



UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

**THE CONCEPT OF ECONOMIC INTEGRATION WITH SPECIFIC REFERENCE TO
FINANCIAL INTEGRATION IN SOUTHERN AFRICA**

BY

SHIMA HENOCK NOKANENG

Submitted to the

**Faculty of Economic and Management Sciences
Department of Economics**

In accordance with the requirements of the degree

**PHILOSOPHIAE DOCTOR (PhD)
(Economics)**

**Supervisor: Professor M C Breitenbach
Joint-Supervisor: Professor TI Fényes**

**University of Pretoria
April 2009**



ACKNOWLEDGEMENTS

I could not have achieved an enormous project like this one without the assistance of many great minds, colleagues, friends and my academic mentors. Therefore, I would like to express my sincere and heartfelt gratitude to all those who have offered their time, help and resources to make this thesis a success.

- ❖ Professor Breitenbach for his valuable advice, contribution and prompt feedback
- ❖ Professor Fényes for his support and patience and guidance
- ❖ The South African Reserve Bank Staff for their support in acquiring the latest economic data
- ❖ The editor, Ms. Megan Southey
- ❖ My parents Prof Mogobo Nokaneng and Portia Nokaneng
- ❖ My family for their patience and support
- ❖ In particular, my wife for the tireless typing done and her encouragement on this project



DECLARATION

I declare that:

**THE CONCEPT OF ECONOMIC INTEGRATION WITH SPECIFIC REFERENCE TO
FINANCIAL INTEGRATION IN SOUTHERN AFRICA**

is my own work, that all the sources used or quoted have been acknowledged by means of complete references and that this thesis was not previously submitted by me for a degree at another university.

Signed:

Date:

SHIMA HENOCK NOKANENG



ABSTRACT

THE CONCEPT OF ECONOMIC INTEGRATION WITH SPECIFIC REFERENCE TO FINANCIAL INTEGRATION IN SOUTHERN AFRICA

The objective of the study is to establish how original financial integration could be attained in southern Africa in order to attract more foreign investment and develop a financially robust and stable region in the southern part of Africa; also to deal with the challenges, risks and remedies of prospective future financial crises.

Financial markets are rapidly integrating into a single global market. Developing countries of various regions are drawn into the process with little choice, and without having sound financial infrastructure and policies in place. It is against this background that countries and regions of global integration choose policies that would benefit their regional economy and avert potential economic shock.

The challenges posed to countries and regions by the progressive global integration of financial markets are becoming more urgent by the day. These challenges need to be addressed more effectively, either nationally or regionally, as demonstrated by the 1998 financial turmoil in Asia.

Private capital flows are becoming intra regionally concentrated, particularly in the USA, Europe, Asia and Latin America. Be that as it may, failure in one market is likely to have immediate and large regional repercussions. Globalisation also marginalises Africa and other Least Developed Countries (LDC), leaving them more impoverished and with greater disparities in terms of income, GDP and FDI.

Regional financial integration has to be efficient and sound in order to prevent or contain currency and capital market crises in the southern African region. This study identifies macro economic challenges and risks associated with financial integration. Recommendations are made about methodologies of addressing these issues in

order to realise the benefits of regional financial integration in southern Africa, which could be a building block in realising the dream of an African Monetary Union.

The study contributes greatly to the debate around the most appropriate criteria that are to be met by the SADC countries, before monetary integration can become a reality. A comparison of the benchmark macro economic convergence criteria of the EU and of the African Monetary Union is done and the performance of SADC countries is assessed in terms of both sets of benchmarks. Southern African states are found to not even be at a comparable level with regard to the EU targets of 1997. The thesis is also critical to the impact of the political instability in the SADC region on prospective monetary integration. Most importantly, SADC would be at a permanent disadvantage and face a long-run depreciation of its common currency, should it continue to integrate financially at macro economic benchmark levels inferior to those of its major trading partner, the EU.



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Keywords: Financial integration, capital flows, financial markets, SADC, monetary integration, monetary policy, regional economic integration, risks, financial liberalisation, Political economy, southern Africa monetary union

CHAPTER 1: INTRODUCTION AND METHODOLOGY

1.1 Introduction

There have been numerous regional integration efforts in Africa, but without much success. Integration attempts in Africa were mainly limited to the development and expansion of investment opportunities that would benefit Africa as a whole, reduce Africa's dependence on the outside world and create self-sustainable economic conditions that would enhance autonomous development.

The integration initiatives launched in the 1960s were to some extent more successful than the attempts at economic integration in the 1970s and 1980s which could not attain the objective of creating a sub regional economic market, let alone an economic community, despite the human and financial resources deployed (Asante, 1997:47).

Broadly speaking, a number of initiatives of regional integration in Africa have been undertaken, among others, a free trade area, a customs union and an economic union.

Examples of the above include: Communauté Economique de l'Afrique de l'Est Union (CEAO), Communauté Economique de Pays des Grands Lacs (EPGL), the Economic Commission for West African States (ECONAS), the Manu River Union (MRU), the Common Monetary Area (CMA), the Southern African Custom Union (SACU), the West African Economic and Monetary Union (UEMOA), the Preferential Trade Union (PTA) and lastly the Southern African Development Community (SADC), to mention only a few (Asante, 1997:47).

These represent some of the various sub regional integration arrangements in Africa. The main integration arrangements in the southern African region are the

PTA, COMESA, SALU, CMA and SADC, to which special attention will be paid in later chapters.

The term economic integration has been growing in importance in the past three decades. It encapsulates a great many different types of integration in the international economic literature.

Some economists define it as 'state of affairs or a process involving the combination of separate economies into larger economic regions' (Asante, 1997:19). This could include all measures that aim at abolishing discrimination among the member countries of the unit, with the formation and application of coordinated and common economic policies to achieve various economic and welfare objectives.

In some literature studies the concept is used interchangeably as economic regionalism or economic union. This could also be defined as 'the design and implementation of a set of preferential policies within a regional grouping of countries aimed at the encouragement of the exchange of goods and factors between members of the group' (Mills & Handley, 1998:2).

Apart from economic integration, other forms of integration can also be identified, namely trade integration, which could be broken down into a preferential area, free trade area and a customs union. The other important forms of integration are sectoral integration or sectoral cooperation, which revolves around the uniform coordination of sectoral markets within a regional group.

The number of and types of integration initiatives grow, and now include capital, financial and monetary issues. These give rise to other forms of integration, termed financial integration and monetary integration.

Financial integration is a situation where there are open or competitive capital markets with the elimination of barriers to capital movements and a resultant gain

on saving and investment. This could be categorised into regional financial integration and international financial integration.

Monetary integration revolves around the integration of monetary policies, the exchange rate system and the adoption of a single currency. Monetary integration or monetary union requires the convertibility of member countries' currencies and a central monetary policy, unified financial markets, capital market integration, identical rates of inflation, the harmonisation of fiscal systems, regional development and the coordination of economic policies among the member countries (Javanovic, 1997:43).

The focal point of discussion in this thesis is centred on regional financial integration in the southern African region.

1.2 Hypothesis

The rapidly increasing regionalism, globalisation of trade and financial markets, changing technology and integration of markets have created some pressure on Africa, which competes for trade and financial resources with the rest of the global economy.

The profound changes taking place in the global world economy present challenges and opportunities for Africa and compel Africa to revitalise and resuscitate regional financial integration. It is against this background that southern Africa should integrate financially, as a first step towards a sub regional block, establishing an African Economic Community and eventually working toward full global integration.

Although this particular study does not lend itself to the stating of a particular hypothesis, the researcher holds the view that the hypothesis under investigation would be '*Southern Africa is at a disadvantaged state of development with*

financial and monetary integration when its performance is measured against its own macroeconomic benchmark and that of the EU'. The researcher is therefore investigating whether the hypothesis holds true or not.

1.3 The importance of the study

In the past three decades, global financial systems have been gradually changing and this has reached a climax in the earlier part of the 1970s with the collapse of the Bretton Woods system and the establishment of a flexible exchange rate regime.

The major economies of the world, for example America, Asia, Europe and Japan and those of the developing nations have become increasingly interdependent. The interdependency has inevitably compelled national governments to take cognisance of international factors in their formulation of national economic objectives.

The links between national policies are of prime importance in relation to the world's financial and capital markets and this has made borders less significant, to the extent that global financial linkages and capital movement are a top priority of the macro economic policy analysis of every economy.

The need for regional financial integration is paramount, especially so that emerging countries could hedge against the risks in the global competitive financial arena. Financial integration would help emerging economies, including African economies, to gain access to resources and technology to expand and diversify their markets.

Markets could be expanded through intraregional trade, which implies that member countries would benefit if the trade creation effects outweighed any trade

diversion effects. This would allow the complementary production of goods and more potential for specialisation among the regional members.

Regional integration is perceived as having the potential for growth-enhancing investment in both physical and human capital. The efficiency of regional integration would increase both local and foreign investment. This would induce more foreign direct investment (FDI) in the region which would bring some credibility to the regional financial system (Hansohm, 2002:7).

Financial integration in the region would entail flexible policies, which includes investment, fiscal and monetary policy that would increase global integration, reduce the transaction costs and encourage more regional investment. These would afford the southern African region the opportunity to compete in the global financial markets because of a stable, reputable regional financial standing.

The success of regional financial integration could be evidenced by the EU and other East Asian and Pacific economies. These would be a step closer to the African Common Market or the African Monetary Union, because of the economic integration.

The importance of this study therefore lies in uncovering the problems that the SADC countries face in respect of monetary integration, what is required to resolve these issues, whether the macro economic framework for achieving convergence are plausible, and how achieving the macro economic targets for convergence would impact on SADC when measured against the convergence criteria of the EU.

