The Fiscal Foundations for Deep Regional Integration:

from Customs Unions to Economic and Monetary Union†

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I. Introduction

At the end of November 2013, the Presidents of the then five Partner States of the East African Community initialled the *Protocol on the Establishment of the East African Community Monetary Union* committing them to full monetary union by 2024.[1] This step, however tentative it may turn out to be and however attenuated the eventual process is (and it is not unreasonable to think that full monetary union will not take place for a very long time, if ever), marks an important transition point in the process of regional integration in East Africa. In particular, taking the step from integration based on a common market for goods and services towards the deep integration implied by monetary union significantly changes the demands placed on national fiscal policy and requires a significant re-examination of how the institutional economic architecture needs to be modified, at the national and regional level, if effective deep regional integration is to be sustained. In this paper we draw on the experiences of actual and putative monetary unions to explore how the economics of monetary union change the institutional and political demands on countries contemplating deep regional economic integration. The paper draws widely on the evidence but rather naturally tends to emphasise both the lessons from Europe and the current experiences of the countries of East Africa where the journey towards deep integration has begun. The lessons from this discussion are, however, relevant for any and all regional economic groupings.

The essential argument of this paper is that while deep regional integration has the potential to create opportunities for enhanced aggregate economic growth, by unlocking gains from scale and market expansion, it also exposes the region to centrifugal forces that drive economic divergence within regional groupings that are not necessarily self-correcting, at least over the medium term, and as such can risk overwhelming the aggregate gains and threaten the sustainability of deep integration. Thus, as countries move from free trade and customs union arrangements, through single markets for labour, capital and land ownership, and towards full economic and monetary union, the challenges of ensuring that the growth payoff to regional integration is balanced and inclusive, both across and within countries, are elevated.

[1] President Museveni of Uganda; President Nkurunziza of Burundi; President Kenyatta of Kenya; President Kagame of Rwanda; and President Kikwete of Tanzania. The sixth member of the East African Community, the Republic of South Sudan, joined the EAC in March 2016 and hence is not a signatory to the *Protocol.*

One reaction to this challenge is to argue that monetary union, of the form that exists in Europe today and is being envisaged for East Africa, cannot be a stable (economic and political) equilibrium: potential member countries therefore face the choice between either advancing, possibly quite rapidly, towards full and credible political union, such as the political federation envisaged by the East African Community, or retreating back to much looser structures of regional integration based on a customs union and a single markets for goods and services (but possibly not for factors of production). The argument behind this 'hard line' position is that the pressures for economic divergence that are inherent in the deep integration of monetary union can only be managed if there is a fiscal union and that any effective fiscal union necessarily requires governance structures that are underpinned by a political authority to impose macroeconomic and budgetary policies aimed at avoiding imbalances. Only the national or supranational state (the political federation), it is argued, has the political legitimacy to deliver this authority. The logic is that unless potential members are committed to moving to political federation with all deliberate speed, they must question the wisdom of seeking to establish monetary union and instead focus their attention on consolidating the customs union and single market model of regional integration.

An alternative view, the implications of which I wish to explore in this paper, takes a more sanguine position on the necessity of full political union. It starts with the claim that the crisis that afflicted European monetary union over the last decade is not inevitable but rather reflects errors in design, particularly in the fiscal domain, that rendered the Eurozone an 'incomplete monetary union'. Rather, monetary union, it is argued, can endure as a broadly stable equilibrium, even without full political union, but only if the inherent economic tensions that such a monetary union entails are recognized and if a robust institutional architecture that explicitly engages with these tensions (and recognizes that they will not automatically be resolved by market forces alone) can be constructed. Critically, however, successful 'monetary-union-short-of-full-union' still entails significant dilution of economic sovereignty, the creation of fiscal and/or risk-sharing mechanisms at the supra-national level, and requires that these institutions are adequately resourced.

Establishing these latter institutions is likely to require a greater degree of coordination on fiscal issues, and possibly closer political integration, than currently prevails amongst the current champions of deep regional integration in African. This is certainly the case in the East African

region even despite the EAC's explicit commitment to eventual political federation.[2] The extent to which countries committed to deeper regional integration will need to pool political and economic sovereignty in support of monetary union is hard to determine at this stage, but it is likely to be greater than many in the region are yet prepared to acknowledge. In practical terms, therefore, the challenge facing those designing monetary union in East Africa, or elsewhere in Africa, is to strike a balance between the need to establish effective national and supranational governance institutions for the union on the one hand, and to recognize the inevitable resistance on the part of national governments to the delegation and pooling of authority and accountability this demands, on the other. The relevant institutions include not just the fiscal and monetary institutions that are the focus of this paper but also those governing the payments system, financial sector surveillance and regulation, and the generation of harmonized economic statistics for the union.

The European Experience

It is natural in any discussion of regional integration to reflect on the European experience. And while other monetary unions exist – the Common Monetary Area of Southern Africa, the East Caribbean Currency Union (ECCU) and the the Communauté française d'Afrique (CFA) Franc Zone of west and central Africa, for example – and indeed have endured for much longer than the Eurozone, the European experience remains highly relevant. Critically, these other unions have tended to emerge from particular historical configurations and are characterized by deep asymmetries in size and power or other structural characteristics that do not translate directly to the context in which current discussions of deep integration are situated. In particular, what makes contemporary discussions of deeper regional integration strikingly different from these

[2] Although the 'fourth pillar' of the EAC's ambition for regional integration is to establish an East African political federation, progress in advancing this goal has been extremely slow. A 'Committee to Fast-Track the EAC Political Federation', known as the *Wako Committee*, reported on the constraints to federation to the Summit in November 2004 (at a time when the EAC consisted only of the 'big three' of Kenya, Uganda and Tanzania). The Committee recommended an 'overlapping and parallel' process to accelerate the move towards federation that would fast-track the functional economic elements of integration (customs union, single market and monetary union) and would institute the election of a federal head of state and executive and legislative branches of government. The *Wako Committee* report anticipated the first federal elections to take place in 2010, and as a result of the consultative process, the office of Deputy Secretary-General responsible for Political Federation was established in 2006 to coordinate this process. As of the time of writing, however, there has been no formal revision to the *Wako Committee* report nor has a new timetable for political federation been issued.

examples is the ambition to create economic unions between 'communities of equals' with common currencies that go beyond currency boards but are guaranteed by neither a regional nor an international hegemon. Such structures will therefore only be guaranteed by the credibility and a balanced commitment of the partner states to the union.

In this respect, the European experience with monetary union remains highly relevant. Moreover, since 2010, and often under the pressure of events, there have been significant efforts in Europe aimed at correcting earlier errors in design.[3] It is important that policymakers in Africa need to ensure these original European design errors are not baked into the institutional architecture of deep economic integration in Africa and that the lessons currently being learnt in the context of the Eurozone are taken on board.

Perhaps the key lesson from Europe is the depth of the institutional foundations on which the Eurozone is built and the scale of financial and other commitments that have been made to the institutions of monetary union. The global financial crisis and the events that followed have placed the Eurozone under immense stress that has shaken many member states' commitments to monetary union. But so far – and setting Brexit to one side -- the Eurozone has survived and this probably owes something to a convergence process that occupied nearly three decades and conferred substantial political legitimacy on supra-national policymaking bodies; to a design that embodied a view that the union was inviolate and membership irreversible, even to the extent that there is no provision in the enabling legislation for exit from the Eurozone; to growing cross-border financial regulation structures; and to substantial financial commitments, including through structural and stabilization funds and the range of facilities used by the ECB, that have allowed economic policy makers to restore stability to the Eurozone. Although the African initiatives differ substantially from the Eurozone in many respects, the scale of these commitments must be acknowledged.

