MACROECONOMIC CONVERGENCE IN SADC – A POLICY PERSPECTIVE FOR THE CENTRAL BANKS OF THE INTEGRATION ARRANGEMENT[1]

Summary

The success of SADC will depend on its ability to experience growth in intra-regional trade for the benefit of all member states. This will require, amongst others, macroeconomic stability as a condition for capacity-creating, cross-border investment. A strategy of macroeconomic convergence, that is, policies aimed at the convergence of stability indicators in a regional integration arrangement, is not always best policy. In a region like SADC, which is exposed to asymmetrical external shocks, convergence can in fact be counterproductive. In the case of monetary integration macroeconomic convergence is necessary but this is a stage in the progression of regional integration for which SADC is not ready. However, a case can be made for a programme of single-indicator convergence that focuses on inflation as the broadest indicator of balance in resource utilisation. It is recommended that the central banks of SADC conclude a pact that will commit them to negotiated inflation targets over appropriate time periods. The targets could be set at the average of annual consumer price inflation of the three economies with the lowest inflation rates, or as a fixed numerical value.

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[1] Prof C L McCarthy was the primary author of the study. Comments received from the SADC Central Bank Governors were incorporated.

1. INTRODUCTION

This report builds on an earlier study (McCarthy & Du Plessis, 2001) that mainly conceptualised and evaluated macroeconomic convergence within the context of the mandate of SADC to serve as a development integration arrangement for its members. The first report dealt with the differentiation between long run economic convergence or "catch up"-growth, convergence in indicators of macroeconomic stability (also referred to as macroeconomic convergence), and convergence in macroeconomic policy or the harmonisation of macroeconomic policies.

The terms of reference (TOR) for the second report is presented and interpreted in section 2. There it will be made clear that the focus is macroeconomic convergence. The rationale for this is derived from the fact that central banks operate mainly within the domain of macroeconomic stability and hence, through active monetary policies, have a duty to monitor and influence macroeconomic stability indicators.

As a regional integration arrangement (RIA), SADC is one of many in Sub-Saharan Africa (SSA), a region that is also noted for its lack of success with this instrument of trade policy.[2] The many RIA failures and the wide disparity between rhetoric and the reality of the progress made have not weakened the belief that regional integration is necessary if Africa is to catch up with the developed world. In essence, regional integration has come to be seen as an important factor that will facilitate economic development and economic convergence. This importance has recently been manifested in the launching of the African Union (AU), an arrangement and desire which has adopted the European Union and its

[2] In West Africa alone there are more than 30 regional integration treaties. In a recent review of Africa's integration by the African Development Bank (2000: 136) the following is observed: "An overall assessment of Africa's experience with regional integration reveals…that regional integration and co-operation groupings have achieved limited success. ….. (T)he consensus is that there has been no significant increase in intra-regional trade. While intra-regional trade remained stagnant, the continent also

institutions as a model, hence the incorporation right at the start of the ambitious vision of an AU central bank, similar to the European Central Bank.

In a report that deals with macroeconomic convergence in a market integration arrangement, economic considerations will be the focus of attention. However, it will be useful to bear in mind that almost without exception a political agenda serves as the driving force in the establishment of RIAs. Recalling the history of SADC, this facet of regional integration is clear. In the wider continental context, pan-Africanism and the original political visions of leaders like President Nkruma have been an important force in Africa. The great difficulties encountered in integrating regions can be related to the fact that, independent of the political vision, regional integration has a distinct economic rationale that dictates that the building blocks of regional integration are essentially economic. Removing constraints on the intra-regional flow of goods, services and factors in search of political goals can be a difficult exercise.

The economic rationale is found in the static and dynamic consequences of integration that find expression in tangible or observable outcomes like once-off improvements in material welfare (the well known static outcome), economic growth and development and the regional distribution of these benefits. If the economic benefits of integration are perceived not to exist or to be distributed too unequally the political agenda is unlikely to keep the integration arrangement on track. But the opposite also applies. Even where economic benefits are not in doubt, if only in the expectations of society, non-economic factors could cause problems for regional integration as an economic exercise. Rostow (1990: 429) refers to "the inescapable complexity of people and, therefore, societies", which leads to the situation that "noneconomic forces can reinforce, dilute, or frustrate economic motives". The experience of RIAs in SSA, including SADC, provides amble evidence of noneconomic forces that have frustrated economic motives.

experienced increased marginalization in international trade. …Also evident is the failure of Africa's regional groupings to attract foreign direct investment."

The economic rationale of the integration of developing countries has been closely linked to the benefits to be derived from increasing market size. In Africa, with its predominance of small and often land-locked economies, this has always been an important consideration. But the integration of small African economies still leaves a comparatively small market and from this perspective the rationale of integration would appear dubious. It is in this context that Charles Harvey (1999: 2) could refer to the African desire to overcome the problem of small economies through integration as “largely an illusion”. However, combining very small markets will improve the opportunities for economies of scale and it can be argued at length, which we will not do here, that African economies have little option but to follow the route of regional integration. The dismal history of RIAs in SSA and the gap between rhetoric and reality does not contradict the logic of regional integration in Africa. What is required is a clear appreciation of the reasons for the poor experience and realistic policies and strategies to address these. The theme that runs through this report, is that macroeconomic convergence (MEC) should be judged in terms of its ability to facilitate regional integration in SADC. A case will have to be made that MEC is good policy. This reasoning will be developed further when attention is given to the concern of the SADC Committee of Central Bank Governors (CCBG) with MEC.

Macroeconomic convergence, per definition, need not imply greater macroeconomic stability in the region. It is possible to converge at, for example, higher and growing levels of the budget deficit, inflation and external balance. It must be emphasised that this report is concerned with MEC at greater degrees of economic stability and it is in this sense that the concept “macroeconomic convergence” must be understood when encountered in the text of the report. The same applies when the concept “economic convergence” is used. In this case the framework is not one of the weaker economic performers pulling the stronger performers down.