1.4 The objectives of the study

The objective of this study is to analyse the need for regional financial integration in the southern part of Africa and focus on such integration as a building block

towards achieving global financial integration. This process of financial integration is currently unfolding with some speed and sophistication, posing risks and challenges for emerging economies and other regional blocks.

As the international financial environment changes, there is likely to be considerable fluctuations in private capital flows to developing countries. These emerging economies will be highly susceptible to both domestic and regional shocks and to changes in the international financial arena, such as those in global interest rates.

Some contagion is possible; therefore prerequisites for attaining the benefits of regional financial integration have to be made to prepare developing countries and the southern African region to maintain a stable currency and to absorb financial market shocks which might occur in future processes.

The specific objectives of the study are to:

1. describe the concept of economic integration and the current developments in the southern African region
2. analyse developments in financial integration and regional financial integration in southern Africa
3. identify the risk factors associated with regional financial integration in southern Africa
4. analyse the banking sector and equity markets' readiness for financial integration
5. identify and determine the macro economic challenges pertaining to regional financial integration
6. identify and determine the extent of monetary cooperation and financial integration in the region
7. identify and determine the extent of fiscal cooperation and financial integration in the region

8. identify all obstacles to regional financial integration and recommended solutions to the crises related to financial instability
9. analyse the macro economic convergence performance of the region against the European macro economic convergence targets
10. analyse the macro economic convergence performance of the region against the SADC regional targets;
11. analyse SADCs' prospects of attaining the macro economic convergence targets
12. recommend a more attainable and plausible strategy towards financial, and specifically, monetary integration.

1.5 Overview of previous research

A literature study was undertaken of the theoretical aspects of regional integration in the southern African region. The research documented in literature has been mainly on integration in trade-related issues, socio-economic cooperation and sectoral cooperation, but little research has been conducted into sub regional financial integration.

Studies have been conducted by various institutional structures such as the International Monetary Fund (IMF), the Southern African Development Community (SADC), the United Nations Conference on Trade and Development (UNCTAD) and other institutional structures in Africa. No in-depth research has been done of regional financial integration in southern Africa, especially on all issues pertaining to the integration of exchange rate systems, capital and money markets, banking regulatory frameworks, and fiscal and monetary issues.

Only little effort had been done to study regional financial integration aspects by the various sub regional bodies such as SADC and COMESA. The main element contributing to this research is the need to apply integration theories and analyse the regional financial integration situation, identify risks, constraints and ways of

overcoming the constraints on regional financial integration with the objective of achieving a solid integrated sub regional block that could compete with other international regional players such as the European Union.

This study looks at ways of managing the macro economic challenges facing regional financial integration and, most important, the study will also outline proposals and recommendations on making financial regional integration more successful than the previous attempts at regional integration in Africa. This would vitalise the envisaged development of an African Economic Community.

1.6 Confining the area of the study

The study will be confined to the geographic area of southern Africa which mainly comprises the SADC countries, namely Angola, Botswana, the Democratic Republic of Congo, Lesotho, Malawi, Mauritius, Mozambique, Namibia, the Seychelles, South Africa, Swaziland, Tanzania, Zambia and Zimbabwe.

As SADC countries are also members of other regional arrangements in southern Africa, the scope of research will be extended to PTA, COMESA, SACU and CMA because of overlapping membership. The study focuses mainly on the issues of investment, capital, finance and monetary policies pertaining to the southern African region. Most integration attempts in Africa have addressed other regional economic development issues, such as trade and sectoral integration.

The study also focuses on macro economic convergence developments in the region and reviews SADC performance against the European macro economic convergence targets. An assessment is also made of the performance of the region against its macro economic convergence targets with a view to recommending a strategy in overcoming the obstacles. Southern Africa has to make progress towards achieving regional financial integration to establish a sustainable African Economic Community.

1.7 Research procedures and methodology

The research covers a comprehensive literature study. Extensive literature on regional integration and more specially theories of financial integration are analysed regarding integration issues, with a focus on financial integration issues. Risks and benefits of regional financial integration, constraints and alternative options of overcoming the impediments, and the fiscal, monetary and macro economic challenges of integration, are some of the specific issues attended to in this study. Analysis and recommended strategies for successful financial integration in southern Africa are done within the contexts of the international and sub regional political economy.

The researcher recommends certain options and possible solutions to regional financial integration. These solutions or options would achieve faster, more diversified and sustainable economic growth that would enable the southern African region or Africa as a whole to respond effectively to the challenges of global financial integration.

1.8 Outline of the study

In Chapter 1, an introduction to the thesis is provided. The chapter outlines, among other things the importance and motivation for the study. The hypothesis and objectives are clearly specified as well as the research methodology and a brief summary of the outline of chapters is provided.

Chapter 2 surveys the theoretical background of economic integration. The chapter also examines the integration models around the world, more specifically that of the European Economic Community. Various forms of economic integration are also studied which is followed by the levels or steps of economic integration which are outlined as follows, a preferential trade area (PTA), a free

trade area (FTA), a custom union (CU), a common market (CM), an economic union (EU), a political union (PU), and total economic integration (TEI).

The chapter also explores the regional economic cooperation which has led to economic integration in southern Africa. Economic cooperation exists in the regional national states with varying degrees of rigour and intensity. Numerous bilateral and multilateral treaties on economic issues, between countries of the region in southern Africa, are investigated. Economic cooperation has resulted in the formation of the following multilateral organisations of economic integration in southern Africa with different objectives and treaties: PTA, SACU, CMA, SADC, ECOWAS and ESAF.

Chapter 3 reviews financial integration with the centre of attention on southern Africa. These economic integration initiatives are analysed and classified in the following sub regions: West, East, North, Central and the southern African sub region. Measurement of economic integration starting with the theoretical approaches of measurement and followed by an evaluation of the performance of southern Africa, are performed next in this chapter. The chapter includes a discussion of the Optimum Currency Area and African Integration Index Methods of measuring financial integration performance.

Chapter 4 starts with the regional constraints to financial integration in southern Africa, i.e. the barriers to financial integration, and it gets into the costs and benefits of financial integration. Finally, a macro economic overview, regional financial integration in southern Africa, capital flows in the region, structural changes in the international financial markets and regional developments in SADC financial markets, are investigated.

Chapter 5 investigates the financial integration attempts in southern Africa insofar as it concerns banking (monetary) sector integration, and the progress and performance is evaluated. This includes integration in various markets of the

financial services sector, which are the banking sector, clearance settlement and payment system and integration of the equity markets. The chapter also studies the barriers to financial integration and takes a look at the regulatory framework required for sound financial integration.

Chapter 6 focuses on the concept of monetary policy integration, benefits from the global experiences of monetary integration with special reference to the European Monetary System and the West African Monetary Union. Lastly, it presents the monetary integration in southern Africa with a focus on the multilateral monetary area (MMA).

The macro economic convergence developments in southern Africa are assessed against the European Monetary Union targets and the SADC regional macro economic convergence targets. This chapter is mainly concerned with finding the final answers to the stated hypothesis.

Chapter 7 provides both a complete summary of the thesis, which is followed by the conclusions to this research, and recommendations and strategy for financial and monetary integration.

CHAPTER 2: THE THEORETICAL BACKGROUND OF ECONOMIC INTEGRATION

2.1 Introduction

The term economic integration has been growing in importance in the past three decades because of the astonishing changes taking place economically and politically around the globe. This is supported by growing integration initiatives taking place in Europe, Asia and other African regions.

Economic development in the southern African region has been accompanied by an equally significant evolution in thinking towards economic liberalisation and economic and political openness.

Structural adjustments of one sort or another are taking place in virtually all of the African region's economies. Key macro economics aggregates are being transformed throughout the southern African region with the ultimate objective of attaining a beneficial change in the region through political and economic development.

The region has opened up new possibilities for regional cooperation and integration. All governments in the region are in favour of the principle of greater political and economic cooperation. The regional countries have affirmed the links that exist. The international donor community also supports the move towards regional economic integration in southern Africa.

Economic integration encompasses the formulation and application of common regional trade, exchange and labour markets. Common fiscal and monetary policies at the regional level will lead to the development of a common currency

and a single central bank or monetary authority. This would regulate the monetary environment within which national governments could function. Economic integration also allows movement of all factors of production and technology within the region (Rwegasira, 1996:15).

Generally, economic integration is defined as a state or process that derives its importance from the potential for its participants to achieve a variety of common goals more effectively by joint or integrated action as opposed to unilateral effort.

Some economists define it as “a state of affairs or a process involving the combination of separate economies into a larger economic region” (Asante, 1997:19). This could include all measures that aim at abolishing discrimination among the member countries of the unit, with the formation and application of coordinated and common economic policies to achieve various economic and welfare objectives. In some studies the concept of economic integration is used interchangeably with economic regionalism or economic union. Economic Integration could also be defined as “the design and implementation of a set of preferential policies within a regional grouping of countries aimed at the encouragement of the exchange of goods and factors between members of the group” (Mills & Handley, 1998:2).

Apart from economic integration there is also trade integration, which takes place through the establishment of either a preferential trade area or free trade area. Other forms of economic integration are custom unions, common markets, economic unions and total economic integration. Financial integration is a situation where there are open or competitive capital markets with the elimination of barriers to capital movements and a resultant gain in saving and investment (Van den Bergh & Sahajwala, 1989:15). This could be categorised further into regional financial integration and international financial integration. Monetary integration revolves around the integration of monetary policies, the exchange rate system and a single currency.

Monetary integration or monetary unions require the convertibility of member country's currencies and a central monetary policy, unified financial markets, capital market integration, identical rates of inflation, the harmonisation of fiscal systems, regional development and the coordination of economic policies among member countries (Javanovic, 1997:43).

