

Monetary Unification in the EAC

Evaluating the Costs and Benefits of the EAMU



Context

- The East African Community (EAC) is a regional organisation of eight countries with the objective of regional integration and cooperation.
- One of its core objectives is the formation of a monetary union (the EAMU), with a common currency, and shared monetary and exchange rate policy.
- However, factors ranging from economic structures to political & economic instability have driven doubts about a monetary union being beneficial.

Costs of Uniform Policy in the EAC

Factors in determining the cost of uniform policy

Effectiveness of alternate adjustment mechanism

Size of exchange rate (shock generator or shock absorber)

Symmetry of Shocks

Alternative adjustment mechanisms are mechanisms other than monetary policy, such as fiscal policy, labour market, and price and wage flexibility.

Monetary integration means giving up control on exchange rate policy, which involves the possibility of a currency depreciation (through a floating exchange rate), or inflation, and whether currency depreciation (through a floating exchange rate) is a shock generator or shock absorber.

Asymmetric shocks occur when countries in a region aren't affected equally by a shock. This is often the case with supply shocks, which affect some countries more than others. The timing of adjustment shocks is also relevant.

Price and Wage Flexibility

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High Factor Input Mobility

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Structural Similarity of Economies

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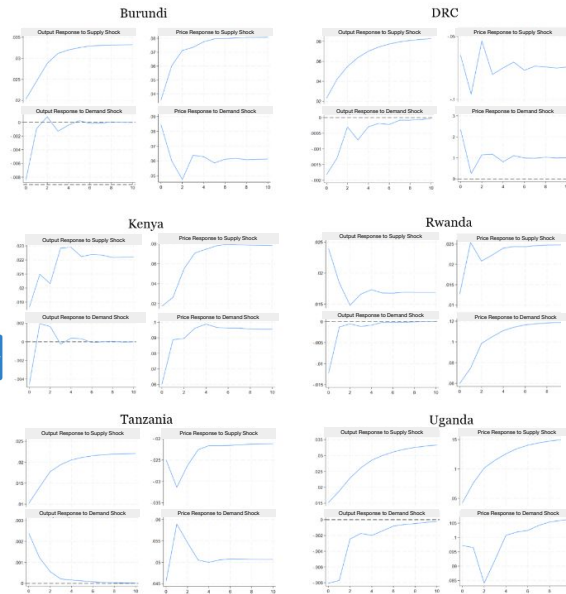
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Public Instability

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Results:

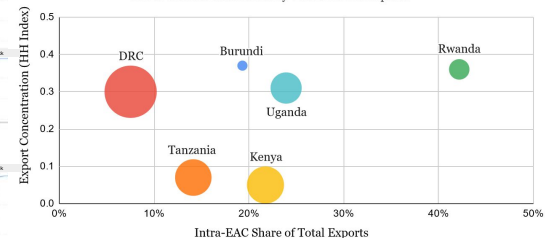


Benefit Analysis: Trade

- Though intra-EAC trade has surged in total value, it has shrunk as a proportion of total trade. This is despite reductions in non-tariff barriers to trade and commitment to a regional common market, among other achievements.
- The EAC's failure to exploit its integration benefits stems from its undiversified economic structures. Dependence on commodities such as tea, coffee and gold, and little focus on specialising in greater value-added sectors means EAC states see little demand as overseas economies are more cost-effective.
- Despite this, the EAC has taken note of this issue; the development of special economic zones (SEZs) aiming to attract FDI may assist in industrialisation - and therefore diversification - of the economies.

Intra-EAC Trade and Export Diversification

Size of Bubbles determined by Value of Total Exports



Methodology

- **Data:** unavailability of higher-frequency data means annual data (from 1996-2023) for output and inflation is used, from the EAC member states (excl. South Sudan and Somalia due to a lack of data)
- **SVAR:** vector autoregressive models are used to model the dynamic relationship between output and inflation over multiple time periods. The optimal lag length is estimated, using the Schwarz-Bayesian Information Criterion, to be 2. A restriction is applied according to Blanchard-Quah such that the effect of a demand shock on output is zero in the long-term.

Findings of Cost Analysis

- **Results:** All countries but Tanzania defy expectations from theory, preventing further analysis.
- **Reasons for this:** firstly, annual data fails to pick up on the short-run fluctuations and dynamics of the variables. Secondly, the restrictions set by Blanchard-Quah (including the assumption of orthogonal demand & supply shocks) are unrealistic.
- **Further analysis:** correlation coefficient analysis suggests that growth correlations are improving while inflation correlations remain poor, though this is not necessarily an issue as inflation correlations were also poor for the Euro area prior to its formation.
- **Conclusion:** there may be some structural convergence, which would lead to lower frequency of asymmetric shocks and therefore more effective uniform policy. Stricter monitoring of progress on convergence criteria could accelerate this process and facilitate monetary integration.

Conclusion

- The limited data on costs outside of the SVAR models would suggest that there is promise for some countries (specifically, Kenya, Tanzania and the DRC) as they have high correlations in growth with each other. However, annual data still leaves much to be desired with this report, so costs cannot be reliably determined.
- As for trade, high export concentration in a few commodities remains a prominent issue, so gains to trade are unlikely to be high at present. However, progress towards export diversification and dismantling barriers to trade may lead to a much better trading environment in the future.
- Overall, the report cannot give a reliable answer as to whether the EAMU would be beneficial or not.