

# Addressing the Challenges of Macro-economic Policy Convergence in the SADC Region



Economic Commission for Africa  
Subregional Office for Southern Africa







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# Abbreviations and Acronyms

ADF	Augmented Dickey Fuller
AU	African Union
CCBG	Committee of Central Bank Governors
CMA	Common Monetary Area
COMESA	Common Market for East and Southern Africa
CPI	Consumer price index
DRC	Democratic Republic of the Congo
EAC	East African Community
ECA	Economic Commission for Africa
ECOWAS	Economic Community of West African States
EMCP	ECOWAS Monetary Cooperation Programme
EMU	European Monetary Union
EU	European Union
FIP	Finance and Investment Protocol
FTA	Free trade area
GDP	Gross domestic product
HIPC	Heavily-Indebted Poor Countries
ICM	Integrated Committee of Ministers
ICT	Information and communications technology
IMF	International Monetary Fund
MCSM	Macro-economic Convergence Surveillance Mechanism
MDRI	Multilateral Debt Relief Initiatives
MEC	macro-economic convergence
MPSU	Macro-economic Performance and Surveillance Unit
MoU	Memorandum of Understanding
MPC	Monetary Policy Committee
MTEF	Medium-Term Expenditure Framework
NPS	National Payments System
NRU	Natural rate of unemployment
OCA	Optimum currency area
OLS	Ordinary least squares
PRP	Peer Review Panel
REC	Regional economic community
RISDP	Regional Indicative Strategic Development Plan



SACU	Southern Africa Customs Union
SADC	Southern Africa Development Community
SDR	Special drawing rights
SPI	Strategic Partner Institutions
SRO-SA	Subregional Office for Southern Africa
UEMOA	L'Union Economique et MonétaireOuestAfricaine (Economic and Monetary Union of West Africa)
TOR	Terms of reference
TWGEFS	Technical Working Group on Economic and Financial Surveillance
WAMZ	West African Monetary Zone
WEMI	West African Monetary Institute



# Chapter I: Introduction

## Background and justification

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Macro-economic convergence is critical for Southern Africa Development Community (SADC) countries to achieve a level of harmonization required for the establishment of a single currency under the proposed monetary union by 2018. According to the SADC Memorandum of Understanding (MoU) on Macro-economic Convergence, signed by the SADC ministers responsible for finance and investment in August 2002, the underlying principle is to achieve and maintain macro-economic stability by converging on “stability-orientated economic policies implemented through a sound institutional structure and framework”. The MoU is annex 2 of the SADC Protocol on Finance and Investment which came into force on 16 April 2010. The key variables for achieving convergence are inflation, fiscal deficit and public debt.

The initial criteria set for 2008 required all countries to attain single digit inflation, a budget deficit that does not exceed 5 per cent of gross domestic product (GDP), government debt of less than 60 per cent of GDP, foreign reserves of at least 3 months of import cover, central bank credit to government of less than 10 per cent of the previous year’s tax income and a GDP growth rate of at least 7 per cent. The convergence criteria for 2012 requires countries to have consumer price index inflation rates of no more than 5 per cent, budget deficits of at most 3 per cent of GDP, foreign reserves of at least 6 months of import cover and central bank credit to government of less than 5 per cent of the previous year’s tax income, while the rest of targets are as for 2008. By 2018, all 2012 targets are maintained except for CPI inflation, which is set at no more than 3 per cent (SADC, 2003).

SADC member States were anticipating a number of benefits when the core numerical targets for macro-economic convergence were initially approved. A harmonized macro-economic policy framework with specific targets increases policy credibility and reduces economic fluctuations. When convergence targets are binding as is the case in a monetary union, members benefit from fiscal restraints inherent in the agreement on macro-economic targets. Central banks become more independent and focused on price stabilization, providing payment systems and reducing distortions in financial markets by eliminating financing of government budget deficits. There are also cost-reduction benefits from macro-economic convergence, including the removal of exchange rate risks that may cause uncertainty to investors, and increase speculative investments through reversals in capital flows and contagion effects (Maruping, 2005).

Macro-economic convergence leading to a monetary union tends to enhance growth prospects of the subregion through economies of scale of a common monetary system and the, elimination of multiple payment systems with their associated transaction costs. It could also stimulate investment through integration of financial markets and increased trade. Although countries lose autonomy over monetary policy in a monetary union, the scheme has many advantages including, among others, lowering inflation and exchange rate fluctuations in time of economic uncertainty. Member States also benefit from strengthening of financial sectors given the changes needed to ensure that central banks are independent to pursue appropriate monetary policies, and allow financial markets to develop in a manner that provides for effective transmission of central bank policies to the economy (Brada and Kutan, 2001).

When the MoU was signed in 2002, most countries were already within the 2008 targets or making progress towards achieving the targets. However, there are concerns that progress is slow among some member States still facing challenges in meeting 2008 convergence criteria, let alone the 2012 targets. Only three countries (Malawi, Mauritius and United Republic of Tanzania) achieved single digit average annual inflation in 2008. A number of countries (Democratic Republic of the Congo (DRC), Seychelles and Zimbabwe) also failed to meet the central government to debt ratio of less than 60 per cent in 2008. There are projections that most countries will fail to meet inflation and other targets set for 2012.<sup>1</sup> Hence, there is need to strengthen capacity of SADC member States to align themselves with SADC macro-economic targets as adopted in 2002. It is also important for SADC to reconsider implications of failure by member States to comply with the convergence targets. This will require, among other things, assessing the gap in terms of technical capacity, policy actions, institutional frameworks and mechanisms necessary to achieve convergence. If the status quo is not addressed, the SADC drive towards a fully integrated monetary union by 2018 may not materialize.

## **Challenges of macro-economic convergence in SADC**

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The slow progress in achieving convergence shows that there are problems either with the convergence framework or with capacity of member States to comply with agreed targets. At a conceptual level, it is argued that a monetary union is not feasible since countries in SADC face asymmetrical external shocks, implying that convergence is counterproductive (Kontolemis, 2003; McCarthy, 2002).<sup>2</sup> While countries in the Common Monetary Area (CMA), the Rand Zone, provide an a prior cohort of SADC member States that can promote a more flexible monetary system, the smaller economies outside the Rand Zone may not be ready for a seamless transition to a monetary union. It is also argued that the more open and similarly diversified economies will reap higher benefits from a monetary

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1 IMF World Economic Outlook Database for April, 2011

2 Henry, L., Monetary Integration in Beautiful Places: Prospects for the Caribbean. <http://sta.uwi.edu/salises/workshop/csme/paper/lhenry.pdf>

union. However, when countries are less synchronized in terms of their business cycles, capital inflows would vary to such an extent that the costs of implementing a monetary union would not be justifiable (McCarthy, 2002; de Haan et al., 2005).

Simultaneously meeting various macro-economic goals in a developing country is a challenge in itself. Whereas inflation targeting is paramount in the convergence discourse, the flipside is that unemployment and poverty alleviation goals may not be easily achieved without breaking the inflation target barrier. It is therefore impractical for most member States to introduce policy regimes that are not geared towards comprehensive development objectives such as economic growth, job creation and poverty alleviation, which in many cases may not be consistent with inflation targeting or equivalent austerity measures on government expenditure and borrowing.

There are also problems with inflexible convergence criteria. Generally, the drawback of setting fixed convergence targets for economies of different sizes and levels of economic activity is reflected in the mixed progress recorded by countries in the subregion. The convergence criterion for economic growth is particularly controversial since the impact of growth in a small economy cannot be compared on a similar scale with a large economy. Hence, there is need for a general principle that would assist smaller economies to match larger economies in some aspects, but not all. For instance, a requirement that smaller economies must at least match long-run growth rates of larger economies may augur well with new growth theories than requiring all countries to achieve a set of fixed targets.

Furthermore, policymakers face a number of technical challenges in aligning with the macro-economic convergence criteria. According to Article 5(1) of the MoU (Information and Data), **State Parties shall provide such data and reports as are required by the Committee of Ministers for Finance and Investment for the implementation and monitoring of macro-economic convergence.** Article 5(2) further stipulates that **data shall be provided by State Parties in accordance with internationally acceptable data standards as defined by the International Monetary Fund (IMF).** While member States have in most cases provided timely and updated data to enable the SADC Secretariat to monitor progress, major technical deficiencies among member States exist in the areas of collecting, modelling, analysing, forecasting and reporting of macro-economic data.

At the institutional and policy level, a macro-economic subcommittee comprising officials from ministries of finance and central banks monitor progress towards macro-economic convergence. This subcommittee reports to a committee of senior treasury officials, which, in turn, reports to ministers of finance. Annex 2 of the SADC Protocol on Finance and Investment establishes a peer review panel (PRB) comprising ministers of finance and central bank governors to establish a **collective surveillance procedure to monitor macro-economic convergence, determine specific targets, assess progress relative to those targets and provide advice on corrective actions.** Since the Protocol only recently came into force, the Panel is expected to meet in 2011 to roll out its surveillance procedures.

The Committee of Central Bank Governors (CCBG) also has a macro-economic Subcommittee which reports to Governors. The CCBG is mandated by the SADC Council to develop and manage the SADC Macro-economic Database. It is therefore central in the process of developing a harmonized policy framework, common currency and monetary union.

The key issue, however, is whether central banks in the subregion are acting independently to influence and implement macro-economic policy. Attainment of macro-economic convergence in its current form depends on member States having sustainable and prudent management of both fiscal and monetary policies that are inextricably linked to inflation, economic growth and other macro-economic goals. A related question is whether there is coordination between ministries of finance and central banks to ensure delivery of macro-economic convergence targets while maintaining independence of the two institutions. Article 7(2) of the SADC MoU on Macro-economic Convergence obliges member States to prepare their convergence programmes annually. According to Article 7(3) *“The Committee of Ministers for Finance and Investment will evaluate and monitor the annual convergence programmes submitted by member States, determine whether they satisfy the common guidelines, advise on possible changes, compare outcomes with previous programmes and make recommendations they may deem appropriate in accordance with the Treaty.”* Article 7(4) also puts the Committee of Ministers for Finance and Investment in charge of issuing communications explaining its assessments to member States and stakeholders.

It is, therefore, crucial that SADC not only take stock of progress made by member States in complying with annex 2 of the Protocol on Finance and Investment, but start addressing technical and institutional challenges faced by member States. It will also be important to take into account the effects that the SADC regional integration milestones will have on progress of member States to achieve macro-economic convergence to ensure that the SADC Central Bank and a common currency are established within the timeframes set by the SADC Committee of Ministers for Finance and Investment. In particular, there are specific national and subregional coordination challenges related to the process of simultaneously transitioning towards various regional integration milestones, such as the SADC Free Trade Agreement (FTA) launched in 2008, a customs union which missed the targeted launch date in 2010, a common market expected by 2015, and a monetary union by 2016 complete with a single currency by 2018.

## Objective of the study

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The objective of the study is to critically review the SADC macro-economic convergence criteria, scope and institutional mechanisms, as well as the extent of their implementation, the challenges and constraints encountered and the way forward. In particular, the study:

Reviews the SADC Macro-economic Convergence Programme in light of new thinking on the theory of macro-economic convergence and its implications; and

Draws lessons and inform policy to accelerate progress in the implementation of the SADC Macro-economic Convergence Programme.

The study cites policy recommendations to accelerate progress towards macro-economic convergence in SADC. It was reviewed by an ad hoc expert group meeting with the view of providing a new impetus for the implementation of the macro-economic policy convergence programme in Southern Africa in line with SADC requirements. This is in accordance with the objective of the sub-Regional Office of the United Nations Economic Commission for Africa (ECA) to enhance capacity of member States, the Southern African Development Community (SADC) and other intergovernmental organizations to formulate and implement harmonized macro-economic and sectoral policies and programmes to address key subregional integration priorities.

## Methodology

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This is a desk study on “**Addressing the challenges of macro-economic convergence in the SADC region**”. It involved a systematic analysis of theoretical and empirical literature as well as data from the Internet and other sources to reveal facts about relevant experiences of member States with macro-economic policy convergence in the SADC region.

## Organization of the report

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The remainder of the report is organized as follows. Chapter 2 discusses the theory of macro-economic convergence developed from the perspective of creating a monetary union within a subregion. Chapter 3 provides an outline of the SADC monetary policy convergence criteria, its scope and developments to date and an assessment of the capacity of member States’ ability to comply with SADC macro-economic convergence targets based on the current global outlook. Chapter 4 offers an overview of the institutional arrangements and strategies for monitoring macro-economic convergence at the national and subregional levels. It also critically analyses the institutional arrangements for the

SADC macro-economic programme in order to identify areas that need strengthening, as well as policies and frameworks that should be implemented to steer the programme and chapter 5 concludes the report with policy recommendations.



# Chapter II: Macro-economic Convergence: Theory and Principles<sup>3</sup>

## Introduction

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The theory of optimum currency areas or the optimum currency area (OCA) theory explores the criteria as well as the costs and benefits of joining and/or creating a common currency area. In addition, the OCA theory can be perceived as a guide for selecting the optimum exchange rate regime. It is germane to note that there is no widely-accepted index to indicate explicitly whether a country should join a currency area. In reality, there is no standard theory of optimum currency areas, but rather several approaches that have been inspired by an influential paper written by Robert Mundell.

This chapter attempts to summarize and explicate the key features of the OCA theory as it relates to the macro-economic convergence criteria for the formation of a monetary union. Following the introduction the remaining parts of the chapter is organized as follows. Section 2.2 surveys early contributions to the theory of optimum currency areas, section 2.3 gives an insight into the contemporary views, section 2.4 outlines the role of macro-economic convergence in monetary integration and section 2.5 concludes the chapter.

## Theories of optimum currency areas

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Mundell (1961) is considered to be the cornerstone in the development of the OCA theory. Mundell's insight was on the impact of a high degree of factor mobility. For instance, if there are two countries A and B, a sudden increase in the demand for A's goods and a corresponding decline in the demand for B's goods, would lead to an economic boom in A and a depression in B. If A and B have separate currencies, the solution to the crisis in B would be a depreciation of its currency, which would induce an appreciation of A's currency. But, if labour and capital are allowed to flow freely between A and B, the exchange rate adjustment (which is not available in a union) would be unnecessary in resolving the economic crisis. Instead, resources (labour and capital) would move from the depressed country (B) to the booming country (A). In this case, where factor mobility is a substitute for exchange rate

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<sup>3</sup> This chapter was written by Dr. Emmanuel Ating Onwioduokit, Deputy Director, West African Monetary Institute (WAMI) based in Accra, Ghana. Views expressed are personal to the author and do not necessarily reflect those of WAMI or the United Nations Economic Commission for Africa.

adjustment, a common currency or monetary union would be ideal for countries A and B. Consequently, the costs of A and B of being members of the union would be reduced.

Whenever different currency areas have large intraregional trade flows, moving to a common currency reduced transaction costs. Thus, a high degree of interdependence among union members is likely to minimize the cost of monetary union membership. Similarly, a high degree of product diversification implies less variability in export earnings and import expenditure, and hence a more stable balance of payments positions. In a monetary union set up under these circumstances, the benefits to members outweigh the costs of membership and there is less need to resort to an exchange rate adjustment to maintain external balance. Mackinnon (1963) also proposes that a high degree of openness by which a country's size of tradables is relatively high tends to minimize costs and increase the benefits of monetary union membership. In the absence of a monetary union, a country needs to use exchange rate policy to minimize its vulnerability to inflation and unemployment.

Kenen (1969) considers the opinions put forward by Mundell (1961) and McKinnon (1963) and contributes to the debate by highlighting the importance of product diversification in determining the effects and outcomes of changes in demand patterns. Assuming demand movements that are not business-cycle induced fall (i.e., that they represent a relatively random process), a well-diversified economy has less need to resort to exchange rate devaluation to maintain internal stability. Furthermore, in a well-diversified economy, unemployment and investment are less affected by changes in export demand as in a single-product economy. He also adumbrated the importance of the range and ability in using policy instruments, in particular monetary and fiscal control.