The two concepts (monetary and financial integration) are closely interrelated and inseparable. However, the focal point of discussion in this thesis is on regional financial integration in the southern African region.

Strictly speaking, economic integration refers to the assignment of responsibility for formulating regional policies, developing rules and regulations and the application of these policies to the functioning of all markets at a regional level, superseding national control. This implies sacrificing and ceding sovereignty over specific economic functions, activities and policies to a union or regional authority, which exercises power at the regional level.

2.2 The types and forms of economic integration

The most common process to economic integration is through the progressive liberalisation of trade relations between member countries of a region and this could be taken a step further through various stages in a linear sequence and different modalities.

Different levels of economic integration exist, namely a preferential trade area, a free trade area, a customs union, a common market, an economic union and a political union. These are each defined in the following paragraphs, as summarised from the work of Balassa (1961).

A preferential trade area (PTA) is a form of economic integration, which is described by the existence of lower tariffs and intra regional trade in goods and services originating in member countries.

A free trade area (FTA) is described by the non-existence of tariffs on goods and services from other members leaving open the possibility of each member structuring and applying its own regime of tariffs to goods or services imported from outside the FTA.

A custom union (CU) involves free trade among member countries but applies uniformed external tariffs with members ceding sovereignty to a single unified customs administration or applying their own different tariff regimes alongside a common external tariff.

A common market (CM) arises when a customs union abolishes non-tariff barriers to trade to allow free trade among members. There are also greater harmonisation of trade, exchange rates, and fiscal and monetary policies. This requires some form of internal exchange rate stability and full internal currency convertibility.

An economic union (EUN) is an agreement by member countries on a common currency and a unified monetary policy which confines to specified convergence criteria and parameters within which national fiscal policy can operate.

A political union (PU) represents the ultimate stage or form of integration in which the legislative and judicial processes of member states are either unified or federated under agreed arrangements.

A political union has many elements, but usually depicts the existence and emergence of a political community based on trust, loyalty and common



principles. It has four elements of integration namely institutional union, policy integration, attitudinal integration and security integration.

Total economic integration (TEI) represents an economic union with all the relevant economic policies conducted at the supranational level, possibly in compliance with the principle of subsidiarity. Both supranational authorities and supranational laws need to be in place.

The five steps of regional integration as structured by Balassa (1961) are summarised in Table 2.1 below.

Table 2.1: Five steps of regional integration

THE FIVE STAGES OF REGIONAL INTEGRATION	DEFINITION	SOME EXAMPLES
1. Free Trade Area (FTA)	An area where tariffs and quotas are abolished for imports from area members, which, however, retain national tariffs and quotas against third countries	<ul style="list-style-type: none"> - In 1992 ASEAN countries launched the ASEAN Free Trade Area (AFTA) plan. On 1 January 2002 six out of ten ASEAN countries reduced internal tariffs on most goods (so called 'inclusion list') to levels ranging between zero and five percent. The whole ASEAN area is scheduled to become a fully-fledged free trade area in the coming years - The USA, Canada and Mexico are in the process of completing a North-American FTA (NAFTA): many tariffs were eliminated already in 1994, with others being phased out over periods of 5 to 15 years
2. Customs Union (CU)	An FTA setting up common tariffs and quotas (if any) for trade with non-members	<ul style="list-style-type: none"> - European Economic Community since 1968 - The MERCOSUR aims at becoming a fully fledged CU by 2006
3. Common Markets (CM)	A CU abolishing non-tariff barriers to trade (products and services markets integration) as well as restrictions on factor movement (factor market integration)	<ul style="list-style-type: none"> - European Community since 1993 (establishment of the European Single Market). The CM had already set up an objective under the Treaty of Rome - The Andean Community aims at becoming a common market by 2005
4. Economic Union (EUN)	A CM with a significant degree of coordination of national economic policies and/or harmonisation of relevant domestic laws	<ul style="list-style-type: none"> - European Union nowadays
5. Total Economic Integration (TEI)	An EUN with all relevant economic policies conducted at the supranational level, possibly in compliance with the principle of subsidiarity To this aim, both supranational laws need to be in place	The euro area (i.e., 12 out of 15 countries of the European Union) can be currently classified somewhere between an EUN and a REI. Supranational authorities and rule making were established already with the Treaty of Rome in 1957, and subsequently enhanced

[Source: Compiled from Balassa (1961)]

According to Balassa (1961), five main stages are identified and defined as the outcome of policy decisions taken by regional inter governmental forums and/or supranational institutions in order to affect the depth and breath of regional

integration. The definitions, structure and some examples are illustrated in Table 2.1 above.

2.3 Regional economic cooperation as a step towards economic integration in southern Africa

The term economic cooperation as used in the study denotes a willingness on the part of countries to work together in attaining regional economic goals on the assumption that, in the long run, this will enhance national economic interests, benefits and welfare. National interests might need to be subordinated in the short-run for the sake of regional interests.

This is pursued in threefold, namely through coordination of national economic projects, harmonisation of economic policies and integration of economic activities. Countries can benefit greatly from economic cooperation when they share common resources. In the presence of economies of scale or inter country externalities, market solutions are generally sub optimal, and failing to cooperate can be economically costly.

Economic cooperation already exists across national states in southern Africa with varying degrees of rigour and intensity. Numerous bilateral and multilateral treaties on economic issues, varying by sector have been agreed to, particularly between countries of the region in southern Africa.

Bilateral and multilateral arrangements to promote economic cooperation in the region have advanced tremendously in specific sectors, for example in tourism, mining, soil, conservation, environment, transport, fishing, agriculture, power, water, training, finance and investment, security, telecommunications, trade, labour etc.

Economic cooperation has been steered mainly by the following multilateral economic cooperation bodies:

- PTA, which entrenched its focus on developing and enhancing intra regional trade among regional members through the progressive reduction of tariff barriers.
- SACU, which comprises of South Africa and its neighbouring countries namely Namibia, Lesotho, Botswana and Swaziland, which was formed in 1910. This custom union provided economic cooperation and also provided member countries duty free trade.
- RMA/CMA currently known as the Multilateral Monetary Area provides a free flow of capital within the area but Lesotho, Swaziland and Namibia may impose restrictions if there is a detrimental outflow of funds to South Africa.
- SADC previously known as SADCC focuses broadly on general regional sovereignty through development, subsidiarity, market integration, bank and investment development and greater harmonisation at a progressively higher level of integration within the community as a whole.
- ECOWAS focussed mainly on promoting economic development by establishing a common market and harmonising economic policies, including agricultural policies, industrial development plant and incentives, and monetary policy. It also enhanced cooperation in other sectors like energy and minerals and for the joint development of infrastructure in member countries.
- ESAF the East and Southern African Banking Supervisors is a regional grouping, which was started in 1993. The main objective of the grouping is to harmonise banking legislation and banking supervision practices and share information on matters regarding banking supervision. At present the ESAF

membership comprises of sixteen member countries namely: Angola, Botswana, Ethiopia, Kenya, Lesotho, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Tanzania, Uganda, Zambia and Zimbabwe.

- The other route of enhancing regional economic cooperation in southern Africa is through a sector by sector basis, which is accruing some welfare and efficiency gains for the region and that might be derived through this kind of cooperation.

2.3.1 Sectoral economic cooperation in southern Africa

Sectoral economic cooperation in southern Africa has grown very extensively in the region through the various bilateral and multilateral agreements bases.

This cooperation has been extensively perpetuated by the various regional integration agencies in southern Africa, which are PTA, MMA, SACU, SADC, COMESA and ESAF.

Economic cooperation was enhanced in the following sectors (Economic Integration in Southern Africa, 1993:35):

- Trade
- Finance
- Manufacturing
- Energy
- Transport
- Communication
- Construction
- Mining

- Agriculture
- Forestry and Fisheries
- Environmental Issues
- Natural Resources
- Tourism
- Labour
- Education and Training, and
- Health.

2.3.2 Economic cooperation in the financial sector

Financial sector cooperation is championed by the three multilateral groupings in the southern African region. These regional issues in finance are addressed by SADC through its two main structures namely the directorate of Trade, Industry and Finance and Investment and the Committee of Central Bank Governors in SADC (Hansohm, 2001).

The other multilateral grouping in the finance sector is ESAF, which also enhances financial sector cooperation. The Multilateral Monetary Area (MMA) is another important financial cooperation agent in the southern region of Africa, notwithstanding the importance of ECOWAS, which is comprised mainly by countries in the eastern and southern part of Africa.

Regional cooperation in finance is eminent, taking into consideration the complex nature of the financial systems of countries in the region. Throughout the region almost all countries are confronted by similar financial and monetary problems, which prohibit economic growth and development in the region.

Some of the basic common problems are fiscal laxity, bad monetary discipline, lack of institutional capacity, undeveloped financial markets and a shortage of investment and foreign reserves.

Regional financial cooperation would over time resolve these obstacles and enhance greater financial sector integration with greater economic benefits by achieving convergence in the region.

Regional cooperation in the financial sector must be done with the objective of promoting sustainable economic development and growth. Financial sector cooperation can be achieved through sound measures, which aim at macro economic stability, financial system strengthening, mobilising and using external and domestic savings more efficiently, and by encouraging expansion and diversification of international and intra regional investment.

Regional financial sector cooperation was thus far based on the following platforms: banking sector cooperation, cooperation in the insurance industry, money and capital markets cooperation, intra regional currency convertibility, external debt management cooperation, cooperation in attracting project and trade finance and clearing and settlement cooperation. These platforms also used by Hansohm (2001) are now discussed individually.

