. The period over which sound policy must be maintained in order to create sufficient credibility is much longer for countries with poor track records. This is particularly the case if the government, and the political system, have not changed in the interim. Credibility is particularly difficult to establish where the same government and/or ruling party presided over an earlier period of disequilibrium. It has then to convince investors that it has genuinely changed its convictions, and that those convictions will not change back again. In these circumstances, establishing credibility can take a long time, too long for the urgent needs of African countries, and too long for *political sustainability* if the benefits of increased investment are delayed.

10.3 Credibility based on a self-imposed (intra-COMESA) agency of restraint

A second way of establishing credibility is for policy to be "locked in", by an unbreakable link to some "external agency of restraint". To a limited extent, this role is played by the IMF, the World Bank, and the other donors which have lined up behind IMF/World Bank conditionality. There are at first sight powerful reasons for arguing that IMF conditionality can act as a credible external agency of restraint. Failure to meet IMF conditions results in the withdrawal of IMF credit, and in most cases the withdrawal of World Bank and other donor inflows as well.

Unfortunately, IMF conditionality *is only second-best* as an external agency of restraint. There are many examples of countries failing to implement IMF conditions, leading to breakdown of IMF agreements and the cutting off of further capital inflows. There are many reasons for these breakdowns, for example increases in export prices which make it possible to do without IMF credit for the time being, and instances where implementation of conditionality attacks powerful vested interests. A self-imposed agency of restraint, introduced as a result of conviction rather than imposed from outside, would be more likely to be sustainable, and would have greater credibility as a result.

An alternative agency of restraint, therefore, would be for COMESA member countries to negotiate an agreement among themselves, to prevent inflationary finance of budget deficits. In one sense, that has already happened in that COMESA countries have agreed to the Monetary Harmonisation Programme. However, there is no evidence that this agreement has influenced member countries' macroeconomic policy decisions. That is most probably because there is no significant sanction or penalty for failure to reach and then maintain the agreed targets. The only available sanction is that member countries might be excluded from COMESA for failing to reach the targets of the MHP. It is doubtful that such a threat would be effective. Intra-COMESA trade is a relatively small

proportion of members' total international trade. Moreover, it seems unlikely that member countries would in fact be expelled for this reason, so that the threat of expulsion would lack credibility and would therefore be ineffective.

As regards the potential loss of trade privileges, COMESA is significantly different from, for example, SADC. In SADC South Africa represents 80% of regional GDP, so that exclusion from duty-free access to the South African market might just be a significant sanction were the SADC countries to agree on macroeconomic policy convergence. Even in SADC, however, several of the member countries are not currently in a position to export significantly to South Africa. The threat of exclusion from a market to which a country is not currently exporting, and to which it has no immediate prospect of exporting, would not be a strong incentive to conform with an agreed set of macroeconomic policies (Harvey, 1999).

Unfortunately, exclusion from COMESA is an even weaker sanction in this context, because the largest market (Egypt) is a smaller proportion of COMESA GDP than is South Africa in SADC. Egypt is also less well placed geographically to be an attractive market for many of the COMESA member countries. The latest Direction of Trade Statistics (IMF, 2000), show Egypt as having negligible trade with the rest of Africa in general, and even less with COMESA countries. Specifically, Egyptian imports from the whole of Africa were 1.4% of total imports in 1999, and imports from COMESA countries were 0.9% of total imports. From the point of view of COMESA countries exporting to Egypt, the significance of the Egyptian market was only slightly greater (see table below).

Table 18: COMESA exports to Egypt, 1999

	Exports (\$million)	Share of exports (%)
Kenya	72	3.3
Sudan	33	4.7
Ethiopia	12	2.7
Malawi	6	1.3
Zimbabwe	4	0.2
Somalia	1	0.8
Other COMESA	negligible	negligible

Source: IMF *Direction of Trade Statistics Yearbook*, 2000

11 Long-term credibility through currency pegs and currency boards

11.1 Individual country links to an extra-regional currency

The strategy with the best prospect of implementation would be for *COMESA countries to choose individually* to lock in future macroeconomic stability, by creating *irrevocable links* with one or more major currencies.

It would then be a relatively small step for them to link to the same currency, creating a common currency area, with a single currency. Such a currency could be given an independent name, but would be de facto equivalent to the external currency to which it was linked, in approximately the same way as the CFA Franc has been linked to the French franc (and will now be linked to the euro).

The first step would be for individual COMESA currencies to peg to a major currency. The euro would be preferable because of current trade flows, although the US dollar or even another major currency would be acceptable. Maintaining a currency peg requires extremely cautious macroeconomic policy. Precisely because the peg can be changed, it does not carry full credibility and is therefore liable to speculative attacks. Furthermore, simply establishing a currency peg does not remove the possibility of governments' financing their budget deficits by "borrowing" from their central banks. It is for precisely this reason that some countries chose in the 1990s to impose further restrictions on themselves by establishing currency boards.

The currency board option means that the money supply fluctuates with the balance of payments, removing from the government the ability to control the money supply. However, African government control over money supply is already extremely weak. For example, African governments cannot finance a budget deficit by raising interest rates moderately, as is possible in developed market economies.

Countries with currency boards also give up some degree of control over domestic interest rates. They cannot normally have interest rates significantly different from the major currency to which they have allied themselves, since significant differences induce large cross-border flows (but note that they may have to raise interest rates precisely in order to counter speculative attacks on the exchange rate). Giving up some control over domestic interest rates, if it meant having the same interest rates as a major developed economy, could be an advantage rather than a disadvantage. It would mean having positive real interest rates, with moderate nominal interest rates. This should anyway be the objective of interest rate policy in COMESA member countries, both for individual member governments, and for the objectives of the MHP.

In effect, therefore, central banks in countries which have opted for currency boards lose one of their main functions, which is control over monetary policy. For the reasons given in the previous paragraph, however, most COMESA central banks have had relatively little control over monetary policy. They have not been politically independent of their governments, and financial markets have not been deep enough for them to act effectively using indirect policy instruments.

Some moves have been made in this direction (see below), and there has been a great deal of progress in COMESA towards macroeconomic stability. It would be a major further step forward for countries to *lock in* these gains by making it impossible for governments to finance future budget deficits with money creation. This would greatly shorten the period required for investors to believe that macroeconomic stability will be

sustained. Furthermore, credibility must be sustained by sound macroeconomic policy; adopting a currency board may be necessary, but it is not sufficient.

Locking in the gains already made (to the extent that it is possible by establishing a currency board) would also provide the most rapid means of progress towards monetary harmonisation within COMESA, with all the benefits thereof.

11.2 Dollarisation

A move to market-determined exchange rates has not been without its problems for developing countries. Relying on the market can result in excessively volatile exchange rates, or else having to maintain very large levels of foreign exchange reserves (which is beyond the capacity of most African countries) in order to even out fluctuations. The latter amounts to a managed float, and runs into the eternal difficulty of deciding what is temporary and should be offset, and what changes in the exchange rate should be accommodated. This invites speculation.

The currency board solution does not entirely prevent speculative attacks, as shown by recent experience in Argentina and Hong Kong. Even if the exchange rate is maintained, fighting off a speculative attack may require higher interest rates than required for other objectives, generating recession. Complete dollarisation could be a way to avoid these problems. It has been argued that “the newest answer to the question of what exchange rate regime countries should choose is 'none'.” (Berg and Borensztein, 2000b: 39).