The remainder of this paper is structured as follows. We start in Section II to discuss basic economics of regional integration with a focus on the tensions between growth and its distribution. In this section we focus in particular on the additional divergence pressures that the step towards monetary union bring. Section III then discusses the politics of integration. In Section IV we look at the design of specific fiscal institutions and their resourcing. Section V concludes.

[3] See for example the *Five Presidents' Report on Completing Europe's Economic and Monetary Union (June 2015)* http://ec.europa.eu/priorities/publications/five-presidents-report-completing-europes-economic-and-monetary-union_en .

II. The Economics of Deep Regional Integration

The basic economics of regional integration

Regional economic integration entails combining previously distinct national markets for goods and services – initially through free-trade or customs union arrangements and subsequently for labour, capital and, potentially the ownership of land -- into a single integrated market. Larger integrated markets typically produce greater competition between producers and the erosion of local monopoly power; they offer greater opportunities for operation at scale – in production and in distribution -- with the attendant potential for positive productivity effects; and they provide greater capacity for firms and markets to absorb 'lumpy' infrastructure operating at efficient scale. The cumulative effect of these scale effects create a more attractive environment for capital flows, be they FDI flows, debt or portfolio flows, which in turn lays the foundations for increased productivity growth, supporting higher real wages and incomes for members of the region. These same gains can make goods produced by firms inside the regional grouping more competitive relative to imports and by the same token more competitive in world markets.

This simple economic case for integration, based on trade creation, productivity and the reduction of transactions costs is only part of the argument for regional integration. Viewed over a broader canvas much of the impetus for regional integration non-economic, political and security considerations. As the various phases of European integration highlights the development of ever-closer interlocking economic arrangements were seen as a way of reducing the risks of conflict (The European Coal and Steel Commission of 1952, for example, was explicitly established to, as its founder Robert Schuman stated, "make war not only unthinkable but materially impossible"). This close interaction, which, as a by-product, demands ever closer political and functional cooperation, builds trust and reduces the cost of cooperation, both in economic and other spheres. Moreover, participation in regional economic institutions creates obligations that can also help anchor domestic policy commitments; in this case, the regional institutions represent a form of external 'agency of constraint', a role that may be extremely important in helping stabilize fledgling nations. This was the case in the 'new' democracies in Europe (e.g. Spain, Portugal, Greece in the 1970s and the Central European accession countries in the 1990s) and may be an important stabilizing force for the Republic of South Sudan, for example. Similarly, regional integration can also give voice to small member states, possibly

through governance institutions within the region, and through the collective leverage of power in global markets.

Where regional integration becomes difficult is when the aggregate gains to integration come at the cost of powerful distributional pressures that are intimately entwined with processes of regional integration and are capable of outweighing the aggregate gains. These start with the well-known processes of trade creation, trade diversion and trade location. Creating a customs union entails eliminating tariffs on internal trade between the members while establishing a common tariff on imports from outside the union. At an aggregate level, this change in relative prices lowers transactions costs within the union favouring regional supply relative to imports – a trade creation effect. At the same time, however, the same change in relative prices sees consumption switch from imports to higher-cost (i.e. less efficient) but-protected regional production. This is the trade diversion effect. The third element is that these changes in the internal terms of trade will favour locations and producers that enjoy the protection of the common external tariff. Hence, while the net benefits to consumers from trade creation tend to be dispersed across the regional grouping, the gains on the production side following the elimination of internal tariffs on trade tend to be location- and sector-specific. Hence the *net welfare gains* may vary substantially across the union. Moreover, while these initial gains may reflect static comparative advantage, these initial distributional effects can be locked in as economies of scale and agglomeration in specific locations are reinforced. Thus skill-intensive production will tend to converge to these high-skill and high productivity locations, a process that can be reinforced by the location of regional infrastructure, both hard, such as roads and communications, and soft in the form of higher education and training institutions. Viewed through a lens of dynamic comparative advantage, these processes of divergence may reflect intrinsic advantage but equally may reflect the cumulative effects of 'first-mover' advantages.

These pressures towards economic divergence can and do threaten the political viability of regional economic arrangements when the benefits from economic integration are perceived to be poorly distributed. Many analyses of the collapse of the original East African Community in the 1970s identify perceptions that the trade diversion gains from integration were increasingly concentrated in favour of the dominant economy of the time, Kenya, as the root cause for its collapse (Hazelwood, 1979)[4]. Similarly, an important and much-contested element in the history of the origins of the American Civil War – aside from the primary issue of slavery -- concerns how

[4] Arthur Hazelwood (1979) "The End of the East African Community: What are the Lessons for Regional Integration Schemes" *Journal of Common Market Studies* vol 18 (1) pp 40-58.

changes in the (common) external tariff in ante-bellum America generated powerful distributional effects that triggered a deep and ultimately existential threats to the United States and brought to the fore deep questions about the rights and autonomy of individual States relative to that of the Federal government. . Essentially, manufacturing (and shipping) interests in the Northern US benefited from increased tariff protection for its industry; agricultural interests in the Southern states which were dependent on shipping and also net consumers of manufactured goods from the North, were opposed, as each tariff increase adversely affected their external and internal terms of trade. Tariff increases through the early 19th century – starting with the so-called 'Tariff of Abominations' of 1828 – put the Union under increased stress and precipitated regular and intensified political and constitutional crises through the decades leading towards the cessation of the Confederate States in the early 1860s.

As we discuss later, the management of these pressures centre on the deployment of fiscal arrangements. Before we discuss these we consider how these stakes are raised with monetary union.

Upping the stakes: the economics of monetary union

Countries enter into monetary unions for three main reasons, the balance of which may vary even across partners within a given union. These include: to accelerate a process of union-wide political integration; and to improve the quality of monetary and exchange rate policy; and to promote and support trade, financial and real economic integration with union partners and the rest of the world.

The first of these motivations is virtually always present and is a crucial part of the motivation for union across Africa. The second is particularly relevant for countries with histories of monetary instability: these countries may view the delegation of policy to a supra-national authority as a way to reduce inflation bias and promote greater macroeconomic stability. The final motivation is a stated objective of the EAC and has typically played a role in grand plans for monetary union across Sub-Saharan Africa, although as the European case has shown, questions of political confederation are highly contentious.

At a technical level, creating a monetary union involves the member countries relinquishing nominal exchange rate adjustment as an instrument of (country-level) economic policy and simultaneously accepting a common monetary and exchange rate policy, typically set and/or managed by a supra-national central bank. The common monetary policy may take various

forms depending on choices over the nominal anchor: the bank may choose to fix the common exchange rate (as in the CFA Franc Zone); it may let the (common) exchange rate float and set the common interest rate in order to stabilize the union-wide aggregate economy in the face of external shocks (as occurs in the Eurozone, at least in normal times, and is anticipated in the EAMU *Protocol*); or it may adopt some hybrid framework in which it uses both the interest rate and exchange rate intervention to pursue an agreed set of objectives (see for example, Ostry *et al* 2012).[5] This latter case is the closest to the current *national* monetary policy frameworks adopted across many African countries, including the 'Big Three' EAC partner states, where monetary frameworks are fundamentally focused on hitting an inflation target but where consideration is also given to managing exchange rate movements, at least over the short-term.