2.3.2.1 Banking sector cooperation

Banking sector cooperation should address the challenges facing the regional banking sector. Banking sector reform should ensure good banking practices that would attract foreign banks to the market and allow the development of domestic and regional banks. Banking cooperation focuses on the following areas: banking supervision, credit specifications, licensing and regulation, capital adequacy, deposit insurance, the inter bank deposit market, collateral, liquidity ratios and reserve requirements.

Numerous projects of cooperation have been undertaken on the above-mentioned issues. The SADC Banking Association was established to uniform norms and standards for the banking practices in the region. Banking cooperation will enhance the attainment of the right mix between national institutions' regional and global banks and that could benefit the region as a whole.

2.3.2.2 Insurance sector cooperation

The need for insurance sector cooperation is important because the sector is very small and undeveloped with the exception of South Africa and Zimbabwe. The development of the sector throughout the region is a priority in regional cooperation because this sector is a crucial source of long-term funding for investment and also a pillar for the development of other types of markets.

There are three potential areas for regional cooperation in the insurance sector, that is, the introduction of competition into a re-privatised insurance industry at national level, regionalisation of reinsurance and supervision and regulation of insurance companies.

2.3.2.3 Capital market cooperation

Most countries in the region have less developed or no stock exchanges, which could be utilised as a means of mobilising savings and facilitating privatisation of national assets. To date, countries with established stock exchanges are South Africa, Namibia, Botswana, Mauritius, Swaziland, Tanzania, Malawi, Zambia and Zimbabwe.

Regional cooperation on stock exchanges will enhance policies and strategies that would harmonise and rationalise operations of stock exchanges in the region. The process will include the exchange of information, expertise and experiences.

The Committee of Stock Exchanges was formed in January 1997 as a private sector initiative within the SADC framework to establish an integrated real-time network of the region's national securities markets. This will enhance harmonisation, regulation, surveillance, listing and other functions needed for the smooth operation of the markets in the region. The following exchanges have harmonised their listings requirements based on 13 principles extracted from the Johannesburg Securities Exchange listings requirements (Regional Economic Review, 2000):

- Botswana Stock Exchange
- Malawi Stock Exchange
- Namibia Stock Exchange
- Zimbabwe Stock Exchange
- Mauritius Stock Exchange
- Tanzania Stock Exchange

2.3.2.4 Money and debt market cooperation

The development of money and long-term debt markets are of critical importance to the development of the region's financial system. A developed regional Treasury Bond (TB) market will provide a benchmark against which to promote the development of long-term lending by banks and of financial intermediation.

2.3.2.5 Intra regional currency convertibility

The other important element for regional economic integration in southern Africa is convertibility of national currencies in the region. Markets are thinly traded and there is extreme exchange rate volatility.

The biggest success in convertibility cooperation is demonstrated by the establishment of the MMA, formerly called the Common Monetary Area (CMA), whereby the exchange rates of Namibia, Lesotho, and Swaziland are pegged to each other on a one-to-one ratio.

In recent years, there have been structural adjustments to stabilise the exchange rates in the region. The process towards more realistic exchange rates began at different times in different countries within the region and has progressed at different speeds.

2.3.2.6 External debt management cooperation

The excessive indebtedness of the countries in the region constitutes, directly or indirectly, a major impediment to regional trade and economic integration largely because it depletes the little financial resources available to expand trade or channel cross-border investment flows through trade and project debt finance. Generally, all southern African regional countries are in a bad state insofar as indebtedness is concerned, with the exception South Africa. This implies that the region's import levels are supported largely, if not entirely, by concessional credits from multilateral organisations.

Such dependence provides little prospect of significant expansions in intra regional trade and financial activity without more meaningful debt relief. The performance of debt in the region is depicted in Table 2.2, which shows that the aggregate external debt in the region is very high with the exception of South Africa, Mauritius, Namibia, Botswana, Swaziland, Comoros and Seychelles, which are also a reflection on external trade in the region.

Table 2.2: External debt as a percentage of GDP in SADC, 1997-2007

COUNTRY	1997 - 2001	2002	2003	2004	2005	2006	2007
Angola	68.4	52.7	45.1	33.6	23.7	17.4	12.7
Botswana	10.2	7.5	5.3	4.5	4.0	3.7	3.3
Comoros	100.7	91.3	90.5	81.6	67.7	69.9	55.9
DRC	186.3	162.4	170.6	168.9	71.2	57.8	66.3
Lesotho	60.8	75.5	170.6	188.9	71.2	57.8	66.3
Madagascar	114.6	98.6	83.5	77.5	70.6	31.1	31.7
Malawi	137.2	590.6	657.8	621.3	572.3	202.4	133.8
Mauritius	24.4	20.9	17.9	14.2	13.3	12.3	12.0
Mozambique	101.7	88.1	83.0	73.8	68.1	40.5	41.6
Namibia	2.8	4.5	5.4	5.4	5.6	6.0	6.0
Seychelles	21.1	39.7	34.8	39.6	44.9	35.5	43.7
South Africa	3.4	4.5	3.0	2.3	2.1	2.0	1.9
Swaziland	17.4	24.7	18.5	21.5	15.7	14.8	14.3
Tanzania	83.4	54.2	53.1	50.9	48.1	48.4	15.9
Zambia	197.9	182.4	154.5	114.4	56.8	4.9	6.7
Zimbabwe	38.5	38.1	47.1	49.0	35.6	35.6	35.8

[Source: IMF, 2007]

The impact of debt servicing in draining foreign exchange reserves is apparent in the countries' reserve positions. Countries with high debt-service payments have low levels of reserves. There has been a gradual reduction in debt levels in the region through bilateral and multilateral debt relief programmes.

The Paris Club official DECD creditors agreed to some relief packages to ease the debt burden. The debt relief measures applied to the southern African region

so far have succeeded in providing a modest amount of breathing space in the short-run. Regional economic cooperation could also address the debt problem more radically by working cooperatively within regional countries and also by looking at alternative debt reduction strategies. By expanding the scope of private debt reduction through a range of techniques including buy-bucks, debt-equity conversions, debt for development swaps and debt for local currency swaps, the region could further ease the debt burden.

2.4 Economic integration around the world

Over the past decade major changes in the world have taken place, which has turned the economies of the world into regional blocks, namely, East Asia, South Asia, Sub-Saharan Africa, Latin America, Caribbean and OECD, among others. The focus is on the southern African block based on the emergence of the European Monetary Union in 2000, which bears testimony to the success of economic integration to date. Other important trade block formations that are quite powerful today are the Free Trade Area in North America and the establishment of Mercosur, both which fulfil the optimum currency area criteria.

On the whole Latin America and Mercosur have shown some progress towards fully-fledged economic integration arrangements. In eastern and southern Asia, major transformations have already come to the fore and more is on the horizon. An attempt to intensify economic integration in some sense has primarily manifested itself within the context of the Association of Southeast Asian Nations (ASEAN). Also, the collapse of the Soviet Union has created much more potential to various political and economic integration initiatives in the east of Eurasia. At the same time, Africa has to adapt to the dynamic political and economic changes in order to cope with the pressures to promote economic development and economic growth. Throughout Africa vigorous efforts are being made to promote adjustment, development and economic regional integration.

The unfortunate failure of economic integration at the continental level has left only the option of integration at sub regional level, which has been much more successful in certain areas of the world. Some barriers to economic integration still exist in some sub regions.

Economic integration initiatives in Africa can be analysed and classified in the following sub regions namely:

- The West African Sub region
- The East Africa Sub region
- The North African Sub region
- The Central Africa Sub region
- The Southern African Sub region.

Economic integration at the regional level could in this light be interpreted as a leap towards a solution, at least on the front, for the African continent as whole. Economic integration in Africa is indispensable for the transformation and growth of 53 African economies and for Africa's integration with the global economy.

Economic development would be enhanced through economic integration based on efficiency in production, enlarged markets and better utilisation of economies of scale. Furthermore, mobility of factors of production across the whole continent and coordination and harmonisation of monetary and fiscal policies through a supranational organ would spill over into faster economic growth and enhanced welfare for the whole continent. Economic integration in Africa would move towards the integration of Africa as an integral part of the world economy and avoid further marginalisation.

2.4.1 Economic integration initiatives in Africa

Economic integration in Africa has been mainly orchestrated at regional and sub regional levels across the continent. This section looks at some developments with economic integration in all the five main sub regions of Africa.

2.4.1.1 The West African sub region

The West African sub region is geographically located in the Western side of Africa comprising fifteen member countries, of which eight are former French colonies, four former British colonies, one Portuguese and one Spanish.

There have been a lot of economic integration initiatives and attempts in the region in the form of the West African Customs Union (UDAO) in 1966, West African Customs and Economic Union (WEAO), West African Economic Community (CEAO) in 1973, Economic Community of West African States (ECOWAS) in 1975 and West African Monetary Union in 1985 (Ally, 1994:13).

ECOWAS bears testimony to the economic integration success of this region. Africa has regional economic communities, which could be used as building blocks for a continental economic integration. These are (Ally, 1994):

- The Arab Maghreb Union (AMU), with five members.
- The Common Market for Eastern and Southern Africa (COMESA), with 20 members.
- The Economic Community of Central African States (ECCAS), with 15 members.
- The Economic Community of West African States (ECOWAS), with 15 members.

- The Southern African Development Community (SADC), with 14 members.
- The Inter-Governmental Authority on Development (IGAD) with seven members in Eastern Africa.
- The Community of Sahel-Saharan States (CEN-SAD), with 18 members.
- The other seven are subsets of the above seven groupings.
- The West African Economic and Monetary Union (UEMOA) with eight members, also belonging to ECOWAS.
- The MUNO River Union (MRU), with three members, also belonging to ECOWAS.
- The Central African Economic and Monetary Community (CEMAC), with six members, also belong to ECCAS.
- The Economic Community of Great Lake Countries (CEPGL), with three countries, also belonging to ECCAS.
- The East African Community (EAC), with three members, two belonging to COMESA and one to SADC.
- The Indian Ocean Commission (IOC), with five members, four belonging to COMESA and one to SADC.
- The Southern African Custom Union (SACU), with five members, all of which belong to SADC and two to COMESA.
- The MMA, with four members. (Economic Commission for Africa, 2003:6).