Grubel(1970) introduces the "theory of optimum regional associations" based on a theoretical analysis of welfare effects accompanying institutional changes, such as the creation of custom unions, common markets, currency areas or the formation of new states that are necessary in order to put into effect the various kinds of regional associations. This theory was interpreted in two distinctive ways: first, as a region of welfare-maximizing network of associations of which each one is an optimum, and second, as a region in which the welfare of its residents is maximized with disregard for the effects on the rest of the world. What is important to put across credibly is the idea that regional cooperation at any level is the best way to maximize the welfare of the members joining the regional associations.

Sequel to the foregoing contributions to the OCA theory, other studies, such as Corden (1972), Ishiyama (1975) and Tower and Willett (1976), emphasize weighing the specific cost and benefit of monetary integration in comparison with other exchange rate arrangements. Whereas, the work reviewed above tended to give vague indications of when monetary integration would be most beneficial, or more accurately when the loss of exchange rate controls would be less detrimental, the "cost-benefit"

type analysis sought to clarify the varying costs and expand on the benefits discussed in previous works.

Corden (1972) argues that monetary integration increased price stability in the economy, and that the degree of improvement increased in line with the openness of the economy, with exchange rates having the ability to play an insulating role. Earlier submissions presume stable foreign prices and micro-orientated supply and demand shifts. They also presume that when shocks originated abroad and were of a macro nature, exchange rate fluctuations insulated the domestic currency from foreign shocks, increasing its liquidity. Consequently, according to Corden, McKinnon's argument that the benefits to be gained from monetary integration are dependent on the assumptions made concerning the disturbances to the system applies in cases in which the disturbances are structural microshocks to the domestic economy. But in situations in which they represent foreign macro movements in costs and prices, increased openness may raise the costs of monetary integration.

Corden has also clarified the arguments of Mundell (1961) concerning the role of money illusion in determining the effectiveness of exchange rate movements in maintaining internal balance. This role for flexible exchange rates is based on the assumptions of real wage flexibility and money wage inflexibility. If real-wage flexibility is not present, as may be the case in an extremely open economy, the assumption of money illusion becomes difficult to accept, thus reducing the effectiveness of the exchange rate in maintaining price control.

Ishiyama (1975) defends the ability of small countries to control domestic shocks and cogently argued against monetary integration, concluding that "the theory of optimal currency areas was primarily an academic discussion which contributes little to practical problems of exchange rate policy and monetary reform".

Tower and Willett (1976) discuss broad areas of importance in determining the costs and benefits of monetary integration to an economy. With the aid of a graphical synthesis, they summarized the relative net benefits of a system of flexible exchange rates compared with those of a currency area and indicated that as the degree of openness increases, the benefit of a currency area rises, while the benefits of a flexible exchange rate falls. They conclude that very open economies would benefit from adopting a currency area, while closed economies should operate a system of flexible exchange rates.

In summary, the main factors that the traditional OCA theory underscores should be considered when planning monetary integration between two or more countries as summarized by Obaseki and Onwioduokit (1999). These factors are:

- (a) Asymmetry of shocks;
- (b) Factor mobility;
- (c) Price and wage flexibility;
- (d) Size and openness of countries;
- (e) Product diversification;
- (f) Production structures; and
- (g) Inflation convergence.

## **OCA: Contemporary views**

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The earlier contributors to the OCA theory assumed that monetary policies could be used to achieve the desired trade-off between inflation and unemployment, as represented by the Phillips Curve. Consequently, monetary integration, which requires the abandonment of national monetary policy to a centralized body, exerts a cost if nation states are unable to fine-tune the economy to the desired balance of inflation and unemployment.

The Monetarist Critique, typified by Lucas (1972) and Friedman (1968), asserts that in the long-run, monetary policies are ineffective in controlling unemployment. The Phillips Curve becomes vertical in the long-run because unemployment is related to the natural rate of unemployment (NRU) and inflation can be controlled without detrimental effects on the level of long-run unemployment. These developments were primarily anchored on the notion of expectations formation, whereby rational economic agents are able to, without cost, obtain and use information to form expectations of future inflation and thus negotiate in terms of real rather than nominal wages and prices.

The theory was enhanced by the prevalent economic problems in Western countries, where inflation and unemployment were simultaneously and persistently high. Though the Phillips Curve may still exist in the short-run, the major implication of the long-run with regard to the Phillips curve for the OCA theory is that the perceived costs of monetary integration are reduced. Since monetary policy is ineffective in balancing unemployment and inflation in the long-run, the costs of monetary integration are reduced. However, there remain important cases and issues surrounding the notion of monetary neutrality when considering currency unions.

Strikingly, whereas the traditional OCA theory had viewed convergence of inflation rates as a prerequisite for the formation of a monetary union, modern theory demonstrates how monetary integration may be more beneficial when the divergence of inflation rates is high, provided that the central bank adopts a credible policy stance of optimal inflation. This is because the high-inflation country can achieve a low-inflation reputation overnight by surrendering itself to the control of the low-inflation central bank at no cost to the low-inflation country. This result is mainly based on the expectations theory and most importantly the debate between discretionary and fixed policy rules. This work was

developed by Kydland and Prescott (1977) and subsequently by Barro and Gordon (1983) and De Grauwe (2000).

In their contribution to the OCA theory, Kydland and Prescott (1977) explore the use of the optimal control theory in various economic situations, and highlight its failures in the presence of rational economic agents who maintained and adjusted their expectations for the future. Where such “rational expectations” existed, a policy rule could result in an improved social outcome over the use of optimal control theory as embodied in discretionary policy. Kydland and Prescott (1977) further argue that the optimal control theory was only applicable in cases when decisions were based on past and present information. In dynamic economic situations, this is not the case, since rational economic agents form, and act upon, expectations of future policy changes. Discretionary policy thus leads to a “game” between policymakers and agents which can be either divergent or convergent in relation to a stable policy-outcome mix, but in all cases socially suboptimal.

Barro and Gordon (1983) extend the work of Kydland and Prescott (1977) to show the importance of time consistent policy rules in determining credible and therefore achievable inflation outcomes from monetary policy. They use an expectations formation framework to show that an irrevocable policy rule was preferred over discretionary monetary policy to maintain an optimal mix of unemployment and inflation. This mix was argued to be zero inflation and unemployment equal to the NRU. Discretionary policy, set in each time period, created incentives for surprise inflation to reduce the short-run unemployment level according to the preferences of the policymaker; but such reductions came at the cost of higher inflation and lower credibility in the long-run.

This problem of time inconsistency can be overcome through a system of policy rules which are perceived to be fixed, or when the costs of breaking those rules outweigh the gains from “surprise” inflation. De Grauwe (2000) extends the argument to an open economy model to show that Barro and Gordon’s analysis was also applicable to exchange rate policy. Promises to maintain a fixed exchange rate would not be credible unless the cost of renegeing exceeds the gains from imposing surprise devaluation: Monetary integration represents a convincing solution to that problem and enables a lower inflation equilibrium than what would otherwise exist.

Such insights clearly have far-reaching implications for the OCA theory since monetary integration embodies a set of policy rules that “tie the hands”, both in terms of monetary and exchange rate policy of domestic policymakers, enhancing the reputation of high-inflation countries. In such countries, the loss of monetary and exchange rate control would in part constitute a benefit as it would enable them to achieve lower inflation rates over the long-run, without any cost to employment levels. Clearly, there remains a cost in relinquishing control of exchange rate policy since the ability to manage external equilibrium is removed. However a growing body of literature within the new

theory suggests that exchange rates are less effective than traditional theory would suggest in maintaining external balance.

The development of the portfolio-balance model of exchange rates has called into question the flow type model adopted by the traditional OCA theory. Given that foreign and domestic assets are imperfect substitutes, the current account induces exchange rate changes through the movement of wealth and the effect on the risk associated with holding foreign assets. In cases in which perfect foresight is present, correction of the current account is lagged and dependent upon the distribution and changes in wealth. Without perfect foresight, it is possible to reach a situation of speculative bubbles in which exchange rate movements do not react to and fail to correct external imbalances. In both cases, the exchange rate does not adjust smoothly or instantly to correct external imbalances.

Other theoretical arguments assert that exchange rates enact corrections imperfectly and over a longer time period than assumed in the traditional OCA theory. These involve interactions of the portfolio-balance model with the notion of Ricardian Equivalence to create a situation whereby economic agents react to negate the movement of exchange rates since they foresee a reversal of exchange rates in future. Company policy also is believed to increase the time lag of exchange rate effects as described by the Sunk Costs model of industrial relations, whereby firms would be reluctant to react to exchange rate movements in the short-term if this is perceived to increase or maintain profitability in the long-run.

These arguments reaffirm the conclusions made by other strands of the new OCA theory that the loss of the exchange rate as a policy tool may be less detrimental than originally thought. As well as the reduction in perceived losses, the elimination of exchange rate uncertainty has been cited throughout the literature as a benefit of monetary integration, through which countries are able to achieve welfare gains and improvements in growth. However, both theoretical and empirical developments have proved this belief is misplaced, as the effect of exchange rate certainty is ambiguous and difficult to quantify.

In particular, De Grauwe (2000) highlights the body of work initiated by Poole (1970) that use an IS-LM model to show that fixing exchange rates (or forming a currency union) results in increased volatility in output. Reduced exchange rate uncertainty simply moves the risk to another area of the economy. Furthermore, De Grauwe (2000) points out the one-off benefit to growth of an increase in exchange rate certainty that is indicated by the Neoclassical theory and was used in the influential "One Money, One Market" report (EC 1990). This suggests that though monetary integration would reduce risk, this effect would only have a one-off effect on growth as the economy moves to a lower risk equilibrium.

Even though a large body of literature concerning exchange rates exists, the theoretical conclusions to be made here are indeterminate. On the one hand, lags in the effects of exchange rate movements reduce their effectiveness and thus reduce the costs of monetary integration. Yet, on the other hand, the benefits to be gained from exchange rate certainty, embedded in monetary unions, seem to be overstated by the traditional OCA theory. Both the costs and benefits relating to the loss of exchange rate control have been reduced by the new OCA theory and thus the high importance of exchange rate convergence in the traditional OCA criteria appears misplaced.

The traditional OCA theory assesses the feasibility of monetary union in terms of an economy's shock-absorbing capacity. It is primarily concerned with starting positions, with the preconditions that would enable a successful monetary union. The analysis is static. It assumes, for example, a given level of labour mobility or openness.

Notably, the contribution by Frankel and Rose (1997) provide the OCA theory with a more forward looking outlook, arguing that many of the prerequisites for monetary union, espoused by traditional theorists, are in fact reinforced by the creation of monetary union. This is in direct contrast with another popular argument from Krugman (1993) that increased economic integration improves the likelihood of asymmetric shocks. Krugman's outcome was the result of the possibility of increased localized specialization, which increases rather than decreases the divergence of shocks between two countries, thus increasing the cost of monetary union.

While Frankel and Rose (1998) believe that increased economic integration (including, most importantly, customs and monetary union and increasing factor mobility) increases convergence between nations, hence reducing the costs of monetary union in terms of loss of exchange rate control, Krugman (1993) uses evidence from North America to conclude that increased economic integration does not guarantee convergence and could lead to divergence, thus increasing the costs of monetary union.

An interesting issue, that has only recently received attention in the literature, concerns the long-run, endogenous consequences of monetary union. One strand of modern research on the OCA theory hypothesizes a positive link between a common currency and trade integration. The central insight underlying this hypothesis is that a national currency is a major barrier to trade. Thus, a single currency and a common monetary policy prevent future competitive devaluations, ease foreign direct investment and the building of long-term relationships, and might (over time) promote forms of political integration. These outcomes would, in turn, encourage reciprocal trade, economic and financial integration, and business-cycle correlation among the economies sharing a single currency (Rose and Van Wincoop, 2001; Mongelli, 2002).



Eichengreen (2001) has identified a number of channels through which monetary union can, over time, affect the financial sector, the labour market, and the fiscal situation. For example, the elimination of currency risk makes it easier for firms to borrow long-term at home and abroad, thereby promoting the development of financial markets. The remarkable impact of the European Monetary Union (EMU) on the growth of European financial markets is supportive of this view. Monetary union may also lead to labour market reform, encouraging greater real-wage flexibility (in the absence of the exchange rate option). Finally, by bringing down interest rates and reducing debt servicing costs, and by removing seigniorage at the national level, EMU should force governments to live within their means (Eichengreen 2001).

The issue of symmetries plays a key role in the traditional OCA theory. If an economy is subjected to an asymmetric shock, or if there are asymmetries in the economic structure (so that economies may react differently to symmetric shocks), then, in the presence of rigid prices and nominal wages, a nominal exchange rate adjustment is desirable. A key problem with the OCA literature, however, is that the role of asymmetries has not been investigated thoroughly. Specifically, there has been very little formal modelling of asymmetries; the relative importance of alternative asymmetries has not been examined and the overall quantitative importance of asymmetry in the cost-benefit calculus of monetary union remains unexplored.

Dellas and Tavlas (2003) attempts to examine this issue within the framework of a stochastic, dynamic, three-economy general equilibrium model with optimizing agents. The main features of the model are nominal wage rigidities, active monetary policies (Taylor rules), and complete assets markets. The authors consider three types of international monetary arrangements: (a) flexible exchange rates among the three countries; (b) a “mixed” regime, and (c) a catholic monetary union. After examining the effects of asymmetries in the labour market and with respect to both fiscal and monetary policies, they found that in the case of perfect symmetry, economies are better off when they participate in a currency union and that the benefits increase with the number of participants. The benefits could be significant when the degree of nominal wage rigidity is high but tended to be small when rigidity is low. This finding contrasts with the traditional OCA analysis as well as Friedman’s (1968) case for flexible rates, namely that flexible rates are desirable when wage rigidity is high and holds despite activist policy.

This result is attributable to the following factors. First, with fixed wages (as opposed to fixed prices), an economy’s terms of trade can still adjust to a shock. As wages become more flexible, the monetary regime’s affect on economic activity and welfare diminishes, or in other words, the economy becomes closer to being monetary neutral. Second, the model assumes production independence among economies. This assumption implies that a change in the exchange rate that has a favourable effect on demand for domestic goods and also has unfavourable effects on the supply side of the economy because it increases the cost of production through an increase in the price of imported



goods. Third, while a monetary union amplifies the effects of economy-specific supply shocks on the economic activity of the participants by inducing real wage changes even in economies that have not experienced a productivity shock, it contributes to greater output stability by limiting terms-of-trade effects. The authors conclude that asymmetries matter, especially when there are differences in the extent of wage flexibility among economies.

Other empirical evidence tends to suggest that the hypothesis of Frankel and Rose (1998) is correct for the countries that have been studied, predominantly in the European Union. Artis and Zhang (1995) show that increasing trade links in Europe gravitated members of the European Monetary System towards a universal business cycle. Fidrmuc (2001) uses an explicit test of endogeneity to confirm the hypothesis. However, this is done with the caveat that the effect may be working through increasing structural similarities of foreign trade rather than the direct effect of increased trade, as previously proposed.

## **The role of convergence in economic integration**

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With the emergence of the European Union as an economic and monetary union, the role of the macro-economic convergence criteria in the transition process has gained acceptability in integration programmes. The issue of convergence has always been relevant for integration programmes. The only difference in the European Union case, however, has been the quantification of such criteria. The requirement for market integration and sectoral programmes has emphasized the need for convergence or harmonization of policies. Convergence as a necessary condition for an economic or monetary union has become the norm whether the union is launched quickly or is developed over a long period. A union must have strong economic fundamentals to be effective.

Thus, the concept of economic convergence for an integration arrangement implies two situations, compliance by member countries of some qualitative macro-economic targets and the process of promoting market integration. In the first situation, the targets must be considered the norms or international best practices for sustained macro-economic stability, with the main one related to inflation, fiscal and monetary conditions and the external sector position. A set of economic policies is usually adopted in order to comply with the macro-economic targets. These policies must be coordinated within the group of countries and need to move in the same direction, but do not necessarily have to be identical. Regarding, the second situation, the process of promoting market integration includes the creation of the common market by subscribing to the relevant requirements, such as free movement of persons, liberalization of trade in goods and services and the introduction of a common external tariff. Also cooperation within the group in the promotion of socio-economic programmes, which tend to enhance regional economic policy coordination and economic development, is critical.

