Emmanuel Tumusiime-Mutebile: The planned introduction of the East African Monetary Union

Remarks by Mr Emmanuel Tumusiime-Mutebile, Governor of the Bank of Uganda, at the opening of the East African Legislative Assembly Consultative Workshop on the East African Monetary Union, Kampala, 9 September 2013.

*   *   *

Honourable Ministers and

Honourable Members of the East African Legislative Assembly

Ladies and Gentlemen

The issue that we have gathered here to discuss today – the planned introduction of the East African Monetary Union (EAMU) – is one which will have profound effects on this region for decades to come. Later this year I expect that the heads of state of each of the partner states of the East African Community (EAC) will sign the Protocol for the introduction of the EAMU. The Protocol will pave the way for the transition to EAMU over the course of the next 10 years and the complementary legal, institutional and economic reforms.

The East African Monetary Union is a project with potentially large long term benefits for all of the economies in the EAC but which also entails considerable risks. The long term success of EAMU will be dependent upon major changes to public policy and in the way in which public policy is made in all partner states of the EAC. A successful monetary union is only possible if each partner state is prepared to accept the pooling of its economic sovereignty. Many economic decisions which are now made at the national level will have to be made at the regional level.

This pooling of economic sovereignty extends beyond the loss of independent national monetary policy and exchange rates, which is of course inherent in a monetary union; it also requires that each partner state accepts constraints on its fiscal policy and implements fully the provisions of the common market, including not just free trade in goods and services within the EAC but also the free movement of capital and labour within the EAC. If we do not build the requisite foundations for monetary union, the introduction of EAMU may actually harm our economies. The problems which are currently being experienced by some of the peripheral members of the Euro zone – Greece, Portugal and Spain for example – which have lost competitiveness on international markets and can no longer use exchange rate depreciation to restore their competitiveness, should provide a salutary lesson to everyone involved in planning for the introduction of the EAMU.

Without wishing to pre-empt any of the contributions from my colleagues in the EAC Secretariat, the Ministry of Finance, Planning and Economic Development and the Economic Policy Research Council which we will hear later on in this workshop, I would like to take a few minutes of your time to explain why I believe that monetary union in East Africa will make an important contribution to the long term development of our region, potentially helping to accelerate the transition of our economies to middle income status, and also to identify the critical prerequisites for the successful introduction of EAMU.

Why is monetary union important in East Africa?

The partner states of the EAC are implementing a customs union and a common market in order to promote regional economic integration. Deeper regional economic integration will provide a major spur to development in all partner states by strengthening competition within our respective domestic markets, by allowing producers to reap greater economies of scale and thus become more efficient, and by widening opportunities for trade. The regional market will also provide a stepping stone for domestic producers to access global markets.

The primary rationale for the monetary union is to cement the benefits of regional economic integration. Replacing individual currencies with one single common currency will reduce the costs and risks of transacting business across the national boundaries of the partner states of the EAC. Monetary union removes the costs of having to transact in different currencies and the risk of adverse exchange rate movements for trade within East Africa.

Furthermore, because the combined economy of all of the partner states together will be more diversified than that of any individual partner state, it will be less vulnerable to external shocks such as commodity price shocks and as a consequence, the volatility of the common exchange rate against that of other major currencies such as the dollar or Euro should be less than the volatility of the currently existing national currencies of the partner states. Exchange rate volatility is a major risk for business and a deterrent to private investment, especially in the traded goods sectors of the economy. Hence by eliminating entirely exchange rate movements within the EAC, and by reducing exchange rate volatility with respect to third party currencies outside of the EAC, the EAMU should reduce some of the commercial risks of doing business in East Africa and, as such, help to promote more private investment.

EAMU will also be important for the future of East Africa because of the signal it sends to the rest of the world. Having a common currency is one of the clearest statements of intent that the EAC can make to demonstrate its long term commitment to deep regional integration. It sends a message to foreign investors that the EAC really is a genuine single market in which to do business. Because it involves a major loss of economic sovereignty, the introduction of the EAMU is also a political statement about the commitment of partner states in the EAC to a common future as East Africans, rather than just as citizens of individual nation states.

What are the prerequisites for the success of monetary union?

The first prerequisite for the EAMU is that all partner states implement the customs union and common market in full. This means removing all non tariff barriers (NTBs) to intra-regional trade in the EAC. It means allowing firms in the services industries, such as transport firms, domiciled in any partner state to sell their services without restriction in all other partner states. It also means accepting without preconditions the free movement of labour throughout the EAC: for example Kenyans should be able to live and work in Uganda without restrictions and without having to pay for work or residency permits. Finally, it means allowing the free movement of capital across borders within the EAC. Free capital mobility within the EAC will only be meaningful if each partner state imposes no restrictions on the purchase of assets by investors from any other partner state.