Table 2.3 indicates that integration in the west of Africa (Economic Commission for Africa, 2003) started as early as 1959 with CEAO as a partial free trade area and evolved into a larger formation of economic community, ECOWAS (established 1975, bears some testimony to efficiency and success).

Table 2.3: Regional integration in West African communities

REI	MEMBERS	MEMBER-SHIP	ESTABLISHMENT DATE	PURPOSE
1. La Communauté Economique de L' Afrique L' Ouest	Burkina Faso, Ivory Coast, Mali, Niger, Senegal and Mauritania	6	1959	Partial free-trade area
2. West African Economic Community (UMVA) (WAEC)	Benin, Mali, Niger, Burkina Faso, Togo, Senegal, Ivory Coast	7	1962	Common Central Bank Currency (CFA Franc)
3. West African Economic Community	Benin, Burkina Faso, Ivory Coast, Mali, Mauritania, Niger and Senegal	7	1974	Regional economic development
4. West African Development Bank (WADB)	Benin, Burkina Faso, Ivory Coast, Mali, Mauritania, Niger and Senegal	7	1962	Cooperation and sectoral integration
5. Economic Community of West African States (ECOWAS)	Benin, Burkina Faso, Cape Verde, Cote d' Ivoire, Gambia, Ghana, Guinea-Bissau, Liberia, Mali, Mauritania, Togo, Niger, Nigeria, Senegal and Sierra Leone	15		Development of the Union and achievement of West Africa Integration

[Source: Economic Commission for Africa, 2003]

2.4.1.2 East African sub region

Economic integration in the east of Africa dates back as early as 1917 with the establishment of the East African Common Market (EACM), which is made up of Kenya, Tanganyika (now part of Tanzania) and Uganda.

This was followed by the signing of a treaty of East African cooperation in Kampala, Uganda on 06 June 1967, which led to the establishment of the East African Community (EAC), which collapsed in 1977 (Ally, 1994:16).

The East African Currency Board comprised of Kenya, Uganda, Tanganyika and Zanzibar was formed in 1919. The other important institution for economic integration was the East African Development Bank, which was established in 1967. The third organisation was founded by Uganda, Kenya and Tanzania in 1967 with the sole purpose of establishing an entity that would provide financial assistance to national projects and implement the efforts of national development finance institutions.

Because of the collapse of the EAC there is, to date, no active economic integration community service in the eastern region. Some eastern African countries have, however, subscribed to other regional economic communities like the PTA, ESAF, COMESA and SADC.

2.4.1.3 North Africa sub region

The North African sub region mainly comprises Algeria, Egypt, Libya, Mauritania, Morocco, Sudan and Tunisia. This region is by far the least active of all African sub regions in terms of economic cooperation and integration initiatives (Ally, 1994:20).

The most renowned economic arrangement in the region is the Maghreb Arab Union (MAU), consisting of Mauritania, Morocco, Algeria, Egypt, Tunisia, Libya, Sudan and Polisario, which was formed in 1989 (Matthews, 1998:22).

The purpose of this regional economic arrangement was economic cooperation and coordination of economic activities and the development of an Economic Community.

There is a slow pace of economic integration in this region and blame could be directed at the dual cultural identity of affiliating both to North Africa and the Arab world. Mauritania is also affiliated to the other regional economic arrangements in the west of Africa.

2.4.1.4 Central Africa sub region

There has also been slow progress in the central African region with economic integration issues. However, in 1959 an Equatorial Custom Union (UPE) was established with a hope of becoming a common market. This arrangement operated on the basis of free movement of goods and services, common external tariffs and harmonisation of fiscal policies (Ally, 1994:27).

Later, in 1964, the Economic and Customs Union (UDEAC) of Central African states was established, which had a broader scope in terms of objectives. This included a sub regional development policy.

The other important arrangement which was established in 1983 in this region was the Economic Community of Central Africa States (ECCAS), which included Burundi, Cameroon, Central African Republic, Chile, Congo, Gabon, Rwanda and Zaire. The main objectives of this community were fiscal harmonisation, trade liberalisation and economic development.

The region also had the establishment of the Bank of Central African States (BACAS) in 1973, which was founded by Cameroon, Chile, Central African Republic, Congo, and Equatorial Guinea. The region experienced some success because BACAS promoted and coordinated monetary policies and currency convertibility for the member states (Matthews, 1998:18).

Economic integration in the central region was enhanced by other institutions like the Economic Community of the Countries of the Grand Lakes, (CEPGL) and also the Central African States, (EEAC).

2.5 Economic integration in southern African regions

Economic cooperation and integration has occurred across national borders in southern Africa, with varying degrees of rigour, intensity and success, with some bilateral and multilateral entities in the southern African regions.

The frameworks of economic integration were essentially driven by the following integration communities:

- SADC
- PTA
- SACU
- MMA
- COMESA, and
- ESAF.

The southern African region, primarily encompassing Angola, Botswana, DRC, Lesotho, Malawi, Mozambique, Mauritius, Namibia, Swaziland, Seychelles, Tanzania, Zambia, Zimbabwe and some of the south eastern countries such as Kenya, Comoros, Burundi, Ethiopia, Rwanda, Uganda and Somalia, have subscribed to various economic integration initiatives.

2.5.1 The benefits of economic integration for southern Africa

The benefits to be derived from economic integration are insurmountable; these gains can yield greater economic development benefits through multilateralism rather than unilateral use of economic resources and policies. The southern African region will benefit regionally as a building block towards an African union. The benefits of economic integration in the region are enumerated on in the next section.

2.5.1.1 Trade development and diversification

Regional economic integration will enhance deeper intra regional trade and grow trade diversification in the southern region of Africa. Tariff and non-tariff barriers need to be eliminated in order to allow for a convergent tendency towards trade liberalisation in the region. This should result in efficiency gains from regionally enlarged markets.

2.5.1.2 Economies of scale

Economic integration will rationalise national economies and expand them. This will enhance investment flows and integrate production to achieve economies of scale. Economies of scale will be realised through large cost savings and rationalisation of projects through regionally coordinated investment in resources, and social and institutional infrastructure in the region.

Economic integration will also exchange public savings from rationalisation of investments in various sectors like energy, transport, water, agriculture, mining, health, labour, education, tourism, technology, telecommunication and industries.

Regional integration would also allow the member countries to benefit from positive externalities such as improvements in production methods which reduce costs, development of markets and market techniques which result into a larger production with diversity in the form of product diversity. This will also enhance specialisation in production of certain goods and services.

2.5.1.3 Benefits arising from externalities

Greater benefits would be realised with the existence of expanded markets and a stronger new currency being used by the member countries. Exchange rate shocks and balance of payment instabilities could easily be managed by the supranational structures of the regional formation.

2.5.1.4 Greater economic competitiveness

Financial integration enhances financial robustness which has spill over benefits to the regional economy in terms of its competitiveness in a number of areas like the currency, trade, exports, employment skills and market prices.

2.5.1.5 Inflow of foreign direct investment

Financial integration also improves growth prospects in the region and this will create greater opportunities for foreign direct investment needed for the development of the region. More foreign direct investment will flow to the region because of the integrated and developed financial system of the region. The financial system's robustness will eliminate the economic and financial risks to which southern African economies are prone.

2.5.1.6 Better policy coordination

Better policy coordination through regional synchronisation institutions would yield overall welfare gains and minimise welfare costs across the southern African regions. Much more gains could potentially be realised by the success of MMA (formerly MMS), SACU, COMESA and SADC.

2.5.2 The impediments to economic integration in southern Africa

The potential of achieving substantial benefit from economic integration in the southern region exists. It is heavily dependant on the reduction of various economic integration barriers, which hampers the success of effective integration. This section discusses these fundamental obstacles for regional economic integration in southern Africa.

2.5.2.1 Political instability

It is common knowledge that the African continent ranks high when it comes to political instability. The internal insecurity of many states has since been reinforced by the pandemic of military coups, countercoups, and threat of coups.

Economic development and economic integration are stalled by the high costs of political instability. However, the southern African region has sustained some peace and political stability when compared with other regions on the continent with the exception of Angola. Examples include the DRC, Zimbabwe and, relatively less so, Swaziland and Zambia.

Political stability is a crucial element for laying a foundation for economic integration in the region. The ability to plan and execute various projects of economic integration both at national and regional level requires strong elements of political stability.

2.5.2.2 Limited and undiversified production

The southern African region is confronted with a problem of limited and undiversified indigenous production, and this also affects welfare gains arising from trade creation. However, to the extent that increased imports from partner countries displace lower cost imports from the rest of the world, a country experiences welfare losses from trade diversion (Venables, 1999:4).

2.5.2.3 Acute shortage of foreign exchange in southern Africa

Throughout the region, there is an acute shortage of foreign exchange, which hinders trade and economic development in the southern African region. The region's monetary arrangements are not aligned and regional currencies cannot be converted to the other regional currencies and other international currencies, with the exception of South Africa.

2.5.2.4 Lack of trade finance and investment capital

This shortage of foreign exchange in the southern African region also prohibits trade finance and investment capital. This also constrains operating inflows of investment capital to the region and inhibits intra regional trade flows.