The central policy challenge facing policymakers is that when countries form a monetary union, they accept a *centralized* common monetary and exchange rate policy, set and managed by a supra-national central bank, yet continue to operate a *decentralized* fiscal policy, which remains under the control of national governments. This two-level assignment of responsibility is what distinguishes monetary union from a full fiscal or political union,[6] and unless or until countries move toward full fiscal and political union, the proposed monetary union requires the creation of explicit fiscal institutions to coordinate between the two levels of authority.

These institutions are required to function both over the medium term to secure the integrity and prosperity of the union in the face of pressures leading to economic divergence; and over the short-term to ensure that individual partner states can implement efficient response to macroeconomic imbalances when nominal exchange rate adjustment is not an option but where 'internal devaluation' may be difficult and/or protracted.[7] The former task –adjustment -- is concerned with eliminating misalignment of the economy relative to its *medium- to long-run* equilibrium, in particular when the economy's long-run equilibrium is altered by, for example, shocks to technology, demographic pressures, resource discovery and external developments

[5] Jonathan Ostry, Atish Ghosh and Marcos Chamon (2012) "Two targets, two instruments: Monetary and Exchange Rate Policies in Emerging Market Economies" *IMF Staff Discussion Note, SDN/12/01.*

[6] Full fiscal union would typically entail an explicit sovereign bailout fund, a banking union and the capacity for individual member states to issue debt in a common debt instrument. Full political union would then bring these enhanced fiscal functions under a single system of political authority and accountability granting it authority in addition over tax and spending powers to a single authority, whether federal or unitary.

[7] The key relative price here is the *real* exchange rate, which can be defined as $e = EP^*/P$ where *E* is the nominal exchange rate, $P^*$the 'world' (i.e. extra-union) price level and *P* the 'internal' price level. Devaluation of the real exchange rate (an increase in *e*) requires either a nominal devaluation or a *fall* in the domestic price level. The fall in domestic prices is referred to as 'internal devaluation'.

such as structural changes in the terms of trade, world interest rates and capital flows. The latter, which is a stabilization task, is concerned with the deployment of policy instruments in the *short-run* to keep the economy on or close to its equilibrium path, where the latter is the level of economic activity characterized by low and stable inflation combined with the absence of significant involuntary unemployment of resources. Both matter, but our focus here is primarily on the issue of stabilization.

Assignment and policy coordination: the single country case.

It is useful to first recap the principles of monetary and fiscal policy coordination in the context of a single country. This benchmark highlights the precise nature of the policy coordination problem that confronts monetary unions. In a single country, the authorities have the freedom to deploy their fiscal and monetary policy instruments as they wish to achieve their stabilization objectives. However, contemporary views on macroeconomic policymaking *in a single country* have settled on a relatively straightforward view of the fiscal-monetary coordination problem that has proven relatively robust, the Global Fiscal Crisis notwithstanding.

In this setting, monetary policy is assigned the task of providing a nominal anchor for prices ('controlling inflation') which, in turn, depends on the choice of nominal exchange rate regime and, subject to this, stabilizing the economy in the face of shocks that otherwise knock it off its equilibrium path. It does this using the interest rate (or reserve money) as its policy instrument. Faced with excess aggregate demand leading to over-heating, a rise in the interest rate would reduce excess demand, by reducing the interest-sensitive components of expenditure, and thus bring inflation back to target. The same runs in reverse if there is a deficient aggregate demand. The effectiveness of this stabilization function depends on strength, reliability and predictability of the monetary transmission mechanism, a topic on which there has been substantial research, including on the economies of low income countries.[8] With monetary policy shouldering the burden of short-run macroeconomic stabilization, fiscal policy is assigned a dual mandate of anchoring the long-term sustainability of public debt which in turn means targeting an overall fiscal balance that is consistent with debt-sustainability, and determining the composition of public expenditure and the structure of taxation. These compositional considerations are

[8] See for example Mishra, Prachi, Peter J. Montiel, and Antonio Spilimbergo (2012) "Monetary Transmission in Low-Income Countries: Effectiveness and Policy Implications," *IMF Economic Review* **60** (2): 270-302.

fundamentally long-run or supply-side considerations where the aim is to make sure the economy operates with an efficient quantity of public infrastructure capital and that this is financed by a tax system that minimizes distortions and is consistent with society's distributional considerations.

In reality, of course, the clean separation of roles implied by this description of the assignment is less distinct. For example, in mature economies, the tax and expenditure systems also embody a fairly powerful degree of 'automatic stabilization' – taxation falls and non-discretionary expenditures such as unemployment benefits and other welfare spending rise as the economy goes into recession and *vice versa* without purposive changes in tax rates or spending decisions. Automatic stabilizers add a *counter-cyclical* element to fiscal policy thereby supporting the stabilization efforts of monetary policy.

Automatic stabilizers tend to be weak(er) in emerging market and developing countries. On the expenditure side, countries are less likely to have well-developed unemployment benefit and other welfare-based payments, and on the revenue in part because tax revenue – which tend to be dominated by indirect taxes – tend not to less cyclical. As a result, in many emerging market and developing countries the fiscal stance tends to be *pro-cyclical* (i.e. it has an element of 'automatic *de-stabilization*') so that other things equal a 'do-nothing' fiscal strategy exacerbates rather than eases the stabilization burden placed in monetary policy, requiring a more aggressive deployment of monetary policy.

On the other side of the ledger, monetary policy may also play a quasi-fiscal role, most notably though its role as lender-of-last-resort, under which the central bank can use its own balance sheet to supply liquidity to distressed institutions. Since the central bank is generally a public institution, this ultimately entails pro-cyclical quasi-fiscal effects.[9]

The coordination between fiscal and monetary policy can usefully be described in game-theoretic terms where both parties have well-defined and incentive-compatible objectives. Suppose the central bank has a clear mandate to pursue price stability and that its actions are credible in the sense that the fiscal authorities know and fully anticipate the reaction of the

[9] When a central bank engages in lender-of-last-resort actions it typically issues credit against bad or doubtful debts of financial institutions. The losses associated with these rescue operations reduce the dividend the central bank would otherwise remit to government. *Ceteris paribus*, this reduces the fiscal balance. Lender-of-last-resort operations are meant to respond to liquidity rather than solvency crises so that the central bank may reasonably expect to recover these funds in due course (as was the case for the Fed and the Bank of England during their lender-of-last-resort activities in 2008 and 2009).

central bank to its fiscal actions. Specifically, if the fiscal authorities loosen the fiscal stance thereby generating excess aggregate demand, the central bank will tighten the monetary stance to neutralize the fiscal expansion and *vice versa* if the fiscal authorities tighten fiscal policy. Anticipating the central bank's response, the fiscal authorities will therefore internalize the monetary policy reaction when they, the fiscal authorities, choose their own policy choices. This generates an essentially stable outcome and is sometimes referred to as the fiscal authorities acting as a 'Stackleberg-Leader'.

As described, this policy assignment is internally consistent and since questions of policy coordination are incentive compatible no specific institutions of policy coordination are required, beyond the creation and maintenance of an independent central bank with a clear stabilization mandate and fiscal authorities that value macroeconomic stability and understand the rules of the coordination game.