A genuine single market in the EAC, without any restrictions on the movement of goods, services or factors of production, is an essential foundation for EAMU for two reasons. First, the benefits of monetary union to the partner states are positively correlated with the amount of trade between the partner states and the degree of integration of their economies. Unless there is very substantial trade within the EAC, there will be only minor benefits to be derived from a common currency. East Africa will not be able to attain the fullest degree of economic integration which is possible until all of the artificial barriers to intra-regional trade and to the movement of factors of production within the EAC have been abolished.

Secondly, the member states of the EAC will inevitably suffer what are called “idiosyncratic economic shocks”; these are shocks which affect the economy of one member state but not those of others. For an economy with its own currency and an independent monetary policy, the optimal response to a macroeconomic shock will usually involve monetary and exchange rate policy; for example, an economy might adjust to a negative terms of trade shock through a depreciation of the real exchange rate to restore external balance. It is self evident that membership of a monetary union means that national authorities cannot use either monetary or exchange rate policy to adjust to an idiosyncratic macroeconomic shock, leaving them more vulnerable to the adverse consequences of such shocks.

However, regional integration offers an alternative adjustment mechanism for countries experiencing idiosyncratic shocks. For example, suppose the economy of one partner state suffers a major decline in the international price of one of its main exports. Such a shock would reduce the incomes of exporters and thereby cut aggregate demand, causing a recession in the domestic economy if the shock were large enough. In this case, the shock to aggregate demand could be mitigated if domestic producers were able to redirect their output to the markets of their partner states. Hence the initial idiosyncratic shock to one partner state can be absorbed by all partner states within the monetary union, lessening the adverse impact on the partner state which suffered the initial shock. But this mechanism of adjustment will only be possible if there are no barriers to trade across national boundaries within the EAC, so that it is not much more difficult for Ugandan firms to sell their goods or services in Kenya than it is in Uganda itself.

Another example is that of the Dutch disease which is often created by the domestic spending generated by a natural resource boom. The adverse impact of Dutch disease can be mitigated through the entry into the resource boom economy of labour and service sector firms from partner states, which can ease supply constraints and thus inflationary pressures in the resource boom economy. The point that I want to emphasize is that, if we introduce a monetary union without first having put in place a genuine common market which can act as a shock absorber for idiosyncratic shocks hitting individual economies, we run the risk of exposing our economies to greater macroeconomic volatility.

The second prerequisite for a successful monetary union is sound fiscal policy, as is very clearly demonstrated by the problems currently afflicting some of the Euro zone members, notably Greece. The credibility of the monetary policy of the common central bank of the EAC will depend on it never having to finance the fiscal deficits of partner states. Unfortunately, it is difficult for a common central bank to credibly commit itself never to finance the fiscal deficit of a partner state, because there may be circumstances when providing deficit financing is the least worst option available if the alternative of allowing a sovereign default to occur risks a systemic financial crisis throughout the EAC. This is the dilemma which has faced the European Central Bank since the global financial crisis broke out: a sovereign default in, for example, Italy would not just affect Italians; the damage would be spread throughout the Eurozone because of the contagion to financial institutions in other Euro zone members.

To avoid any danger of monetary policy being undermined by having to bail out the Government of a partner state, it is necessary that the public debt of each partner state of the EAMU must be sustainable and also perceived to be sustainable, so that each Government can always fully meet its borrowing requirement from the market without having to resort to finance from the common central bank to avoid a sovereign default. To ensure public debt sustainability institutional mechanisms must be put in place, and enforced, to impose ceilings on fiscal deficits and public debt. The Euro zone had the mechanisms to ensure public debt sustainability in the Stability and Growth Pact, but they were not properly enforced. In the EAC we are formulating fiscal rules to curb fiscal deficits and public borrowing. These targets will be set out in the EAMU Protocol to be signed later this year. It goes without saying that it is imperative that these fiscal rules are complied with at all times. Failure to abide by these fiscal rules could fatally undermine the prospects for a successful monetary union.

Conclusion

The introduction of a monetary union is undoubtedly the most challenging project ever undertaken at the regional level in East Africa. The difficulties and risks involved should not be underestimated. The potential long term benefits of monetary union are large. If the monetary union is designed well and implemented properly, it should contribute to faster growth in trade, productivity, jobs and output over several decades. But the benefits will not be realized unless partner states are prepared to undertake the radical reforms necessary to put in place the essential foundations for monetary union, which include the implementation in full of the common market within the EAC and the establishment of rules based sound fiscal policies.