## Summary and conclusion

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The major conclusions from the expansive literature on OCA and by extension, convergence requirements for the formation of a monetary union over the last six decades, reveal the following critical conditions/requirements:

- (a) Increased openness (in terms of the proportion of tradables to non-tradables) boosts the net benefit of monetary union due to reduced transactions costs and reduced price variability;
- (b) Increased symmetry of shocks (as created by business cycles) reduces the cost of abandoning monetary control;
- (c) Increased symmetry between potential members, in terms of trade shocks, reduces the cost of abandoning exchange rate control;
- (d) Increased trade, intensities with potential members may lower the future costs of monetary union by reducing the divergence of shocks; and
- (e) Increased factor mobility between potential members lowers the cost of monetary union by reducing the need for exchange rate fluctuations.

Other conclusions are the following:

- a. Increased wage and price flexibility cuts the cost of monetary union by reducing the need for exchange rate adjustment;
- b. Monetary integration may provide a way for high-inflation countries to achieve credibility through the adoption or creation of a credible central bank;
- c. Product diversification, by reducing the impact of asymmetric shocks reduces the need for counter-balancing monetary or exchange rate movements;
- d. Fiscal integration is necessary in situations in which factors may not be perfectly mobile to perform immediate and automatic redistribution in case of asymmetric shocks; and
- e. If the exchange rate is not a perfect adjustment mechanism, or policy neutrality exists in the long-run, as has been suggested above, then the costs of monetary union, in terms of loss of exchange rate and monetary control, fall.

When considered in a very objective manner, it is difficult to conclude that most countries meet the necessary conditions to run an effective monetary or economic union. This view is valid when the issue is examined in either a static or dynamic sense. In fact, political problems facing developing countries, especially in Sub-Saharan Africa, may completely erode the positive economic factors that may support viable economic integration efforts. But, nevertheless, compelling arguments, as discussed below, justify the right for these countries to continue to be involved in integration efforts.

First, the formation of monetary unions in developing countries could engender or hasten the process of macro-economic stability. In other words, such efforts could strengthen national programmes of macro-economic management. Many of the countries in sub-Saharan Africa, for instance, embarked on economic reform programmes in the early 1980's, but have not really succeeded in achieving sustained macro-economic stability. A collaborative strategy could strengthen such efforts by enhancing monetary stability as demonstrated by the European experience is the establishment of relevant institutions which are given powers that may not be possible in a national context. The example of an independent central bank is noteworthy. Countries that aim to form a monetary union understand that the common central bank empowered to manage the unified monetary policy must be given the authority that would enable it to avoid the pitfalls of subservient national central banks, otherwise national economic imbalances could be multiplied at the regional level.

Second, developing economies must read correctly the dynamics of the world economy by which the developed countries have become relatively stronger than, say, three decades ago. One of the strategies they have adopted is to integrate their economies. This has resulted in improved economic performance, rapid technological progress and stronger bargaining power at the global level. Delays in forging economic cooperation among developing countries will further widen the gap between their economic performance and that of the developed countries. If the developing countries were to improve their economic performance through collaborative efforts as indicated earlier, they would likely attain greater clout in dealing with international issues, such as external debt overhang, reform of the international financial system, the flows of resources and secular decline in primary commodity prices.

Third, monetary and economic unions among developing nations would encourage the mobilization and improved management of human and financial resources. Presently, domestic human resources are not efficiently utilized, especially in the Africa region, because of limited opportunities. Consequently, many professionals migrate to developed nations to the detriment of poor African countries. In addition, the lopsided international trade structure is against the interests of the developing countries in Africa, a development that has contributed to their low level of industrial development. African nations should enhance their economic status through regional and subregional economic and monetary cooperation programmes.

The danger of isolating monetary union as the beall in economic integration should be avoided as even in the theoretical foundations, monetary union is the last segment of economic integration. The temptation of fixing a short-term unrealistic deadline for monetary union should be resisted; no effort should be spared in ensuring that the required building blocks are properly put in place. The prime objectives of maintaining price and exchange rate stability should be the guiding principle. The immediate removal of all non-tariff barriers to trade and movements of persons and capital across the intending region is indeed the first test of political will. The demonstration of political should transcend

signing protocols and making pronouncements with no intention of implementing them. However, policymakers should now feel secure enough to rethink their assumptions about the introduction of the common currency.

Overall, an effective, efficient and lasting monetary union should and must be based on sound macro-economic fundamentals as well as a reasonable level of institutional and infrastructure development. The focus in the medium-term should be on how to achieve these twin critical requirements.

# Chapter III: Progress and Prospects for Macro-economic Convergence in SADC

## Introduction

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This chapter examines progress and prospects of macro-economic convergence programme in the SADC region. In particular, it assesses the compliance of SADC member countries with the macro-economic convergence (MEC) targets for 2012, based on estimates contained in the IMF publication, *Regional Economic Outlook: Sub-Saharan Africa*. It also estimates the long-run steady state for each SADC member country with respect to each MEC indicator and then compares the estimated results with their associated MEC indicator targets. Based on this information, it can be determined which MEC target is likely to be achieved and by which country. In this chapter, the speed of convergence towards its own steady state of each country's MEC indicators is computed to assist in ascertaining which countries are likely to move faster towards or away from the SADC convergence targets.

Under the SADC MEC programme, member States were and are expected to meet a set of macro-economic convergence criteria at three points in time over a ten-year period from 2008 to 2018. These targets, consisting of primary and secondary quantitative macro-economic convergence targets are outlined in the SADC Regional Indicative Strategic Development Plan (RISDP) (table 1). A descriptive analysis of the performance of the countries against MEC indicators over the two years from which the targets were expected to have been met is used. The estimation of the long-run steady state and speed of convergence to the long-run steady state complements the assessment of progress being made by member States.

**Table 1: SADC macro-economic indicators and targets**

	2008	2012	2018
Indicators	Primary indicators		
Inflation (annual - %)	<10	<5	<3
Fiscal deficit (%)	<5	<3	<3
Public debt/GDP (%)	<60	<60	<60
	Secondary indicators		
Current account/GDP (%)	<9	<9	<9
Economic growth (real GDP annual rate %)	7	7	7
Central Bank Credit (% of revenues)	10	5	5
External reserves (import cover months)	3	6	6
Domestic savings (% of GDP)	25	30	35
Domestic investment (% of GDP)	30	30	30

**Source: SADC data**

## Assessment of macro-economic convergence in SADC region

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### *Performance against the primary indicator targets*

#### **Inflation (5 per cent by 2012)**

With regard to inflation, the performance of SADC countries in the debut year for the 2012 MEC targets was relatively poor when compared to the performance under the 2008 target as only three countries met the target (table 2). Nonetheless nine countries reported that their average inflation was in a single digit compared to an average of eight countries that met the 2008 target in the two years to 2008. The raising of the indicator standard to 5 per cent from less than 10 per cent under the 2008 target explains why only three countries were reported to be on track. In 2010, seven countries met the 2012 inflation target of less than 5 per cent.

**Table 2: Performance outcome against primary MEC indicators, 2009-2010**

Country	Inflation (Period Average in %)			Budget Balance as % of GDP			Public debt as percentage of GDP		
	2008	2009	2010	2008	2009	2010	2008	2009	2010
Angola	13.2	14	15.3	8.8	-9.1	1.5	17.6	22.6	19.1
Botswana	12.6	8.2	6.9	4.2	-5.6	-10.1	4.5	6.8	25.5
DRC	17.9	46.1	23.5	-0.5	0.6	1.23	91.8	113.5	28.3
Lesotho	10.8	7.3	3.6	4.7	-3.8	-6.4	55	40.1	36.8
Malawi	8.7	8.4	7.4	-6.5	-5.7	1.9	31.6	40.8	35
Mauritius	9.7	2.5	2.9	-3.3	3.1	-4.5	51.9	59.3	57.6
Mozambique	10.3	3.25	12.7	-2.5	-5.4	-3.6	40.5	43.7	54.7
Namibia	10.3	8.8	4.5	2	1.9	-7.1	18.9	18	15.1
Seychelles	37	31.7	-2.4	5.7	14.2	9.1	223	117	83
South Africa	9.9	7.2	4.3	0.9	-0.7	-5.5	31.4	31.5	39.4
Swaziland	12.6	7.5	4.5	-1.5	-7.1	-14.3	16	12	14.4
United Republic of Tanzania	10.3	12.1	5.5	-1.7	-4.3	-7.5	31.5	40.9	43.2
Zambia	12.4	13.5	8.5	-2.5	-2.6	-2.2	26.7	26.4	27.6
Zimbabwe	231.2m	-7.7	3.2	-11	0	3.3	147.7	109.8	94.3
SADC Average	13.52	11.63	7.17	-0.68	-2.12	-3.15	56.29	48.74	41.00
Convergence criteria (2004-2008)	Single digit inflation rate by 2008			Deficit smaller than 5% of GDP by 2008			Less than 60% of GDP by 2008		
Convergence criteria (2009-2012)	5% inflation rate by 2012			Deficit 3% as an anchor within a band of 1%			Less than 60% of GDP by 2010		

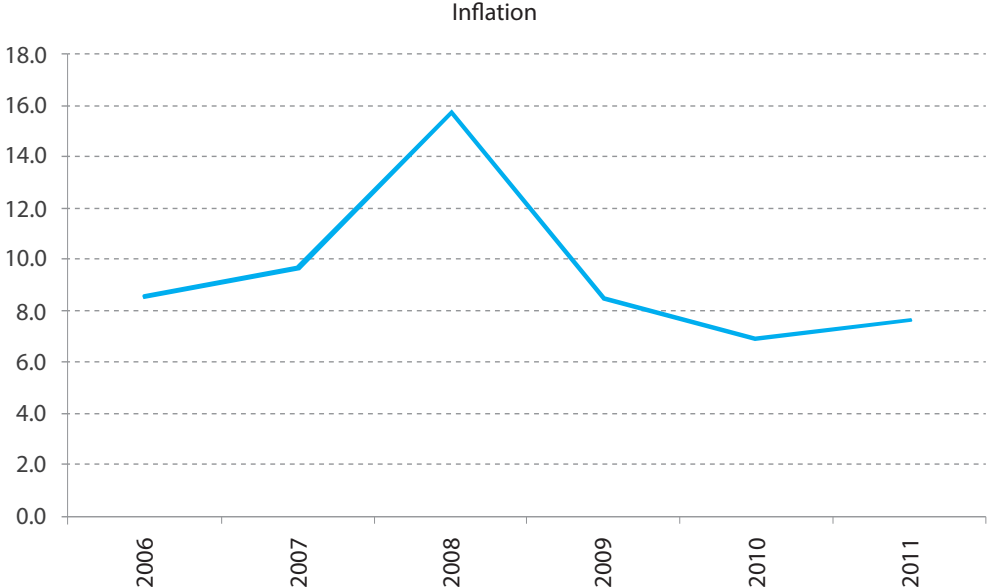
**Source:** Various SADC country reports.

Annual headline inflation in the SADC region declined from an average of 10.3 per cent in 2009 to an average of 7.3 per cent in 2010. The decline largely reflected the strong and robust monetary policy stance being implemented by member States. The most notable decreases in inflation were experienced in DRC and Seychelles, where inflation fell from 46.1 and 31.7 per cent in 2009 to 23.5 and 2.4 per cent in 2010, respectively.

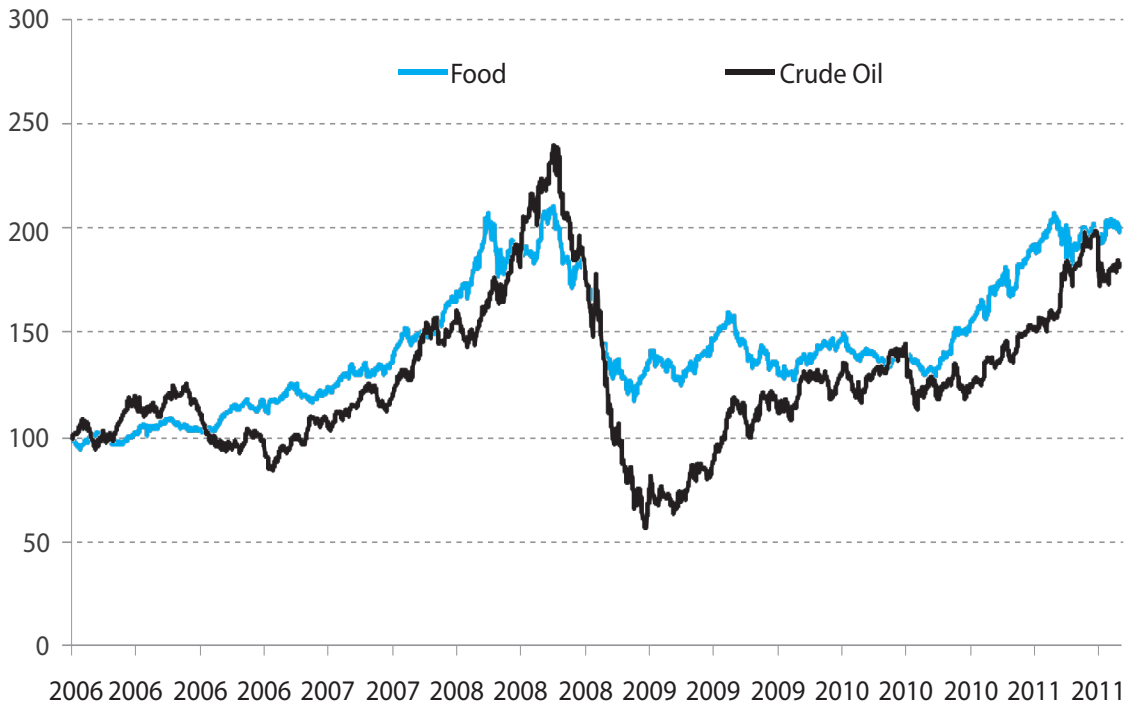
Other countries that witnessed a significant drop in inflation were Botswana, South Africa, Swaziland, United Republic of United Republic of Tanzania and Zambia. Countries that experienced increases in inflation were Angola, Madagascar and Mozambique. In Mozambique, the increase was significant,

rising 9.4 percentage points from 3.3 per cent in 2009 to 12.7 in 2010, due to inflationary pressures resulting from the weakening of the Mozambican metical against the United States dollar and the strengthening of the South African rand. Notably, South Africa is a major trading partner of Mozambique. In Angola, inflationary pressures in 2010 were largely attributed to the depreciation of the kwanza against the United States dollar. On the other hand, inflation declined in Zimbabwe from 6.3 per cent in 2009 to 3.2 per cent in 2010.

**Figure 1: Inflation and commodity prices developments in SADC countries**







In a number of low-income countries, the 2010 harvest was strong, limiting general price increases. This out-turn was due to improved food supply following favourable weather conditions and augmented by the favourable pass through effects stemming from the exchange rates. Most of the exchange rates of member countries stabilized or appreciated following the recoveries achieved in the global economy. On the other hand, middle-income countries such as Angola, South Africa and other resource-rich countries had mixed outcomes due to the lagged impact of the global financial crisis as well as the high cost of imported food and rising international oil prices.

Angola, DRC and Seychelles registered budget surpluses arising from high revenues realized from tourism, minerals and oil, respectively. Countries in the Southern Africa Customs Union (SACU) experienced widening fiscal balances due to falling SACU revenues and increasing capital expenditures. For South Africa, wage increases are a significant cause of inflation due to the presence of strong trade unions while for the SADC region, as a whole, South African rand/United States dollar exchange rate is a source of inflation. When the rand appreciates against the dollar, goods imported from South Africa become expensive. Considering that most countries in the SADC region rely on South Africa for imports, the impact of rand appreciation on the countries' inflation is quite significant. According to 2011 and 2012 IMF projections, the SADC region remains susceptible to external shocks, such as sharp increases in food and fuel prices, with only, Mauritius, Seychelles and Zimbabwe on track to meet the MEC inflation target.