2. TERMS OF REFERENCE

The report is guided by terms of reference that require the following:

- The scope and the role of the CCBG in macroeconomic convergence must be outlined, with due attention given to what central bank Governors can do to contribute to macroeconomic convergence;
- The variables in terms of which macroeconomic convergence should practically be pursued by central banks must be defined;
- A delineation of desirable targets and ranges and the likely costs and benefits of adopting such variables must be attempted;
- The present position regarding such variables in the various SADC countries must be reviewed and common strategies and policies as well as relevant time frames must be delineated;
- Possible differences between the focus of central banks and that of other economic policy agencies and ways to improve policy co-ordination between them must be highlighted;
- The relationship between pursuing macroeconomic convergence and pursuing stability independently in each country must be explored;
- Linkages between macroeconomic convergence and other CCBG initiatives must be recognised;
- The experiences of other groupings, which attempted convergence, such as the EU, must be drawn on.

In discussions on the issue, the SADC Governors also made a number of observations that are relevant to the TOR.

- Whatever the dispensation regarding convergence and integration proposed, to be successful its ownership must be ensured at the level of the Heads of state and there must be a political buy-in at the ministerial level.

- The subject of macroeconomic convergence is too broad to be handled by the CCBG alone, hence the need to concentrate on monetary issues and leave other sectors of FISCU to deal with other aspects.

- The SADC Ministers of Finance believe and expect the central bank Governors to do something about macroeconomic convergence, develop the framework with regard to policy harmonisation, common currency and monetary union. Therefore, it is important to be proactive and take the initiative, which will inform the Heads of State about the requirements and steps needed to be undertaken rather than wait for them to instruct the CCBG.

The TOR are extensive and wide-ranging and difficult to do full justice to in the time available. The aim is to have a policy document on hand that will serve as a guide in co-ordinating policies in the endeavours of central banks to achieve MEC. However, the TOR do not reveal why a programme of MEC is sought. The TOR would seem to presuppose that such a programme is good policy and not to be considered as one in a range of policy options that exist. For example, the advantages and disadvantages of MEC vis-à-vis other policy approaches like the harmonisation of macroeconomic policies (policy convergence) or co-ordination in the planning and implementation of macroeconomic policy are not required to be considered.

Two possibilities suggest themselves when MEC is considered in the context of the linear model of regional integration. The first is that the aim is to achieve monetary integration, a goal that cannot be achieved unless participating states meet certain macroeconomic criteria. The prerequisites for membership of the European Monetary Union are a good example of this. The second possibility is that MEC has a specific role to play in facilitating trade flows and the creation of productive capacity. SADC has launched a free trade area and the possibility exists to argue that MEC will encourage market integration and intra-regional trade flows. These two possibilities will be considered below when the question is asked of how MEC will serve the process of integration in SADC.

It is implied in the TOR that the CCBG is not the only SADC agency that has an interest in macroeconomic convergence. Macroeconomic stability falls within the domain of central banks and the treasuries of the member governments. The Committee of the Ministers of Finance and Investment, supported by the Committee of Senior Treasury Officials and its Macroeconomic Subcommittee, has made some progress in preparing for a programme of macroeconomic convergence. The Ministers met on 31 July 2001 and endorsed a Memorandum of Understanding (MOU) that covers the principles and process of achieving what the Communique calls economic convergence in SADC, the establishment of a regional surveillance mechanism, and the key economic indicators to be monitored. The latter are inflation, the budget deficit, debt and the external account. It stands to reason that the two agencies responsible for macroeconomic stability, namely the central banks and the national Departments of Finance, should not proceed separately in advising the Heads of State on approaches to macroeconomic policy. Liaison in this regarded should proceed without raising questions on the independence of the respective agencies. In the European Union, for example, the close co-operation in designing macroeconomic strategies never brought into question the independence of the central bank from political structures. In fact, cooperation in planning current and future EU macroeconomic policy was premised on instilling in the European Central Bank an independence similar to that enjoined by the German central bank, the Bundesbank.

3. SADC AND THE CONVERGENCE ISSUE

All three concepts of convergence are relevant for SADC. The TOR requires this report to focus on macroeconomic convergence (convergence in macroeconomic stability indicators). However, SADC is a RIA of developing countries and one characterised by substantial regional inequality, which means that economic convergence (catch-up growth), lies at the heart of the arrangement. Two dimensions can be identified in this respect.

- First, economic convergence should be achieved around a higher level of economic growth. This means that SADC as a whole is seeking faster growth so that it can in the long run catch up economically with the industrialised economies. Faster economic growth forms part of the dynamic consequences of regional integration and is seen as a means to facilitate the faster growth of member states.

- The second dimension concerns the inequality that exists in SADC, with countries like Botswana, Mauritius and South Africa far ahead of the rest in per capita income. South Africa, furthermore, dominates the region in terms of economic size and economic diversification. This regional inequality will require SADC to converge on the regional average in per capita income.

The two dimensions of economic convergence are important: member states share a vision that SADC will allow them to achieve higher growth with a fair distribution of the benefits of integration. All other goals will be judged as intermediate in expediting faster growth. Simultaneously, policies will have to be in place to ensure a reasonable degree of equity in the regional distribution of the growth. If left to market forces primarily, the theory and experience of economic agglomeration suggest that the outcome is unlikely to be equitable, with South Africa benefiting more than the smaller and lesser developed SADC member states.

Economic convergence, however, does not directly fall within the realm of central bank operations and policies. Monetary and financial policy, the domain of central banks, has an important indirect role to play in facilitating the engine of regional growth, namely specialisation in production, trade and capacity-creating investment. Traditionally, a central bank administers and guides the payments mechanism and through its conventional policy instruments, derived from its function of acting as banker of the banks and government, have an important impact on the money supply, the interest rate and the exchange rate. These target variables are important instruments of monetary policy and instrumental in achieving macroeconomic stability.