2.5.2.5 Labour market problems

The region is constrained by high unemployment levels with high labour migration to South Africa emanating from other member countries. The region's labour force is unskilled and this requires regional coordination in respect of training and development in technical and technological areas in order for production capacity building by all the member states.

2.5.2.6 Overlapping functions of regional economic integration initiatives in southern Africa

Economic cooperation and integration in the southern African region experience duplication. Overlapping in terms of the objects, policies and principles of the various regional multilateral communities in the form of a PTA, such as COMESA, SADC, SACU and MMA, is rife. The need for an institutional framework at the continental level could resolve the problem at hand, without comprising the success of regional economic integration.

Overlapping also exists in membership with some member countries in the southern African region. This is due mainly to geographical vicinity, political diversity and differing economic interests.

Table 2.4: Integration aims and objectives of SADC and COMESA

SADC	COMESA
<p>To achieve development and economic growth, alleviate poverty, enhance the standard and quality of life of the people of South Africa and support the socially disadvantaged through regional integration;</p> <p>to evolve common political values, systems and institutions;</p> <p>To promote and define peace and security;</p> <p>to promote self-sustaining development on the basis of collective self-reliance, and the inter-dependence of Member States;</p> <p>To achieve complementarities between national and regional strategies and programmes;</p> <p>To promote and maximise productive employment and utilisation of resources of the region;</p> <p>To achieve sustainable utilisation of natural resources and effective protection of the environment;</p> <p>To strengthen and consolidate the long standing historical, social and cultural affinities and links among the peoples of the region.</p>	<p>To promote joint development in all fields of economic activity and the joint adoption of macro economic policies and programmes to raise the standard of living of its peoples and to foster closer relations among its Member States;</p> <p>To co-operate in strengthening the relations between the common market and the rest of the world and the adoption of a common position in international arena;</p> <p>To co-operate in the promotion of peace, security and stability among the Member States in order to enhance economic development in the region;</p> <p>To co-operate in the creation of an enabling environment for foreign cross-border and domestic investment, including the joint promotion of research and adaptation of science and technology for development;</p> <p>to attain sustainable growth and development of Member States by promoting a more balanced and harmonious development of its production and marketing structures;</p>

	<p>and</p> <p>to contribute towards the establishment, progress and the realisation of the objectives of the African Economic Community.</p>
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[Source: Chanthunya & Musokotwane, 1992]

Table 2.4 above indicates that SADC and COMESA have extensive common ground in terms of the objectives of the two structures. Table 2.5 below illustrates close and common areas of cooperation, which exists among the two regional initiatives, namely SADC and COMESA.

Table 2.5: Areas of cooperation between SADC and COMESA

SADC	COMESA
Food, security, land and agriculture	Agriculture and rural development
Infrastructure and service	Transport and Communication
Industry, trade, investment and finance	Industry, Trade, and Monetary and Financial
Human Resource Development,	Human Resources Development,
Science and Technology	Science and Technology
Natural Resources and Environment	Natural resource and Environment
Social Welfare, Information and Culture	Customs
Politics, Diplomacy, International Relations, Peace and Security	Energy
Additional Areas to be decided by Council	Health
	Standardisation and Quality Assurance
	Tourism
	Information systems' Investment
	Promotion and Protection
	Peace and Security

	Free movement of Persons, Labour, Services, Right of Establishment and residence Other fields.
--	---------------------------------------------------------------------------------------------------

[Source: Chanthunya & Musokotwane, 1992]

Both PTA and COMESA have treaties, which contain explicit political and economic pursuits, which will accelerate regional cooperation and integration in the southern part of Africa.

There are similarities and differences in principles of the two communities, but there is greater common ground on principles, for example both COMESA and SADC advocate sovereign equality of members, solidarity, peace and security, human rights, democracy, the rule of law, and peaceful settlement of disputes.

Table 2.6: Common principles between SADC and COMESA

COMESA	SADC
Equality and inter-dependence of all member states	Sovereign equality of all member states
Solidarity and collective self-reliance among member states	solidarity, peace and security
Recognition, promotion and protection of human and peoples right in accordance with the provisions of the African Charter on Human and People's Rights	Human rights, democracy and the role of law
Accountability, economic justice and popular participation in development	Equality, balance and mutual benefits and
peaceful settlement of disputes	peaceful settlement of disputes
Non-aggression between Member	



States regional peace, stability and neighbourhood recognition of the rule of law Promotion and sustenance of democratic system Inter State cooperation Harmonisation of policies and integration of programmes among the member states	
--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------	--

[Source: Chanthunya & Musokotwane, 1992]

There has to be some level of harmonisation, rationalisation and coordination in order to resolve this overlapping problem in the region. The Joint Ministerial Committee of the PTA / COMESA and SADC Summit undertook a study on this matter, and made the following recommendations:

- i. Option 1- Maintaining the Status Quo and making provisions for harmonisation, rationalisation and coordination.
- ii. Option 2 - Merger of PTA and SADC
- iii. Option 3 - Creating four regional groupings within the broader framework of PTA/ COMESA
- iv. Option 4 - Splitting PTA / COMESA into PTA north including IOC PTA South
- v. Option 5 - PTA/COMESA and SADC resolve issues towards rationalisation, and harmonisation of activities

- vi. Option 6 - PTA/COMESA should provide Abuja Treaty as a building block of African Economic Community (Mudenda et al, 1994:1).

Table 2.7 illustrates the overlapping of memberships of economic integration in SADC.

Table 2.7: Economic integration membership in SADC

COUNTRY	PTA/COMESA	SACU	SADC	MMU	ESAF
Angola	YES		YES		
Botswana	YES	YES	YES	YES	
Comoros	YES		YES		
DRC	YES		YES		YES
Lesotho		YES	YES	YES	
Madagascar	YES		YES		
Malawi			YES		
Mauritius	YES		YES		
Mozambique	YES	YES	YES	YES	
Namibia	YES	YES	YES	YES	
Seychelles	YES	YES	YES	YES	
South Africa	YES		YES		YES
Swaziland	YES		YES		
Tanzania	YES		YES		
Zambia	YES				
Zimbabwe	YES				

[Source: Hansohm et al., 2002]

2.6 Measuring economic integration in southern Africa

The African continent is characterised by having a multitude of cooperation and economic integration schemes, some of which had extremely disappointing results. Some collapsed and only a few became prominent such as ECOWAS, MRU, UDE, PTA, SADC, MMA, SADC and COMESA.

Economic integration in southern Africa can be measured on the basis of COMESA, SACU, MMA and SADC, which have shown evidence of success in their endeavours toward integration.

Measuring economic integration in the southern Africa region is a complex exercise. The study focuses on two basic methodologies of measuring economic integration, notwithstanding the fact that they have some limitations in design and in measurement. The first method to be deployed in measuring economic integration is the Optimum Currency Area theory, which was first developed by Mundell in 1961 (Dorrucci et al., 2002:12).

The second method is referred to as the African Integration Index Method which is constructed from the African Integration Indicators (Annual Report on Integration in Africa 2002:16).

It should be noted that there have been numerous attempts from around the globe and specifically within the EU to compile integration indexes to measure integration. The most well-known of these methods are, namely to measure integration by the degree to which trans-national firms are integrated by measuring an index of the flow of goods within firms internationally, and studies that measure the relationship between the level of integration by index method and the impact of higher levels of integration on employment, are just two examples of many conducted by employing integration indexing. However,

depending on the objective of the measurement, the composition of these indexes varies rather widely.

The two methods under discussion are the main ones considered in evaluating African integration developments and hence receive the deserved attention.

2.6.1 The Optimum Currency Area (OCA) criteria

The Optimum Currency Area criterion measures economic integration by several yardstick measures, which are real, financial and monetary integration.

The OCA theory measures economic integration of the following variables:

- Convergence of inflation rates
- Exchange rate variability
- Trade openness and integration
- Convergence of interest rates
- Income convergence (Dorrucci et al., 2002:2).

In the southern African region the high level of synchronisation is only realised with the SADC, MMA, and SACU countries because of the common policies pursued in terms of trade, monetary and fiscal policies.

- **Convergence of inflation rates**

Economic integration is a very important variable for regional integration. Inflation convergence is also a key variable for the formation of European Monetary System as stipulated by the Maastricht Treaty. The inflation rate variable is a similarly important variable for SADC, COMESA, and other economic integration initiatives.

Table 2.8: Annual percentage change in consumer prices in SADC

Table 2.8: Annual percentage change in consumer prices in SADC							
COUNTRY	1997-2001	2002	2003	2004	2005	2006	2007
Angola	211.0	108.9	98.3	43.6	23.0	13.3	10.2
Botswana	2.9	6.3	0.6	0.3	2.0	5.3	1.5
Comoros							
DRC	3.8	3.1	1.5	3.6	2.5	4.0	3.5
Lesotho	7.2	12.5	5.0	5.0	3.4	6.1	6.0
Madagascar	7.3	16.2	-1.1	14.0	18.4	10.8	9.6
Malawi	28.1	14.9	9.6	11.6	12.3	9.0	7.0
Mauritius	6.1	4.4	5.1	3.9	5.6	5.1	10.4
Mozambique	6.7	16.8	13.5	12.6	6.4	13.2	5.9
Namibia	8.4	11.3	7.2	4.1	2.3	5.1	5.9
Seychelles	4.4	0.2	3.2	3.9	1.0	-0.5	11.0
South Africa	6.4	9.2	5.8	1.4	3.4	4.7	5.5
Swaziland	7.2	11.7	7.4	3.4	4.8	5.1	5.8
Tanzania	9.8	4.6	4.4	4.1	4.4	5.8	5.5
Zambia	24.7	22.2	21.4	18.0	18.3	9.1	8.0
Zimbabwe	47.4	133.2	365.0	350.0	237.8	1.016.7	2.879.5

[Source: IMF, 2007]

Table 2.8 indicates that there is a lot of non-convergence of inflation rates among the countries in the region. There are exceptions by members of MMA, which have a sound monetary policy correlation shared by South Africa.