Policy assignment in a monetary union

Things are different in a monetary union, since there is an additional dimension of how responsibilities are partitioned between national and supra-national institutions. The conventional assignment of stabilization to monetary policy and medium-term fiscal discipline and public sector solvency to fiscal policy still applies except now the former is centralized under a single supra-national agency – the regional central bank – and the latter is decentralized to national fiscal authorities that retain full authority over taxation, aggregate government expenditure and the issue of public debt. This creates two tensions, the management of which constitute the essence of macroeconomic policy in a monetary union.

The fiscal free rider problem

The first challenge monetary union must contend with a fiscal free rider problem. This problem, which does not arise in the single-country case (although does raise its head in federal states where states have discretionary tax and spend powers), emerges from the fact that in a monetary union national fiscal authorities have an incentive to run a looser fiscal stance (or face a lesser incentive to adopt necessary fiscal contraction in the face of adverse developments) than if they operated in a unitary system. This is because the supra-national central bank will respond to the impact of fiscal expansion on the aggregate demand of the union as a whole and hence the consequences of its offsetting actions are shared across all union members. This

creates an externality: the nation state enjoys the full benefit of its fiscal action but bears only a fraction of the cost of the offsetting action by the central bank. In other words, the internal consistency that characterises the Stackelberg coordination game in the single-country case is weakened; the individual country thus expands more than it otherwise would (it free-rides), creating an *inflation bias* in which the monetary union economy as a whole will end up with higher inflation and lower external competitiveness for all members of the union but without generating any output gains to the country in the long-run.

This 'fiscal free rider' problem is of particular concern when the costs are borne by an external guarantor, such as in the CFA franc zone. The willingness of France to bear the cost of the continuously loose fiscal position amongst most, if not all, CFA member states meant that by the mid-1990s the CFA real exchange rate was severely overvalued. The 1994 devaluation, which saw the CFA franc depreciate by 100% against the French Franc/ Euro, restored competitiveness for a while but did not address the underlying problem and in both the West African and especially the Central African Franc Zones, real exchange rate misalignment and loss of competitiveness remains a serious concern.

Thus when fiscal policy is a delegated function, the collective action problem means that the system is not self-regulating as in the single country case and so the fiscal free-rider problem needs to be confronted in the design of monetary union institutions. Addressing these spill-over risks requires some additional constraints on national fiscal behaviour. In practical terms this translates into the set of targets on countries' fiscal deficits and public debt stocks, often accompanied by a schedule of sanctions or other punishments for non-observance.

In the European context this was the central function of the fiscal chapters in the Maastricht Treaty (1992) and associated Stability and Growth Pact (1997). The macroeconomic criteria defined in the *EAMU Protocol* (both for attaining and maintaining monetary union) mirror directly the Maastricht and SGP criteria. But as we will see in the next section, while these inflexible rule-based measures seek to address free-riding concerns, they may have important negative implications for the extent to which fiscal policy can also be used to address the second concern about macroeconomic stabilization in a monetary union, namely the need for an active counter-cyclical fiscal policy to counter latent pressures for real economic divergence..

The need for active counter-cyclical fiscal policy

The need for an activist fiscal policy arises as a direct consequence of the transition from the single country to the monetary union which removes monetary instruments from the policy toolkit of national authorities. With monetary policy no longer addressing stabilization *at the individual country level* fiscal policy may need to take greater responsibility for macroeconomic stabilization, particularly in environments where the countries in the union are subject to asymmetric and/or idiosyncratic shocks. Failure to do so exposes individual countries and hence the monetary union to pressures of economic divergence, the resolution of which through other means is inefficient and disruptive.

The Walters Critique

The clearest way to understand how centrifugal can play out in the macroeconomic policy domain is through the lens of the so-called 'Walters Critique'. Named after Alan Walters, who served as economic adviser to British Prime Minister Margaret Thatcher in the late 1980s, the Critique probably did more than anything to keep the UK outside the single currency arrangement. It starts from the observation that the key relative prices keeping an economy on its balanced and sustainable growth path, as defined above, are the *real* exchange rate and the *real* interest rate where the latter governs the inter-temporal balance between aggregate consumption and aggregate saving. Monetary union fixes the *nominal* exchange rate between partner states while the supra-national central bank sets a single *nominal* interest rate for all partner states. What then determines a country's real exchange rate and hence competitiveness relative to other members of the union is the difference in their respective price levels and what determines a country's real interest rate is the difference between the supra-national nominal interest and its country-specific *domestic* inflation rate. Given actions at the supra-national level, both these relative prices are endogenous, in other words not under direct policy control of the partner states.

To see how this can lead to macroeconomic divergence under the policy assignment just discussed, consider the case where a member of a monetary union experiences a positive demand shock (for example, an unbudgeted increase in public salaries) that puts upward pressure on prices and inflation in that country, and where this shock is not experienced by other countries in the region. If this country was operating its own monetary policy, the national

central bank would raise the nominal interest rate so that the real interest rises, choking off the excess demand and bringing inflation back to target.

But if the *supra-national* central bank does not change the nominal interest rate, because the expanding country is small relative to union as a whole, or does so by less than the increase in domestic inflation. As a result, the rise in domestic prices means the real interest rate (defined as the nominal interest rate adjusted by inflation) in the country will actually *fall* which is precisely the opposite of what is needed! And in the face of a booming economy, the falling real interest rate further stokes price pressures, leading to a further overheating of the economy and, as prices rise, the economy becomes less and less competitive and the current account balance with the rest of the union and the rest of the world worsens. This is a process of *economic divergence.*

Exactly the same mechanism works in reverse: a negative shock which reduces aggregate demand and reduces inflation should be accompanied by a fall in the real interest rate to stimulate demand. But with the nominal rate given by the central bank, the fall in domestic inflation leads to a rise in ex post real interest rates which would exacerbate the recession.

This is the 'Walters Critique': the corollary is that since the centralized monetary policy does not react to these pressures towards divergence, then national fiscal policy *may* need to step in to play a more active counter-cyclical role to lean against the tendency for the monetary union's common monetary policy to exacerbate the problem of macroeconomic stabilization. Thus when the economy is over-heating relative to the union as a whole fiscal policy should be tightened and *vice versa* when it is in (relative) recession.

Clearly, if all countries faced similar shocks then the *aggregate* monetary policy would be optimal for each country and the Walters Critique would evaporate. Similarly if the monetary union was truly an optimal currency area where factor mobility was complete and wage and price rigidities were absent, then private adjustment to even idiosyncratic shocks would be efficient and fiscal policy would have no role to play.

But these textbook settings are not present in reality and hence the Walters Critique remains relevant: left to its own devices, a monetary union subject to asymmetric shocks will be vulnerable to cumulative pressures towards economic divergence with expanding countries running every expanding current account balances and those on the other side ever greater surpluses.

Without active counter-cyclical fiscal policy, the resolution of these pressures can come through two channels, neither of which are attractive but both of which have characterized different phases of the European experience. First, on the gradualist path, when there is no access to nominal exchange rate adjustment, convergence will eventually occur through 'internal devaluation'. As domestic inflation rises in the booming country the real exchange rate becomes less competitive and eventually output growth slows as export demand falls and that sector contracts, laying off workers. This starts to put downward pressure on domestic prices and equilibrium will eventually be restored. The cost of internal devaluation is that it is slow and requires prolonged recession in the domestic economy; the 'sacrifice ratio' is high.[10] The alternative is more abrupt and comes about when creditors are no longer willing to finance the current account deficit. In this case debt is not rolled over, there is a 'sudden stop' and the current account adjustment must take place rapidly and at considerable cost, typically through an abrupt and very deep domestic recession, debt restructuring or some other form of emergency adjustment, such as an IMF adjustment programme. This too entails 'internal devaluation', albeit more dramatic.