### **Fiscal balance (<3 per cent of GDP)**

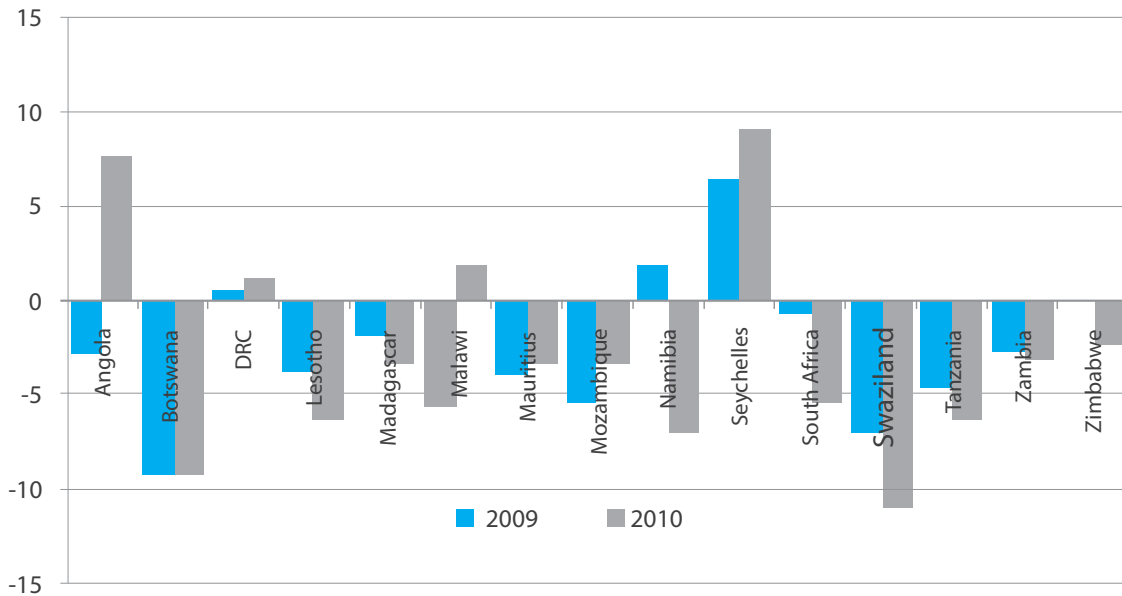
With regard to the performance against fiscal balance targets in 2009, six countries were on track, benefiting from prudent fiscal management. However, this outcome is very poor when compared to the performance under the 2008 target in which almost all the countries met the target. The impact of the global financial crisis largely explains this poor performance as member countries, particularly the resource-rich countries such as Angola, Botswana, DRC and South Africa had to carry out an expansionary fiscal policy to stimulate internal demand and mitigate the impact of the global financial crisis.

In 2010, the fiscal balance indicator's performance was not different from the 2009 outcome as in both years; only six countries met the target. DRC and Malawi, however, managed to maintain budget surpluses in 2010. In Malawi, the budget surplus was attributed to a 49.7 per cent increase in domestic revenue and budgetary grants of about Malawi kwacha 13.2 billion (US\$79 million). Madagascar, notably, fell short of meeting the target and its performance was worse when compared to 2009. The budget deficit of South Africa increased from 0.7 per cent in the 2009/2010 fiscal year to 5.5 per cent in the 2010/2011 fiscal year, with cyclical forces playing a major role in the deterioration. United Republic of United Republic of Tanzania and Zambia experienced further increases in the budget deficits in 2010 and Zimbabwe recorded a low budget deficit of 2.3 per cent in 2010 due to austerity measures being implemented by the government.

With regard to consistency, only four countries met the target for the two-year period that they have been in force, namely DRC, Seychelles, Zambia and Zimbabwe. However, it should be noted that the position of Zimbabwe deteriorated in 2010 when compared with the 2009 while the best performance was recorded by Seychelles with a remarkable improvement in the indicator followed distantly by DRC. Countries that have consistently failed to meet the new target include the SACU members, namely Botswana, Lesotho, Swaziland and South Africa plus Malawi, Mozambique and United Republic of United Republic of Tanzania.

As for the prospects of member countries to meet the 2012 SADC fiscal targets, IMF projections for 2011 and 2012 indicate that Botswana, Malawi, Namibia and Seychelles are on track to meet the fiscal deficit target of less than 3 per cent.

**Figure 2: SADC budget balances**



**Debt ratio (<60per cent of GDP by 2012)**

Most SADC countries have managed to reduce their public debt to sustainable levels. This was done by expanding economic activity and implementing effective debt management strategies. Seychelles and Zimbabwe were the only countries that failed to meet the debt to GDP target in 2010 (table 2). This performance compares well with the outcome under the 2008 target in which three countries failed to meet the target in the three years prior to 2008. Notably, the public debt ratio of DRC became favourable in 2010 with a remarkable improvement that stemmed from a massive debt write-off by multilateral and bilateral lenders following the country’s attainment of the Heavily-Indebted Poor Countries (HIPC) Initiative completion point in 2010. Malawi, Mozambique, United Republic of United Republic of Tanzania and Zambia also benefited from debt relief initiatives under the HIPC Initiative supplemented by the Multilateral Debt Relief Initiative (MDRI). Eight countries, Botswana, Lesotho, Malawi, Mauritius, Namibia, Swaziland, United Republic of United Republic of Tanzania and Zambia, were consistent in meeting the target in the two years under review. In Seychelles and Zimbabwe, the proportion of public debt to GDP has fallen although, as indicated earlier, the levels still remain above the 60 per cent sustainability threshold.

Regarding prospects for meeting 2012 targets, IMF projections for 2011 and 2012 indicate that 13 countries, namely Angola, Botswana, DRC, Lesotho, Madagascar, Malawi, Mauritius, Mozambique,

Namibia, South Africa, Swaziland, United Republic of United Republic of Tanzania and, Zimbabwe are on track to achieve public debt as a percentage of GDP of less than 60 per cent.

***Performance against the secondary indicator targets***

**Current account (<9 per cent of GDP)**

With regard to the 2009 performance, the data show that seven countries were on target to meet the MEC current account target of less than 9 per cent of GDP in 2012 as compared with nine countries on target in the previous year. The performance deteriorated again in 2010 but only marginally with six countries meeting the target. Notably, only four countries, Botswana, Namibia, South Africa and Zambia met the target in both 2009 and 2010. Botswana and Namibia registered current account surpluses in 2010, largely on the back of an increasing share of mineral exports. DRC, Malawi, Mozambique and Zimbabwe, however, experienced widening current account deficits due to rising international oil prices and heavy reliance on imports. IMF projections for 2011 and 2012 indicate that Botswana, Madagascar, Namibia, South Africa and Zambia are on track to meeting the 2012 MEC current account.

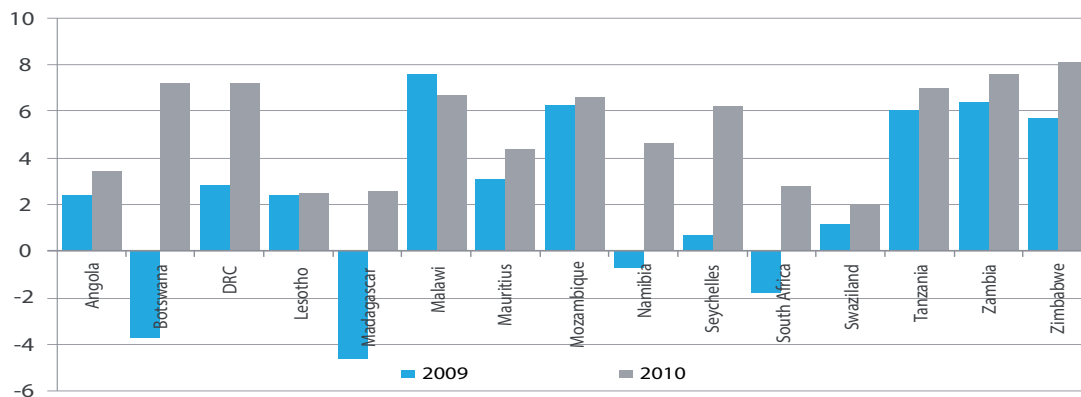
**Table 3: Performance outcome against secondary MEC indicators, 2009-2010**

Country	Months of Import Cover			Real Growth Rate		
	2008	2009	2010	2008	2009	2010
Angola	5	3.8	5.3	13.8	2.4	3.2
Botswana	22	19	15	3.1	-4.9	7.2
DRC	0.1	2	1.78	6.2	2.8	7.2
Lesotho	8.5	6.8	5.9	3.4	2.4	2.5
Malawi	2.4	1.9	3.1	8.6	7.6	7.1
Mauritius	5.2	7.2	7.0	5.1	3.1	4.4
Mozambique	4.7	5.61	4.92	6.7	6.4	6.2
Namibia	5.7	4	3	4.3	-0.7	4.6
Seychelles	1.1	1.6	2.5	-0.9	0.7	6.2
South Africa	3.7	5.1	4.9	3.6	-1.7	2.8
Swaziland	4.6	4.1	2.9	2.4	1.2	2
United Republic of Tanzania	4.3	5.7	5.3	7.4	6.0	7.0
Zambia	2.1	5.1	4.1	5.7	6.4	7.6
Zimbabwe	0.3	1.3	1.4	-14.7	5.7	8.3
SADC Average	4.98	5.23	4.79	3.91	2.67	5.45
Convergence criteria (2004-2008)	Not less than 3 months by 2008			Not less than 7%		
Convergence criteria (2009-2012)	Not less than 6 months by 2012			Not less than 7%		

### Real GDP growth rate (of at least 7 per cent)

Economic growth in the SADC region accelerated in line with the rebound in global economic activity and prudent economic policies implemented by member States. Notable expansions in GDP were registered in Botswana, Malawi, Zambia and Zimbabwe, all of which surpassed the 7 per cent growth target in 2010. Strong growth in some member States was supported by a boost in public sector investments in infrastructure and extensive human capital development. Other supportive growth factors in the region were the rich mineral resources, attractive tourism areas, fertile agricultural land, high literacy rates, political stability and a steady recovery in the mining, agricultural, construction and tourism sectors.

**Figure 3: SADC real GDP growth rate (%)**



In 2009, only one country, Malawi, met the economic growth target as most countries' out turns were relatively poor, owing to the impact of the global financial crisis on many of these countries' real economy. In most of these countries, export-oriented sectors slumped as global demand fell during the crisis. It should, nonetheless, be noted that the real GDP growth rates of Zambia and Zimbabwe improved during the year compared to the performance in the previous year. The stronger Zambia economy can be attributed to increased mining output triggered by higher copper prices and increased agriculture out put while growth in Zimbabwe was spurred by good results in all sectors of the economy with agriculture and mining being the star performers as the stabilization measures put in place by the unity government started bearing fruits. Sound macro-economic policies including, among others, the multicurrency system, a significant improvement in the business climate, in particular, regarding enforcement of property rights and labour legislation, and debt relief, are essential for moving toward external and domestic stability. For example, Zimbabwe is in debt distress, and the debt overhang cannot be resolved without debt relief even if policies are improved and mineral extraction is increased (IMF, 2010).

In 2010, the performance out turn improved as six countries met the 2012 real GDP growth rate of not less 7 per cent (due to global economic recovery). Most countries in the region, notably DRC, Mozambique, Seychelles, United Republic of Tanzania, Zambia and Zimbabwe, registered growth rates in excess of 5 per cent, reflecting improved economic fundamentals and more robust policy stances that provided room for the effective use of countercyclical macro-economic policy to counter the global downturn. Furthermore, the pronounced shift in the region's trading pattern toward faster-growing parts of the global economy has boosted export growth. Zambia and Zimbabwe also registered strong growth in 2010 with estimated real GDP growth rates of 7.6 per cent and 8.3 per cent, respectively. Growth in Zambia was driven by increased agriculture and mining output following a good agriculture season and improved performance of the copper industry. Robust growth in

Zimbabwe was driven by phenomenal growth in the mining and agriculture sector, which expanded by 47 per cent and 34 per cent, respectively (CCBG, 2011).

Botswana recorded a GDP growth rate of 7.2 per cent in 2010 after experiencing negative growth of -4.9 per cent the year before. Growth in Botswana was driven by the mining, trade, tourism and construction sectors, with additional support coming from a combination of strong fiscal policies and a rebound in the global demand for diamonds. In South Africa, the normalization of manufacturing activity and increased mining activity spurred the economy. In addition, substantial investment deployed to develop infrastructure within the context of the 2010 World Cup boosted economic activity in the region. Growth in other countries was supported by increased public sector investment, which, in turn, helped boost private sector investment. IMF projections for 2011 and 2012 indicate that Angola, Mozambique and Zambia are on track to meeting the target of not less than 7 per cent.

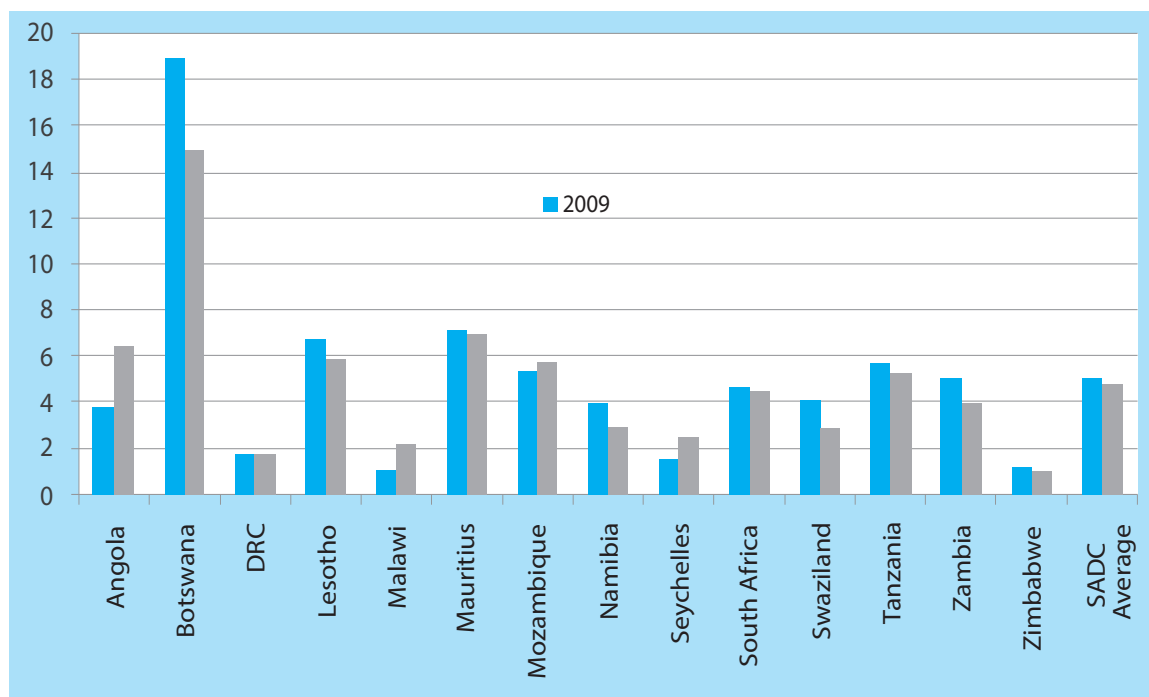
### **Months of import cover (6 months of import)**

Most countries in the SADC region do not have enough foreign reserves to cushion external shocks. The SADC average gross international reserve position as measured by months of import cover deteriorated marginally from an average of 5.1 months in 2009 to an average of 4.8 months in 2010. The region's international reserves were given a boost in 2009 by the special drawing rights (SDR) allocations from the International Monetary Fund for the mitigation of the adverse effects of the global financial crisis. Botswana remains the single most insulated country in SADC with reserves of more than 15 months of import cover.

In 2009, only three countries, Botswana, Lesotho and Mauritius, met the target of six months of import cover with regard to foreign exchange reserves position. In 2010, Botswana and Mauritius were joined by Tanzania as the only three countries that satisfied the MEC target on months of import cover. Botswana and Mauritius were the only two countries to have met the target in both 2009 and 2010. This outcome was mainly due to sound macro-economic policies, particularly in managing the key foreign exchange earners in the two countries.

