Policy Brief

EAC convergence ahead of establishment of a Monetary Union

This policy brief examines progress made in achieving two of the set macroeconomic convergence criteria for the establishment of the East African Community (EAC), and more specifically, the East African Monetary Union.

Introduction

The objective of EAC integration is to formulate policies and initiatives that promote broader and deeper cooperation among the Partner States in the economic, social, cultural, and political domains, with the aim of benefiting all involved. This collaborative effort has already yielded results in the establishment of a customs union and the creation of a common market.

Similarly, the community has set its sights on establishing an East African Monetary Union (EAMU) by 2024. This is to be accomplished through achieving macroeconomic convergence and harmonizing policies related to monetary affairs, exchange rates, financial sector supervision, payment and settlement systems, as well as the production of standardized statistics.

Similar to other regional economic communities, the East African countries developed convergence criteria to guide and expedite the integration process.

Originally, the criteria included targets for budget deficit, average inflation, external reserves, and the adoption of a single East African currency, to be achieved over a three-stage period: 2007-2010 (Stage I), 2011-2014 (Stage II), and 2015 (Stage III).

In 2013, the EAC Council revised these criteria to consist of four primary convergence criteria focusing on headline inflation, fiscal deficit, public debt ceiling, and reserve targets, along with three non-binding, indicative convergence criteria intended to serve as early warning indicators.

However, with only one year remaining, the EAC member countries continue to perform below par on fiscal deficits and public debt levels, challenging the achievement of the common goal.

EAC Monetary Union Convergence Criteria

The objective of the EAC Monetary Union is to promote and maintain monetary and financial stability aimed at facilitating economic integration and attain sustainable growth and development of the community. Several preconditions must be met before establishing EAC monetary union, they include: i) harmonization and coordination of fiscal monetary and exchange rates policies; ii) adoption of common principles and rules for payments and settlements; iii) harmonized policies and standards for statistical information; iv) fixed bilateral exchange rate bands; and v) integrated financial systems and adoption of common principles and rules for regulation and supervisions of the financial system.

In addition, the member countries are required to face-out central banks' lending to the government and public sector and maintain the convergence criteria for three consecutive years before 2024 to pave way for a monetary union. To this end, EAC adopted nominal (as opposed to real) convergence, akin to the Maastricht Treaty criteria that established the European Union. The initial criteria set in 2007 was revised in 2013 and consists of four convergence criteria depicted in Box 1.

There are also three non-binding indicative convergence criteria whose purpose is to serve as warning indicators, systems, as well as the production of standardized statistics.

Box 1: EAC Monetary Convergence Macroeconomic Criteria

Primary Convergence Criteria

1. Ceiling on headline inflation of 8 percent.
2. Fiscal deficit (including grants) ceiling of 3 percent of GDP.
3. Ceiling on gross public debt of 50 percent of GDP in net present value terms.
4. Reserve cover of 4.5 months of imports.

Indicative Criteria

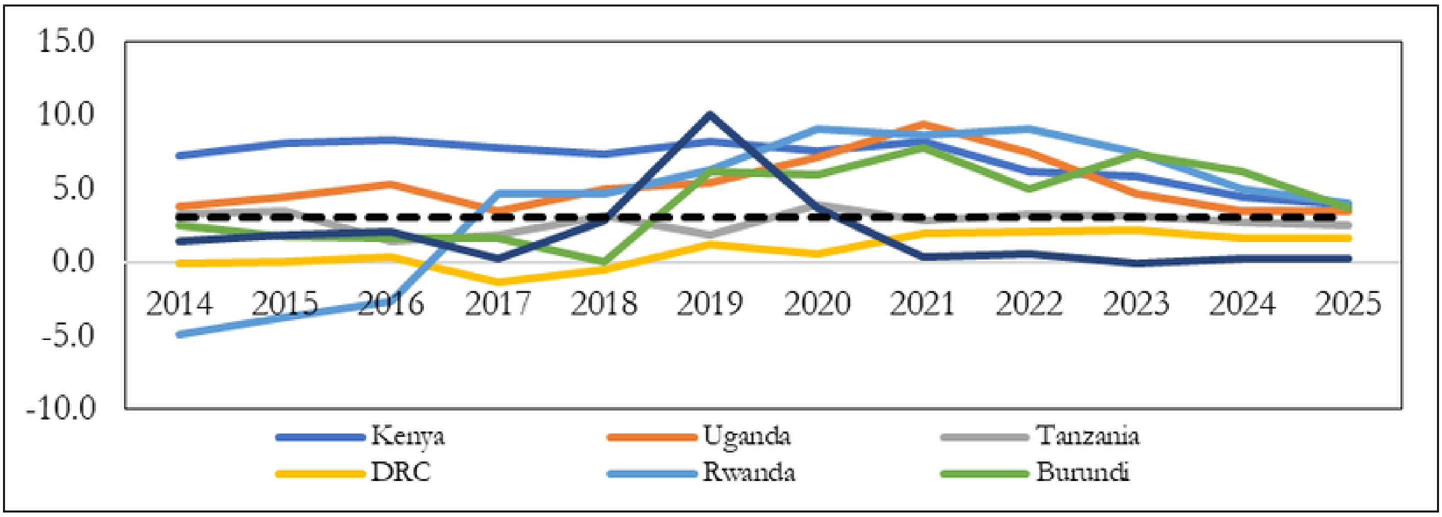
1. Core inflation ceiling of 5 percent.
2. Fiscal deficit (excluding grants) ceiling 6 percent of GDP.
3. Tax-to-GDP ratio of 25 percent.