Summary and implications

How then should policymakers respond to these competing pressures on fiscal policy? To what extent should they privilege fiscal rules to address the free-rider problem relative to fiscal discretion to offset the Walters Critique problem? What is striking about original European Stability and Growth Pact was the apparent absence of concerns about the Walters Critique and the need for stabilization role of fiscal policy; the rationale for the Pact rested entirely on the concern about the free-rider problem. This seems to reflect in part a widely-held belief that the automatic fiscal stabilizers would be strong enough to give fiscal policy the counter-cyclical leverage required to support short-run stabilization objectives. In other words, a belief that the system was self-correcting. As the evidence in the periphery countries such as Ireland, Greece, Spain and Portugal during the Eurozone crisis showed, this was not the case: even with some degree of automatic stabilization in the fiscal system, the overall fiscal stance was strongly pro-cyclical.

This is an important observation since we know that automatic stabilizers are weak or non-existent in low-income countries, including those in Africa. It is notable, though, that in the EAC

[10] The sacrifice ratio is a measure of output lost per percentage reduction in the inflation rate, a measure of the real cost of alternative macroeconomic stabilization efforts.

Protocol and the broad discussion of convergence criteria in ECOWAS, the CFA zone and elsewhere tend to closely follow the original European SGP and are defined in terms of ceilings rather than reference rates around which the fiscal position can move over the short- to medium-term.

Other beliefs appeared to reinforce this confidence in the systems self-correcting ability. First, it was believed in Europe that the act of forming a monetary union itself would accelerate the deep real economic integration set in motion by the Single Market provisions of the EU, so that labour mobility and wage flexibility would be enhanced. Moreover, a number of influential academic papers from the early 1990s argued that monetary union would lead to a convergence of economic cycles so that shocks were less likely to be asymmetric across member states. Taken together, these two anticipated developments – which did not in the end come about – would weaken the force of the Walters Critique. Moreover, even if asymmetric shocks persisted and automatic stabilizers were weak, there was the expectation that financial markets would be the missing 'disciplining institution' in the system. The expectation was that markets would enforce medium-term fiscal discipline by pricing the debt of countries differentially. Countries on an excess demand path whose current account deficits were growing rapidly – because of either Walters Critique or spill-over effects – would find investors demanding ever higher risk premia which would choke off lending and hence force adjustment, *and vice versa.*

The experience from the EU was that disciplining device did not materialize – at least not until the risk of full sovereign default became apparent – when market discipline was anything but disciplined. Rather, at least up to 2007, there was a strong belief in the financial markets that Eurozone country debts were treated as inter-changeable because market investors did not believe the 'no bail out' provisions in the Maastricht Treaty and SGP were credible. Not only did markets genuinely believe that credit risks had truly reduced in the brave new world of the Euro, they could not conceive that the various institutions of the Commission and the ECB, would ever allow sovereign default. This belief was sufficient to reduce country risk premia and as a consequence to neutralize the markets as institutions of country-level fiscal discipline.

As it turned out this belief was correct; when pressures did seem to threaten the systemic integrity of the Eurozone – at which point the country risk premia on the debt of distressed economies of Portugal, Ireland, Greece, Spain and Italy became astronomically high -- the

actions of the 'troika' of the IMF, European Commission and ECB, took actions to ensure prevent open sovereign default (although it got very, very close with Greece).[11]

The final reason is political: powerful nations in Europe, most notably Germany, were sufficiently concerned about moral hazard problems – small countries would free ride on the macroeconomic discipline of the large – that they were implacably opposed to granting too much discretionary fiscal autonomy. Hence the strict SGP rules and the absence of any bail-out or lender of last resort provisions. Much of the Eurozone history, certainly since the Eurozone crisis of 2010, has been a process of *ex post* adjustments to the architecture to address the consequences of these earlier errors and misconceptions. There still remains a reluctance on the part of many policymakers, especially in Germany, to allow for greater fiscal flexibility in the Eurozone, but some progress is being made. Clearly, if the architects of deeper regional integration in Africa believe the same structural features prevail on the continent – and there are strong reasons for believing they do – it is advisable to address them from the beginning.

III. The Political Foundations of Deep Regional Integration

There are two opposing views about the fundamental nature of deep regional integration – as exemplified by monetary union -- The first is that 'incomplete' monetary union such as exists in Europe today cannot be a stable (economic and political) equilibrium and hence participants in such a union face the choice between either advancing towards full and credible political union, possibly quite rapidly, or retreating back to structures of regional integration based on single markets for goods and services (and possibly for capital and labour) factors but retaining macroeconomic sovereignty at the national level. In terms of the four stages of the EAC project, for example, this view holds that unless the Partner States are committed to moving to political federation (Stage Four) with all deliberate speed, they must seriously question the wisdom of seeking to establish monetary union (Stage Three) and instead focus their attention on consolidating Stages One and Two (the customs union and single market) of regional integration.[12]

[11] See Varofakis *Adults in the Room: My Battle with Europe's Deep establishment* (Bodley Head, 2017) for a discussion of the unfolding of the Greek crisis and how close Europe came to 'Grexit'.

[12] The Brexit debate in the UK is not about monetary union but more fundamentally about the earlier stages of integration and the relationship between national sovereignty and the so-called 'four freedoms' of Europe – the free movement of goods, services, labour and capital – which define the customs union and single market.

The alternative view takes a more sanguine position on the necessity of full political union and instead argues that the 'instability' of the European monetary union, for example, is not inevitable but rather reflects errors in design. In other words, monetary union can endure as a broadly stable equilibrium *without* full political union, even though effective and resilient design will necessarily require that some degree of economic sovereignty must be ceded to the supranational level.

Proponents of the former view that monetary union cannot survive in the long run without deep political union, often point to the historical record which reinforces the claim that monetary unions not embedded in full political union tend not to endure. It is no accident, they would claim, that three of the more successful monetary unions of current times are the United States, the United Kingdom and, perhaps, the United Republic of Tanzania. The clue is the name: common currencies persist only when underpinned by a sovereign state. Supporters of this view also tend to cite examples of 'failed' monetary unions: the incomplete Latin Monetary Union between France, Belgium, Switzerland and Italy that existed from the mid-19th century until the First World War; the Scandinavian Monetary Union of 1873 which eventually collapsed when Norway gained its own political independence from Sweden in 1905; and the Irish monetary union with the UK which ended in 1979 as the Republic of Ireland sought to align itself with the European exchange rate 'snake', the pre-cursor of the exchange rate mechanism of the European Monetary System.[13] Amongst those successful unions, the sequencing may differ. In the case of the United Kingdom political unification (the "Union of the Crowns" in 1603) pre-dated monetary union ("the Union of Parliaments" in 1707) by more than a century. But as the example of 19th Century Germany shows, political union may in fact actually post-date monetary union, although the forces driving political union were very much in train by the time the functional components of unification were enacted. The north German Zollverein (customs union) was formed in 1834 out of a panoply of smaller state-level customs arrangements but was dominated by the emergent Prussian state. By 1847 a common central bank and single currency had been established to serve the Zollverein, some 25 years before Bismarck's eventual creation of the modern German state in 1871. The common central bank became the Reichsbank in 1875 before itself being replaced by the Bundesbank at the end of the Second World War.