But in many instances central banks also find that they have a role to play in developing the financial system, that is, the institutions that act as intermediaries between surplus and deficit spending units in the economy. This applies in particular in developing countries with underdeveloped financial systems and weak institutional capacity. It is widely accepted that an efficient financial and payments system encourages faster growth. Circumstances in SADC differ substantially with respect to financial development and does so in line with general levels of economic development. On the one extreme there is South Africa and its developed financial system and on the other extreme several economies where the financial system lacks capacity and sophistication.

Central bank operations and policies take pole position when it comes to ensuring macroeconomic stability. Hence, to the extent that convergence in stability indicators is important for the success of a RIA, the central banks of the region have an important role to play. But regional integration is a dynamic process that proceeds in degrees of integration and it does not necessarily follow that MEC as such is important at all stages of integration. This much becomes clear if the conditions for monetary integration are compared with the requirements of a free trade area.

At this point it is worth repeating that clarity on the convergence concepts is important for the logical consideration of appropriate policy. In the discourse among those responsible for policy-making in Africa, "convergence" in the sense of economic convergence or catch-up growth came to be accepted in policy deliberations. Conscious of the regional dimension to growth in Africa and the experience in Europe, convergence subsequently was confused with macroeconomic convergence, macroeconomic policy convergence, regional integration and common currency areas.[3]

4. CHALLENGES FACING SADC AND THE RELEVANCE OF THE EXPERIENCE OF OTHER RIAs

The SADC Trade Protocol, which excludes the D.R. of Congo and the Seychelles, has been ratified and came into force in September 2000. The negotiations have been protracted and difficult, as would be expected from a RIA with all the crosscutting influences that stem from its heterogeneous nature of its membership. While it should be appreciated that SADC as an institution has political substance that is of strategic importance in the governance of the region, sight should not be lost of the fact that it is foremost an economic institution which since 1992 has market integration as its principal aim.

Hence, whether history will judge SADC a success as RIA will depend on its ability to succeed as a free trade area (FTA). The linear model of integration describes integration in terms of successively deeper levels. It starts with a free trade area and then a customs union with its free trade behind a common external tariff. This is followed by a common market that adds the free flow of factors of production to a customs union and finally an economic union, which

[3] In the communique (2001) issued after the recent meeting of the SADC Finance Ministers the Memorandum of Understanding agreed on at the meeting is said to "cover the principles and process of achieving economic convergence in SADC" when the issue addressed in the MOU is macroeconomic convergence.

adds fiscal and monetary integration to a common market. It must be emphasised that the model is descriptive and it is quite possible that deviations from the step-wise model would appear in the real world of integration. But integration is an economically and politically difficult process and it is difficult to envisage a group of national states that have no significant preferential trading arrangements starting out as a common market, an economic union or even a fully-fledged customs union. In recent years the experience of, for example, MERCOSUR in Latin America, CARICOM in the Caribbean and currently the re-instated East African Community, has shown that the common external tariff of a customs union can be put in place fairly quickly but it then still takes years for intra-regional free trade to be phased in.

Integration is best proceeded with in a phased and committed way. This lesson can also be learned from the experience of the European Union, as will be emphasised at the end of this section. At each level of integration, national governments sacrifice some sovereignty and policy autonomy and it takes time to devise the appropriate policy, control and supra-national governing mechanisms to integrate the markets of often diverse economies and implement common policies. Proceeding to deeper integration with stealth and incrementally seems to be the only option available.

If the proposition of *incrementalism* and *gradualism* is accepted, it follows that the eventual success of SADC as an integration arrangement will depend on the success it makes of the FTA. In the context of this study the issue to address then is the contribution of a programme of MEC as such to the success of the FTA. It must be noted that acceptance of the proposition rules out the adoption of MEC at this stage as a step in the direction of monetary integration. Furthermore, ruling out MEC *as such* as important in the evolving integration of SADC does not mean that macroeconomic stability is regarded as unimportant; in fact, it will be argued below that stability is crucial, but that this may not require a programme of MEC.

Success as a FTA will depend on SADC meeting certain conditions for success.

- The potential for economic *gains from market exchange* must exist in the region. The size of the market, as discussed earlier, is an important condition since this will determine whether there is room for significant economies of scale.

- All participants must *benefit* from integration. The experience of abandoned integration attempts shows that a principal cause of failure is the perception of members that they are gaining nothing, or even that the benefits of integration are distributed unequally. In Africa, the earlier East African Community was regarded as a RIA with great potential to succeed. However, the perception that only Kenya was benefiting from the integrated market was an important cause of the collapse in 1971. Like-wise, the strains that have existed in the Southern African Customs Union (SACU) can be related to strong views on the unequal distribution of the benefits of the customs union.

- A strong *political commitment* to the integration goal and the institutions required to make it work is required. The wide gap between supporting rhetoric and the reality of poor progress in Africa can be ascribed to a lack of real political commitment. Agreements are concluded and RIAs established with enthusiasm but this is not followed by member governments committing themselves to implementation. The benefits derived can strengthen political commitment, especially where this can be seen as an integration payoff to political leaders. However, on a continent characterised by hub-and-spoke trade patterns[4], low levels of regional complementarities and hence low levels of intra-regional trade, the perceived benefits of integration are not substantial and thus not conducive to a strong political commitment. On the issue of

[4] The hub-and-spoke trade pattern is a colonial legacy of most trade taking place with an industrialised country or a few of them, notably exports of primary products and imports of manufactured goods, and little between neighbours.

commitment to create and abide by the rules of integration the point has been well made that "..even willing political leaders may be unable to supply regional institutions because of collective action problems. One such problem, co-ordination, is particularly salient in integration. This leads to a key supply condition: the presence of a benevolent leading country within the region seeking integration. Such a country serves as a focal point in the coordination of rules, regulations, and policies; it may also help to ease tensions that arise from the inequitable distribution of gains from integration, for example, through side-payments. Contested institutional leadership or the absence of leadership makes coordination games very difficult to resolve" (Mattli, 1999: 42).