- **Exchange rate variability**

Exchange rate stability lays a foundation for a common monetary area or sharing of a single currency. If the real exchange rate variability is low and currencies are stable or the other way round, the cost of abandoning exchange rate flexibility is lower or the chances of adopting a single currency for integration into a monetary union are slim.

- **Trade openness and integration**

OCA theory implies that the various member states in an economic integration arrangement benefit extensively from intra regional trade. Therefore, the ratio of intra regional trade to GDP is deployed as a fundamental indicator of trade openness in measuring economic integration in the southern African region.

Table 2.9 illustrates the extent of intra regional trade and trade with the rest of the world in the form of exports.

Table 2.9: Exports to other regional economic communities (RECs)

EXPORTS						
	Individual intra-REC exports as share of total Intra-REC exports		Share of intra-REC exports in total Africa exports		Individual Intra-REC exports as a share of its total exports	
	Per cent	Rank	Per cent	Rank	Per cent	Rank
CEMAC	1.1	10	0.1	10	1.9	11
CENSAD	12.8	3	1.3	4	3.6	8
CEPGL	0.1	12	0.0	13	0.5	12
COMESA	9.3	4	1.0	5	6.0	6
EAC	4.7	7	0.5	7	18.1	1
ECCAS	1.3	9	0.1	9	1.9	10
ECOWAS	19.9	2	2.1	3	10.2	5
IGAD	4.4	8	0.5	8	13.5	2
IOC	0.7	11	0.1	11	4.0	7
MRU	0.0	13	0.0	12	0.3	13
SACU						
SADC	31.3	1	3.3	2	12.8	3
UEMOA	5.9	6	0.6	6	11.2	4

UMA	8.6	5	8.6	1	3.1	9
Total	100		10.5			

[Source: Annual Report on integration in Africa, 2002]

According to Table 2.9, SADC countries have the greatest trade among themselves, with 31 percent of exports and 24 percent of imports emanating within the SADC region. Other countries which contributed towards trade in the region are Mauritius, Zimbabwe, Malawi and Mozambique. The SADC tops the other integration schemes despite the fact that it began implementing track protocol only in September 2000 (Annual Report on Integration in Africa 2002:10).

- **Financial market integration**

Financial market integration is another measure of weighing economic integration but it involves a number of variables like investment, capital and equity markets, centralisation of markets, instruments and also interest rate convergence. On this aspect (Kenen, 1976:20), Africa as a whole and also the southern African region is battling with creditability on this aspect. The success of interest rate convergence as a measure of financial integration is realised by the MMA, with South Africa leading MMA countries.

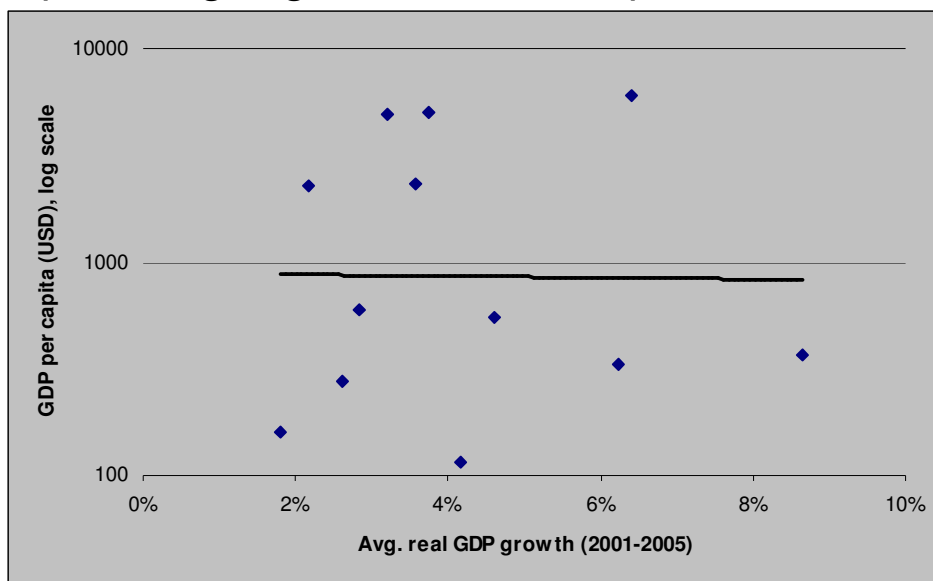
- **Income convergence**

Economic integration can also be measured by the convergence of income across countries in the southern region of Africa. The real GDP per capita could be the yardstick for income convergence.

There seems to be a steady growth trend in terms of income levels in the region. Figure 2.1 illustrates all the average GDP figures for SADC countries. Among the SADC countries GDP per capita shows a mixed picture. Botswana, Mauritius and South Africa have GDP per capita levels that are higher whereas on the other extreme, the majority of countries have lower levels of GDP growth per capita, namely Malawi, Namibia, DRC and Zimbabwe.

In general, the region shows no real signs of economic convergence in the region. Overall, the region remains unequal in terms of GDP per capita income growth with the majority of countries constantly below the region's average.

Figure 2.1: Real per capita GDP growth in SADC (excluding Angola and Zimbabwe), 2001-2005



[Source: Jefferis, 2007]

2.6.2 African integration index method

The method is constructed from the African Integration Indicators, with some limitations, which can be refined in the future. The indicators have been assembled for eight sectoral clusters of activity.

- ❖ Trade and market integration
- ❖ Monetary, fiscal and financial integration
- ❖ Transport
- ❖ Communication
- ❖ Industry
- ❖ Energy

- ❖ Food and agriculture
- ❖ Human development and labour markets

Each sectoral cluster comprises of a subset of variables, with the trend calculated as a weighted average of the components of the subset. For example, the trade indicator is a weighted average of intra regional exports and imports. The individual REC performances are measured against the best performance of each sectoral cluster. Scores are based on technical and statistical criteria with a benchmark of 10 for each individual index (Annual Report on Integration in Africa, 2002:16).

Table 2.10 illustrates the Composite Integration Index by REC. The various integration communities in Africa showed some progress in 1997, with the monumental weakening in some communities especially CEPGL, ECCAS, IUC and MRU. The southern regional economic communities have had a relatively mixed but dissatisfactory performance.

Table 2.10: Composite integration index by RECs

REC	1994	1995	1996	1997	1998	1999
CEMAC	100.0	127.5	133.8	134.1	132.5	122.0
CEPGL	100.0	91.0	89.9	95.1	91.0	87.3
COMESA	100.0	110.1	123.0	125.2	127.2	118.3
EAC	100.0	114.7	120.3	118.5	120.5	119.2
ECCAS	100.0	124.6	128.1	132.0	126.8	121.7
ECOWA S	100.0	117.3	132.2	131.0	137.7	134.2
IGAD	100.0	112.4	116.4	119.5	120.8	119.2
IOC	100.0	116.2	126.2	118.3	123.8	109.6
MRU	100.0	90.2	96.4	119.3	109.3	117.1
SADC	100.0	113.7	124.8	127.2	133.2	132.9



UEMOA	100.0	117.4	130.5	132.3	134.7	136.2
UMA	100.0	112.3	125.0	124.8	119.2	121.7
Average	100.0	113.1	121.4	124.1	123.0	120.1

[Source: IMF, 2007]

When consolidating the integration measurements in Africa and the southern African region there has been a slow pace, which could be blamed on a number of factors, political and economic in nature.

The southern African region has made tremendous inroads in terms of regional economic cooperation. There is a high degree of uncertainty surrounding the future of various multilateral economic arrangements, the pace of globalisation, the emergence of various trading blocks like the European Union, regional conflicts, and global political change, which are all major external challenges and opportunities for the southern region of Africa.

In dealing with all these opportunities and challenges, there has to be a consensus on a regional economic integration strategy of development for the region if it is to compete successfully with other trading blocks around the globe

CHAPTER 3: FINANCIAL INTEGRATION IN THE SOUTHERN AFRICAN REGION

3.1 Introduction

The globe hinges on globalisation and this generates a lot of political and economic alignment problems at regional and continental level.

The economic ranking of many African countries is appalling because of various political and socio economic hurdles. Many African country economies are dilapidated in terms of growth and development. The economic status could be pictured by an adverse outlook in terms of declining growth, double-digit inflation, dependence on aid, poverty, no savings, low investment, high levels of unemployment, high deficits and under utilisation of production resources.

Tremendous efforts have been taken to address some of these problems after the colonial era, to emancipate their economies through economic cooperation and economic integration.

Various initiatives were taken, but mainly in trade and sectoral cooperation and much fewer efforts were made in the financial sector. There is some evidence of monetary and financial cooperation in the western African region and also other regions in the form of currency boards.

The inception of the EMU has sparked a new wave of interest in economic and financial integration in Africa. The formation of an African Economic Community may provide some foundation to empower the African continent in developing technical, technological, political, economic and financial infrastructure to address numerous problems on the continent.

Throughout the continent of Africa vigorous efforts had been made to promote economic development and regional integration, but much needs to be done to address financial issues which will enhance much monetary, fiscal and financial harmonisation with the eventuality of realising an African Monetary Union.

In light of the above, this chapter discusses the concept of financial integration and all issues of financial integration such as the development of various financial markets, instruments, and risks and benefits pertaining to this subject.

The research will also look at barriers prohibiting financial integration and its measurement and finally provide some options for accelerating integration in the southern African region.