International reserves levels in DRC, Malawi, Namibia Seychelles and Zimbabwe, remain below 3 months of import cover, indicating the need to build buffers to cushion these economies against external vulnerabilities. Regarding prospects for meeting 2012 targets, IMF projections for 2011 and 2012 show that only Angola and Botswana are on track to meet the import cover target of not less than 6 months.

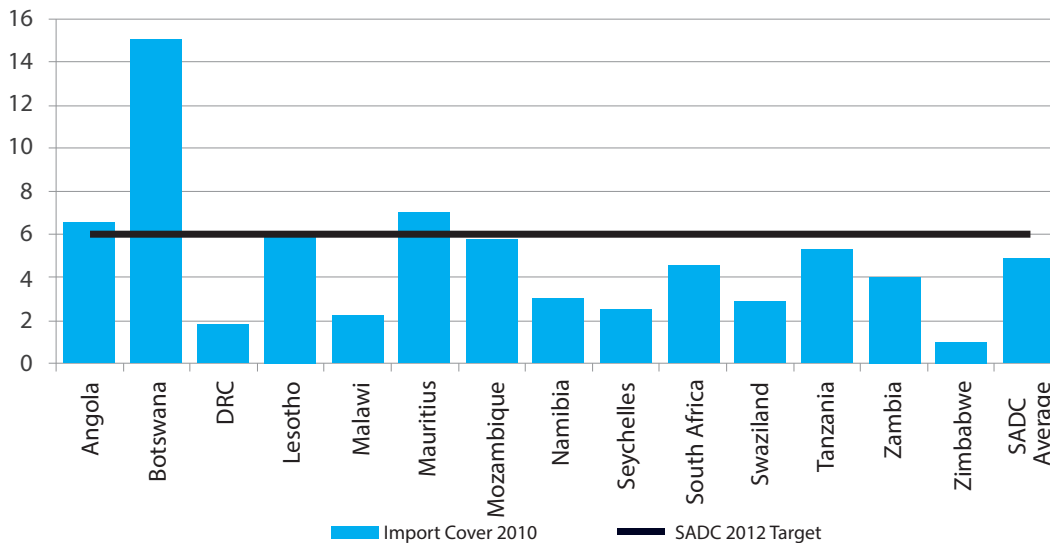
**Figure 4: International reserves in months of import cover**



In general, Botswana, Malawi, Mauritius, Namibia and, Seychelles are on track to meet two 2012 primary MEC targets. No country is on target to meet more than two primary targets. As for secondary targets, only Botswana is on target to meet two targets. Malawi, Seychelles, and Mauritius are on target to meet one target.



**Figure 5: Reserves in months of import cover**



### Overall performance

In discussing the overall performance, the following six status categories were applied:

- (a) **Improved remarkably**, the case in which a country improves its record by attaining at least two targets when compared to the previous record of targets met;
- (b) **Improved**, the case in which a country improves its record by adding one target on the number of targets met when compared to the previous record of targets met;
- (c) **Unchanged but satisfactory**, the case in which a country's number of MEC indicators met remains unchanged but at least one target was met in the previous year;
- (d) **Unchanged**, the case in which a country has yet to meet a target;
- (e) **Slump**, the case in which a country has met one less target when compared to the previous year's record; and
- (f) **Deteriorated**, the case in which a country has met two less targets when compared to the previous year's record.
- (g) Primary MEC indicators

Overall, Angola improved considerably with regard to progress in meeting the primary MEC indicators for the periods 2009 and 2010 with a score of two in 2010 compared to none in 2009 (table 4). Improvements were recorded by DRC, Lesotho, Malawi, Namibia, Seychelles and United Republic of Tanzania while the performance of Madagascar was unsatisfactory as it deteriorated in view of the country missing all the targets compared to a relatively good performance of the previous year

in which two targets were met. The status for the rest of the countries was unchanged but remained satisfactory in the sense that each country met at least one target.

The overall progress in the two-year period can be regarded as satisfactory since the frequency distribution is concentrated around improved (modal score, 7 out of 15 countries) and unchanged but satisfactory (second popular, 6 out of 15 countries) in respect to the status attributed to each country's performance for a total of 13 out of the 15 countries. Besides, only two countries recorded an overall decline in the performance indicator in the two-year period.

### **Secondary MEC indicators**

The number of countries that completely failed to meet any of the targets in the two-year period was four (the status marked unchanged), with another four countries having recorded unchanged but satisfactory progress (table 4). The countries with an unchanged status are DRC, Madagascar, Mozambique, and Swaziland while countries with an unchanged but satisfactory status are Malawi, Namibia, South Africa and United Republic of Tanzania. The status of only two countries either slumped or deteriorated. The status of Mauritius slumped while the status of Lesotho deteriorated.

The overall progress in the two-year period can be regarded as relatively poor since the relative frequency distribution is concentrated around the statuses unchanged to unchanged but satisfactory (8/15 countries) and slump-deteriorated (2/15 countries) for a total of 10 out of 15 countries. Only five countries recorded an improvement in their status for the period between 2009 and 2010.

**Table 4: Number of indicator targets met and progress status by each SADC country**

Description	2009		2010		Status on progress between 2009 and 2010	
	Primary (out of 3 targets)	Secondary (out of 3 targets)	Primary (out of 3 targets)	Secondary (out of 3 targets)	Primary	Secondary
Angola	0	0	2	1	Improved remarkably	Improved
Botswana	1	2	1	3	Unchanged but satisfactory	Improved
DRC	1	0	2	0	Improved	Unchanged
Lesotho	1	2	2	0	Improved	Deteriorated
Madagascar	2	0	0	0	Deteriorated	Unchanged
Malawi	1	1	2	1	Improved	Unchanged but satisfactory
Mauritius	3	2	2	1	Slumped	Deteriorated
Mozambique	1	0	1	0	Unchanged but satisfactory	Unchanged but satisfactory
Namibia	1	1	2	1	Improved	Slumped
Seychelles	1	0	2	1	Improved	Unchanged
South Africa	1	1	1	1	Unchanged but satisfactory	Unchanged but satisfactory
Swaziland	2	0	2	0	Unchanged but satisfactory	Unchanged
United Republic of Tanzania	1	1	2	1	Improved	Unchanged but satisfactory
Zambia	2	1	2	2	Unchanged but satisfactory	Improved
Zimbabwe	2	0	2	1	Unchanged but satisfactory	Improved

Based on the performance with respect to both the primary and secondary MEC indicators, there is a greater chance that two primary indicators, fiscal balance and debt ratio are likely to be met by the majority of member countries at the end of 2012. The inflation target has been elusive to many countries and it is likely that the new target may not be met by many member countries by 2012 given the volatility in global commodity prices. The region, however, has immense growth potential as evidenced by the availability of natural resources, and vast tracts of arable land. Its main challenge is to attract and sustain meaningful foreign direct investment flows in order to unlock the growth potential. Investment opportunities abound in mining, agriculture, manufacturing, financial services, information and communications technology, tourism and infrastructural development. In addition SADC is a huge market with a population of more than 250 million and GDP that exceeds \$400 billion, presenting huge trade and growth opportunities. This will provide momentum towards attainment of long-term growth and stability, employment creation as well as enhance competitiveness in regional and global markets.

### **Econometric approach**

This section provides the econometric methodology for assessing the level and the rate of convergence of macro-economic indicators in the SADC region. It is anticipated that true integration cannot take place unless the economies of participating countries in an integration area deal with economic shocks harmoniously. Therefore, analysing the degree of harmony and coordination in the macro-economic policies of the economies trying to integrate is an important element in assessing the state of integration. Evidence of macro-economic convergence in the selected indicators is often a sign that policy coordination in the regional economic community (REC) is achieving the desired macro-economic outcomes. This would provide the necessary foundation for moving the REC through the various phases of integration towards monetary union, as argued in OCA theories.

Various methodologies have been used to test the convergence hypothesis as well as to compute the speed of convergence. In literature, macro-economic convergence appears to be related to the OCA theory advocated by Mundell (1961), and Talvas (1993), among others. This approach refers to convergence with regard to economic performance to an agreed upon target among the identified class of macro-economic variables of a given set of countries. Other convergence approaches have been considered within the context of the neoclassical growth theory the case in which the amount of time it would take for less developed countries less developed countries to catch up with their developed counterparts in terms of per capita income.

The methodological framework draws heavily on a series of studies undertaken by Ben Hammouda et al (2007a, 2007b). Estimation of the macro-economic convergence criteria has been generally achieved with a number of different approaches. Among them includes the beta convergence (Sala-i-Martin, 1996;Barro and Sala-i-Martin,1995; and Mankiw and others, 1992); sigma convergence

testing the dispersion (standard deviation) of the variables over time (ECA-AU, 2008 and Sala-i-Martin - 1996); stochastic convergence (ECA-AU, 2008, Mutoti and Kahangire,2006; and Bernard and Darlauf, 1995) with modifications applied with respect to Qual - 1992 and 1994 and Levin and Lin (1993) in Mutoti and Kahangire (2006) by imposing homogeneity and thereby assuming common convergence rates) and the mean reversion (Hlivnjak,2009; and Jiandong and Shang-Jin,2007).

Under the beta convergence, a distinction is made between absolute and conditional beta convergence. Absolute convergence presupposes that all the economies in a given group will be moving to one steady state. The key test is, therefore, to establish whether the countries in a given REC are all moving towards this unique and joint steady state. Conditional convergence, on the other hand, assumes that each country has a unique steady state and the formal test that is carried out essentially aims to establish whether within a given group of countries each one is converging towards its individual steady state. This is necessitated by the fact that countries are likely to have different steady states owing to different technological and behavioural parameters arising from different levels of technology, savings and population growth. The beta convergence assumes that poor countries would grow faster than rich ones due to low capital as they would accumulate more capital in the process.

Suppose that *absolute* convergence holds for a group of countries  $i = 1, 2, \dots, N$ , a standard growth equation is given as (Barro and Sala-i-Matin, 1995):

$$\log(x_{it}) = a + (1 - b)\log(x_{i,t-1}) + v_{it} \quad (1)$$

Where  $y_{it}$  is the income level of the country,  $a$  and  $b$  are constants, with  $0 < b < 1$ ,  $v_{it}$  is the disturbance term, and  $t$  is the time index. The condition  $b > 0$  implies absolute convergence since the annual growth rate, is inversely related to  $\log(y_{i,t-1})$ .

The sigma convergence ( $\sigma$ -convergence) states that the dispersion (as measured by standard deviation) of a given economic variable, such as income, across a group of economies tends to decline over time. This is the case when standard deviation at period  $t$  is less than the standard deviation at time  $t-n$ ,  $n = 1, 2, 3 \dots T$ . In other words, a group of economies are said to converge in the sense of sigma  $\sigma$  (standard deviation) if  $\sigma_{t+T} < \sigma_t$ , when  $\sigma_t$  is the time  $t$  standard deviation of  $\log(y_{i,t})$  across  $i$ .

A formal test of sigma convergence to see whether the dispersion (standard deviation) of a given economic variable declines over time is to regress  $\sigma$  with the time trend. Convergence in the variable holds if the coefficient of time is significantly negative. Specifically, define the standard deviation of  $x$  across countries in the region at time  $t$  as  $\sigma_t$ . Then one way to assess convergence is to see whether  $\sigma$  decreases over time. A formal test involves estimating the regression:

$$\sigma_t = \alpha + \phi T_t + \varepsilon_t \quad (2)$$

When  $T$  is a time trend,  $\varepsilon$  is a disturbance, and  $\alpha$  and  $\varphi$  are the parameters to be estimated. Convergence requires the estimated  $\varphi$  to be significantly negative. Equation (2) can be estimated using ordinary least squares (OLS).

### Stochastic convergence and common trends

The stochastic convergence is based on the concepts of unit roots and cointegration in time series econometrics. This notion of convergence was introduced by Bernard and Darlauf (1995) in their study of income convergence in a stochastic environment. In general, stochastic convergence tests determine whether the long-run forecasts of output differences tend to zero over time. This is under the assumption that if the output differences is a mean zero stationary process, then their outputs must be cointegrated with a cointegrating vector  $[1, -1]$ .

Bernard and Darlauf suggest that if countries do not converge in the strict sense of the above definition, they might still respond to the same long-run driving processes, which means that they may face the same permanent shocks with different long-run weights. Countries  $i = 1, 2, \dots, N$  contains a single common trend if the long-term forecasts of output are proportional at a fixed time. In other words, countries  $i$  and  $j$  have a common trend if their output series are cointegrated with a cointegrating vector  $[1, -\alpha]$ .

The Johansen multivariate tests of cointegration may be used to test for stochastic convergence, assuming the output vector process has a finite-vector autoregressive representation as:

$$\Delta Y_t = \Pi_0 + \Pi Y_{t-1} + \Pi_1 \Delta Y_{t-1} + \dots + \Pi_p \Delta Y_{t-p} + \varepsilon_t \quad (3)$$

Where  $Y_t$  = vector of a macro-economic variable (for example per capita income),  $\Pi$  = matrix of coefficients;  $\varepsilon_t$  is the error term.

In equation (3), the main interest is the rank of  $\Pi$ , which is related to the number of cointegrating vectors. If the rank ( $\Pi$ ) =  $N$ , then  $t Y$  is a stationary process. If the rank ( $\Pi$ ) is  $0 < r < N$ , there are  $r$  cointegrating vectors for the individual series in  $t Y$  and thus, the group of countries is being driven by  $(N - r)$  common shocks. If the rank ( $\Pi$ ) =  $0$ , there are  $N$  stochastic trends and the long-run output levels are not related across countries. For individual output series to converge, there must be  $(N - 1)$  cointegrating vectors of the form  $(1, -1)$  or one common long-run trend. In general, stochastic convergence tests determine whether the long-run forecasts of output differences tend to be zero over time.

## **Data issues**

Average annual data are applied for the period 1994 to 2010. The choice of the period coincides with the time when most member countries started experiencing a rapid decline in inflation after implementing structural adjustment policies and the following variables are used: inflation, fiscal balance, public debt, and current account. The data was obtained from various sources including, among others, *International Financial Statistics* and *Regional Economic Outlook* (sub-Saharan Africa region) published by the International Monetary Fund, and *World Development Indicators* published by the World Bank.

## **Estimations results**

### **Unit root tests for primary MEC indicators**

The unit root test is another test of convergence used in this section. Unit root tests for the series from member countries were conducted using the Philips-Peron test as it is considered better than the Augmented Dickey Fuller (ADF) test for time series data that are short. The tests determine whether the countries in a regional economic group are converging towards a regional mean.

### **Unit root test for real GDP**

The unit root test results show that the data for, Mozambique, South Africa and United Republic of Tanzania are stationary, i.e.  $I(0)$  (table 5). On the other hand, Botswana, Madagascar, Malawi, Mauritius, Seychelles, Swaziland, and Zambia data have unit roots, i.e.  $I(1)$ ., an indication that more policy interventions are needed to stabilize real growth in these countries. This problem also poses challenges on the computation of the speed of adjustment/convergence to the countries' specific steady states.

**Table 5: Augmented Dickey Fuller (ADF) unit root test for real GDP**

Country	Lags Criterion	ADF statistics		
		Level (with intercept)	Level (with intercept & trend)	First difference (with intercept)
Botswana	2	-1.93	-1.78	-4.33
Madagascar	4	-1.74	-1.65	-4.22
Malawi	3	-2.32	-2.46	-5.06
Mauritius	1	-2.29	-2.48	-5.88
Mozambique	1	-3.57	-3.74	-6.92
Seychelles	2	-1.27	-1.42	-4.16
South Africa	4	-3.75	-3.67	-6.95
Swaziland	3	-2.73	-2.72	-4.04
Zambia	4	-1.62	-2.32	-4.31
United Republic of Tanzania	1	-3.84	-3.79	-7.27

### **Fiscal balance**

The unit root test results show that the data for Swaziland and United Republic of Tanzania are stationary.i.e. I(0) (table 6). On the other hand, Botswana, Madagascar, Malawi, Mauritius, Mozambique, Seychelles, South Africa, and Zambia data have unit roots i.e. I(1).