- The fourth condition is that of *incrementalism* or *gradualism* discussed earlier. As noted above, regional integration requires fundamental changes in economic structure and management, which increase in intensity when integration deepens. This calls for patience and a phased strategy of deepening integration. Mindsets and national policy structures need to adapt as integration proceeds, which is not something that occurs in the short run. Successful exercises in integration, like the EU (see Annexure A), have therefore been noted for its incremental development over the long run. In Africa, however, the targets set for progress have tended to be overly optimistic, aiming for common markets within short time horizons.

- An important condition that applies in the case of developing countries is the establishment of a *capacity to produce* tradable goods competitively. In SADC, intra-regional trade is noted for a trade balance that is strongly in favour of South Africa. This balance, in a ratio of about 6:1 in favour of South Africa, reflects the structures of the economies of SADC countries, with the South African economy the only one sufficiently diversified to produce a wide rage of manufactures for export to other countries in the region. In fact, a feature of South African foreign trade since 1994 has been the fast growth in manufactured exports, especially to non-SACU SADC countries. The one-way flow of trade can partly be blamed on South African trade barriers, which will be removed in a FTA, but the most important constraint, which will not be removed by the Trade Protocol as such, is the absence of a capacity to manufacture goods that can find a ready market in South Africa.

Testing SADC on the basis of these conditions and the likelihood that they will be met is a difficult task. The implicit question is why would SADC be successful where so many other African RIAs have failed?

On the question of market size the presence of South Africa, the continent's largest market, means that the first condition can be met. Access to the South African market is the main benefit that the smaller members of SADC derive from the RIA and this access lies at the heart of much of the difficult negotiations with respect to sensitive industries like textiles and clothing that falls outside the asymmetrical free trade agreement. On the issue of political commitment there is the view that "there is no doubt of deep political solidarity within SADC", but that "real political integration in the form of supra-national institutions has still escaped the Organisation" (Maphanyane, 2000: 3). Part of the explanation can be that the political solidarity is not really as deep as imagined, as is illustrated in the case of SADC intervention in the D.R. of the Congo

When it comes to building a regional capacity to produce tradables, South Africa provides hope for progress. There is a strong and fairly pervasive perception in the region that South Africa has benefited more from the post-apartheid opening up of markets in the region, often as the outcome of SAP-initiated programmes of unilateral trade liberalisation. South African exports to the region have grown fast and out of proportion to her imports. While South African trade barriers offer part of the explanation, cognisance has to be taken of the fact that regional integration and growth in two-way trade is being hampered by a lack of capacity to produce tradable goods that can find a ready market in South Africa and elsewhere. If the non-SACU members of SADC are to gain from intra-SADC trade they will have to attract new manufacturing investment that will be competitive in a free trade area with the South African (SACU) market as its largest component. This will require an environment that is attractive to domestic and foreign investors, both with respect to, amongst others, macroeconomic stability and a supply of infrastructural services necessary to attract international footloose investment.

If recent experience is anything to go by South African business is likely to be the most prominent source of new investment in the region. It is in this regard, viewed from the supply-side, that efforts to increase South African investment in the region are important. The more liberal allowances for firms wishing to invest in the region and the extension of the scope of the investment activities of the Southern African Development Bank and the Industrial Development Corporation to include infrastructural development and the building of business capacity in the region, are examples of these efforts. These, as well as access to the South African market, may give substance and support to SADC serving as a convergence club "in which relatively backward member countries are able to take advantage of technological improvements in the leading member and therefore 'catch up'" (Jenkins and Thomas, 1997: iv).

On the issue of the incremental approach and the lessons that can be learned from other RIAs, special attention may be given to the European Union (EU). The EU is undoubtedly the most successful example in modern history of economic integration and it is therefore not surprising that it is often treated as a role model to be followed, in fact some kind of road map on regional integration. The main developments in the evolution of the EU are summarised in Annexe A. Two characteristics of the development from a customs union to a partial economic union (monetary union in a common market) stand out. The first is that the development path adopted was one of gradualism in a logical step-wise way. The second feature is that the principle of variable geometry came to be accepted, with member states who met the convergence criteria having the choice to opt out of joining the European Monetary Union.

The EU represents an arrangement of diversified industrial economies that are linked together through a high degree of intra-regional trade. It took more than 40 years to develop to a point of monetary union. A closer study of the history of the EU will reveal that the road of development has not been smooth and easy. Analysing the experience of the EU will also make it clear that the primary concern of the post-war years was the economic build-up of devastated European economies and that Marshall aid and the common market were expected to play an important role in this regard. A number of crises occurred and in the end it took strong political commitment to maintain the process of integration. All things considered, the structure of SADC economies would suggest that no option exist but to be even more gradualist while the structures of the constituent economies change and a strong sense of political commitment to the goal of progressive integration develop.

5. MACROECONOMIC CONVERGENCE IN SUPPORT OF REGIONAL INTEGRATION

A programme of macroeconomic convergence requires a clear perception of the appropriate target variables. As noted in Annexe A, the EU adopted five convergence variables: inflation, interest rates, budget deficits, national debt and exchange rates. The first two were set in bands of deviations from specified averages of the three member states with the lowest inflation rates. The budget deficit criterion was set at a maximum of not more than 3 per cent, national debt as a maximum of 60 per cent of GDP at market prices, and the exchange rates as having been within the normal Exchange Rate Mechanism bands for at least two years with no re-alignments or excessive intervention.

The SADC Committee of Ministers of Finance and Investment, as noted earlier, have identified inflation, the budget deficit, public debt and the external account as the key indicators to be monitored. However, at a workshop prior to the meeting of the Ministers of Finance and Investment that prepared a report to the Committee it was strongly recommended that inflation should be targeted "as the anchor of stability and credibility in the region" (SADC Macroeconomic Convergence Workshop, 2001). The overriding conclusion at the workshop was that the number of variables targeted should not be too many.