The case for complete dollarisation is that financial globalisation has increased the frequency and scale of currency crises, making it much more difficult to sustain a peg, even in a well managed economy. There are other advantages. In particular, dollarisation is likely to be regarded as even more irreversible than a currency board arrangement, and therefore to give greater credibility to the exchange rate. This should reduce the risk premium demanded by investors.¹⁸

Dollarisation in Africa can have several meanings:

- (1) the pricing of goods and services in US dollars, usually beginning with hotel services for foreign tourists, and sometimes extending to a wider range of goods and services, and to residents as well as foreign tourists (as currently in Zambia);
- (2) the gradual substitution of the US dollar for local currency, with the two currencies both circulating in a country, usually without the consent of the authorities, and therefore illegally;
- (3) the setting up of a currency board, issuing a local currency linked at a fixed exchange rate to the US dollar, with the local currency freely exchangeable at that fixed exchange rate for US dollars;

¹⁸ It should be noted that there are other forms of risk. It is possible to get into deep financial trouble without having an independent currency and a central bank, as shown for example by New York City requiring financial rescue and the history of financial crises in Panama (which uses the US\$).

(4) the total, official and legal substitution of the US dollar for a local currency, which then ceases to exist (or perhaps circulates only in denominations smaller than the dollar, as is planned for Ecuador).

One argument against complete dollarisation is political unwillingness to abandon a national symbol. A second is that, in the absence of a central bank, there is no lender of last resort for the banking system. Moreover, using the currency of another country rather than a currency board means that a country loses the profits of the note issue. These are:

- the difference between the cost of printing notes and their nominal value, on the increase in the note circulation each year;
- the interest-free loan implicit in the total note issue, on which the central bank (and therefore the government) can make a profit by investing in interest-bearing securities.

These profits are foregone if local notes in circulation are those of a foreign country, unless an agreement is reached to share the 'seignorage'. Such an agreement exists in the Common Monetary Area, with the South African Reserve Bank sharing the profits of the note issue with the other members. This requires agreement on how the notes in circulation in each country may be estimated. There is no direct or definitive way of determining the value of notes circulating in one part of a common currency area. The United States has shown no interest in sharing the profits of the note issue in this way, so that substituting US dollar notes for local currency notes would probably mean the loss of note issue profits.

In countries using the US dollar, inflation should be the same as in the US; similarly, using the euro should mean that the inflation rate is the same as in the EU. This is not guaranteed. It is possible for inflation differentials to develop, at which point devaluation in a fully dollarised country, (4) above, is not an option for restoring the real exchange rate. The alternative, forcing a fall in nominal wages and prices (or at least lower rates of increase than in the US or the EU), is both difficult and economically costly in terms of lower growth. For this reason, it is frequently argued that higher-inflation countries should retain use of the exchange-rate instrument, and float their currencies.

The argument for retaining the option of devaluation is weakened, however, by the difficulty of making devaluation work successfully. This has been frequently demonstrated in Africa. It can be particularly difficult to make a success of devaluation if the economy, and in particular the banking system, has large external debt which becomes more expensive to service in local currency following a devaluation.

Unfortunately, information on the degree of dollarisation in COMESA member countries is not consistently obtainable from published sources. Using anecdotal evidence, several African countries have undergone the limited dollarisation implied by (1) above. However, US dollar bills do not circulate on any scale, because foreign exchange earnings are not sufficient. This would be necessary in order for dollarisation as specified in (2) above to take place. The economy would have to earn foreign exchange in order for US dollar bills to be available, but not spend that foreign exchange on imports in order

for the US dollar bills to circulate in the local economy. As far as is known, no COMESA member country has gone as far as stage (3) or (4). The nearest that any COMESA country has got to dollarisation is that Djibouti has had the same fixed exchange rate against the US dollar since 1977, and has no exchange controls so that local currency is freely exchangeable for the US dollar. It has not been possible to obtain information on whether dollar bills circulate in Djibouti on a significant scale.

It has been argued in this report that the most viable strategy for moving towards a common currency area in COMESA is for individual countries to create irrevocable links with a major non-regional currency (preferably the euro). The question arises as to whether complete dollarisation, (4) above, should be encouraged, or whether a currency board is the better option.

On balance, it would seem that the currency board option is preferable. African countries cannot afford to forgo revenue from the note issue, and this probably outweighs the greater risk implicit in the possibility of devaluation. The success of the 1994 devaluation of the CFA Franc, in sharp contrast to the failure of so many devaluations elsewhere in Africa, suggests that it may be easier to manage devaluation successfully in a currency board situation. The main reason must be that having a currency board does not allow inflationary finance of the budget deficit, which is the underlying reason for the failure of most devaluations to achieve their objectives. Thus retaining local currencies (or a single local currency for COMESA), linked very tightly to the euro (or the US dollar), issued by a currency board, would be better than complete dollarisation or euro-isation. However, either option would be better than a continuation of the past historical experience with independent monetary systems, and their failure to maintain the real value of independent currencies.

12 Relations between COMESA, the CFA Franc countries, and other African regional organisations

12.1 The CFA Franc countries

The CFA Franc countries already have a de facto common monetary area. Strictly speaking, there are two central banks. BCEAO acts for seven countries: Benin, Burkina Faso, Cote d'Ivoire, Mali, Niger, Senegal and Togo. BEAC acts for five countries: Central African Republic, Chad, the Republic of the Congo, Equatorial Guinea and Gabon. However, the two currencies are both called the CFA Franc, and have always exchanged freely at the same rate of exchange with the French Franc. In practice, this means that the CFA Franc now exchanges freely at a fixed rate of exchange with the euro.

It has been argued above that the most likely way in which COMESA member countries can arrive at monetary harmonisation will be for individual member countries, or groups of countries within COMESA, to link to a non-regional major currency. It has also been argued that if COMESA countries were to choose to peg to different major currencies, the problems that would arise would be relatively small. Thus although the euro would be

the most obvious choice for most COMESA countries based on current international trade, it would be of relatively little importance if other major currencies were to be chosen. In practice, there is a tendency for developing countries to choose the United States dollar when establishing a currency peg, or currency board, because of its dominance in international finance.

There is a case for COMESA pointing out to member countries the advantages of pegging to the euro, both individually and as groups. The main reason would be the greater importance of trade with the European Union as compared with trade with the United States, but it would also simplify trading with the CFA Franc countries. It would also be positive for the development of the African Economic Community. If COMESA members were also to peg to the euro, then those 20 countries would be added to the 12 of the CFA Franc area, *making 32 African countries whose exchange rates would de facto be fixed against each other*. This would be a major step forward towards economic integration in Africa.

It would be relatively unimportant if different COMESA member countries were to choose to be linked irrevocably to, say, the United States dollar, the euro and the SDR.¹⁹ By establishing irrevocable links to major currencies, COMESA countries would already have achieved low rates of inflation, which in turn would be sustained by the external peg, as argued above. In these circumstances, it would be a relatively minor problem for them to reach total monetary harmonisation by moving to a single external peg, or to an internally-generated common currency, because the conditions for such a move would already have been established.

A further point in this context is that there are established futures markets in the major currencies, so that hedging currency risks between the United States dollar, the euro and the SDR is both simple and relatively cheap. This would mean that hedging currency risks between the CFA Franc and a COMESA common currency based on the US\$ would also be simple and relatively cheap. The more important point is for COMESA member countries to establish macroeconomic stability. Establishing an irrevocable peg to a major currency is one way of doing that, and it could lead in due course to all the benefits of a COMESA common currency.