[13] By the 1970s, Ireland was the last country of the former Sterling Area to retain its original parity with Sterling.

One of the leading scholars on monetary union in Europe, Paul de Grauwe, recently offered a robust summary of this position in a paper aimed at drawing lessons for East Asia from the recent European experience. His conclusion is worth quoting in full:

> *"The only governance that can be sustained in the Eurozone is one where a Eurozone government backed by a European parliament acquires the power to tax and spend. This will then also be a government that will prevail over the central bank in times of crisis and not the other way around. This will also be a government that has the political legitimacy to impose macroeconomic and budgetary policies aimed at avoiding imbalances. Put differently, the Eurozone can only be sustained if it is embedded in a fiscal and political union" (p16).*[14]

If de Grawue is correct and African governments are not genuinely committed to full political union, wherever this is configured, this leads inevitably to the question of whether effective real economic integration -- in terms of goods and services (the customs union) and factor markets (the single market) -- requires monetary union. Or, to put it slightly differently: does the absence of full monetary union significantly limit the gains from real economic integration between separate sovereign states, particularly over the medium- to long-run? Part of the impetus behind the Eurozone was clearly that it does,[15] but this view is not universally held. For example, the position that ultimately prevailed in the UK in the context of the debate over British membership in the Eurozone in the late 1990s was that the real gains from participation in the European single market would not be jeopardised by failing to adopt the euro and that the balance of risks favoured remaining outside monetary union. The UK thus remained a full and (at least at that time) enthusiastic member of the EU but chose not to participate in the Eurozone.[16] This view is also held much more widely outside the European context, with the

[14] Paul de Grauwe (2016) "European Monetary Unification: A Few Lessons for East Asia" *Scottish Journal of Political Economy* **63** (1), pp1-17.

[15] See for example, the (much contested) empirical work by Andrew Rose (2000) "One Money, One Market: Estimating the Effect of Common Currencies on Trade" *Economic Policy: A European Forum* **30** pp7-33, which suggested a common currency had a very large positive effect on trade. Subsequent analysis suggested that this effect was, in fact, much smaller.

[16] In 1997 the Labour Chancellor of the Exchequer, Gordon Brown, established 'five tests' designed to assess whether the UK would benefit from membership of the putative monetary union. These were billed as purely economic criteria focused on issues of growth, employment, macroeconomic convergence and the role of the financial sector, although many argued that the five tests had been constructed in such a manner that it would have been virtually impossible to generate an unambiguously positive case for membership, thereby allowing the government to avoid the debate over euro membership becoming (what it surely is) a fundamentally political debate about sovereignty. The Treasury assessment was, in fact, broadly positive but sufficiently cautious to allow the Chancellor to rule out membership 'for the foreseeable future'. The UK is the only EU member with a permanent opt-out from the Euro. Other members of the European Union have an obligation to move towards membership of the Eurozone with all deliberate speed.

foremost example being the relationship between Canada and the US (and Mexico). At no stage in the development of the Canada-US Free Trade area in the 1980s or its successor, NAFTA which was created in 1994, was there a view that real economic integration or the integrity of the free trade area was threatened by the absence of monetary union. A similar story could be told about the ASEAN nations who have made significant steps towards real integration but have not, despite much discussion, made any substantive moves towards monetary union. This is, in fact, the fundamental message of the de Grauwe (2016) paper quoted above.

These are powerful arguments that need to be taken seriously. However, the view is contested by an extensive and respected literature that argues that a well-designed monetary union that recognizes the inherent economic tensions that will arise can be constructed and sustained *without* full political union or confederation. As we note above, however, such a design is likely to require the Partner States to reform their domestic political structures; put in place fiscal and/or risk-sharing mechanisms at the supra-national level; and ensure that these are adequately resourced. In the next Section we draw out some of the key implications from this review for the design of specific fiscal and quasi-fiscal institutions.

IV. Institutional Design and Resourcing

To recap, deep regional integration requires fiscal and other institutions to secure convergence and place countries on a path towards an initial macroeconomic equilibrium as the union is formed without 'baking-in' structural imbalances to the post-union configuration; to maintain macroeconomic convergence once monetary union has been established; and to allow member countries to adjust to idiosyncratic and asymmetrical shocks across the union when nominal exchange rate adjustment is not an option but where 'internal devaluation' may be difficult and/or protracted so that the Walters Critique looms large. In addition, the supra-national central bank will require lender-of-last-resort facilities to manage liquidity to government and the financial sector.

Stabilization facilities in monetary unions

Stabilization facilities are risk-sharing mechanisms designed to mitigate the costs of adjustment faced by member states faced by shocks that are less than fully accommodated by the common union-wide monetary actions, either because the shocks are idiosyncratic (and hence elicit no

common monetary response), because they are asymmetric (so that from the perspective of one or more partner states monetary policy moves in the 'wrong direction'), or because the magnitude of the shocks differ (policy moves in the right direction but not far enough). Since monetary union removes a policy instrument at the country level, national central banks no longer have the capacity to tighten or ease liquidity off their own balance sheets to support short-run macroeconomic adjustment. Governments can borrow in the common currency, of course, but this becomes akin to foreign currency debt in a single-country setting (since, in popular terms, the national central bank can no longer 'inflate away' domestic debt through their own balance sheet operation and hence this debt can only be serviced from the government budget). To avoid macroeconomic and fiscal shocks generating liquidity crises, therefore, monetary unions need to be supplemented by back-stop lending facilities.

The rationale for supranational stabilization facilities is based on three ideas. First, when the authorities are unable to use monetary policy, the whole burden of adjustment falls on fiscal instruments. Even if counter-cyclical fiscal policy is in place fiscal policy can be temporarily overwhelmed by events. It cannot react quickly enough or to an appropriate magnitude to address incipient imbalances. Second, even if fiscal policy is effective in the long-run, since relative prices never adjust as quickly as a flexible exchange rate could, real exchange rate adjustment still relies on 'internal devaluation' which is necessarily more sluggish, even when supported by fiscal policy and, as a result, is more costly to achieve. Finally, even in the context of short-term stabilization, the premium on external market finance may be strongly counter-cyclical, falling when the economy is strong and rising when it is hit by adverse conditions so that external private market finance may be punitively expensive or even unable exactly when government most needs to borrow.[17]

This rationale is directly analogous to the fundamental principles of IMF core lending facilities in the Bretton Woods fixed exchange rate era. Article I[v] of the *Articles of Agreement of* outlining the purposes of the IMF states:

[17] Note, the presumption here is that the loss of monetary autonomy deprives a country of its capacity to conduct short-run stabilization precisely because monetary policy was previously effective in stabilizing output. While this might have been the case in Eurozone countries, it is less clear that in low income countries monetary policy actually played *any* decisive role in stabilizing output (as opposed to anchoring inflation over the medium term). This does not preclude consideration of a stabilization facility in the future: the relevant criteria is whether such a mechanism supports effective macroeconomic management in the future, regardless of individual countries' past track-record on stabilization.