**Table 6: Unit root test for fiscal balance**

Country	Lags Criterion	ADF statistics		
		Level (with intercept)	Level (with intercept & trend)	First difference (with intercept)
Botswana	3	-0.38	-1.97	-5.57
Madagascar	9	-3.53	-3.60	-12.56
Malawi	9	0.28	-2.13	-6.75
Mauritius	9	0.60	-1.53	-4.63
Mozambique	5	1.96	-0.92	-3.40
Seychelles	4	-1.66	-3.47	-4.69
South Africa	4	0.39	-2.91	-3.71
Swaziland	9	3.23	3.51	-4.76
Zambia	1	1.09	-2.31	-3.32
United Republic of Tanzania	6	3.78	3.63	-3.57

### **Public debt**

Finally, the public debt of the SADC countries is stationary only in first differences, except for Botswana, Mauritius and Swaziland (table 7).

**Table 7: Unit root test for public debt**

Country	Lags Criterion	ADF Statistics		
		Level (with intercept)	Level (with intercept & trend)	First difference (with intercept)
Botswana	1	-3.98	-3.89	-9.99
Madagascar	3	-2.63	-2.03	-5.54
Malawi	1	-2.55	-2.68	-5.76
Mauritius	1	-3.37	-3.35	-8.00
Mozambique	1	-2.26	-2.19	-4.17
Seychelles	1	-1.62	-1.67	-3.71
South Africa	5	0.90	1.35	3.05
Swaziland	4	-3.66	-3.64	-8.77
Zambia	11	-2.53	-2.61	-4.33
United Republic of Tanzania	1	-2.26	-2.40	-4.65

### Cointegration tests

Another notion of convergence holds that if there are two or more series (in this case, country) sharing a long-run equilibrium or persistent co-movement, economic variables may diverge from each other in the short-run but maintain a common path (equilibrium) over time, with non-increasing individual diversions from the equilibrium (ECA-AU, 2008). Cointegration tests in this subsection determine whether there is co-movement of macro-economic variables within SADC.

The inflation rate is considered one of the essential monetary convergence criteria. Therefore, the evidence of convergence among inflation rates underscores the existence of a long-run relationship among different monetary variables (Rofael and others, 2011). Only eight countries are qualified for the cointegration test using inflation rates. When including all eight countries together, at most two cointegration relationships exist. However, it is theoretically unsound to estimate cointegration relationships over inflation of countries whose business cycles are neither synchronized nor determined by the same set of industrial processes or consumer demands. Instead, we test cointegration on real GDP for the eight countries. The results show that at most 1 cointegrating relationship among eight I(1) countries, which implies partial convergence (table 8).

**Table 8: Johansen cointegration analysis of real GDP in SADC countries**

Sample(adjusted): 2000:06 2009:12

Included observations: 63 after adjusting endpoints

Trend assumption: Linear deterministic trend

Series: Botswana, Lesotho, Mauritius, United Republic of Tanzania, Zambia, Malawi, Swaziland, South Africa

Lags interval (in first differences): 1 to 4

Unrestricted cointegration rank test

Hypothesized	Trace	5 Per cent	1 Per cent
No. of CE(s)	Eigenvalue	Statistic	Critical Value
None **	0.311124	85.32547	67.38
At most 1	0.224501	42.304578	47.25
At most 2	0.118249	21.278921	29.32
At most 3	0.068942	10.264231	15.51
At most 4	0.004216	0.2811523	3.65

\*(\*\*) denotes rejection of the hypothesis at the 5%(1%) level

Trace test indicates 1 cointegrating equation(s) at both 5% and 1% levels

Regarding fiscal balance of SADC countries, the results in Table 9 show at most 1 cointegrating relationship among seven I(1) countries, which implies partial convergence.

**Table 9: Johansen cointegration analysis on fiscal balance of SADC countries**

Date: 11/09/11 Time: 22:43

Sample(adjusted): 2000:06 2009:12

Included observations: 65 after adjusting endpoints

Trend assumption: Linear deterministic trend

Series: Botswana, Madagascar, Malawi, Mozambique, Seychelles, South Africa and Zambia

Lags interval (in first differences): 1 to 4

Unrestricted cointegration rank test (Trace)

Hypothesized	Trace	0.05	
No. of CE(s)	Eigenvalue	Statistic	Critical Value
None *	0.257439	77.68195	69.81889
At most 1	0.225287	43.45215	47.85613
At most 2	0.084044	14.09697	29.79707
At most 3	0.030793	4.001481	15.49471
At most 4	0.003512	0.404648	3.841466

Trace test indicates 1 cointegrating eqn(s) at the 0.05 level

\* denotes rejection of the hypothesis at the 0.05 level

\*\*Haug and others (2000) (1999) p-values

## ***Conclusion***

SADC countries have made significant progress towards attaining the macro-economic convergence targets. As the region is poised for further growth, inflation pressures will remain a challenge in the years to come. This, consequently, underscores the need for sustaining sound macro-economic policies.

The descriptive analysis shows that the overall progress in the two-year period to 2012 targets have been satisfactory. However, among the primary indicators, the inflation target seems to be a foremost challenge for the member countries. For instance, IMF projections for 2011 and 2012 show that only, Mauritius, Seychelles and Zimbabwe are on track to meeting the inflation target of less than 5 per cent. This is because the SADC region remains susceptible to external shocks, such as sharp increases in food and fuel prices.

With regard to the secondary indicators, most of the member countries are likely to achieve the current account target. In general, the majority of countries are on track to meeting their public debt as a percentage of GDP of less than 60 per cent. The low level of debt to GDP ratios are beneficial as they provide governments with fiscal space, particularly those with small economies that cannot borrow at low interest rates. On the other hand, real GDP projections for 2011 and 2012 show that only Angola, Mozambique, and Zambia are on track to meeting real GDP targets of not less than 7 per cent. Finally, only Angola and Botswana are on track to meet the import cover target of not less than 6 months.

The cointegration tests show that different sets of countries are plausible candidates to constitute a currency union. For a monetary union, seven countries, namely Madagascar, Malawi, Mauritius, Seychelles, South Africa and United Republic of Tanzania, relatively fulfil the convergence prerequisites.

The macro-economic targets for 2012 are ambitious and, in some cases, warrant further evaluation, given that achieving the targets may be neither necessary nor sufficient to achieve good macro-economic results. The striking diversity among SADC member countries means that macro-economic targets that are realistic and appropriate for one subgroup of member countries, such as politically stable low-income countries may be unachievable and/or inappropriate for other groups of member countries, such as, middle-income countries. Additionally, SADC protocols do not make provisions for non-compliance by member States.

Based on the Balassa-Samuelson effect that poorer counties must develop faster to catch up with rich nations, further re-examination of the MEC performance results is needed. In particular, poorer economies may face inflation from non-traded goods because of wage influences from tradable goods, resulting in divergence from MEC targets. This calls for a review of implementation mechanisms

particularly as they relate to country waivers for non-compliance with MEC targets. It is, therefore, recommended that SADC countries undertake substantial structural and institutional changes. If nothing is done in that regard, monetary integration cannot be achieved.

The SADC macro-economic convergence programme presents greater opportunities for much deeper integration in the region. Efforts should be made to move away from dependency on a narrow range of commodities towards commodity beneficiation and value addition. In addition, member States need to enhance infrastructure development, particularly the road networks in order to facilitate intra-regional trade.

Strong fiscal and monetary policy should remain in place to keep the fiscal deficits under control and contain inflationary pressures in the region. Extensive reforms are also required to unlock productive potential, promote trade and financial sector development, and encourage domestic savings and investment as well as to strengthen institutional capacity to help attract sustained capital flows into the country.

# Chapter IV: Review of the Institutional Mechanism for Macro-economic Convergence in SADC

## Introduction

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This chapter provides an overview of the institutional setup and strategies for monitoring compliance by member States of the macro-economic convergence programme within the regional integration agenda of SADC. The regional integration agenda is outlined in the Regional Indicative Strategic Development Plan (RISDP), adopted by member States in 2003. The RISDP established a roadmap for deepening regional integration over a 15-year period, outlining a number of targets and milestones to be met along the way. Its stated economic goals are the creation of a FTA by 2008, a customs union by 2010, a monetary union by 2016 and a single currency by 2018.

An important component of the RISDP is the programme to achieve macro-economic convergence among member States. Recognizing that economic instability in any one country has negative spillover effects on the rest of the region, SADC member States agreed to a Memorandum of Understanding (MoU) that committed the countries to achieving and maintaining macro-economic stability, and to follow stability-oriented economic policies. The MoU also set a procedure for the countries to be monitored with regard to achieving macro-economic convergence and measured against specific convergence criteria for inflation, fiscal balance, public debt and the current account balance.

Subsequent to the signing of the MoU in 2002, an agreement was reached to establish the Macro-economic Performance and Surveillance Unit (MPSU) within the SADC Secretariat, with an accompanying Peer Review Mechanism (PRM), whereby ministers of finance and investment and central bank governors would monitor the annual convergence programmes submitted by each member State. The actual monitoring of macro-economic convergence activities is carried out by a subcommittee of the Committee of Central Bank Governors (CCGB). Membership of the subcommittee currently comprises chief economists from the central banks of South Africa, Swaziland, United Republic of Tanzania, Zambia and Zimbabwe. CCGB is, therefore, central in the process of developing a harmonized policy framework, common currency and monetary union.

A SADC workshop to validate the proposed Macro-economic Convergence Surveillance Mechanism (MCSM) was on 24-25 November 2010 in Gaborone, Botswana. The proposed framework is meant to facilitate the operationalization of the PRM based on joint surveillance to monitor implementation of the SADC macro-economic convergence agenda. It focuses on the adaptation of the existing SADC structures to ensure that they are operational in the immediate future. The rest of the chapter outlines the key provisions and articles in the RISDP, MoU on macro-economic convergence as well as proposals that member States are considering in the implementation of the surveillance mechanism.

## **The RISDP**

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The RISDP aims to provide strategic direction with respect to SADC programmes and activities, and to align the strategic objectives and priorities of SADC with the policies and strategies for achieving its long-term goals.

The successful implementation of the RISDP, to a large extent, depends on the capacity at both the national and regional levels. Key capacity constraints relate to human resources, financial constraints and an appropriate institutional framework. Among the number of challenges faced by the RISDP are securing human and financial resources required for it to be implemented at the national and SADC Secretariat level, and coordinating institutions with regard to managing the various interests and perspectives of all stakeholders. The latter poses a major hurdle that may further require capacity strengthening of the SADC Secretariat and institutional structures of member States.

At the political level, the SADC Council of Ministers through the Integrated Committee of Ministers (ICM) are the key institutions that will provide policy direction and oversight to the implementation of the RISDP while at the operational level, the Secretariat is primarily responsible for the management and coordination of the RISDP during implementation. According to the Treaty, the Secretariat is the principal executive institution of SADC. At the programme level, the key structures in the implementation of a particular programme should include some or all of the following bodies: The Secretariat; cooperating partner(s); technical committees and sub-committees; programme steering committees; member States participating in the programme; SADC national committees; other stakeholders; implementing agents; and contractors.

## **SADC Protocol on investment and finance**

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The SADC Finance and Investment Protocol (FIP) aims to accelerate growth, investment and employment in the region through increased cooperation, coordination and macro-economic management. The SADC ministers of finance are at the helm of the Protocol. The SADC strategic objective of the

FIP is to contribute to the establishment of a Regional Common Market that allows free movement of capital, labour, goods and services. The establishment of such a market is the end goal of SADC in the economic arena. The Protocol will facilitate regional integration, cooperation and coordination of financial and investment policies in the SADC region. The Memoranda of Understanding developed by various finance and investment technical committees have been converted into annexes, which form an integral part of the Protocol. Among them is the MoU on Macro-economic Convergence.

## **Memorandum of understanding on macro-economic convergence**

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According to the SADC MoU, which was signed by the SADC ministers responsible for finance and investment in August 2002, the underlying principle of macro-economic convergence is to achieve and maintain macro-economic stability by converging on “stability-orientated economic policies implemented through a sound institutional structure and framework”. The MoU is now annex 2 of the SADC Protocol on Finance and Investment, which came into force on 16 April 2010. The key variables for achieving convergence are inflation, fiscal deficit and public debt.

The MoU entails a commitment to converge in the key indicators by specific dates. Article 2 of the MoU emphasizes the need to “converge on a stability-oriented economic policies implemented through a sound institutional structure and framework.” Article 3(1) stipulates that “macro-economic stability is a desirable outcome of macro-economic convergence and that macro-economic convergence in the region will be measured and monitored by the following indicators: the rate of inflation in each member State; the ratio of the budget deficit to GDP; the ratio of public and publicly-guaranteed debt to GDP; and the balance and structure of the current account”. Article 3(2) states that member States shall “identify common guidelines for each of these indicators and other complementary indicators that may be specified, including structural performance and financial conditions”.

According to Article 5(1) of the MoU (Information and Data), “member State parties...shall provide such data and reports for the implementation and monitoring of the MoU. Article 5(2) further stipulates that “data will be provided in accordance with internationally accepted data standards as defined by the International Monetary Fund”.

Article 6(1) stipulates that the Committee of Senior Treasury Officials will be responsible for the implementation of this MoU and will report on implementation to the Committee of Ministers for Finance and Investment. Article 6(2) states that “the Committee of Senior Treasury Officials may make use of, or recommend to the Committee of Ministers for Finance and Investment, the establishment of, any structure that may be necessary to facilitate the implementation of this MoU”. Article 6(3) states that “member States agree that, for the purposes of this Article, the Committee of Ministers for Finance and Investment will collaborate with the Committee of Central Bank Governors”.



Article 7 (1) stipulates that the Committee of Ministers for Finance and Investment will “*establish a collective surveillance procedure to monitor macro-economic convergence in the region, determine specific targets, assess progress relative to these targets and provide advice on corrective actions*”. Article 7 (2) states that *member States will present to the Committee of Ministers for Finance and Investment an annual convergence programme*”. Article 7 (3) stipulates that “*the Committee of Ministers for Finance and Investment will evaluate and monitor the annual convergence programmes submitted by member States, determine whether they satisfy the common guidelines, advise on possible changes, compare outcomes with previous programmes and make recommendations they may deem appropriate in accordance with the Treaty*”.

In article 8, the MoU states that member States will develop a protocol on finance and investment matters in accordance with the understanding herein recorded and the objectives set out in the Treaty. This has been fulfilled as expected, and the MoU is duly incorporated as annex 2 of the Protocol. Further, Article 9 empowers the Committee of Ministers for Finance and Investment to review the SADC macro-economic convergence programme while Article 10 is on settlement of disputes. Revisions of the MoU are provided for in Article 11, which when read together with Article 9 provides for changes to the Agreement as the Council of Ministers of Finance see fit.

At the institutional and policy level, a macro-economic sub-committee, comprising officials from ministries of finance and central banks, monitors progress towards macro-economic convergence. This subcommittee reports to the Committee of Senior Treasury Officials, which then reports to Ministers of Finance and Central Bank Governors. Annex 2 of the SADC Protocol on Finance and Investment establishes a Peer Review Panel (PRP) comprising ministers of finance and central bank governors. The Committee of Central Bank Governors (CCBG) also has a macro-economic subcommittee which reports to the governors. The CCBG is mandated by the SADC Council to develop and manage the SADC macro-economic database.

## **Proposals on operational and sustainability issues of the SADC macro-economic surveillance mechanism**

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A workshop held for senior treasury and central bank officials on 29-30 March 2011 in Johannesburg, South Africa, considered the findings and recommendations of the report on the SADC Macro-economic and Surveillance Framework. The framework is meant to facilitate the operationalization of the PRP based on a joint surveillance mechanism to monitor implementation of the SADC Macro-economic Convergence Agenda. It focuses on the adaptation of the existing SADC structures to a peer review process to ensure its feasibility in the future. Article 7 of annex 2 to the SADC Protocol on Finance and Investment (FIP) provides that “*the Peer Review Panel shall establish a collective surveillance procedure to monitor macro-economic convergence, determine specific targets, assess*

*progress relative to those targets and provide advice on corrective action.*" This procedure shall be referred to as the SADC Macro-economic Convergence Surveillance Mechanism (MCSM).