It would have been unlikely for any of the COMESA countries to choose an external link with the French Franc in the past. However, it is currently quite likely that COMESA countries thinking of establishing an irrevocable link, at a fixed exchange rate with a major non-regional currency, might choose the euro. Many of them trade more with the European Union than with the United States or Japan (see Table 19 below for Egypt, Kenya and Zimbabwe). This is likely to increase rather than decrease because of the reciprocal trading arrangements to be established under the Cotonou agreement.

¹⁹ It seems unlikely that any COMESA country would choose to peg to the Japanese yen or to the British pound. COMESA has relatively weak trade and other links with Japan. The pound has become a relatively minor currency, and may anyway have been absorbed into the Euro before monetary harmonisation is achieved in COMESA countries.

Table 19: Significance of the Euro and the US\$ in COMESA trade

(selected countries, percentages)

	Egypt	Kenya	Zimbabwe
USA	11	5	5
EU	41	42	33
Africa	3	36 ^(b)	37 ^(c)
Middle East	19	6	1
Other	26 ^(a)	11	24 ^(d)
Total	100	100	100

Notes: (a) of which Asia 10%; (b) half of which (18%) to Tanzania and Uganda; (c) two thirds of which (23%) to South Africa, Botswana and Malawi; (d) most of which (14%) to Asia and non-EU Europe.

Source: IMF *Direction of Trade Statistics*

12.2 African Economic Community

The African Economic Community (AEC) was established in 1991 by the Heads of State and Government of the Organisation African Unity, at Abuja. Its broad objectives are to promote economic, social and cultural development, and integration of African economies, and to mobilise and utilise human material resources in Africa so as to achieve self-reliant development. The means to achieving these objectives are to liberalise trade by creating free trade areas and customs unions at sub-regional and regional levels, until they converge into an African Common Market.

The AEC also envisages cooperation in monetary and financial policy. As a means to that end, it plans to establish

- an African Clearing of Payments House
- an African Monetary Union
- an African Central Bank
- a Community Solidarity, Development and Compensation Fund.

In addition, the AEC Treaty provides for the establishment of The Economic and Social Commission, The Pan-African Parliament, and The Court of Justice. It also provides for the establishment of a number of Specialised Technical Committees. The Secretariat of the AEC is identical with that of the Organisation of African Unity (OAU).

The AEC Summit held its inaugural session in 1997, when it received formal reports on the implementation of the AEC by the Chairman of regional economic communities. A Protocol on relations between the EEC and the regional economic communities was approved.

At this stage, the AEC has got no further than what is described above. It would appear, therefore, that any progress within COMESA towards monetary harmonisation through achieving a series of macroeconomic stability targets would be fully in harmony with the objectives of the AEC. Indeed, it would contribute considerably to those objectives. The creation of a fully integrated African Economic Community, with an African Central Bank and African Monetary Union, would require regional economic communities to converge on low rates of inflation, which in turn would require low budget deficits, low

rates of monetary growth, which would in turn generate positive real interest rates provided that interest rates are market-determined.

12.3 ECOWAS

ECOWAS was established in 1975, but prior to the revision of the Treaty in 1992, little was accomplished. ECOWAS did not influence member policies, if anything causality ran the other way. Various studies showed no appreciable change in the ratio of intraregional trade to total trade during this period, and research also showed that dummy variables representing the influence of ECOWAS were insignificant. Although intra-ECOWAS trade was relatively small (about 4% of exports), a fear of revenue losses was a major constraint. Treaty revision in 1992 proposed a customs union by 2000, followed by an economic and monetary union in 2005. It has been estimated that the potential for intra-regional trade is much greater than at present (Ogunkola, 1998), but there are at present no signs of this occurring.

It has been shown that ECOWAS has remained ineffective mainly because domestic policy is at variance with ECOWAS objectives (Jebuni, 1998). The same source reports that customs officials deny duty-free access to each other's markets. As with COMESA, it is reported that some progress has been made towards macroeconomic stability under structural adjustment programmes, which may lead to greater intra-regional trade. Any progress towards monetary union by COMESA would if anything be positive for ECOWAS countries, and the reverse would also apply.

12.4 SADC

Relations between COMESA and SADC are complicated by overlapping membership, and also by the fact that the dominant economy in SADC (South Africa) is not a COMESA member. Angola, Congo, Malawi, Mauritius, Namibia, Swaziland, Tanzania, Zambia and Zimbabwe are members of both organisations. It has been reported on occasions that Madagascar is also seeking membership of SADC.

A further complication is that Namibia and Swaziland are already members of a common currency area, with irrevocable links to the South African rand. Strictly speaking, Swaziland has negotiated the right to change its exchange rate against the rand, but has never done so, and the arguments against doing so are very strong (Harvey, 1998). This link with the rand by two member countries of COMESA raises the possibility that other members of the southern sub-group of COMESA (see below) might choose to establish an irrevocable link with the rand, rather than with a major non-African currency.

This seems extremely unlikely in current circumstances, however, because as shown below in Section 14 the larger economies in the southern sub-group are suffering from serious macroeconomic disequilibrium with no current signs of improvement. They are not therefore in a position to establish irrevocable links with any other currency.

In the longer run, the SADC members of COMESA have relatively little option but to maintain as far as possible constant real exchange rates against the rand, because of the very large extent of their trade with South Africa. At present, they have large bilateral trade deficits, importing heavily from South Africa and exporting relatively little. Producers of tradable goods and services need, therefore, to remain competitive with imports from South Africa. The SACU members of SADC have always had to do this, and the non-SACU members of SADC will increasingly have to do so if the SADC free trade area does indeed reduce intra-SADC tariffs. South Africa will lower its tariffs on imports from other members of SADC before it requires reciprocal treatment, but that asymmetrical arrangement is only temporary. In addition, the South African market (80% of SADC) offers an opportunity for SADC members to develop non-traditional exports (services as well as goods) in a relatively large and geographically convenient market. This could be a useful stepping stone towards exporting outside the region.

Fortunately, sound macroeconomic policy in South Africa since the change of government in 1994 has reduced the South African budget deficit as a percentage of GDP. That should lead in due course to lower inflation and a more stable exchange rate against non-regional currencies. This has not yet occurred, with the rand being seriously unstable: periods of relative stability against the US\$ followed by large and rapid depreciations (as in 2000 and 2001). This creates a dilemma for the neighbouring countries. They do not necessarily wish to follow the rand depreciations, but have no choice if they wish to remain competitive with South African goods in their own markets, and in the South African market for their exports.

It must be hoped that the South African economy moves further towards macroeconomic equilibrium in the longer run, leading to greater stability against the euro and the US dollar. At that point, there will be no conflict between COMESA policy and the interests of the SADC members of COMESA. In the meantime, most of them will probably have to give greater priority to their real exchange rates against the rand than to other, including COMESA, exchange rate objectives.

However, there is no real conflict of interest. The urgent priority for those SADC members in serious macroeconomic disequilibrium (most notably Malawi, Zambia and Zimbabwe) is to address that disequilibrium. At present, even if their high rates of inflation are accompanied by depreciation adequate to maintain real exchange rates against the rand, they will find it difficult to attract most forms of investment.

As for South Africa, the economy has a single digit inflation rate, which should continue to fall. Other macroeconomic objectives are comparable to those of the COMESA monetary harmonisation programme. Restoring macroeconomic equilibrium in SADC, and convergence of macroeconomic policy in SADC, are therefore consistent with COMESA objectives.²⁰

²⁰ As noted above, SADC has an advantage as compared with COMESA, in that South Africa represents a very large market in relation to the rest of SADC, which could provide a sufficient incentive and/or sanction to hold the SADC free trade area together. Even with this advantage, it has also been argued that those countries not currently exporting significantly to South Africa, and with little immediate prospect of

12.5 Other regional organisations

Relatively little progress has been made in other regional organisations, such as the Economic Community of Central African States (ECCAS, or CEEAC in French). The Arab Maghreb Union (AMU, with Algeria, Libya, Mauritania, Morocco and Tunisia as members) has been dormant since 1994, because of political differences. Meanwhile the EU has recently concluded separate association accords with Morocco and Tunisia.