> *"To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity."*

Drawing lessons from international experiences in the use of stabilization facilities is not straightforward. Formal stabilization facilities do not play an important role in the small monetary unions of the CMA or the ECCB. Nor are they an important *explicit* feature of the CFA Zone. Stabilization facilities do exist but they are intimately linked with the role of the France as the external guarantor of the CFA Franc and as such tend to be negotiated on an *ad hoc* basis and without full transparency. Moreover for the (smaller) member states of the CMA and ECCB and for all of the CFA zone countries, the IMF has played an important role as a back-stop (and occasional front-line) provider of stabilization facilities. This has, of course, also been the case for the countries of the EAC – and may continue to be so in the future – but it is important to draw a distinction between 'external' stabilization facilities and 'internal' risk-sharing mechanisms.

National-level fiscal stabilization may be feasible if a high degree of fiscal flexibility prevails and/or if automatic stabilizers are strong. On the other hand, a supranational mechanism is likely to be favoured if domestic fiscal structures are relatively inflexible and pro-cyclical and if domestic debt markets are thin.

It follows, that, as with IMF resources, stabilization facilities should be revolving funds that are neutral in the long run and based on temporary loans that are repaid and allocated under clear conditionality. Stabilization facilities should grow over time – through increased subscription – but only in line with the level of economic activity in the union. Crucially, given the powerful incentives arising from the fiscal free-rider problem, stabilization facilities should not be used to support 'permanent' transfers and should not undermine incentives at the national level to put in place appropriate policy measures to improve fiscal flexibility and resilience. The relevant principle in this case is one of solidarity and mutual self-interest (since the whole of a union will generally bear at least some of the cost of protracted recession in any member state).

Rules vs discretion and the design of stabilization funds.

Successful stabilization facilities need to be able to respond quickly to (or even in anticipation of) shocks that might otherwise have triggered a monetary policy response which requires a degree of discretion in fiscal policymaking. But the need for fiscal discretion must deal with a

range of problems. Failing to address these problems increases the likelihood that an initially flexible stabilization fund designed to operate as a rotating 'insurance-like' institution morphs into a 'transfer union' that channels resources from consistent creditors to consistent debtors in a manner that leads to the exhaustion of the fund, pressures to replenish and a growing perception that the underlying insurance rationale has been eroded.

The first concerns the nature of the shocks to which the facility is designed to respond and hence the efficient size of the fund. Conceptually, the pay-out pool would need to be large enough to cover the expected value of the loss of consumption faced by the group. Clearly this expected value will increase the larger the individual shocks are assumed to be, the longer their duration (or the more serially correlated they are through time) and the more correlated they are across members of the group.[18] The harder issue to address concerns the duration of shocks. The theory of 'consumption smoothing' tells us that it only makes sense to draw finance from the stabilization facility if the initiating shocks are perceived to be transitory. If the shocks are persistent, the appropriate policy response entails some degree of structural adjustment (to the level of consumption) rather than drawing down on a stabilization fund (although some resources may be released to smooth the transition). The problem facing policymakers is to determine whether a shock, such as a fall in commodity prices, is transitory and when it is permanent. Treating shocks as transitory when in fact they are actually persistent, not only undermines the financial sustainability of the fund (since timely repayment of advances is not possible) but more problematically delays the necessary adjustment by the debtor partner state. And if the stabilization facility is debt-based delayed adjustment raises the risk of an unsustainable accumulation of debt.

This problem of delayed adjustment is exacerbated by the 'fiscal free-rider problem' as discussed above. Countries are subject to potential economic shocks and can confront these by investing in domestic mitigation mechanisms (*ex ante*) or by undertaking costly measures to deal with the shock (*ex post*). The third option is to declare a fiscal crisis, avoid the costly remedial measures (*ex ante* or *ex post*), and appeal to the stabilization fund for relief. Those running the stabilization fund can choose to grant relief or enforce a 'no-bailout' rule and deny financing from the fund on the grounds that countries have not undertaken the relevant investment in mitigation or response to the shock. The fundamental problem is that denial is difficult and the stabilization fund comes under pressure to provide the bailout. But knowing

[18] There is a caveat to this last point since the more correlated are the shocks across countries the more the common monetary policy in the union will act in the interest of each member and the less demand will be placed on the stabilization fund.

this, the country authorities will face incentives to underinvest in mitigation and to run policies that leave them more vulnerable to shocks in the knowledge that the fund will step in. The incentive to do so is simple: the national authorities enjoy the full domestic benefit of their fiscal choices while bearing only a fraction of the costs (i.e. their contribution to the stabilization fund). The 'free-rider' problem undermines both the financial integrity of the stabilization fund and its political credibility as a risk-management institution.

It may prove difficult for the stabilization fund to credibly enforce the fiscal rule (so that a stabilization fund can function as designed). The most obvious is the 'Samaritan's dilemma', the idea that the fund is not able to credibly commit to withhold stabilization funds when the costs are concentrated on a particular group or groups of individuals, but denial is also difficult when a stabilization fund operates by country vote or consensus it can end up being run as a 'solidarity network' in which country delegates do not want to deny clemency to their compatriots, in order not to be denied clemency themselves in the future.

This challenge may be exacerbated if the union is perceived to include a deep-pocketed player that may find it hard to deny a bailout to a partner state in distress. This is the challenge facing federal governments in the US, India and Nigeria, for example and it is the same challenge facing France in its role as implicit guarantor of the CFA Franc zone. Germany plays the same role in Europe (although the German electorate and its government have demonstrated a remarkable resistance to pressures to yield, even in circumstances where a supra-national response may be warranted).

The key lesson from this discussion is that this form of socially inefficient outcome for the union may be an equilibrium unless a fiscal stabilization facility can be underpinned by a credible institutional entity that operates independently of short-term political advantage.

Design and Resourcing

Stabilization funds can be set up as a budgetary 'transfer union' making direct fiscal transfers from a supranational budget, replenished on the basis of regular contributions from members. But given that a stabilization facility should be able to provide quick-dispersing support to partner states, a short-term lending facility providing short-term credits (in the regional currency) to member states under the monitoring and enforcement of a supra-national institution, either the common central bank or a separate institution. The facility could be part funded by member state contributions and augmented by the sale of mutualized bonds issued against the balance sheets of the partner states. These bonds could be issued in the new

regional currency and/or foreign currency depending on the cost of capital and on-lent through the stabilization fund.

One important final lesson from the European experience is that the costs, both economic and political, of introducing stabilization or other risk-sharing mechanisms are likely to be much lower if these institutions are in place *ex ante* rather than built *ex post* following a crisis. If they are in place, such stabilization facilities are more likely to be perceived as genuine insurance mechanisms, available to any country that finds itself the victim of a shock; when constructed after the event such mechanisms are often perceived as a bailout or one-way transfer mechanism and hence attract hostility from the population or tax-payers of the creditor nation with all its attendant problems.[19]

The underlying principle is that a good medium-term fiscal stabilization mechanism diminishes the need for countries to call on it. Good design promotes greater investment in domestic fiscal resilience and flexibility which obviates the need for external financial support, while the more credible are underlying fiscal structures the more likely private capital markets will be willing to provide finance at non-punitive rates.