Furthermore, chapter 10, article 17 of the FIP provides for the establishment of the PRP and article 20 of the same chapter provides that the PRP *"shall consist of: (a) the Committee of Ministers for Finance and Investment; and (b) Central Bank Governors from each of the State Parties"*.

The workshop came up with the following proposals concerning the SADC MCSM.

### ***Designation of peers to respective member States***

According to best practice, the SADC Secretariat, in consultation with the review committee (in our case PRP), will designate two or more of its members as "peer examiners for each review". Peers examiners along with members of the Secretariat, and the PRP Chairperson serve as an integral part of the review team, Ministers of and central bank governors make up the PRB. They are considered to be representatives of the PRP as a whole, tasked with contributing to as well as learning from the peer review process. In this regard, they are expected to take an active role during all stages of the process, i.e. planning, field visits, missions to the capital, and contributing to the peer review reports, issues paper for the review meeting and the Chairperson's Press Release. They also lead discussions at the peer review meeting itself.

The proposed designation of peers is based on country differences in terms of economic size. Thus, the following peers have been proposed: Botswana and Mauritius; Namibia and Seychelles; Swaziland and DRC; Lesotho and Mozambique; South Africa and Zambia; Zimbabwe and United Republic of Tanzania; and Angola and Malawi.

### ***Sub-peer review panels***

Participants at the workshop felt that the 30-member PRP was too large to efficiently interact with all of the member States at the same meeting. Hence a proposal for sub-panels was made. Based on the recommended proposal on designation of peers, the following Sub-Peer Review Panels were recommended as parallel sessions before the main Peer Review Panel Session for reporting back and finalizing the communiqué: (a) Angola, Botswana, Malawi, Mauritius, Namibia and, Seychelles; (b) DRC, Lesotho, Mozambique and Swaziland; and (c) United Republic of Tanzania, South Africa, Zambia and Zimbabwe.

In terms of meetings, it was proposed that the PRP should convene at least once a year to discuss, review and consider all SADC surveillance matters. These issues would be presented by the Chairperson of the Committee of Senior Treasury and Central Bank Officers. It was also proposed that the

Macro-economic Sub-committee should meet at least two times in a year, or as and when necessary, to monitor progress or otherwise of member States with the SADC Macro-economic peer review process.

### ***Lead country reviewers***

It was noted at the workshop that the PRP was composed of members that may not be able to directly undertake a professional assessment of a member State performance with respect to Macro-economic Convergence and the coherence of the National Macro-economic Convergence Plan. Therefore, it was proposed that lead reviewers be designated by the SADC Secretariat in consultation with the peers of the member States.

The lead country reviewers will be responsible for: (a) leading a team of professionals (leader, assistant, and SADC Secretariat) that will undertake the independent assessment of a country; (b) leading the comparison of their independent assessment to the self-assessment of the country to come up with issues for discussion with national stakeholders; (c) presenting their findings and issues for discussions with national stakeholders; (d) leading preparation of the final report and issues paper to present to the SADC Macro-economic Sub-committee; (e) leading discussions at the Peer Review Panel meetings as required; and (f) leading preparation of the Press Release by the Chairperson of the PRP.

To ensure credibility and professionalism, the workshop also proposed that lead country reviewers should be practicing or retired professional macroeconomists. These could be sourced from academia, consulting companies or economic policy research departments/institutions, such as central bank research departments or member country research institutes. It was further proposed that the SADC Secretariat in consultation with the peers should designate lead country reviewers.

### ***Member State operational structure***

According to the proposed framework, each member State has to compose or designate the following; MCSM committee (could be existing economic policy coordination committee), Focal Point, and Secretariat. At the member State level, member States are to communicate their focal point to the SADC Secretariat two weeks after the first meeting of the PRP.

### ***Implementation of action plan***

Given the scope and institutional capacity of requirements of the MCSM, the following road map for implementation of the mechanism was proposed: (a) Inaugural meeting of the PRP to consider recommendations of the Senior Officers Committee (to be determined by the Secretariat and member States); (b) rationalization of the institutional capacity requirements at MSPU<sup>4</sup>/SADC Secretariat. For the immediate future, it was recommended that the Executive Management of the Secretariat develop

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4 Macro-economic Surveillance and Performance Unit

a collaboration and coordination mechanism for the MPSU and the Macro-economic Convergence and Policy Unit (by end of May/June 2011); (c) communication of designated focal points from member States to MPSU/SADC Secretariat (depending on item a)); (d) Assessment and establishment of institutional requirements of member States (depending on item a); (e) identification of lead reviewers and composition of country review teams (depending on items a and d); (f) preparation of review schedule and communication to member States; commencement of review processes with first group of member States to be reviewed (depending on items d and e); (g) commencement of review processes with first group of member States to be reviewed (depending on item f).

Senior treasury and bank officials from the member States noted that it was not possible to put a specific timeline on the activities since they depended on the first meeting of the PRP panel. Thus, the committee recommended that the SADC Secretariat explore possibilities to facilitate the first PRP meeting as soon as possible, preferably in September 2011.

### ***Memorandum of Understanding with International Monetary Fund***

Due to capacity constraints within the SADC Secretariat and member States, the IMF and the World Bank were identified as partner institutions for collaborations in technical reviews of member States and also in capacity-building. This proposal was supported by the senior treasury officers and ministers responsible for finance and investment as recorded during their meetings of July 2010 in Livingstone, Zambia. The record states that *“due to capacity constraints at the SADC Secretariat, and the need for the exercise to be credible and objective, the regional surveillance mechanism could be coordinated with the World Bank for the economic management aspects and the IMF for fiscal aspects”* (Item 9.3.10 of record of Annotated Agenda of Ministers’ meeting) (SADC, 2010). Thus, the committee recommended that a MoU be developed with IMF, African Development Bank and the World Bank. It also recommended that the SADC Secretariat request technical assistance from the Fund on behalf of all member States.

### ***Sustainability issues***

Effective economic review and policy discussions contribute to the prevention of financial crises through the early detection of irregularities and the swift implementation of remedial policy actions. It also lays the foundation for providing immediate assistance, in the event of a crisis. The proposed SADC MCSM will examine regional economic and financial developments through economic reviews and discussions that could require actions from member countries and search for means of policy cooperation. The Secretariat recommended that a Technical Working Group on Economic and Financial Surveillance (TWGEFS) be established and be tasked with the development of this strategy.

The SADC Macro-economic Sub-committee further recommended that the TWGEFS be composed of four representatives from the central banks of the following member States: Angola, Botswana, DRC and Lesotho. The sub-committee also recommended that four representatives come from the

ministries of finance of the following member States: Malawi, Mauritius, Mozambique and Namibia; and one representative come from the SADC Secretariat and one from the Committee of Central Bank Governors Secretariat. The SADC Secretariat was tasked with setting minimum requirements for membership of the Working Group within two weeks and communicate them to the relevant member States with a time framework for submission of nominees.

### ***Guidelines for country assessments and national convergence programmes***

At the workshop of senior treasury and central bank officials, a presentation was made on the guidelines and recommendations from the Macro-economic Sub-Committee. The sub-committee recommended the guidelines be adopted as presented as they provided a means of standardizing reports to the PRP.

## **Framework for surveillance of macro-economic convergence**

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Ministers responsible for finance and investment approved the interim arrangement to establish the MSPU at the SADC Secretariat during a meeting held in July 2004 in Dar-es-Salaam, United Republic of Tanzania. The primary objective of the Unit is to coordinate the collective surveillance procedure to monitor macro-economic convergence. In August 2007, the ministers responsible for finance and investment approved the establishment of the PRB.

### ***Mandate of the Peer Review Panel***

The mandate of the PRP as provided for in Article 7 of Annex 2 to the FIP is to “evaluate and monitor the annual macro-economic convergence programmes submitted by State Parties” to determine whether the programmes satisfy the common guidelines, advise on possible changes, compare outcomes with previous programmes and make such recommendations as the PRP may deem appropriate in accordance with the Treaty. By implications, the mandate of the PRP is to ensure that the economic policies and practices of SADC member States conform to the agreed macro-economic convergence targets.

### ***Aims and objectives of the Macro-economic Convergence Surveillance Mechanism (MCSM)***

The overall aim of the MCSM is to foster the adoption of economic policies and economic management standards and practices that will facilitate regional economic and financial integration and consequently facilitate economic growth, sustainable development and poverty alleviation. As per a peer review process, the ultimate goal of the MCSM is to encourage the reviewed country to improve its policymaking capacity, adopt best practices and comply with agreed standards and principles - in this case macro-economic convergence.

### ***Principles of the MCSM***

The SADC MCSM is based on the concept of peer review which has its origins from professional bodies and involves two broad areas: the evaluation of proposals and projects by experts and the monitoring of State compliance with the provisions of a Treaty.

The effectiveness of the MCSM shall be guided by the following principles:

- (a) Inclusive participation (All countries shall participate in the MCSM, whether reviewing or being reviewed);
- (b) Simplicity (the MCSM shall be straight forward, objective and clearly understood by all member States);
- (c) Ownership (the SADC member States shall be the driving force in the operation of the MCSM);
- (d) Fairness (the MCSM shall provide equal treatment for all member States);
- (e) Complementarity (the MCSM shall complement the global and continental surveillance exercises undertaken by institutions, such as the IMF and African Peer Review Mechanism); and
- (f) Credibility (every review carried out by the MCSM will be technically competent, credible and free from any form of manipulation).

### ***Scope of the surveillance***

The scope of the surveillance activities shall include the following areas: (a) utilize early warning models and other tools to monitor and analyse macro-economic developments within the region and the world with respect to the potential impact on SADC member States; (b) assess macro-economic performance of member States against SADC convergence targets; (c) monitor any other specific areas, including structural and sectoral issues, as approved by the SADC PRB Panel; (d) consult relevant private sector and international organizations within and outside SADC region to enhance surveillance work whenever the need arises; and (e) monitor implementation of recommended actions and programmes.

### ***Participation***

All SADC member States shall participate in and support the SADC Surveillance Process. In this regard, all member States are to provide to the SADC Macro-economic Statistics Database, hosted at the CCBG Secretariat, a set of baseline data based on an agreed template.

### ***Leadership and management structure***

Article 20 of chapter 10 of the FIP provides that the PRP “shall meet once a year to effect the provisions of macro-economic monitoring and surveillance as provided in Article 7 of Annex2”. By implication, operations of the MCSM shall be directed and managed by this Panel. It was proposed that

the chair and vice-chair of the PRP should be ministers of finance and/or central bank Governors of member States from which the SADC Chair and vice-Chair comes from.

The Chair of the PRP will oversee the review process. The PRP will be facilitated by the MSPU, to undertake any analytical work that underlies the review process. The MSPU, in its capacity as secretariat of the PRP, may engage, with approval of the PRP Chair, the services of regional experts and/or institutions that it considers competent and appropriate to act as its agents in the peer review process.

### ***Operational issues***

For the interim, operational proposals were broadly defined for the SADC regional and member State levels. It was proposed that there be three main institutions and strategic partners at the SADC regional level with the SADC Macro-economic PRP holding the leading position with the overall responsibility of the MCSM. Following article 20 of chapter 10 of the FIP, the PRP *“shall consist of: (a) the committee of Ministers of Finance and Investment; and (b) Central Bank Governors from each of the State Parties.* The article further proposes that *“the next in line operational institution be a committee of Senior Officials from both the Ministries of Finance and Central Banks of member States”.*

In line with the existing structures, it was recommended that a committee of senior treasury officers (STOs) and senior officers from central banks be set up to closely follow the macro-economic surveillance and review process being coordinated by the MSPU and ensure that reports presented to the PRP are of the required quality. With regards to quality control, it was further proposed that this committee meet once a year just before the PRP annual meeting to review the annual reports of the MSPU and member States to be presented to the PRP and to consider the PRP meeting's agenda. The SADC Macro-economic Sub-committee would be next in line with task of convening twice a year to consider the technical aspects of the reports before being submitted to the Committee of Senior Treasury and Central Bank Officers. It was proposed, however, that this committee should be allowed to meet whenever it was deemed necessary. The MSPU would handle the secretarial, technical, coordinating and administrative support services for the MCSM. The functions of the MSPU would include maintaining databases of information on economic developments in all member States and the MCSM processes and outputs, tracking economic and convergence performance of individual member States and preparing back ground documents and annual reports for the PRP.

Also proposed was setting of procedures to work with Strategic Partner Institutions (SPIs) to provide technical support to the MCSM upon request. The proposed partners included the African Peer Review Mechanism, the African Development Bank, IMF and the World Bank. At the country level, the establishment of the following three institutions were proposed:

- (a) The National MCSM Committee would serve as the top institution. It would be responsible for the overall national review process and made up of high-level members that



comprise representatives from the private sector, civil society and government, with the chair preferably not in government so that the focal point does not end up as the chair of this committee. A high-level national economic policymaker could also serve on the committee;

- (b) The national MCSM Focal Point would be the next level in the hierarchy. The position, to be held by a member of the National MCSM Committee entails coordinating the review process. Technically, the person with this role should be a senior officer in the ministry of finance or central bank; and
- (c) The MCSM Secretariat would be the third level. It would be responsible for providing secretarial, technical and administrative services to the National Focal Point and national MCSM Committee. Its functions would include preparing the National Macro-economic Convergence Programme comprising the member State's Self-Assessment and National Programme of Action for consideration by the National MCSM Committee before submission to the SADC Macro-economic Sub-committee. Members of the Secretariat should include appropriate technocrats from all the institutions responsible for macro-economic convergence, including, among others, macro-economic statistics. An existing national macro-economic policy coordination committee could also be tasked to carry out this function. Considering the capacity of various institution at the member State level, it was recommended that central banks, and in particular, their Research Departments be considered for taking a leading role in a National MCSM Secretariats.

## **The SADC Macro-economic Peer Review Process**

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The MCSM is designed around the duality of national processes by which member States evaluate their state of economic management and governance on the basis of the Macro-economic Convergence Indicators and targets. They then would prepare a National Programme of Action on the basis of which they are peer-reviewed through an external process of validation that is anchored by the SADC Macro-economic Peer Review Panel facilitated by the MSPU. The process would entail periodic reviews of the economic policies and practices of member States to ascertain progress being made towards achieving mutually-agreed targets for macro-economic convergence.

The process consists of seven inter-related stages embedded in three phases as indicated below:

### ***The preparatory phase***

Stage 1: The MSPU prepares a broad schedule for reviews of the member States. Each member State, in turn, indicates that it agrees to the schedule pertaining to its review or offers an alternative proposal to the timing of the review.



Stage 2: Member States set up a national MCSM committee, a national MCSM Focal point and a national MCSM Secretariat jointly responsible for the establishment of an internal surveillance mechanism.

Stage 3: The MSPU, in consultation with the PRP Chairperson, identify and compose a country review team.

Stage 4: The MSPU team, in consultation with the team leaders and National Focus Points, schedule specific dates for the country review missions.

### ***The consultative stage***

Stage 5: The country review team undertakes a mission to the member States under review for discussions on the issues paper. At the end of the mission, the country review team prepares a draft final report. Based on feedback from the member State, and the Macro-economic Sub-Committee, the final report is prepared for the Peer Review Panel.

### ***The assessment phase***

Stage 6: The report is presented and discussed at a meeting of senior treasury and central bank officers who, in turn, present at the meeting of the PBR. At the end of the meeting, the final report is adopted. The PRP shall then issue a communiqué explaining its assessment through summaries of the main issues.

Stage 7: The MSPU published the PRP communiqué and final report on the SADC website.

### ***Role of the Macro-economic Surveillance and Performance Unit***

The MSPU shall prepare, coordinate, review, and consolidate inputs and information from member States, the CCBG Secretariat and strategic partners for presentation to the SADC Macro-economic Sub-committee and the SADC Macro-economic Peer Review Panel meetings. The MSPU shall also perform the administrative functions for the SADC Macro-economic Sub-committee, the Senior Treasury and Central Bank Officers Committee and the SADC Peer Review Panel meetings. These include preparing the agenda and relevant documents, collecting relevant information and papers for discussions at the SADC Macro-economic Sub-Committee and the SADC Peer Review Panel meetings, providing secretarial services, drafting any press release or communiqué for the SADC Peer Review Panel meetings.