However, the same arguments as used above apply to both active and dormant regional economic associations. So long as COMESA does not develop a common external tariff to protect COMESA economies, or encourage anti-trade measures (import controls), or discourage cross-border investment (exchange controls), progress within COMESA should be beneficial rather than damaging to other regional organisations.

Progress might attract additional foreign investment to COMESA countries. Indeed, that should be one of the most important benefits. It is conceivable that such investment might be attracted to COMESA countries at the expense of non-COMESA countries. However, so long as COMESA countries do not offer excessive subsidies to attract such investment, but rely on macroeconomic stability sustained over a sufficiently long period to give it credibility (or credibly locked in), and on reductions in intra-COMESA trade barriers, foreign investment could hardly be regarded as being at the expense of other countries. On the contrary, success in attracting investment could have positive effects on non-member countries: firstly by providing a growing market for non-member countries' exports, and secondly by providing an example which might inspire other countries to try and attract investment through similar means, notably by establishing credible macroeconomic stability.

There is nothing in past COMESA actions, or in the proposals in the 1995 Review, or in this Report, which would be counter to the AEC objective: "to ensure that their [Regional Economic Communities] policies, measures, programmes and activities do not duplicate efforts or jeopardise the achievement of the objectives of the [African Economic Community]" (*AEC Protocol on Relations between the African Economic Community and the Regional Economic Communities, 1998*).

13 Incentives and sanctions

13.1 Compensatory mechanisms

If some countries within a regional integration initiative are seen to be benefiting more than others, there can be *political* pressures for cross-border payments. Any moves towards greater trade liberalisation within COMESA will generate these pressures, and

doing so, will not see any short-term benefits from the SADC free trade area. This could lead them to question the benefits of membership. Moreover, they will not feel threatened by the sanction of being excluded from the free trade area (Harvey, 1999).

the governments of member countries will need to consider the issue of spreading the benefits of regional growth. The main problem is that short-term costs, in those businesses and jobs previously protected, occur first and are highly concentrated, whereas the longer term benefits come later, are more dispersed, and therefore generate less political support.

International experience is that the larger and more advanced economies attract a disproportionate share of the benefits of regional trade integration (increased trade and additional investment). The potential dominance of some countries in COMESA is not as great as the dominance of South Africa in SADC, for example. Nevertheless, there remains a considerable potential bias in the benefits of further development of COMESA, if future increases in trade follow the existing pattern (as is very likely).

In particular, Kenya exported US \$691 million to COMESA countries, Zimbabwe US \$199 million, Zambia US \$108 million and Egypt US \$70 million in 1999. This amounted to 79.1% of all intra-COMESA exports. These established trading patterns constitute a considerable potential bias in the allocation of benefits from increased intra-COMESA trade, and in the allocation of future investment.

In order for a regional trade agreement to be sustainable, politically and economically, it may therefore be necessary to develop some form of compensatory mechanism (Jenkins, 2000). This is true, even though the issue of compensation is logically associated with the case of customs unions (with a common external tariff, such as SACU), rather than with free trade areas. Compensation may be required in the case of free trade areas for political rather than for economic reasons

International experience is mixed. MERCOSUR has a common external tariff without compensation (Bulmer-Thomas, 1997). The growth in intra-MERCOSUR trade has encouraged continued participation of all members. There is also no compensatory mechanism in NAFTA, even though it was recognised that the United States would have a net trade surplus with Mexico. Compensation within the West African Economic Community (CEAO) had to be abandoned because those countries making net contributions were unwilling to continue (Robson, 1997).

It is significant that the new UEMOA provides only for transitional compensation, to be replaced by regional development funds. These will finance infrastructure and human capital investment, for which donor finance might be available (donors would not normally finance continual compensatory payments). This proposal may be particularly relevant to COMESA, because UEMOA is a group of relatively poor developing countries

The European Union also has compensatory mechanisms and development funds to compensate the poorer areas which gain least from European Union growth, such as those regions which are heavily dependent on declining industry, or which are geographically remote. Subsidies for infrastructure investment, education and incentives for inward investment are provided. It is recognised that these mechanisms only work in areas which

are conducive to development in other ways, and that this is why they have not worked in southern Italy for example (Leonardi, 1995). More generally, compensation mechanisms are based on a recognition that market forces will not compensate for larger initial inequalities.

There are alternatives to direct compensatory payments. One is to reduce or eliminate exchange controls on investment by the more advanced economies in the less advanced economies. This has been done within SADC, where South Africa has more liberal limits on investment by South African companies in the rest of Africa than on investment in the rest of the world.

A second alternative is the free movement of labour between countries within a free trade area, but it is unlikely that this would be acceptable in COMESA.

13.2 A COMESA regional development fund and intra-COMESA investment

A third alternative is the provision of regional investment incentives, and a fund for infrastructure and education investment.

A development fund has been proposed for SADC, financed primarily by SADC member countries, the private sector, and (possibly) the World Bank (Jenkins, 2000). For this fund, it is been suggested that there be a focus on investment in infrastructure, especially transport and telecommunications. There is evidence that such expenditure is positive for growth (Easterly and Rebelo, 1993). It facilitates intra-regional trade, and if directed at regional transport projects would facilitate regional cooperation. Against this, such investment would only have positive economic effects in suitably conducive environments. It would also be difficult although not impossible to manage the fund according to technical considerations, and not according to political and/or corrupt pressures. Co-financing by the private sector would probably improve the quality of project selection, implementation and management. There is some experience in SADC of private sector involvement in the finance and management of roads, for example.

A possible way forward for COMESA could be to encourage removal of some exchange controls within COMESA, especially capital controls on outward investment by the more advanced COMESA economies.²¹

COMESA could also consider setting up a regional development fund, with the specific intention of financing investment in transport and telecommunications infrastructure, for example, in the poorer countries and regions of COMESA. However, it would have to be realised that such a fund would not be able to attract significant finance from COMESA member countries, and would therefore have to be mainly financed by donors. It would probably divert aid flows from other uses and thus have a significant opportunity cost. This cost would have to be weighed against the potential benefits of accelerating intraregional integration.

²¹ At present, it would not be feasible to remove all intra-COMESA exchange controls, because this would provide an exit through those countries which have abolished exchange controls, such as Zambia.

Such a COMESA development fund, if successful, would meet the implicit requirement in the Terms of Reference, also mentioned in the Proposal for this report (Objective 5), to create incentives and sanctions which would promote further progress with policy convergence and monetary harmonisation. Access to a COMESA development fund would provide an incentive to conform with COMESA agreements, and the prospect of exclusion from such a fund would provide a sanction against failure to conform.

13.3 A COMESA stabilisation fund

Greater flexibility, than currently available under IMF conditionality, might also be made possible by the availability of credit from a COMESA stabilisation fund. This could be used to smooth out members' responses to exogenous shocks to their balance of payments, and leave individual COMESA governments with greater budgetary discretion than is currently available from the IMF, the World Bank and other donors. This would effectively require a COMESA stabilisation fund to substitute for the credit and grants currently available from donor institutions. It would be of no use in providing additional flexibility if it were merely to complement finance available from the donors, because the latter would still apply the same conditionality as at present.