But stabilization funds do demand significant capitalization. Again there is little comparable evidence but the scale of European schemes is instructive: Funding of the European Stability Mechanism is based on countries' GDP with paid up capital subscribed from European member states of €140bn (1.25% of Eurozone GDP) and around a further €560bn of bonds raised on private capital markets which together support lending activities of around €500bn, and equivalent to 4.5% of Eurozone GDP. Whether the efficient relative scale of stabilization funds for African regional groupings is likely to be larger or smaller is a moot point. On the one hand, given that African financial sectors are smaller the insurance required against systemic financial crises may be lower. Similarly, if African regional groupings are smaller in number and if shocks are more highly correlated, the common monetary policy will do more of the stabilization work. On the other hand however, weaker automatic fiscal stabilization capacity and countries exposure to larger idiosyncratic shocks may argue for relatively larger fund financing. The final consideration for African stabilization mechanisms is the currency in which capital contributions need to be made. In the ESM, given the reserve-currency nature of the Euro and the fact that

[19] This was the experience in Europe where reform proposals – such as European Stability Mechanism (ESM) and its predecessor the European Financial Stability Facility (EFSF) -- that would probably have been accepted initially by member states faced consistent opposition from Europe's major creditor nation, Germany, on the ground that they function simply as bail out mechanisms for Greece and other southern debtor nations.

the shocks to the region are overwhelmingly 'internal', contributions are exclusively in the currency of the monetary union. For African arrangements, including the EAC, however, there may be a case for requiring contributions to be partly in the new East African currency and partly in foreign currency.

Structural Funds

Given the pressures for economic divergence that deep integration generates, stabilization facilities need to be supported by *structural* funds. These provide medium- to longer-term support to peripheral areas and to sectors than might be perceived as particularly vulnerable to the centrifugal forces created by economic integration. The members of a union need to stand ready to provide this long-term adjustment financing but this should be seen as a separate lending instrument with no presumption that it is self-financing: in other words, structural funds *ought* to be budgetary transfer arrangements. Structural and region funds have played an important role in the development of the European Union with outlying regions and 'sunset' sectors receiving transfers from the common budget either to improve access to the core of the regional economy (the 'European Roads Fund' for example); to help the management of declining industries that may have moved to lower-cost locations within the union (for example, transitional support to the UK steel industry when the UK was still a member of the EU) or to industries in long-run decline (through agricultural support mechanisms). The current budget for structural funds is approximately US$100bn per annum or 0.5% of EU GDP.

Lender of last resort facilities

The final component of institutional support to the deep economic integration associated with monetary union is to substitute for lender-of-last-resort facilities targeted at domestic financial sectors that national central banks can no longer provide. The rationale is straightforward. Within a monetary union, national governments can still issue debt (in the common currency and against the collateral of their own national balance sheet) but the inability of national central banks to directly provide liquidity to the financial system effectively 'converts' local currency debt instruments into the equivalent of foreign-currency debt.[20] Because banks operate an inherently risky business model – borrowing short and lending long – they face a rollover risk (the risk that short-term funders do not roll over their lending / deposits). Most of

[20] This is the reason why the creation of monetary union is often described as "swapping exchange risk for credit risk".

the time the access to the short-run liquidity required to finance rollover risk is provided by the short-run interbank money market but ultimately the model only works if depositors believe that the banks can be rescued by a 'lender of last resort' – typically the national government (for example through deposit insurance) or the central bank. In relatively under-developed financial markets, where the interbank market is relatively thin, much of the market liquidity is provided by claims on governments (treasury bills for example); hence without lender-of-last-resort functions national short-term liquidity problems can quickly turn into solvency problems, both for the debtors and, as a result, for the bondholders themselves. The latter are often the banking sector and other financial institutions and the risk is that liquidity crises in the financial sector can quickly get amplified and become self-fulfilling if bondholders fear that liquidity will dry up. This can create a so-called "doom loop" where the banking sector holds substantial claims against government, voluntarily and to meet regulatory requirements, and as concerns about the quality of government debt mount these spill over to concerns about banks' balance sheets and as their balance sheets weaken they demand an ever higher risk premium on government debt, or engage in fire-sales of assets, putting further pressure on fiscal sustainability. Left unchecked, the spiral of rising risk premiums and deteriorating budget deficits can suck nations into a debt default vortex.[21] The "doom loop" needs a circuit breaker and the supranational central banks' lender-of-last-resort capacity is one such institution. The key point of a lender-of-last-resort facility is simple: it is a 'back-stop' commitment device that promises to use the central bank's money-creation facilities to provide liquidity to solvent but illiquid institutions *in whatever amounts required* to ensure that private investors and banks have confidence in the currency. This is not an *ex post* transfer or bailout provision but an *ex ante* promise. Credible Lender-of-last resort mechanisms work because they are 'off-equilibrium' mechanisms: if successful the provision is never called because their mere existence is sufficient to give confidence to markets. The idea is often summarized in the phrase: "in a crisis instead of staring into an abyss, investors and financial institutions should be able to see a floor".

Lender-of-last-resort provisions are in addition to other short-term standing loan facilities that the supranational central bank may provide. Within a monetary union they must operate at the

[21] This happened to Greece, Ireland and Portugal and came close to happening to Italy, Spain and Belgium. The 'doom loop' is a cause of the sudden stop and contagion in the sense that it opens the door to self-fulfilling crises. It makes monetary union vulnerable to shocks that get amplified all out of proportion even if the initial debt imbalances are not extreme.

surpra-national level, even if, in practice, they may be implemented through the integrated central bank system.

V. Conclusions

This paper has reviewed the demands placed on policymakers as they consider and plan steps towards deeper regional economic integration, and particularly towards economic and monetary union. It is easy but wrong to think the creation of a single currency is a technical *monetary* step. As this paper argues, it is not: it is much more about real economic integration, the pooling of economic sovereignty and the demands this places on national and nascent supra-national fiscal institutions. In considering these steps xxx core tensions must be confronted and assessed:

The first is the need to reconcile the tension between the 'fiscal free-rider problem' – which places an emphasis on fiscal rules designed to constrain debt and the deficit – and the need for fiscal policy to bear more of the stabilization burden – which places an emphasis on fiscal discretion. This tension is particularly acute when shocks are asymmetric across the union, where automatic fiscal stabilizers are weak, when fiscal policy is naturally pro-cyclical and when debt mark are relatively thin which, we argue, is a reasonable characterization of many African economies. The architects of European monetary union placed disproportionate weight on ensuring the 'free rider' problem was contained. In the end it was not and in fact the lack of attention on the need for fiscal discretion played an important role in the build-up of the crisis.

Second, the basic fiscal-monetary coordination process needs to be supplemented by a clear and flexible supranational stabilization facility that can be deployed quickly and under adequate safeguards to ensure fiscal policy is not overwhelmed in the face of shocks to macroeconomic stability. This entails urgent consideration of the design and governance of stabilization funds and the issue of local (supranational) currency bonds.

Finally, although we have not discussed this in depth in the paper, the creation of these additional fiscal and other institutions entails a significant resource costs. Surveillance and collective policymaking requires a capacity similar in scope and authority to the surveillance and assessment role currently carried out at a country level by the IMF. Any such body needs to be able to specify the fundamental principles of fiscal discipline to be followed by member states; to assess the macroeconomic coherence and feasibility of members' macroeconomic performance and policies; to formulate policy recommendations for corrective action in

response to incipient macroeconomic imbalances; and to follow-up and monitoring of such actions.

This is a demanding task which, in effect, requires regional grouping to have their own 'regional IMF'. Securing this quantity of technical (PhD-level) capacity, without cannibalizing the built capacity already in national central banks and finance ministries will be a serious challenge for the region and one that will have a non-trivial budgetary implication for member states.