In the first study prepared for the CCBG (McCarthy& Du Plessis, 2001) the following indicators were monitored: external debt to GDP ratio, the budget deficit as a percentage of GDP, growth in the broad money supply (M2), CPI inflation rates, interest rate spreads, and current account deficits. The overall impression gained was one of divergence during the 1990s and not convergence. The question is whether macroeconomic convergence will contribute to the process of integration.

Macroeconomic convergence is necessary if monetary integration is the goal but monetary integration lies far down the road of regional integration. Some observers might point to the significant degree of monetary integration that exists within SACU through the Common Monetary Agreement (CMA) to which South Africa, Lesotho, Namibia and Swaziland are signatories and also to the CFA zone in Francophone Africa. These examples could be presented as indicative of the fact that it is not necessary to proceed to monetary integration through successive stages of deeper integration. An argument like this will miss an important point. SACU/CMA and the CFA zone, the latter with a strong agency of restraint exercised by the French government, have a history deeply imbedded in the colonial experience of the member states.[5] Although they are examples of

[5] It could be argued that a colonial relationship is the ultimate form of forced integration in favour of the imperial power.

successful integration in Africa, they cannot be replicated by a group of neighbouring countries that start a process of regional integration *de novo*.[6]

The success of SADC will be measured by growth in intra-regional trade. Trade tends to flourish in a stable economic environment. It therefore follows that sound macroeconomic policies can have a positive impact on trade flows. But of more importance is that economic stability and credible macroeconomic policies are generally accepted to be a necessary condition for capacity-creating investment. The proliferation and growth of productive capacity in SADC will be necessary if all member states are to benefit from intra-regional free trade. It has been emphasised that for the non-SACU members of SADC, the biggest challenge will be to develop capacity to produce for the South African market to which unconstrained access will exist once the free trade area is fully operational. Foreign direct investment, notably by South African firms, will have to supplement domestic investment in the building of this capacity. A stable macroeconomic environment, it is often stressed, is an important requirement for this investment without which South Africa's SADC partners will gain little benefit from the free trade area.

These causal links establish a case for sound macroeconomic policies, but does the soundness of the policies depend on the ability to bring about convergence in stability indicators? For SADC the question is whether a free trade area needs a programme of MEC? Charles Harvey (2000: 9) has answered this question when he argued that "countries in a free trade area can have different inflation rates, changing nominal exchange rates, and different levels of budget deficit", provided that member countries allow their currencies to depreciate if they have higher inflation rates than the others. If the nominal exchange rate is not adjusted to maintain a competitive real exchange rate, the current account situation of the

[6] Neither would it be valid to refer to experiences like that of Argentina who linked its currency, the peso, at par to the US dollar. This is not an example of monetary integration that sacrifices national autonomy in monetary affairs to a supra-national body, as is found in the EMU. In the case of the CMA the

member state with the overvalued exchange rate will not be sustainable. Macroeconomic convergence is not a prerequisite for the efficient operation of a free trade area.

A convergence programme in a RIA is not necessarily good policy. It can even be argued that the need for macroeconomic stability does not require an absolute stance on policy harmonisation (convergence of macroeconomic policy). Policies must be designed to address national development needs and since circumstances may differ policies may at times have to diverge, which means that MEC could under certain circumstances not be best policy. For example, the loss of customs duties as an important source of recurrent revenue because of intra-regional free trade may force some governments either to accept a larger and diverging deficit, especially if greater demands are made on the exchequer to finance the education and training required for capacity building.

But the most pronounced case where strict adherence to convergence targets would be bad policy occurs in the event of asymmetric external shocks in the region. This may require a fair degree of flexibility in policy implementation. SADC is characterised by disparate changes in the terms of trade of member states, as shown in Table 1, and external shocks need to be accommodated by flexible policy. Comparing the sharp deterioration in the terms of trade of Angola and Mozambique with the relative stability of countries like South Africa and Zimbabwe illustrate the disparate regimes of external shocks that has to be managed with stabilisation policies. These shocks can in the long run best be dealt with through the diversification of economic activity and external trade but in the short run macroeconomic policy has to meet the challenges posed by the radical changes in national income. To expect convergence in exchange rates and interest rates under these circumstances is unrealistic, not good policy and

monetary policies of Lesotho, Namibia and Swaziland are also largely subservient to the monetary authorities of South Africa.

will in fact not be in the interest of macroeconomic stability. Locked into a convergence strategy will not be a wise option.

Another instance that can be noted as one that does not call for strict MEC is with respect to a favourite target indicator, namely the budget deficit. Fiscal discipline is a virtue under all circumstances, but even in the EU it has now transpired that the stability and growth pact with its near-automatic penalties against countries that have excessive budget deficits is difficult to maintain. Firstly, arguments are raised for a more enlightened approach to expenditure, which distinguishes between investment and consumption expenditure.[7] In SADC where the need for investment in infrastructure and human capital varies significantly this distinction is important. Secondly, the pro-cyclical nature to stick to deficit targets have become obvious.

Table 1: Terms of trade of SADC economies, Index 1995=100

	1990	**1998**
Angola	144.5	70.0
Botswana	110.4	91.4
Congo, DR	108.3	81.9
Lesotho	84.1	100.8
Malawi	115.5	108.9
Mauritius	108.2	101.1
Mozambique	161.1	104.2
Namibia	134.5	106.5
Seychelles	71.5	106.9
South Africa	98.6	100.2
Swaziland	116.1	82.2
Tanzania	104.9	91.1
Zambia	131.1	83.8
Zimbabwe	100.0	104.7

Source: World Bank, *African Development Indicators 2000*, Washington D.C.

Thus far emphasis has been placed on the need for macroeconomic stability and on the fact that it does not call for a strategy of MEC. What would appropriate central bank behaviour be?

