



21st Intergovernmental Committee of Experts

Transformative Growth in Eastern Africa: *Catalysts and Constraints*

Venue: Moroni, Union of Comoros

Dates: 7-9 November 2017

Ad-hoc Experts Group Meeting:

**Exchange Rate Regimes: Options and
Policy Implications**

I. Background

One of the fundamental policy choices facing central banks in Eastern Africa relates to the adoption of an exchange rate regime. The theoretical and empirical evidence suggests that the choice of exchange rate regime can significantly affect macroeconomic performance, especially inflation and economic growth. For instance, evidence tends to suggest that fixed regimes are associated with lower inflation. The rationale is that a fixed regime (with a low-inflation anchor currency) creates confidence in the country's price stability commitments. On the other hand, a flexible regime's depreciating currency increases the domestic value of foreign goods, which increases inflationary pressures. The IMF (2016) suggests that, in sub-Saharan Africa, inflation rates in a pegged regime are on average 4-7 percentage points lower than in other regimes.

A fixed regime also reduces exchange rate uncertainty, which can promote trade and investment, and thus stimulate growth. However, the inability to adjust relative prices (to tackle inflation differentials) may result in a real exchange rate misalignment. An overvalued exchange rate, in particular, may undermine economic growth through resource misallocation and lower export competitiveness. In contrast, a flexible regime allows the nominal exchange rate to adjust to relative prices and trade imbalances. Nonetheless, volatile exchange rates can undermine growth through higher economic uncertainty. The IMF (2016) argues that, since 2000, GDP per capita growth in sub-Saharan Africa has been 1-2 percentage points lower in fixed regimes. Some studies advocate a positive relationship between undervaluation and economic growth, which appears specifically strong among developing countries.¹ However, an undervalued currency may inflate import costs, potentially undermining growth. Overall, the theory and empirical evidence remain relatively ambiguous with regard to the net effect on economic growth.²

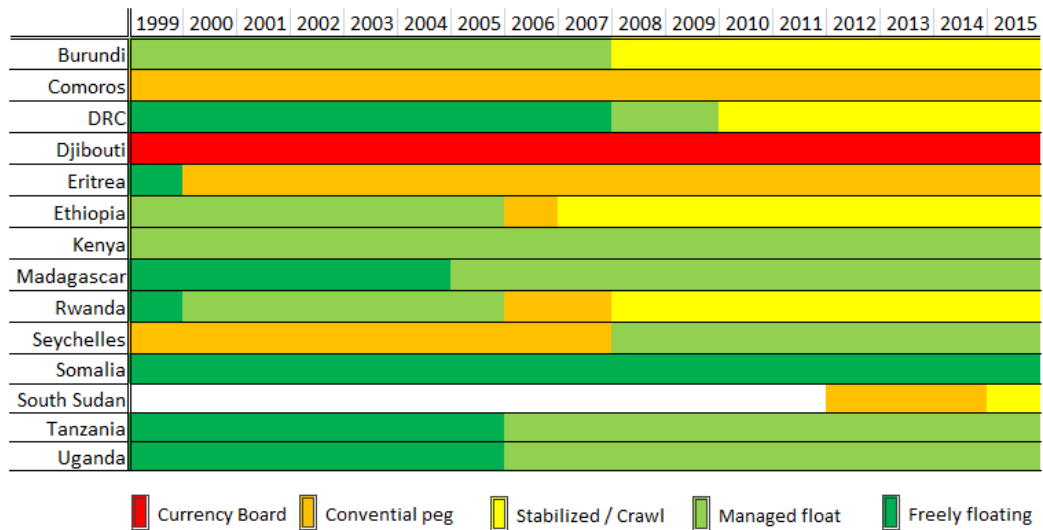
In the 1990s, a growing number of countries in Eastern Africa experiencing declining terms-of-trade adopted floating (flexible) regimes to allow for real depreciations. However, there are some signs of 'fear of floating' in the region, while 'de jure' and 'de facto' regimes often mismatch.³ The table below depicts 'de facto' regimes according to IMF's Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER).

¹ Rodrik (2008) and Rapetti et al. (2012).