However, a COMESA stabilisation fund could, in reality, probably only be funded adequately by the same international donor institutions. It seems fundamentally unlikely that COMESA would be able to get them to agree to such finance if it were to be independently managed. In effect, this would require the IMF, the World Bank, and the other donors, to provide unconditional funding to COMESA, while relying on COMESA to ensure that the funds were used wisely, and could be recovered. The trend has, if anything, been in the opposite direction in recent years, with IMF and World Bank conditionality becoming tighter and covering more aspects of policy than previously. Meanwhile, other donors have become increasingly unwilling to fund countries without an IMF/World Bank programme, apart from limited aid defined as humanitarian.

It seems equally unlikely that COMESA member countries would be willing, or indeed able, to finance a stabilisation fund of sufficient size to make a difference, out of their own resources. Furthermore, it would be difficult for the managers of such a fund to impose sufficient conditionality, because they would find it difficult to resist political pressure from member countries.

The argument that COMESA countries are unlikely to finance their own stabilisation fund is strengthened by realising that contributions would presumably have to be in proportion to each country's GDP. That would require Egypt, for example, to provide more than 50% of the finance. It is difficult to imagine the Egyptian government being willing to do this. If the Egyptian government did provide more than 50% of the fund's resources, it would presumably wish to have a controlling say in the fund's lending policies. It is equally difficult to imagine that the other COMESA members would be willing to accept this.

A further point regarding a COMESA stabilisation fund, set up in order to provide COMESA member countries with greater flexibility than is available under donor conditionality, is that its whole rationale would be for it to have less stringent conditionality than the donors (as led by the IMF). This underlying rationale also assumes that donor conditionality is currently stricter than necessary, meaning that COMESA countries could recover from exogenous shocks and endogenous (bad) policies with less tightening of macroeconomic policy (and other policy changes) than those which the donors currently try to impose. However, if COMESA countries are to move towards monetary harmonisation, to the point where a common currency becomes feasible, they need to adhere to more strict not less strict macroeconomic policy.

Greater policy flexibility would, of course, be possible if COMESA member countries were able to build up financial reserves, both in the form of foreign exchange reserves greater than needed for normal fluctuations, and in the form of access to commercial credit. Neither seems likely.

Meanwhile, individual COMESA member countries will continue to be eligible for IMF support when suffering from exogenous shocks. At present, IMF conditionality remains controversial. However, as more COMESA members get their inflation rates into single figures, and eventually to 3% or less, they will become good candidates for conventional IMF support in the event of exogenous shocks. That is what the IMF was originally designed for, and does well: providing short-term balance of payments support to industrial economies, with developed money markets, relatively low inflation, and a need for temporary finance because other constraints can be dealt with easily, or do not exist. What it has found more difficult, perhaps not surprisingly, is assisting developing countries in a state of gross disequilibrium and with major non-financial constraints. In such circumstances, effective assistance involves not only economic policy, but also institutions, politics and other factors, which is why conditionality is so controversial.

13.4 Other potential COMESA institutions

If COMESA member countries move further towards macroeconomic stability, and this can be used to further the objectives of the monetary harmonisation programme, then additional institutions should be considered. Examples include a common financial sector supervisory authority (as in the CFA Franc zone), a common investment promotion and assessment authority, a competition bureau, and the use of the common central bank or similar institution to negotiate such external agreements as the GATS. However, although such common institutions will be needed as COMESA moves towards the establishment of a Common Currency Area, they should not be set up prior to progress being made. This would be premature. They should be established *after* rather than *before* the final system has been established, because at this stage it is not known what form that system will take. At most, there may be a case for establishing new institutions as progress is made. Basically, institutions should *follow* real progress. They cannot *create* economic reform. This is demonstrated by observing that there are many examples in Africa of institutions which have achieved very little, because they were created ahead of their services being required.

14 Sub-groups within COMESA

14.1 Choice of sub-groups

An alternative possibility for monetary harmonisation is for sub-groups of COMESA member countries to have convergent policies, leading to macroeconomic convergence. It would seem most likely that such sub-groups would be mainly geographical, and based on the largest and/or most dynamic economies in each sub-region. Basic macroeconomic statistics are compared for the following sub-groups, with the possible "leading" economy listed first:

- Egypt: Sudan, Djibouti, Ethiopia, Eritrea (northern sub-group)
- Kenya: Burundi, Comoros, Congo, Mauritius, Rwanda, Seychelles, Tanzania, Uganda (central sub-group)
- Zimbabwe: Angola, Madagascar, Malawi, Namibia, Swaziland, Zambia (southern sub-group).

Arguably, Comoros, Mauritius, and/or the Seychelles could be included with Zimbabwe rather than Kenya. They have been put with Kenya because they had noticeably more trade with Kenya in 1999, than with Zimbabwe (see Table 14).

14.2 Northern sub-group

If the war-torn countries of Eritrea and Sudan are excluded, the remaining three economies of Egypt, Ethiopia and Djibouti have already converged considerably. All three inflation rates (averaged over 1995-99) were below 5%. The range of budget deficits as a percentage of GDP is also small, with the highest ratio being only 3.4%. The debt service ratios of Djibouti and Egypt are also manageable, and their ratios of external debt to GDP are relatively low. Ethiopia has a more serious external debt problem, both as regards the debt service ratio and the ratio of external debt to GDP. Unfortunately, Ethiopia is not scheduled to benefit from the HIPC. This could be a problem with sub-regional integration, because of the greater demands that Ethiopia would make on the sub-group's foreign exchange.

Rather unusually among COMESA members, both Djibouti and Egypt already have stable rates of exchange against the United States dollar, and Ethiopia's exchange rate is *relatively* stable, depreciating by less than 10% per annum against the United States dollar in the last three years. This provides a promising base for further progress, either through an irrevocable peg against the US\$, or by a sub-group agreement.

On the negative side, only Djibouti has acceded to IMF Article VIII, with the others retaining some exchange control restrictions on current account transactions, as well of course as on capital account transactions. Progress would be needed on this issue, perhaps by removing exchange controls within the sub-group, in order for the sub-group to increase intra-group investment, and in order to obtain the other benefits of closer sub-regional integration.

Overall, the prospects for progress within this sub-group are quite promising, considerable macroeconomic policy convergence having already been achieved, although the economies remain divergent in real terms (Figure 8). This sub-group also has the very large advantage of having Egypt as a member, with its large market (more than 50% of COMESA GDP).

Table 20: Northern sub-group: selected indicators

Country	Average inflation	Budget Deficit (% of GDP)	Broad money growth	Central bank fin/20% of prev yr's rev	Lending and deposit rates
Djibouti	3.1 ^(a)	3.4	- 5.3	0.0	Positive
Egypt	4.7	1.0	12.2	1.7	Positive
Eritrea	-	-	-	-	-
Ethiopia	-0.7	2.9	6.5	5.4	Positive
Sudan	43.5	2.1	37.3	5.2	Positive
Range	-0.7 to + 43.5	1.0 to 3.4	- 5.3 to +37.3	0.0 to 5.4	Positive
Range ex-war	-0.7 to +4.7	1.0 to 3.4	- 5.3 to +12.2	0.0 to 5.4	Positive
	Debt service ratios	External debt/GDP	Total govt debt/GDP	IMF Art VIII	Cost of US\$1 (1996-99)
Djibouti	4.4	57.8	57.9	Yes	0.0
Egypt	16.3	45.5	79.0	No	+0.5%
Eritrea	-	-	-	No	-
Ethiopia	25.4	173.1	168.8	No	+25.0%
Sudan	8.9	433.3	251.8	No	+101.9%
Range	4.4 to 25.4	45.5 to 433.3	57.9 to 251.8	Yes 1/No 4	0.0 to 101.9
Range ex-war	4.4 to 25.4	45.5 to 173.1	57.9 to 168.8	Yes 1/No 3	0.0 to 25.0

Notes: see earlier tables

14.3 Central sub-group

Considerable progress has been made within the sub-group based on Kenya. If Burundi is omitted because of its severe political problems, then Tanzania is the only country with inflation greater than 10% over 1995-99. The case of Tanzania may not be relevant, as the government has announced its intention of leaving COMESA. It appears that inflation is well under control in the remaining seven countries, with Kenya actually having the highest rate (7.6%).