[7] In Europe, the need to maintain fiscal discipline and adherence to strict budget deficit targets on the one hand, and the need to allow the less prosperous members to address their development on the other hand, has prompted the establishment of the Cohesion Fund. The Fund allows the lesser developed member states to maintain expenditure directed towards reducing their backwardness while simultaneously

Central banks have one primary and specific objective within the broader aim of maintaining financial stability and that is to to protect the value - the purchasing power - of the currency. Guarding against inflation is a principal task of the central bank. Inflation is the most basic and visible indicator of a lack of balance between the demand and supply of resources in the economy. High and rising inflation demonstrates an imbalance in resource utilisation in the economy and serves as a prime indicator of macroeconomic instability.

SADC's experience with inflation has been divergent, especially during the 1990s Table 2 and graph 1, showing the country specific and average inflation experience for SADC confirm this. While the average inflation experience[8] was similar during the eighties and nineties, the dispersion around the average experience was far greater during the nineties.

By implication, the SADC countries have failed to converge with respect to inflation criteria.

Table 2

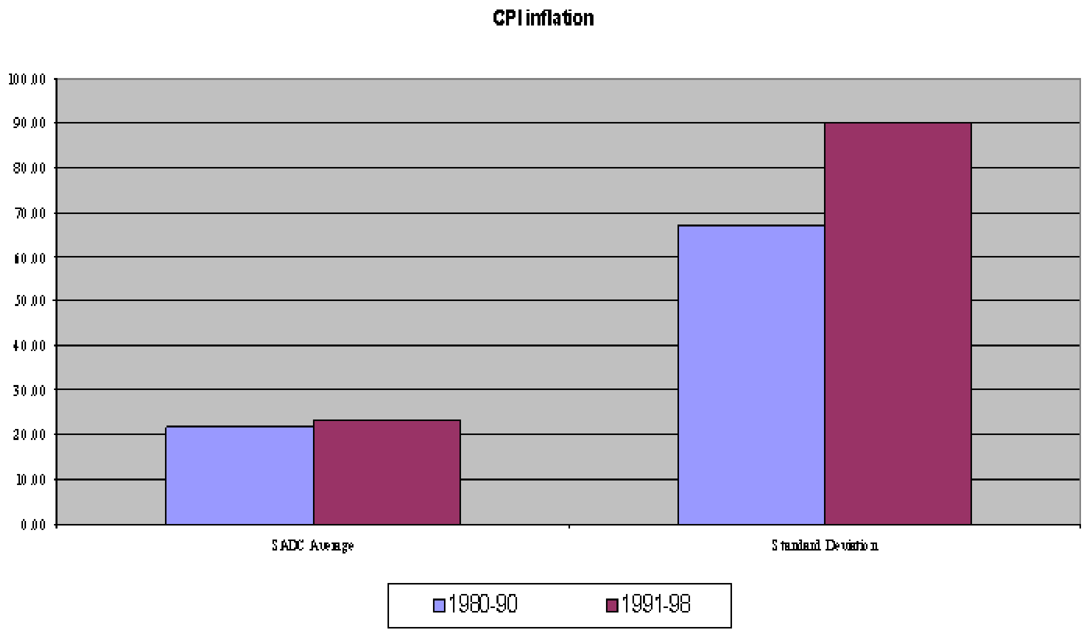
	Consumer price inflation (% per annum)											
Period	AGO	BWA	LSO	MRT	MWI	MOZ	NAM	ZAF	SWZ	TAN	ZAM	ZIM
1980-90		10.9	13.6	11.4	16.3	52.3	17.5	14.6	13.9	30.7	46.2	13.2
1991-98	1031.5	11.1	11.5	6.9	29.6	36.4	10.1	9.8	11.9	23.4	79.2	25.6

Source: African Development Bank, 1999

tightening their fiscal policy. The SADC situation would require a similar dispensation if convergence at low levels of the budget deficit is adopted as regional policy.

[8] Angola has been omitted due to the distortionary effect which the inclusion of Angola's average inflation rate for the nineties (1031%) would have on the SADC average.

Graph 1



Source: African Development Bank, 1999

SADC members can be divided in two clear groups with regard to inflation rates (Jenkins, 2001). During 1990-1998 the inflation rate in seven member states (Angola, DR Congo, Malawi, Mozambique, Tanzania, Zambia and Zimbabwe) was in excess of about 25 per cent, reaching the echelons of hyperinflation in two countries (Angola and DRCongo). The other seven SADC members (Botswana, Lesotho, Mauritius, Namibia, Seychelles, South Africa and Swaziland) have been relatively stable with inflation rates ranging from about 12 per cent to less than 2 per cent.

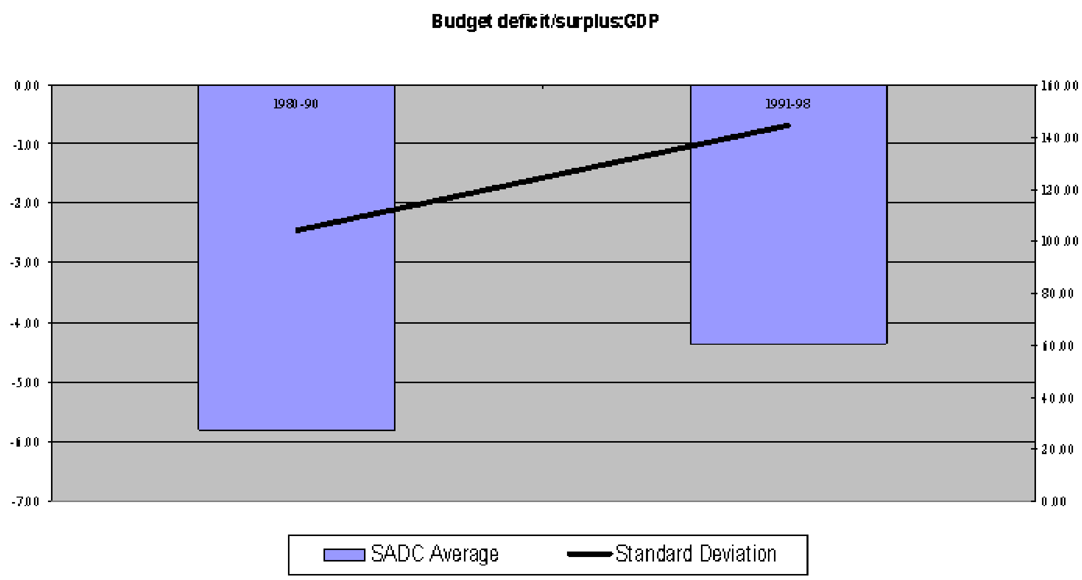
The central bank, as noted earlier, has the primary responsibility to protect the value of the currency, which translates into a monetary policy that seeks to achieve the fullest utilisation of resources that is consistent with an acceptable rate of inflation (EAGER, 2001). In addition to having to deal with problems arising from external shocks and balance of payments deficits, the central bank is often expected to finance government deficits, itself at times the outcome of external shocks. In this way budget deficits are converted into increases in the general price level. This is the most common explanation of inflation in SADC countries (Harvey, 2000). As shown in table 3 and graph 2, divergence in budget deficits is a feature of recent SADC experience. Should the central bank act out its independence and maintain its control over the rate of inflation it will be forced to crowd out private investors through high interest rates.