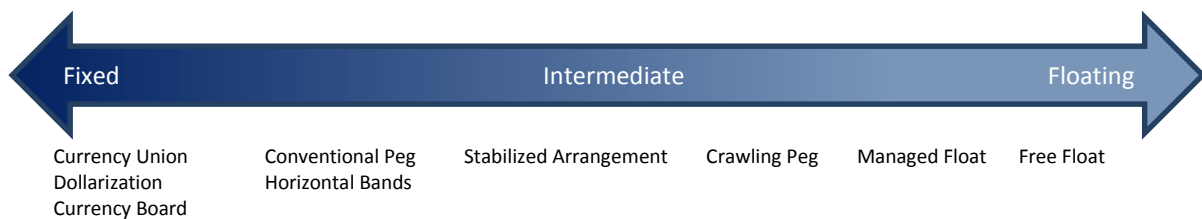
² Levy-Yeyati and Sturzenegger (2016).

³ Slavov (2011).

Exchange Rate Regime Classification in Eastern Africa



Exchange rate regimes range from irreversibly fixed to freely floating. A currency board (e.g. Djibouti) guarantees unlimited currency conversion at a fixed rate, which is backed by foreign-exchange reserves. A currency union (e.g. the prospective East African Monetary Union) is also an example of a fixed exchange rate regime. On the other extreme is a free float (e.g. Somalia), whereby the currency's value is purely determined by market forces. Intermediate regimes are hybrids of the two extremes. A conventional peg (e.g. Comoros) does not commit to full parity, but admits a tight band around the central rate. A crawling peg (e.g. Ethiopia) tolerates small adjustments to account for inflation differentials. In a managed float (e.g. Kenya), the authorities smooth the path of the otherwise market-determined exchange rate in order to prevent excessive fluctuations.



The East African Monetary Union is the third stage of integration of the East African Community (EAC) and aims to launch a single currency across Partner States. It is envisaged to be fully implemented by 2024. The stated objective of the EAMU is to “promote and maintain monetary and financial stability aimed at facilitating economic integration to attain sustainable growth and development of the Community.”

As pre-requisites for the EAMU, EAC countries ought to harmonise and coordinate fiscal, monetary, and exchange rate policies; adopt common principles and rules for payments and settlements; harmonise payments and settlements systems; harmonise policies and standards on statistical information; introduce bands and gradually fix their bilateral exchange rates; and integrate their financial systems and adopt common principles and rules for the regulation and supervision of the financial system. Moreover, Partner States ought to phase out any outstanding national central bank lending to its Government and public entities, while attaining and maintaining the pre-defined macroeconomic convergence criteria for at least three consecutive years.

II. Objectives of the Session

The objective of this Ad-hoc Expert Group Meeting (AEGM) is to provide a platform to discuss the Eastern African experience with different exchange rate regimes, and generate policy recommendations to accelerate economic growth and structural transformation. Participants will be invited to provide inputs to the discussion. The main issues to be debated include:

- a. The current range of exchange rate regimes in Eastern Africa;
- b. Main theories and existing evidence on the economic impacts of different regimes;
- c. Advantages and disadvantages of each exchange rate regime.
- d. Achievements and challenges, including their practical implementation and policy implications.

This AEGM aims to provide a better understanding of the suitability, pre-conditions, and trade-offs of different exchange rate regimes by complementing existing theory and evidence with the practical experience of Member states.

III. Participation

The AEGM will gather experts from Eastern African countries, as well as representatives of the private sector, civil society organizations, and other relevant institutions. For further information and clarification, you may wish to contact Mr. Pedro Martins, Email: martinsp@un.org

IV. Provisional programme

Wednesday, 08 November 2017

16.15-16.30 **Overview of Exchange Rates Regimes and Evidence**

Pedro Martins, Economic Affairs Officer, ECA

16.30-18.00 **Country experiences: achievements and challenges**

Selected country delegates

Thursday, 09 November 2017

08.30-10.00 **The East African Monetary Union**

Thomas Kigabo, Chief Economist, National Bank of Rwanda

10.00-10.45 **Wrap up for plenary**

References

- ECA (2016) Macroeconomic Policy and Structural Transformation of African Economies.
- IMF (2016) Regional Economic Outlook: Sub-Saharan Africa, October 2016
- Levy-Yeyati, E. and F. Sturzenegger (2016) "Classifying Exchange Rate Regimes: 15 Years Later," Working Paper Series 16-028, Harvard University, John F. Kennedy School of Government.
- Rapetti, M., Skott, P. and A. Razmi (2012) "The Real Exchange Rate and Economic Growth: Are Developing Countries Special?" International Review of Applied Economics, 26(6), 735-53.
- Rodrik D. (2008) "The Real Exchange Rate and Economic Growth," Brookings Papers on Economic Activity, Fall
- Slavov (2011) "De Jure versus De Facto Exchange Rate Regimes in Sub-Saharan Africa," IMF Working paper 11/198.