There is a similar picture of stability presented by the budget deficit figures. All of the group have ratios of budget deficit to GDP of less than 5%, with the single exception of the Seychelles (and the Seychelles had the lowest inflation rate, less than 1%). In these circumstances, the statistics for money supply growth are of no real concern. Only the Seychelles had monetary growth greater than 20%. As argued above, the MHP target of 10% is probably too low. The picture on interest rates is also quite good, with most countries having positive real lending rates.

The external debt situation is less good, but Rwanda and Uganda were among those countries accepted for the HIPC initiative at the end of 2000 (as was Tanzania). Apart from Burundi, the country with the highest debt service ratio is Kenya; a ratio of 28% constitutes a severe problem.

There has been good progress with exchange control liberalisation, with all the countries except Burundi having accepted IMF Article VIII. Some exchange rate instability remains, although it is less than in earlier periods for most countries. Further progress with budget deficits and inflation should lead eventually to greater exchange rate stability.

Overall, there is some evidence of policy convergence within this sub-group, although none, as yet, of real economic convergence (Figure 9). Moreover, if Kenya is to be the focus for convergence and growth, then Kenya itself will have to improve its performance. In particular, it will need to reach agreement with the IMF in order to alleviate its external debt burden.

Table 21: Central sub-group: selected indicators

Country	Average inflation (1995-99)	Budget Deficit (% of GDP)	Broad money growth	Central bank fin/20% of prev yr's rev	Lending/ deposit rates
Burundi	18.6	2.9	14.6	1.5	+ve/?
Comoros	4.1	4.9	4.0	-	Negative
Kenya	7.6	0.6	15.5	1.2	Positive
Mauritius	6.8	2.1	12.8	0.6	Positive
Rwanda	6.4	4.7	12.6	3.3	?/-ve
Seychelles	0.7	12.4	25.8	3.1	Positive
Tanzania	12.4	0.4	12.4	2.3	+ve/-ve
Uganda	4.8	2.0	19.0	- 0.9	Positive
Range	0.7 to 18.6	0.3 to 12.4	4.0 to 25.8	-0.9 to 3.3	6+ve/4+ve
Range ex-Burundi	0.7 to 14.4	0.3 to 12.4	4.0 to 25.8	-0.9 to 3.3	6+ve/4+ve
	Debt service ratios	External debt/GDP	Total govt debt/GDP	IMF Art VIII	Cost of US\$1 (1996-99)
Burundi	39.5	93.5	197.3	No	+86.1%
Comoros	2.2	90.8	90.8	Yes	+20.3%
Kenya	28.0	70.0	79.0	Yes	+23.1%
Mauritius	8.6	53.4	79.9	Yes	+40.3%
Rwanda	20.4	71.3	60.6	Yes	+8.8%
Seychelles	5.7	29.5	98.8	Yes	+7.5%
Tanzania	17.3	93.3	98.6	Yes	+28.5%
Uganda	21.0	60.4	60.3	Yes	+39.1%
Range	2.2 to 39.5	29.5 to 93.5	60.3 to 197.3	Yes 7/No 1	7.5 to 86.1
Range ex-Burundi	2.2 to 28.0	29.5 to 93.3	60.3 to 98.8	Yes 7/No 0	7.5 to 40.3

Notes: see earlier tables

14.4 Southern sub-group

The Zimbabwe economy is in no position at present to form the focus of sub-regional integration. For this and other reasons, this sub-group has made least progress towards macroeconomic policy convergence. Even if one leaves out the war-torn economies of Angola and Congo (which are in massive macroeconomic disequilibrium), much of the rest of the sub-region has problems.

The economies of Malawi, Zambia and Zimbabwe should be central to the development of this sub-group. Unfortunately, they are all suffering from fairly severe macroeconomic disequilibrium, without at present much sign of improvement. All have rates of inflation above 25% over 1995-99, with the situation getting worse rather than better (see Table 2). Although their budget deficits do not appear from Table 22 to be particularly severe in relation to GDP, rates of growth of the money supply are dangerously high. In addition, although interest rates have at times been positive in recent years, this has been achieved only with damagingly high nominal interest rates. The latest lending rates available (from IFS) are Malawi 54%, Zambia 37.7% and Zimbabwe 65.5%. As argued earlier, even if such rates do result in positive real costs of borrowing, they crowd out the private sector, and impose very high levels of risk on those private sector borrowers who do obtain commercial bank credit. These three countries also have severe external debt problems, although Malawi and Zambia may gain some relief from being accepted for the HIPC programme at the end of 2000. Not surprisingly, all three countries have suffered from large-scale currency depreciation over 1996-99 (and that has continued since end-1999).

The remaining three countries are in a reasonably satisfactory state. Madagascar, Namibia and Swaziland have inflation rates below 10%, rates of growth of broad money at acceptable rates, and budget deficits under control. These three countries also have manageable levels of external debt service, and absolute levels of external debt (although there is some doubt about the statistics for Madagascar, whose external debt position is anyway less favourable than the other two). The relevance of Namibia and Swaziland to a COMESA sub-regional group is limited, however, because their economies are relatively small in relation to the group as a whole, and they are more integrated into the CMA and SACU.

Overall, even if the war-torn economies are excluded, this sub-group shows no sign of economic policy convergence. A further complication is that all the members except Madagascar are also members of SADC, whose natural focus of convergence is South Africa (historically, the small members of SACU have benefited from income convergence on South Africa, but the non-SACU members of SADC have not). Some 80% of SADC GDP is represented by that of South Africa. So long as South Africa is not a member of COMESA, it is probably more likely that any progress towards sub-regional integration will focus on the SADC free trade area, rather than on COMESA. The prospects for SADC's free trade area developing successfully are not particularly strong (see, for example, Harvey, 1999). Nevertheless, SADC has one major advantage not shared by the COMESA Southern sub-group, namely that members may choose to remain within a SADC free trade area in order to maintain access to the South African

market. There is no comparable incentive in the COMESA sub-group, and its members are furthest from the largest COMESA economy (Egypt).