Table 3

	Budget deficit(-)/surplus(+) as a percentage of GDP											
Period	AGO	BWA	LSO	MRT	MWI	MOZ	NAM	ZAF	SWZ	TAN	ZAM	ZIM
1980-90	-10.7	9	-11.2	-7.1	-6.3	-10.2	-0.6	-3.9	-1.6	-6	-13.2	-7.8
1991-98	-20.2	6.4	2	-7.1	-3.7	-4.5	-4.3	-5.6	-3.2	-1.6	-3.3	-7.3

Source: African Development Bank, 1999

Graph 2



Source: African Development Bank, 1999

For the central bank the real art is to respond timeously to shocks, fiscal imbalances and balance of payments deficits in a way that will contain inflation and prevent expectations of continued inflation. Once inflation expectations have become established in society and imbedded in the thinking and planning of economic agents, macroeconomic stabilisation becomes more difficult. The adoption of inflation targets is a useful instrument to demonstrate the commitment of the central bank not to allow external shocks and spending imbalances to set of inflationary spirals of wage and price increases.

The maintenance of macroeconomic stability through credible anti-inflationary policies does not exhaust the role of the central bank in encouraging the development of a free trade area. Earlier, mention has been made of the need to have a stable financial system that will be efficient in intermediation.In many SADC countries financial markets remain shallow with financial services restricted to a relatively small percentage of the population. It is doubtful whether the typical supply-side actions by governments to improve intermediation will be as helpful as lowering the cost of intermediation and the liberalisation of the financial markets, including closer integration into the global financial markets would be. Liberalisation however does not imply less supervision of the financial system by the central bank. In fact, the opposite is the case. Efficient supervision can be regarded as a condition for market liberalisation to have the desired effect.

There can be little doubt that the central banks of SADC have an important contribution to make to the development of SADC. Throughout this report the argument has been made that macroeconomic stability is decisive for the FTA to succeed since this is required for an environment that favours trade and for investment in production capacity without which equitable intra-regional trade will not grow. However, good macroeconomic policy does not require a strategy of convergence in stability indicators. Where does this leave MEC?

SADC is in the first phase of its market integration and if one looks down the road to the progressive deepening of integration, monetary integration will be an important development. The integration of the money and capital markets will lower the transactions cost of regional trade and will increase the efficiency of capital allocation in SADC. It is widely accepted that monetary integration requires MEC, but SADC is far from ready for this.

In the earlier discussion the negative impact that convergence of the whole series of stability indicators can have, has been emphasised. SADC's first priority is to encourage diversified economic growth through growing intra-regional trade and in this respect interest rate, budget deficit and current account convergence can have a counter-productive effect. However, macroeconomic stability as reflected in low and converging inflation rates can serve a useful purpose. Increasing price stability in the region as a whole will send out a signal of stability and credible policies to potential investors. As progress is made with market integration the range of indicators can be extended to include the ratio of the budget deficit to GDP, the ratio of public sector debt to GDP and the external balances of the economy. The inflation rate (measured as the increase in the consumer price index) is an indicator that better than most signals spending imbalances in the economy. Focusing on it will keep the convergence strategy less complicated to implement and monitor.

6. CONCLUSIONS AND RECOMMENDATIONS

It is an imperative for the future growth of SADC that a success is made of the free trade area, which is a requirement for moving to deeper integration in the region. Success will be measured by growth in intra-regional trade and will require that all countries share in the benefits of this trade. The latter will only be possible if investment in the production capacity of the lesser developed member countries takes place. Investment by South African firms is likely to play an important role in this. Macroeconomic stability is a condition for the necessary investment to take place. However, a programme of macroeconomic convergence is not needed to provide good policy and macroeconomic stability. Macroeconomic convergence, adopted as goal by a group of states in a formal programme, means that these economies will aim to move to similar levels of macroeconomic stability indicators at greater levels of stability. Qualifying or softening convergence programmes, for example, by emphasising wide bands or ranges within which indicators should converge, would miss the point that in a region of highly dissimilar economies that are subject to asymmetrical external shocks, divergence in certain stability indicators may actually be the appropriate outcome.

Convergence is a requisite for monetary integration. SADC, however, is not ready for this step in regional integration. Removing the exchange rate and the rate of interest from each member state's portfolio of policy instruments will restrict their ability to manage external shocks. Does this leave room for a programme of macroeconomic convergence within SADC? Clearly, the story told thus far implies that a fully-fledged MEC programme is not appropriate at this stage of SADC's development but it can be argued that an adapted single-indicator programme will be beneficial.

Macroeconomic stability requires sound and credible fiscal and monetary policies. For central banks, within their broader mandate of ensuring financial stability, a primary responsibility is to protect the value of the currency. The experience of many SADC countries has been that a lack of fiscal discipline has led to demands on the central bank to finance budget deficits with all the inflationary consequences this entail. To a large extent monetary policy, which is the domain of the central bank, starts in the Treasury and if the central bank takes its function of protecting the value of the currency seriously the outcome is higher interest rates and monetary constraint to neutralise the inflationary impact of government spending.

