EXECUTIVE SUMMARY

Introduction

1. This policy brief is the culmination of a study on macroeconomic convergence that a Subcommittee of the SADC Committee of Central Bank Governors (CCBG) has been engaged in over a period of six months. The CCBG appointed Professor Colin McCarthy to act as a researcher for the Committee. Two in-depth reports have been prepared and submitted to the CCBG. In the first report special attention was given to the concepts of convergence, the experience with convergence in macroeconomic stability indicators, that is, macroeconomic convergence, and the process of regional integration in SADC. On the latter point note was taken of the fact that SADC is now in the process of implementing a free trade agreement, which can be regarded as the first steps towards deeper integration, and that central bank policies should be supportive of this development. The second report paid attention to specific policy considerations, notably the relative merit or appropriateness of a SADC programme of macroeconomic convergence and the role of the central banks in this regard.

Economic convergence

2. Economic convergence lies at the heart of SADC and its rationale as a development regional integration arrangement. It refers to the phenomenon of catch-up growth, that is, less developed economies catching up with rich(er) countries in terms of development indicators like per capita income. SADC is a regional integration arrangement (RIA) of developing countries that would like to experience, through the dynamics of regional integration, growth and development that will allow them to catch up with the developed world. But in SADC there is
another dimension to economic convergence. The members of SADC face large discrepancies in economic welfare and development among themselves. Consequently convergence at the higher end of income and development within SADC is an important regional goal, as is a fair distribution of the benefits of integration.

3. The two dimensions of economic convergence are both important. All other economic goals will be judged as instrumental and 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 primarily to market forces, the theory and experience of economic agglomeration suggests that the outcome is unlikely to be equitable, with South Africa benefiting more than the smaller and lesser-developed SADC member states.

4. 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 concerted co-operation in this regard among SADC central banks has achieved significant results and will increasingly make an important contribution through the facilitation of intra-regional trade. The conventional policy instruments of a central bank, derived from its function of banker to 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. The importance of macroeconomic stability will be addressed below.
5. But in many instances central banks 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 highly developed financial system and on the other extreme several economies where the financial system lacks capacity and sophistication.

Macroeconomic convergence

6. Macroeconomic convergence (MEC) refers to convergence in macroeconomic stability indicators. These can be wide-ranging but would typically include inflation rates, budget deficit ratios, public debt ratios, external balances (often the current account), exchange rates and interest rates. MEC has caught attention with the much publicised convergence criteria adopted in the European Union (EU) as condition for admission to the European Monetary Union (EMU). The latter required a specified degree of convergence in five areas: inflation, interest rates, budget deficits, national debt and exchange rates.

7. The EU experience illustrates the role of MEC as a prerequisite for monetary integration. Monetary union and its single currency presumes a common monetary policy with a common interest rate and exchange rate, which in turn requires similar levels of the budget deficit and national debt ratios, and inflation rates that are not divergent. SADC has adopted as its more immediate aim the establishment of a free trade area. While monetary integration may be regarded as a long run
objective at the end of a gradual or incremental process of deepening integration, the current structures of SADC’s constituent economies do not allow monetary integration to be a viable goal in the foreseeable future. SADC countries are exposed to asymmetric external shocks, as is reflected in the different movements of the terms of trade of the various countries. Therefore, it is not feasible or appropriate to expect these economies to sacrifice the exchange rate and interest rate as policy variables and to pursue similar budget deficit and national debt ratios. In fact, external shocks and the differences in economic structures and the challenges the countries face, may require some divergence in these indicators in the process of adjustment.

8. 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 evidence 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. Although they are examples of successful integration in Africa, they cannot be replicated by a group of neighbouring countries that start a process of regional integration de novo.

9. While MEC in pursuit of monetary integration is not a viable proposition for SADC, the question does arise whether MEC is not necessary to ensure macroeconomic stability, which is a prerequisite for the success of SADC. Such 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. For the lesser-developed members of SADC, the 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.

10. But a formal programme of convergence of macroeconomic stability indicators is not likely to be best policy to ensure a stable macroeconomic environment. 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. Again, cognisance has to be taken of the disparate nature of the economies of SADC countries and the phenomenon of asymmetric external shocks. Under these conditions it is inappropriate to expect economies to converge with respect to indicators like the exchange rate, interest rate, external balances and even the budget deficit. Take as example a country that depends on the exportation of primary commodities. In the event of a sharp fall in the price of these commodities, with a substantial deterioration of its terms of trade, the exchange rate must fall to effect the required adjustment. Given the slide in national income it will also be unreasonable to expect the budget deficit not to increase temporarily.
Inflation convergence

11. Macroeconomic stability requires sound and credible fiscal and monetary policies. Central banks, within their broader mandate of ensuring financial stability, have 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. 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.

12. 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 internal 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. It will also keep the strategy relatively simple and easier to implement and monitor. The central banks should co-operate within the institutional framework that exists in the CCBG and conclude an agreement that commits the individual banks to the goal of price stability and inflation convergence at a predetermined level. This target rate, to be determined by a technical subcommittee of the CCBG, could, like in the case of the ECB, be determined as the average rate of the three economies with the lowest inflation rates, or as a fixed numerical value. In determining the target rate and in the monitoring of progress a number of factors need to be considered.
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 agreement 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 systems of price control.

It is important to bear in mind that the target rates should be dealt with in a flexible manner. The impact of external shocks in small economies requires this.

Finally, the use of the concept “target” rate for the purposes of inflation convergence must not be interpreted to imply the acceptance of policies of formal inflation targeting in economies as is conventionally understood; it does not necessarily imply the adoption of an inflation targeting monetary policy framework.

13. The negotiated agreement will 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 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 exert pressure on countries that miss the targets.
14. Adoption of a single-indicator convergence programme with its 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. This will crowd 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.

15. 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 the Committee believes that 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.