Table 22: Southern sub-group: selected indicators

Country	Average inflation (1995-99)	Budget Deficit (% of GDP)	Broad money growth	Central bank fin/20% of prev yr's rev	Lending/ deposit rates
Angola	373.8	17.8	316.1	2.0	Negative
Congo (DR)	371.2	0.1	357.5	0.2	Negative
Madagascar	9.0	1.0	14.5	3.7	+ve/-ve
Malawi	27.4	5.7	39.5	0.4	+ve/-ve
Namibia	7.8	4.0	20.1	n.a.	Positive
Swaziland	7.1	- 0.3	16.0	- 3.0	Negative
Zambia	35.1	5.0	52.6	13.6	+ve/-ve
Zimbabwe	30.4	6.9	29.0	1.5	Positive
Range	7.1 to 373.8	0.1 to 17.8	14.5 to 357.5	-3.0 to 13.6	5+ve/2+ve
Range ex-war	7.1 to 35.1	0.3 to 5.7	14.5 to 52.6	-3.0 to 13.6	5+ve/2+ve
	Debt service ratios	External debt/GDP (1995-99)	Total govt debt/GDP (latest year)	IMF Art VIII	Cost of US\$1 1996-99
Angola	21.5	166.0	156.7	No	+2.2mn%
Congo (DR)	1.2	208.2	>210.0	No	+7824.4%
Madagascar	17.2	110.4	119.4	Yes	+54.7%
Malawi	24.0	235.0	116.0	Yes	+188.0%
Namibia	9.0	6.6	9.0	Yes	+42.1%
Swaziland	2.8	18.1	20.0	Yes	+42.1%
Zambia	19.4	198.3	160.9	No	+97.7%
Zimbabwe	25.2	66.8	101.0	Yes	+286.2%
Range	1.2 to 45.2	6.6 to 235.0	9.0 to 210.0	Yes 5/No 3	42.1 to 2.2mn
Range ex-war	2.8 to 45.2	6.6 to 235.0	9.0 to 160.9	Yes 5/No 1	42.1 to 286.2

Notes: see earlier tables

15 Recommendations

The following recommendations are based on the analysis presented in this report. They are based on the belief that the most promising strategy is for COMESA member countries to proceed at their own speed, in pursuit of their own objectives of macroeconomic stability and the increased investment that should follow. This is thought to be more promising than COMESA endeavouring to get all member countries to move *simultaneously* towards the interim, and eventually the final objectives, of the Monetary Harmonisation Programme.

Individual countries can lock in the macroeconomic stability already achieved, by establishing currency boards or by euro-isation/dollarisation. This would make it possible to establish a de facto common currency, initially for a core group of countries. This group should increase with time. Until macroeconomic stability is attained, however,

countries should not make irrevocable commitments to fix their exchange rates, because the consequences of a policy reversal will be very harmful to long-run growth.

15.1 Overall strategy for moving towards common monetary arrangements

- It is recommended that COMESA countries establish an external agency of restraint, to lock in the gains already made in macroeconomic stability, to lock in future gains, and thereby to give rapid credibility to these gains being sustained.
- It is recommended that COMESA countries seek an external agency of restraint *additional to* any restraint provided by the IMF/World Bank and/or internal COMESA agreements.
- It is recommended that the most practical strategy for achieving macroeconomic stability, and eventually a common currency area, is for individual COMESA member countries to link with increasing irreversibility to a major non-regional currency, as and when the conditions are right for each individual economy.
- It is recommended that COMESA not rely on intra-COMESA agreements to achieve the objectives of monetary harmonisation and a common currency.
- It is recommended that COMESA encourage member countries to link to the euro rather than the US\$, or other non-regional currency (noting, however, that the choice of non-regional currency link is relatively unimportant because any such link will require and then lock in macroeconomic stability, and that financial markets exist to cover the risk of trading in different major currencies).
- It is recommended that COMESA member countries, having once achieved sufficient macroeconomic stability (as defined below), establish currency board arrangements with their chosen non-regional major currency, rather than complete dollarisation or euro-isation, in order to retain the profits of the note issue and the option (in extreme circumstances) of devaluation.
- It is recommended, where a COMESA member government is not in a position to establish a currency board arrangement immediately, that as an interim stage it should establish a stable peg to a non-regional major currency, once the macroeconomic conditions have been established, to be converted as soon as possible to a currency board arrangement, in order to establish as quickly as possible the credibility of future macroeconomic stability necessary for increased investment.
- It is recommended, to the extent that COMESA member countries set up currency board arrangements linked to the same non-regional major currency, and maintain those arrangements for a minimum period of five years, that they create a common currency (which would be called the COMESA Franc, or similar), with the new currency issued by a common monetary authority.
- It is recommended that the common monetary authority itself act as a currency board with a fixed exchange rate to a non-regional major currency (preferably the euro).
- It is recommended that those COMESA member countries using the new common currency retain their central banks to act as agents of the common monetary authority in the issue of the common currency, and to perform the other functions of central banks (including in particular the regulation of each country's commercial banks and other financial institutions), but that these national central banks should not have the power to finance government spending.

- It is recommended that the common monetary authority should not have the power to lend to qualifying member governments in excess of 5% of an average of the previous three years government revenue, in any one year, and that such lending should never exceed 10% in total of an average of the previous three years government revenue.
- It is recommended that those COMESA member countries not yet qualified to adhere to the common monetary authority, should be eligible to join the common monetary arrangements once they have maintained a stable peg against a major non-regional currency (not necessarily the one chosen by the common monetary authority) for a minimum of five years, or have had a currency board arrangement for a minimum of three years.
- It is recommended that COMESA member countries joining the common monetary arrangements, if they had previously been linked (through a stable peg for five years, or a currency board arrangement for three years) to a currency different from that of the common monetary authority, accept a change of link to the chosen link currency of the common monetary authority.

15.2 Interim strategy: inflation

- It is recommended that COMESA member countries with inflation rates during 1995-99 above 10% seek to reduce their inflation rates to 10% or less within five years.
- It is recommended that COMESA member countries with inflation rates during 1995-99 below 10% (and sustained below 10% since then) and above 5%, seek to reduce those rates of inflation to 5% or less within three years.
- It is recommended that COMESA member countries with inflation rates below 5% during 1995-99 (and sustained below 5% since then) and above 3%, seek to reduce those rates of inflation below 3% within three years.
- It is recommended that COMESA member countries with inflation rates below 3% during 1995-99 (and sustained below 3% since then) consider introducing immediately an irreversible link to the euro (or other major non-regional currency such as the US\$) through a currency board arrangement.
- It is recommended, as an alternative to currency boards, that COMESA member countries with inflation rates below 3% during 1995-99 (and sustained below 3% since then) consider immediate euro-isation (or dollarisation).
- It is recommended that those COMESA member countries which have established a currency board arrangement, and sustained it for a minimum of five years, consider setting up a common monetary authority to issue a COMESA currency linked to the euro or other major non-regional currency (the COMESA currency to be called, say, the COMESA Franc).
- It is recommended that any COMESA member country which has chosen euro-isation or dollarisation as an alternative to a currency board arrangement, should be able to join a future COMESA common currency arrangement, by exchanging euros or dollars circulating domestically for the COMESA common currency.
- It is recommended that all of the targets in the inflation recommendations under 15.2 apply to a moving average of the three most recent years, to allow for flexibility in the face of exogenous or endogenous shocks, realising that this will require over-performance in good years to compensate for under-performance in bad years.

15.3 Interim strategy: budget deficits as a percentage of GDP

- It is recommended that those COMESA member countries whose budget deficits (including grants) were less than 5% of GDP during 1995-99 (a majority) and whose budget deficit has remained less than 5% of GDP since then, should have a target that this ratio, using a three-year moving average, should be 3% or less within three years.
- It is recommended that the budget deficit target should be a condition for joining the future common monetary authority, although countries wishing to join could argue that it is sufficient for a COMESA member country to have established and maintained a currency board arrangement (or euro-isation/dollarisation) for the proposed number of years.

15.4 Interim strategy: monetary growth

- It is recommended that there be no monetary growth targets once countries have established currency board arrangements with a major non-regional currency (monetary growth is determined by the balance of payments under a currency board arrangement).
- It is recommended that the monetary growth targets for those countries not yet having established a currency board arrangement with a major non-regional currency be the sum of GDP growth, the appropriate inflation target (as specified in 15.2), and five percentage points for monetisation, all based on a three-year moving average of the previous three years.
- It is recommended, where GDP growth figures are not available for some or all of the three most recent years, that IMF/World Bank estimates, or EIU estimates, be used pending the availability of official statistics.