Credibility of policy and the need to prevent inflation from becoming imbedded in the behaviour of economic agents will require SADC central banks to be very clear about their commitment to protecting the value of the currency. Concentration on the inflation rate as a convergence target will focus on the most comprehensive indicator of imbalance in the economy and keep the strategy relatively simple and easier to implement and monitor. The central banks should cooperate within the institutional framework that exists in the CCBG and conclude a pact committing the individual central banks to the goal of price stability and convergence at a predetermined level. This target rate could, like in the case of the EU, be determined by a technical subcommittee of the CCBG as the average rate of the three economies with the lowest inflation rates, or as a fixed numerical value. In this respect consideration should be given to the fact that Lesotho, Namibia and Swaziland are to a significant extent linked to South Africa through the Common Monetary Agreement. It should furthermore be made clear in the pact that the policies adopted by the member states will aim to achieve convergence in inflation rates through conventional market-oriented measures. The sustainability of price stability and inflation convergence and the credibility of policy will be in serious doubt if convergence is achieved through extensive price controls.

The negotiated pact will then serve as the agency of restraint. The technical subcommittee will have to determine an appropriate and feasible inflation target and, in collaboration with each member state, appropriate time scales for achieving it. As far as the latter is concerned a surveillance mechanism is required to monitor progress. The technical subcommittee of the CCBG should monitor the progress of member countries in meeting the inflation targets and report progress annually to the CCBG, who will in turn report to the Heads of State. At this stage moral suasion is likely to be the only workable means available to deal with countries that regularly miss the targets.

But adopting a single-indicator convergence programme with the focus on inflation will highlight the need for good fiscal policy. As noted earlier, monetary policy often begins in the Treasury. Central banks that are forced to finance growing budget deficits may have to implement neutralising monetary policies that will drive interest rates up, crowding out private investment at the cost of real economic convergence. In economies with poorly developed financial markets, central banks may also find themselves without the means to implement the required anti-inflationary measures. Therefore, while convergence in budget deficits may not be appropriate, the need for responsible fiscal policy is fundamental to convergence at low rates of inflation.

But central banks also have a responsibility to develop and supervise the financial system. This could be important in encouraging economic convergence. It can be envisaged that the liberalisation of national financial markets will lower the costs of intermediation and broaden the scope of the reach of financial institutions. The extension of regional integration beyond trade in goods to trade in financial services could make a valuable contribution to the development of the payments mechanism and intermediation in the region.

In the world of economic policy an overarching principle is that the success of policies is determined by their credibility. Given the diverse nature of the member states' economies, a programme of macroeconomic convergence that covers all the conventional stability indicators will not be perceived as credible at this stage of SADC's development. The less ambitious aim of focusing on inflation will be more credible and supportive of the process of deepening integration.

ANNEXURE A

Development of the European Union

1952: Belgium, France, Italy, Luxembourg, Netherlands and Federal Republic of Germany (West Germany) forms the European Coal and Steel Community, which removed all restrictions on trade in coal, steel and iron between the six countries.

1957: Treaty of Rome signed, which formed the European Economic Community (EEC). The EEC came into operation on 1 January 1958 with a common external tariff set at the average of the 1957 tariffs of the six members. The Treaty committed the signatories to the harmonisation of domestic policies and lift restrictions on the movement of capital and labour. The intention was the establishment of a common market.

1968: Completion of a customs union, two years ahead of schedule, with a common external tariff in place since 1957 and with free trade in industrial goods in the EEC. The Common Agricultural Policy (CAP) which established a common price for agricultural goods was adopted in 1968.

1973: Start of the expansion of membership with the admission of the United Kingdom, Denmark and Ireland. Greece joined in 1981, Spain and Portugal in 1986 and Sweden, Austria and Finland in 1995, bringing membership to the current 15.

1979: The *European Monetary System* (EMS) came into existence with as aim the creation of currency stability, monetary co-operation and the convergence of the economic policies of the member states. The EMS had *exchange rate mechanism* (ERM) that involved participants pegging their exchange rate to each other within bands and jointly floating with the rest of the world. It was possible to join the EMS while staying outside the ERM.

1987: Adoption of the Single European Act that aimed to remove barriers to internal trade. The Act set a date of 31 December 1992 by which its proposals on the removal of barriers should be in place. The Act accepted the principle of *mutual recognition*, whereby if a firm or individual is permitted to do something under the rules and regulations of one member country, it must also be permitted to do it in all the other member states.

1993: The leaders of the 12 European Community member countries convened in Maastricht in December 1991 to negotiate a Treaty on European Union. The Treaty was signed in February 1992 and came into operation on 1 January 1993 On this date all the remaining restrictions on the free flow of goods, services and resources were removed. Among other things, it set down a programme for economic and monetary union. The programme was to consist of three stages. The UK and Denmark negotiated an 'opt-out' from the Maastricht Treaty that allowed them, should they so decide, not to proceed to stage 3.

- *Stage 1* was the preliminary stage during which monetary policy would be monitored by a Monetary Committee, with advice given to the Council of Ministers on monetary convergence. Preparations were also to be made for the establishment of a European Monetary Institute (EMI) as forerunner of a European central bank.

- *Stage 2* would commence on 1 January 1994 at which date the EMI would be established. It would be responsible for the co-ordination of monetary policy and encourage greater cooperation between EU central banks. It would prepare the ground for the establishment of a European central bank. State were to seek convergence on five variables: inflation, interest rates, budget deficits, national debt and exchange rates.

- *Stage 3* would commence on 1 January 1999 with countries that met the five criteria fixing their currencies permanently to the new single currency, the euro. A European System of Central Banks (ESCB) would be created, consisting of the European Central Bank (ECB), independent from governments and EU political institutions, and the central banks of the member states. The euro would physically start circulation on 1 January 2002.

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