In principle, the convergence criteria require the EAC member countries to achieve strong fiscal deficit and public debt positions prior to the formation of the monetary union. This is premised on the fact that large fiscal deficits would impede the ability of monetary authorities to achieve low inflation. As depicted in Box 1 above, the EAC set the convergence criterion for fiscal deficit (including grants) at 3 percent of GDP while the public debt convergence criterion was set at 50 percent of GDP in net present value terms.

EAC Fiscal Deficit trends against the convergence criteria

As demonstrated in Chart 2 below, most EAC member countries have increasingly moved away from the fiscal deficit target, with only South Sudan and DRC reporting fiscal deficits below the 3 percent of GDP threshold. Kenya, Rwanda, Uganda and Burundi recorded fiscal deficits of 6.2 percent, 9.1%, 7.5%, and 5.0% of GDP respectively. On the other hand, Tanzania, DRC and South Sudan achieved lower deficits of 3.3 percent, 2.1% and 0.6% of GDP, respectively. Whereas the COVID-19 pandemic and the Russia-Ukraine conflict were sources of unprecedented shocks, fiscal deficits were on an upward trend way before these shocks. The IMF projects lower fiscal deficits going forward pegged on its on-going fiscal consolidation programs in some countries (including Uganda, Kenya, and Rwanda) through enhanced revenue mobilization and expenditure controls. Even so, IMF projections indicate that EAC countries will not achieve the 3% of GDP threshold until 2025, one year after the set timeline.

Chart 1: Historical Overall Balance, percent of GDP



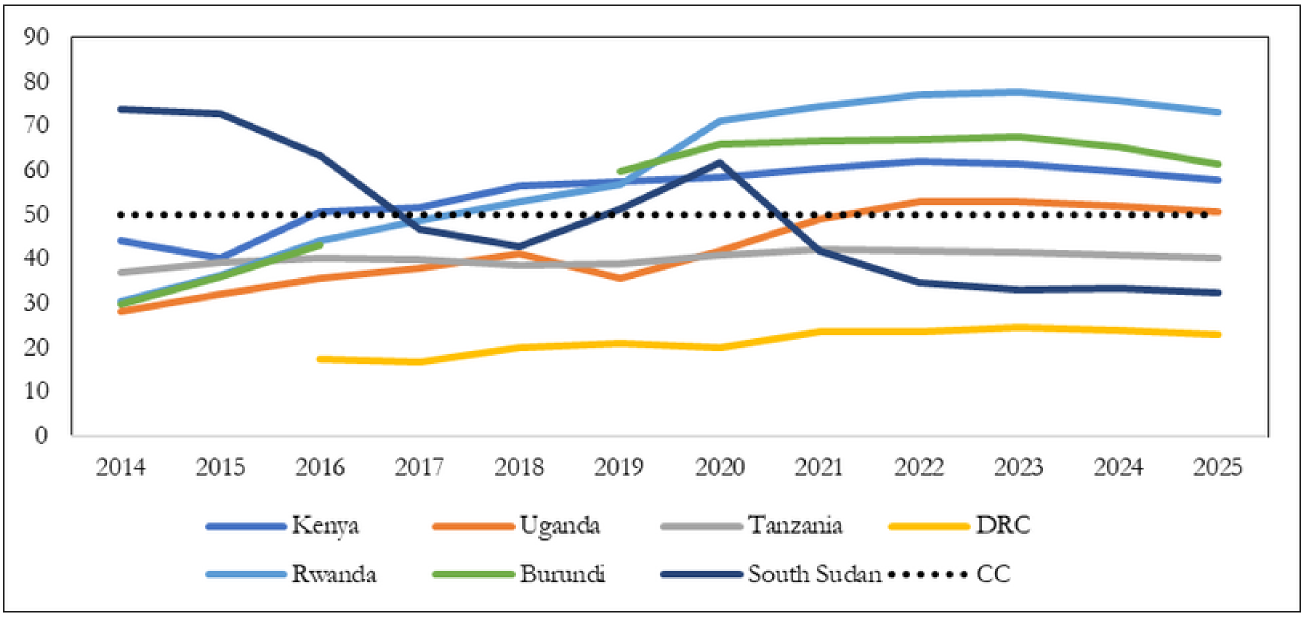
Data Source: Various Country Article IV Mission Reports