15.5 Interim strategy: central bank finance of government spending

- It is recommended, for COMESA member countries which have not yet established a currency board arrangement, that central bank claims on central government should not increase by more than 5%, in any one year, of an average of the last three years' government revenue.
- It is recommended, for COMESA member countries which have not yet established a currency board arrangement, and where the government has net positive balances at the central bank, that these balances should not be reduced in any one year by more than 5% of an average of the previous three years' government revenue.
- It is recommended, for COMESA member countries which have established a currency board arrangement, and have jointly set up a common monetary authority, that the authority should not finance member governments by more than 5% of an average of the previous three years' government revenue, in any one year, and that such lending should never exceed 10% in total of an average of the previous three year's government revenue (see 15.1 above).

15.6 Interim strategy: real interest rates

- It is recommended that the target for both lending and deposit rates be positive in real terms, and that this be achieved without having nominal lending rates of more than 10% (prime rate), noting that this should occur anyway as inflation rates are further reduced in those countries where they are still more than 3%, and as banking risk is reduced by increased and sustained macroeconomic stability, leading to narrower interest rate margins between deposit and lending rates of interest.

15.7 Interim strategy: external debt and external debt service

- It is recommended, in the expectation that external debt will be reduced by the Highly Indebted Poor Countries initiative, that those COMESA member countries which establish currency board arrangements not be allowed to adhere to a common monetary authority until they have reduced the ratio of external debt to GDP, based on an average of the most recent three years, below 50%.
- It is also recommended that COMESA member countries with currency board arrangements not be allowed to adhere to the common monetary authority before they have reduced their ratios of external debt service to GDP below 10%.

15.8 Incentives and sanctions

- It is recommended that a COMESA development fund be established, recognising that it would have to be funded almost exclusively by donor funds which would probably be diverted from other objectives, to which members of the COMESA common currency area would have access, and from which they would be excluded if they fail to meet the criteria for membership (see 15.9 below).
- It is recommended that access to borrowing from the COMESA development fund be limited to those COMESA member countries adhering to a common currency area, and that access be denied should a member be suspended from membership (see 15.9 below).
- It is recommended that it be a condition of membership of the COMESA common currency area that members should eliminate exchange controls on outward investment to other members of the COMESA common currency area, but that this may be suspended should a member be suspended from membership (see 15.9 below).

15.9 Conditions for retaining membership of the proposed common currency area

- It is recommended that continued membership of the common currency area should be dependent on maintaining a budget deficit of 3% or less of GDP, averaged over the three most recent years.
- It is recommended, however, that a member of the COMESA common currency area may have a budget deficit greater than 3% of GDP, averaged over the three most recent years, if it can be demonstrated that the excess of that budget deficit above 3% of GDP has been financed by foreign aid from outside COMESA, and that any

forecast increase in external debt and external debt service payments will not result in external debt and external debt service ratios above the targets set out below.

- It is recommended that continued membership of the common currency area should be dependent on maintaining a ratio of external debt to GDP of less than 50%, averaged over the three most recent years.
- It is recommended that continued membership of the common currency area should be dependent on maintaining a ratio of external debt service to exports of goods and services of less than 10% averaged over the three most recent years.
- It is recommended that a member country of the COMESA common currency area which fails to meet one or more of these three criteria should be suspended from access to the COMESA development fund, and from other privileges of membership, within one year of that failure, and should not be readmitted until it has met the criteria for two consecutive years.

15.10 Relations with other Regional Economic Communities in Africa

- It is recommended that the most effective way for COMESA to pursue good economic relations with other Regional Economic Communities in Africa, and to support the objectives of the African Economic Community is to pursue its objectives of macroeconomic stabilisation, locked in by irreversible links to the euro (or other major currencies), since this will improve the opportunities for economic growth, which in turn should lead to increased intra-African trade.
- It is recommended (as already indicated above) that if COMESA member countries choose to link to a non-regional currency, they should link wherever possible to the euro, and that the euro should be the external currency to which a COMESA common monetary authority is linked, both because of existing strong trade links with the European Union and because of the link between the CFA Franc and the euro.

Appendix tables

Table 23: COMESA: GDP, population, GDP/head

	GNP-98	Pop-98	GNP/ head	GNP/head at PPP	Ratio of PPP to mkt p's ratio
	at market		head	at PPP	PPP to mkt p's ratio
	Prices		mkt p's		mkt p's ratio
	\$ bn	mn	\$	\$	ratio
Angola	4.1	12.48	340	840	2.5
Burundi	0.9	7	140	620	4.4
Comoros	0.2	0.5	370	1480	4.0
Congo	5.3	48	110	200	1.8
Djibouti ^(a)	1.2	0.653	1896		
Egypt	79.2	61	1290	3130	2.4
Eritrea	0.8	4	200	950	4.8
Ethiopia	6.1	61	100	500	5.0
Kenya	9.7	29	330	1130	3.4
Madagascar	3.8	15	260	900	3.5
Malawi	2.1	11	200	730	3.7
Mauritius	4.3	1.2	3700	9400	2.5
Namibia	3.2	2	1940	4950	2.6
Rwanda	1.9	8	230	690	3.0
Seychelles	0.5	0.079	6450	10530	1.6
Sudan	8.2	28.3	290	1360	4.7
Swaziland	1.4	0.988	1400	3540	2.5
Tanzania	6.7	32	210	490	2.3
Uganda	6.7	21	320	1170	3.7
Zambia	3.2	10	330	860	2.6
Zimbabwe	7.1	12	610	2150	3.5
Total	158.6	365.1	434		

Notes: (a) GNP for Djibouti not estimated by the World Bank, but GNP per head estimated to be lower middle income (between \$761 and \$3030), figure in the table is halfway up the lower middle income scale
Source: World Bank *World Development Report 1999/2000*

Table 24: Increase in the cost of US\$1, 1962-2000 (selected African countries)

15.10.1.1.1 Country	Local Currency Units/US\$ 1962	Local Currency Units/US\$ 2000	Ratio 2000/1962
Congo (DRC)	64	245000000 ^(a)	3828125.00
Uganda (a)	7.143	157170	22003.36
Ghana	0.7143	5002	7002.66
Zambia	0.7143	3022	4230.72
Tanzania	7.143	799.54	1119.33
Sudan	0.348	257.15	738.94
Somalia	7.143	2620 ^(a)	366.79
Sierra Leone	0.7143	2006	280.83
Nigeria	0.7143	101.7	142.43
Malawi	0.7143	56.01	78.41
Zimbabwe	0.7143	38.17	53.44
Liberia	1.00	41.25	41.25
Madagascar	245	7213	29.44
Burundi	50	675.31	13.51
Kenya	7.143	77.95	10.91
South Africa	0.7143	6.77	9.48
LNS	0.7143	6.77	9.48
Egypt	0.4348	3.421	7.87
Rwanda	50	378.17	7.56
Botswana	0.7143	5.1203	7.17
Gambia	1.784	12.285 ^(b)	6.89
Mauritius	4.758	26.092	3.36
Ethiopia	2.4845	8.222	3.31
CFA Franc	246.85	686.43	2.78
Comoros	245	528.83	2.16
Seychelles	4.76	5.68	1.19
Djibouti	214.39	177.72	0.83

Notes: (a) latest statistics in IFS are only for end-1998

(b) latest statistic in IFS is for April 2000

Source: International Financial Statistics, various issues

16 References

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