### ***Role of CCBG Secretariat***

The recommendation to establish a financial and macro-economic statistical database was undertaken on 14 September 1995 at a joint meeting of SADC treasury and central bank senior officials. The recommendation was adopted by central Bank Governors in November 1995 and approved and

endorsed by ministers of finance and the SADC Council of Ministers in August 1996. The CCBG was given the responsibility of developing and maintaining the database. Moreover, the CCBG Secretariat was tasked with the responsibility of facilitating appropriate access to the database by MPSU. This support will continue until the MPSU establishes its own databases in the long-run. Technical cooperation will in the meantime be handled by the MSPU, through the SADC Secretariat. Technical assistance and cooperation will be sought from regional and international partners, in particular, IMF and the World Bank, to support the peer review process.

As part of the Surveillance Mechanism, a review of early warning systems with application to SADC Member States was presented to the Macro-economic Surveillance Mechanism A validation workshop was held and recommendations were made to the subsequent Macro-economic Sub-committee. The research was undertaken by a short-term expert with the objective to develop early warning models as one of the tools for conducting macro-economic surveillance. Early warning models have existed for some time but recently became more prominent in the wake of the recent global economic crisis. They use a range of forecasting methodologies in the literature, such as the Probit/Logit Approach, the Signalling Approach, the Markov Switching Approach, the Behavioural Approach, IMF and Regional Organization Surveillance, and Central Bank Surveillance. One model was used to examine the currency crisis as an illustration of measurement issues with application to SADC countries.

### ***Guidelines for preparation of Country Assessments and National Macro-economic Convergence Programmes***

These guidelines are meant to further facilitate the work of the National Macro-economic Convergence Committees and to better harmonize reports that will be submitted to the MSPU and the PRP. The reports have two main sections, the Country Assessment section and the section on the National Macro-economic Convergence Programme (NMCP). The former starts with a discussion of the member States' macro-economic policy framework, followed by an analysis of macro-economic environment and recent developments. It then contains a sub-section on the medium-term macro-economic outlook, followed by another sub-section on the macro-economic convergence performance.

# Conclusion

This chapter discusses the institutional set-up proposed for monitoring the implementation of the SADC macro-economic convergence programme. These proposals are yet to be fully adapted at all levels of SADC, having only been approved at the CCBG level. It must be noted that unlike sovereign governments, the SADC Secretariat and its subsidiary institutions do not have an adequate enforcement mechanism at their disposal for seeing that these proposals are actually carried out but relies, instead, in most cases on consensus and voluntary cooperation of member countries. There is a need to strengthen and empower the institutions that implement and monitor regional integration programmes at the regional and country levels.

The RISDP is an indicative plan with no clear guidelines or roadmap to drive the regional integration process. Thus, there is a need to complement the capacity of member States to provide appropriate policy guidance to the SADC Secretariat and also the capacity of the Secretariat to drive the regional agenda as expected by member States. In particular, the SADC Secretariat has limited human capacity to implement most of its programmes and activities which ultimately affects the Secretariat's financial absorptive capacity. The SADC Secretariat should be capacitated and given the mandate to implement programmes while member States should provide an adequate oversight function over the Secretariat. In addition, member States should develop a clear roadmap to drive the economic integration agenda as outlined in the RISDP.

It should be noted that there is no proper coordination between the SADC Secretariat and member States and no alignment between regional development objectives and national plans and priorities. Furthermore, member States do not have enough political commitment to drive regional initiatives as evidenced from a clear lack of regional messages in national policy debates and programmes. The SADC MEC targets have generally not been mainstreamed into domestic policies of member States, e.g., national budgets and medium-term expenditure frameworks (MTEFs) and their broad macro-economic targets are not in tandem with the overall regional economic objectives.

The most glaring weakness in the MEC programme is a lack of a functioning institutional framework that makes MEC more transparent. Currently, institutional responsibilities are scattered across the Macro-economic Sub-committees of SADC and the CCBG. What are the constraints experienced by these organs? Is there urgency for a superstructure, for instance a team of macro-economic experts to advise and evaluate outcomes, and above all enhance the transparency and credibility of the process? It is important for credibility purposes that any central authority overseeing convergence should be independent of all national authorities' influences. The authority should have mandates anchored on

the agreed key objectives, such as ensuring price stability, with sufficient clout to enforce and supervise compliance by all members for the attainment of the shared objectives. The relationship between such an institution and the roles for national central banks and the common central bank should also be clearly defined beforehand.

Regardless of these limitations, the SADC Secretariat and the CCBG have made a considerable contribution to the implementation of the macro-economic convergence programme. The CCBG, in particular, was instrumental in the formulation of the SADC Model Law and the National Payments System. The CCBG Secretariat, however, has capacity constraints which impedes its ability to deliver on a number of programmes and activities. The recent CCBG meeting, which took place in Lesotho, recommended that with or without a monetary union, SADC should proceed with putting in place a monetary institute. To this effect, it was suggested at the CCBG Meeting held in September 2011 in Mauritius that the terms of reference for guiding the setting up of the monetary institute be developed.

The European experience has shown that it is not necessary to wait for the achievement of theoretically optimal conditions before coordinating policies, but rather that the process of coordination itself strengthens the process of real convergence. The experiences of West Africa, Europe, Latin America also indicate that cooperation among countries require a supranational institution to act as a catalyst and steer the process. Such institutions initially serve to promote and facilitate meetings, and later to oversee - albeit informally - the fulfilment of the agreements.

Whereas legal and institutional convergence should be the starting point toward economic integration, there is also need for a comprehensive capacity-building and enhancement programme for the SADC Secretariat to implement FIP and other SADC protocols. Capacity-building is a necessary precondition for the realization of a monetary union in the SADC region. In addition, it is important to map partners and stakeholders in the subregion to minimize duplication of programmes/initiatives and subsequently cut down on transaction costs associated with uncoordinated and a multiplicity of similar interventions. There is need for a harmonization of institutions and programmes across the subregion, such as institutional convergence anchored on a clear MoU between and among similar institutions with interests in macro-economic convergence.

Macro-economic convergence programmes at the national level are also not fully synchronized with the progress of SADC. Absence of national level macro-economic convergence committees raises questions as to whether central banks and treasury officials are working in coordination. The key issue, however, is whether central banks in the subregion are acting independently to influence and implement macro-economic policy. Attainment of macro-economic convergence in its current form depends on member States having sustainable and prudent management of both fiscal and monetary policies that are linked to inflation, economic growth and other macro-economic goals. A related question is whether there is coordination between ministries of finance and central banks to ensure

delivery of macro-economic convergence targets while maintaining independence of the two institutions.

# Chapter V: Lessons Learned and the Way Forward

## Introduction

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Addressing the challenges of macro-economic policy convergence in Southern Africa is going to be a hurdle on its own since theoretical and practical issues are involved in the process. First, the European model of monetary integration on which the SADC Macro-economic programme was conceived is undergoing one of the worst challenges of its existence, particularly the misalignment never anticipated by the architects of the Treaty. Second, the rate at which countries are complying with the SADC Macro-economic targets has been too slow, threatening the progress of the entire monetary integration process. Third, the institutional architecture for monitoring progress in the implementation of the macro-economic programme is yet to be fully understood at SADC and national levels, with some of the institutional aspects still under discussion at CCGB and other levels of SADC.

In this study, the theory of macro-economic convergence developed from the perspective of a sub-region aiming to create a monetary union is discussed. It also delves the key features of the OCA theory as it relates to the macro-economic convergence criteria for the formation of a monetary union and highlights the limitations of OCA. Another key topic covered is the SADC monetary policy convergence criteria, its scope and developments. In particular, the prospects of member States to comply with SADC macro-economic convergence targets, given performance against 2008 and 2012 targets, is detailed. The study also outlines the institutional arrangements and strategies for monitoring macro-economic convergence at both the national and subregional levels.

## Lessons learned

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The analysis shows that the overall progress towards 2012 targets has been satisfactory although the inflation target seems to be a challenge to most member countries due to the need to deal with the unprecedented shocks in the global economy. The SADC region remains susceptible to external shocks, such as sharp increases in food and fuel prices. With regard to the secondary indicator targets, the current account target is likely to be achieved by most member countries and the majority of countries are on track to meeting their public debt to GDP targets.

The low level of debt to GDP ratios are beneficial as they provide governments with fiscal space, particularly for small economies that cannot borrow at low interest rates. However, real GDP projections for 2011 and 2012 show that only a few countries will meet real GDP growth targets for 2012. Further analysis of the results, particularly the more rigorous methodologies such as unit roots and cointegration tests, indicate that different sets of countries are successful candidates to constitute a currency union. For a monetary union, only a few countries relatively fulfil the convergence prerequisites.

These findings suggest that the macro-economic targets for 2012 are ambitious and, in some cases, warrant further evaluation, given that achieving the targets may neither be necessary nor sufficient to achieve good macro-economic results. The striking diversity of SADC member countries means that macro-economic targets are realistic and appropriate for one subgroup of member States (e.g., politically-stable, low-income countries) but may be unachievable and/or inappropriate for other member States (e.g., middle income countries). Additionally, SADC Protocols do not make provisions for excluding or punishing member States that fail to meet targets. Hence, there is need to strengthen the institutional setup for managing the implementation of the SADC macro-economic programme with member States.

Policymakers face a number of challenges in complying with macro-economic convergence criteria. The slow progress in achieving convergence indicates that problems exist with either with the convergence framework or the capacity of member States to comply with agreed targets. Simultaneously, meeting various macro-economic goals in a developing country is a challenge. Whereas inflation targeting is paramount in the convergence discourse, the flipside is that unemployment and poverty alleviation goals may not easily be achieved without breaking the inflation target barrier. It is therefore difficult to conceive a policy regime in which strategies are not geared towards comprehensive development objectives, namely economic growth, job creation and poverty alleviation, which in many cases may not be consistent with inflation targeting or similar austerity measures on government expenditure and borrowing.

There are also problems with inflexible convergence criteria. Generally, the drawback of setting fixed convergence targets for economies of different sizes and levels of economic activity is reflected in mixed progress recorded by countries in the subregion. The convergence criterion for economic growth is particularly controversial since the impact of growth in a small economy cannot be compared on a similar scale with a large economy. Hence, there is need for a general principle that would assist smaller countries to match larger economies in some aspects, but not all. For instance, a requirement that smaller economies must at least match long-run growth rates of larger economies may not augur well with new growth theories than requiring all countries to achieve a set of fixed targets.

The SADC Macro-economic convergence programme presents greater opportunities for much deeper integration in the region. Efforts should be made to move away from dependency on a narrow range

of commodities towards commodity beneficiation and value addition. In addition, member States need to enhance infrastructure development, particularly the road networks, in order to facilitate intra-regional trade. Strong fiscal and monetary policy should also remain in place to keep the fiscal deficits under control and contain inflationary pressures in the region. Extensive reforms are also required to unlock productive potential, promote trade and financial sector development, and encourage domestic savings and investment as well as to strengthen institutional capacity to help attract sustained capital flows into the country.

Apart from the complexities of interlinkages between macro-economic indicators, there is the issue of independence of central banks in most SADC countries. Attainment of macro-economic convergence in its current form depends on sustainable and prudent management of both fiscal and monetary policies that are inextricably linked to inflation, economic growth and other macro-economic goals.

Lessons from experiences in Europe and elsewhere show that for macro-economic convergence to work, key determinants must be in place. Among them are: as building a consensus in developing the convergence criteria and its implication modalities, as well as commitment to agreed obligations; prioritization in the design of policy objectives, strategies as well as the setting up of relevant institutions and assigning mandates at the national and regional levels; equitable, objective and transparent mechanisms for determining and allocating costs, benefits and corrective measures that integration entails; and an appropriate supranational authority and requisites regional institutions (e.g. a single central bank) with a clear and realistic transition framework towards integration.

European monetary integration highlights the important role of institutions in influencing the level and distribution of costs and benefits of macro-economic integration, especially when the region is affected by exogenous costs. The lessons in Europe provide a basis for a review of the roadmap to monetary union in Africa, in particular the adverse effects of an overly rapid pursuit of integration. If African monetary integration is pursued, it has to be done in a credible manner, ensuring that proper attention is paid to the speed and sequencing of its implementation.

Many of the monetary harmonization programmes in the different African integration subregional blocs have been slower or not in line with the African Monetary Cooperation Programme which aspires to have a single continental currency and central bank by the year 2025. Given the slow progress among many subregional groupings, including SADC, emphasis is being placed on fast-tracking the establishment of regional monetary unions ahead of African Union's 2025 continental target. However, rushing prematurely to a monetary union without sufficient preparation could ultimately pose problems.



## Way forward

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Monetary integration in SADC has been slow and below expectations. It has been argued before that eradicating multiple memberships by rationalizing some overlapping subregional blocs could minimize wasteful costs. This should be based on priority needs and efficiency from a comparative advantage. To deal with this challenge, the reasons for belonging to various groupings or forming subgroups within the same groups should be carefully studied. There is also need to rationalize the number of blocs and membership to them, based on thorough analysis of comparative advantages and cost and benefit. Inter-regional interaction should also be cultivated to “sell” the logic and benefits of rationalization.

Trade and political considerations appear to be more paramount reasons for joining several regional blocs. The COMESA-EAC-SADC tripartite arrangement is poised to be a serious challenge to the SADC monetary integration given that both the Common Market for East and Southern Africa (COMESA) and East African Community (EAC) have monetary convergence arrangements of their own. Hence, securing irrevocable commitment beyond mere political rhetoric among member countries of the various subregional blocs to the ratification and meticulous and punctual implementation of treaties and protocols, without inefficiencies, lapses or reversals, is a priority to SADC member States.

Furthermore, prior informed analysis and internal consultations, including, bringing civil society and the private sector on board much earlier, should precede integration programmes to enhance ownership that motivates full implementation among all stakeholders. The process should be inclusive and participatory. At the national level, there is need for coherent coordination, public awareness, engagement of private sector and civil society, whole-hearted political will and rules-based implementation and accountability.

Strengthening technical capacity of member States and SADC institutions for collecting and analysing macro-economic data, such as conducting informative cost benefit analysis and ensuring fair and equitable sharing of the costs and benefits of integration, should be the starting point. SADC should also plan to deal with changes in country circumstances that may militate against implementation of integration programmes or diffuse their impact.

Capacity for comprehensive and consistent planning, policy formulation and implementation at the national level should be strengthened in the member States to reduce the risks of conflicting policy objectives, and enhance synchrony and complementarity. Capacity also needs to be sharpened to effectively tackle all stages of integration from planning, to coordination, implementation, monitoring and evaluation of impact. This calls for human and institutional capacity-building covering planning, policy analysis/formulation, implementation and monitoring of programmes. Data availability and credibility and other information requirements should also be addressed. This is an area in which

African subregional and regional institutions, complemented by targeted and regionally-coordinated international expertise that cross pollinates regional capacities, can play a meaningful role.

The timeframe for transition to macro-economic and monetary convergence should be agreed to by consensus among all member countries; an amicable decision that is realistic for all members should be reached on whether the transition will be gradual or accelerated, based on an analysis of the *pros* and *cons* and costs and benefits of either option as well as on the ability of members to comply. This reinforces the need for SADC to put in place mechanisms for dealing with countries that do not comply with MEC targets.

There is need to strengthen and empower the institutions that implement and monitor regional integration programmes at the regional and country levels. Any central authority overseeing convergence and integration should be independent and not influenced by national authorities. It should have a mandate that is well anchored on the agreed key objectives, such as ensuring price stability, with sufficient authority to enforce (and possibly supervise) compliance by all members for the attainment of the shared objectives. The roles for national central banks and the common central bank should also be clearly defined beforehand.

SADC also needs to address human capacity constraints at both the SADC Secretariat and relevant institutions at the member States level. This should include harmonization of activities at the SADC Secretariat and the CCBG Secretariat (and its various committees) to avoid duplication of responsibilities. Additionally, proper coordination between the SADC Secretariat and member States must be arranged in order to ensure that national priorities are in line with regional priorities. It is therefore important for member States to mainstream issues of macro-economic convergence in their national development plans and budgets.

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