EAC public debt trends against the convergence criteria

The EAC convergence criteria sets the debt limit at 50 percent of GDP in net present value terms, which is below 60-70 percent of GDP set in other unions including the European Monetary Union, Gulf Cooperation Council, and the Eastern Caribbean Currency Union. At the time of setting the debt limit, most of the EAC countries had their debt well below the target but these countries have continually accumulated more and more debt. In tandem with their lower fiscal deficits, Tanzania and DRC's debts were below the convergence debt limit at 40 percent and 16 percent of GDP, respectively, in 2021. In the same year, South Sudan and Uganda's debts are slightly below convergence threshold at 36 and 46 percent of GDP. Conversely, Kenya, Rwanda and Burundi have accumulated more debt to record debt levels of 68 percent, 66 percent, and 63 percent in 2021, respectively.

Further, the composition of debt has significantly shifted from predominantly concessional with some countries (such as Kenya) taking more commercial debt. The average share of commercial debt to total debt increased from a low of 9 percent to 17 percent between 2013 and 2021. These countries have increasingly borrowed through Eurobonds and other forms of commercial which has increased the burden of public debt. The COVID-19 pandemic did not spare the EAC countries and there was unprecedented accumulation of public debt. The period also EAC saw member countries sign up for IMF programs to reduce their debt vulnerabilities and to support their fiscal consolidation efforts.

Chart 3: EAC Gross Public Debt in Net Present Value Terms



Data Source: Various Country Article IV Mission Reports

Conclusion

In line with the Optimal Currency Area (OCA) theories, a high degree of integration is a prerequisite for countries to benefit from a regional monetary union[i]. This then requires member countries to have similar economic structures where because of a common monetary policy and exchange rate policy, they face similar shocks such that monetary and exchange rate policy response to the shocks is jointly beneficial.[ii] Data on fiscal deficits and public debt and evidence through application of a Generalized method of moments (GMM) model illustrates that EAC countries are yet to achieve convergence on fiscal deficit and public debt[iii]. Such evidence then calls for high degree of policy coordination and harmonization for a coherent policy landscape for the community.

A key challenge in achieving the set threshold has been low revenue mobilization which has meant these economies have persistently run on fiscal deficits and as a result have continually accumulated more and more debt. Total revenue on average was about 21 percent of GPD while expenditures averaged about 26 percent of GDP in 2022 for the region.[iv] Therefore, enhanced revenue mobilization to address fiscal deficit and debt problem is critical towards meeting these benchmarks to pave way for the formation of the monetary union.

EAC's monetary union protocol required member countries to sustain the set criteria for three consecutive years before 2024. However, data on fiscal deficit and public debt illustrates that just one year before the set timeline, only two most recent entrants (DRC and South Sudan) out of six countries have complied with the set criteria. Perhaps due to slow progress in achieving the convergence criteria, technical experts have proposed postponement of adoption of a single currency to 2031. In addition, critical institutions such as East African Monetary Institute (EAMI) are not in place.

With little or no progress among some countries, it will be crucial for the community to commit to harmonization by progressively working towards achieving the convergence criteria before adopting a single currency. This is because whereas the EAC economies have somewhat similar economic structures, they are susceptible to different shocks creating a greater need for policy coordination towards macroeconomic convergence.

Attaining the fiscal deficit and public convergence will require these countries to step up their revenue mobilization effort to reduce deficits and to bring debt below the convergence ceiling. In addition, each member country should continually ensure they have working institutions at the national level as a stopgap measure to ensure compliance.

There is also needed for a robust monitoring framework to ensure all member countries commit and take necessary measures towards meeting fiscal deficit, public debt, and other convergence criteria. The EAC Monetary Union protocol provides strict adherence and maintenance of the macroeconomic convergence and on partner states to monitor compliance beginning 2021.

References

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