3.2 Macro economic overview of the southern African region

Economic and financial integration are influenced and sustained by international economic dynamics as they are by national and regional macro economic policies. Policymakers have to address all macro economic challenges, prior and past economic and financial integration in the southern region of Africa.

The overall economic picture for the region varies from one member state to the other. As a whole, however, the economics of the region are improving with structural adjustment programmes realising some success that can be quantified by their respective economic indicators, with a notable exceptions of DRC, Angola and the ailing Zimbabwe.

The macro economic overview for the region will look at economic growth, exchange rates, budget deficits, external debt and inflation levels of the various member states of the region.

Table 3.1: Demographic and economic indicators for SADC, 2004

	Population (<i>millions</i>)	Surface Area (<i>'000 sq.km</i>)	Population Density (<i>per sq.km</i>)	Gross National Income (GNI) (<i>US\$ billion</i>)	GNI per capita (<i>US\$</i>)	GDP growth (avg. 1966-2003) (%)
<i>Low income</i>						
Congo, Dem. Rep.	54.8	2,344.9	23.4	6.4	120	-2.0
Malawi	11.2	118.5	94.4	1.9	170	3.0
Mozambique	19.1	801.6	23.9	4.7	250	4.9
Tanzania	36.6	945.1	38.7	11.6	330	2.9
Zambia	10.5	752.6	14.0	4.7	450	0.8
Lesotho	1.8	30.4	59.6	1.3	740	4.2
Angola	14.0	1,246.7	11.2	14.4	1,030	5.0
Zimbabwe	13.2	390.8	33.7	n/a	n/a	3.1
<i>Middle income</i>						
Swaziland	1.1	17.4	64.5	1.9	1,660	5.3
Namibia	2.0	824.3	2.5	4.8	2,370	4.4
South Africa	45.6	1,219.1	37.4	165.3	3,630	1.8
Botswana	1.7	581.7	3.0	7.5	4,340	8.6
Mauritius	1.2	2.0	605.0	5.7	4,640	5.2
SADC total	212.8	9,275.0	22.9	230.4	1,154	

[Source: World Development Indicators, 2005]

3.2.1 The size and structure of the economy

The size and structure of the region's economy will mainly be measured and analysed in terms of the various macro economic indicators as it is used in the Regional Economic Review (2000). The region is characterised by low levels of growth and high population which is not affected by HIV/AIDS.

The other factors include a wide range of weak currencies, which discourages capital flows and investment. The region also has low levels of savings, and consumption and investment. The region also suffers in terms of economic and development infrastructure which is improving because various sectors are developing in the region.

The GNP per capita levels and growth show a mixed picture. There is a group of countries with GNP per capita income levels of around \$3 000, which are Botswana, Mauritius and South Africa; the other extreme have GNP per capita of \$500 or as little as \$190 (Malawi) and with Namibia in the middle with a level of \$1 890. In general there is an upward movement in the income levels in the region as illustrated in Table 3.1 above.

The region has relatively low levels of exports and markets. The bulk of the output is generated by SACU and South Africa. This is also depicted in Table 3.2, which indicates that South Africa contributes 80 per cent of GDP in the southern region, 40 per cent of the sub-Saharan region and 25 per cent of Africa as a whole.

The region is fully endowed with all resources and mineral resources but with a very low skilled workforce. The GDP has been mainly dependant on the agricultural sector, but there has been a decline because most of the member countries are industrialised. The service sector appears to be increasing in importance. Table 3.2 illustrates a comparison of shift in output of the region from agriculture, to industry and the service sector.

Table 3.2: Sectoral contribution to GDP by SADC countries, percentage

COUNTRY	AGRICULTURE		INDUSTRY		SERVICES	
	1990	1999	1990	1999	1990	1999
Angola	18	7	41	70	41	23
Botswana	5	4	56	45	39	51
DRC	30	58	28	17	42	25
Lesotho	23	18	34	38	43	44
Malawi	45	38	29	18	26	45
Mozambique	37	32	18	24	44	44
Namibia	12	13	38	33	50	55
South Africa	5	4	40	32	55	64
Tanzania	48	48	16	14	36	38
Zambia	18	17	45	26	37	57
Zimbabwe	16	19	33	24	50	56

[Source: Regional Economic Review, 2000]

Table 3.2 indicates that in 1990 the contribution of agriculture to GDP was a two-digit percentage high with the exception of South Africa and Botswana. However in 1999 much contribution comes from the industry and service sectors. There has been a substantial structural change in the context of overall growth and development of productivity.

In general there exists a considerable heterogeneity in terms of economic development in the region, which is mirrored by the various macro economic indicators in the region.

The analysis from Table 3.3 depicts that on the whole the region is not doing well in terms of savings as a percentage of GDP. Only Namibia, Lesotho, Seychelles,

SA, Swaziland and Zimbabwe had high ratios of above 10 per cent between 1990 and 1999 and Botswana taping the list. This also imported the performance of investment levels in the region because savings provide regular capital inflows for investments.

Table 3.3: Domestic savings as percentage of GDP in SADC

COUNTRY	1997 - 2001	2002	2003	2004	2005	2006	2007
Angola	24.4	23.9	19.2	25.1	34.1	36.7	29.4
Botswana	47.4	52.2	50.7	49.8	47.4	44.2	43.2
Comoros	-7.8	-4.0	-5.8	-10.6	-12.9	-15.6	-12.2
DRC	43.7	51.0	51.3	51.3	58.7	70.2	59.6
Lesotho	-20.3	-15.6	-6.1	-11.8	-17.6	-13.8	-12.0
Madagascar	8.4	7.7	8.9	9.4	8.9	10.0	10.8
Malawi	2.7	-16.7	-12.1	-10.6	-23.9	-13.5	-4.0
Mauritius	24.4	24.7	25.8	23.3	18.5	14.4	15.0
Mozambique	9.4	10.5	10.6	13.2	9.4	19.8	16.6
Namibia	13.7	14.6	23.2	22.3	24.7	30.8	32.8
Seychelles	18.4	24.4	21.5	14.7	-5.0	11.2	-0.1
South Africa	18.3	19.8	18.4	18.1	17.8	18.0	16.6
Swaziland	2.1	19.5	19.9	16.8	13.9	11.2	10.9
Tanzania	5.8	11.8	14.5	13.6	11.7	10.5	10.6
Zambia	6.4	8.7	13.1	19.8	20.3	31.8	30.5
Zimbabwe	13.3	-12.5	-21.1	-3.7	-6.7	8.4	17.1

[Source: IMF, 2007]

Table 3.4: Investment as percentage of GDP in SADC, 1997-2007

COUNTRY	1997 - 2001	2002	2003	2004	2005	2006	2007
Angola	21.8	12.6	12.7	9.1	8.1	15.0	13.7
Botswana	25.1	40.7	41.5	38.4	30.1	25.3	25.8
Comoros	12.0	11.0	10.3	9.4	9.3	10.0	13.5
DRC	34.3	23.4	25.7	24.2	22.4	24.3	31.0
Lesotho	46.3	43.8	45.1	34.6	28.0	26.2	26.4
Madagascar	15.3	14.3	17.9	24.3	22.5	21.7	21.9
Malawi	13.4	10.4	10.8	14.4	13.0	14.2	19.6
Mauritius	26.6	20.3	24.9	22.8	22.9	21.2	23.4
Mozambique	28.2	29.8	27.4	22.6	20.4	24.8	27.7
Namibia	22.4	19.7	29.8	26.4	28.3	29.4	31.9
Seychelles	32.6	25.6	10.4	12.7	21.9	31.9	38.3
South Africa	16.2	16.1	16.9	17.7	18.3	20.3	20.4
Swaziland	19.8	19.8	18.0	18.4	18.2	17.2	17.2
Tanzania	16.2	19.2	21.2	21.0	22.2	23.4	24.5
Zambia	17.4	22.0	25.6	24.3	23.5	23.5	25.0
Zimbabwe	15.5	-8.8	-13.0	5.1	4.4	11.0	17.5

[Source: World Economic Outlook, 2007]

From Table 3.4 one can draw a conclusion that generally our investment levels as a percentage of GDP is below 20 percent with few countries having a score sheet below 10 percent like Botswana, Comoros, Madagascar, Lesotho, Malawi, Mozambique and Zambia.

The region's slow growth pace is also attributable to low rates of savings and investments as well as the quality of investment. A regional approach for financial

integration relies heavily on savings and savings for further regional financial development which will benefit the whole region.

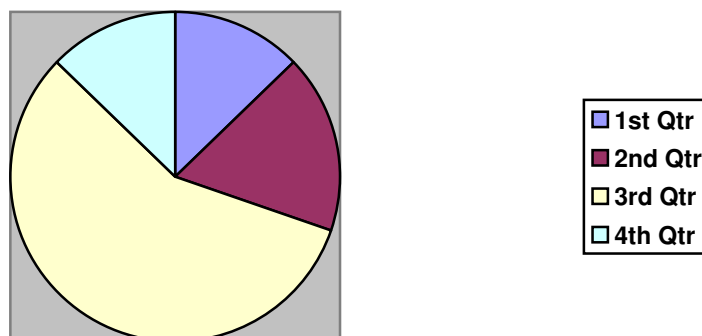
3.2.2 Economic growth performance in the region

The performance of the region in terms of economic growth has been directly linked to the upturn of the global economy after the incursion of the Asian arises, but there have been a number of contributing factors which prohibit progress and sustainable economic growth. The major contributing factors to improvement in economic growth are:

- ❖ A notable acceptance of Zimbabwe
- ❖ Improved international economic climate
- ❖ Deployed regional development of sound macro economic policies
- ❖ General economic reforms

However, there still exist other problems which need to be solved like poor investor confidence and lack of capital flow which affect economic growth performance in the southern region of Africa.

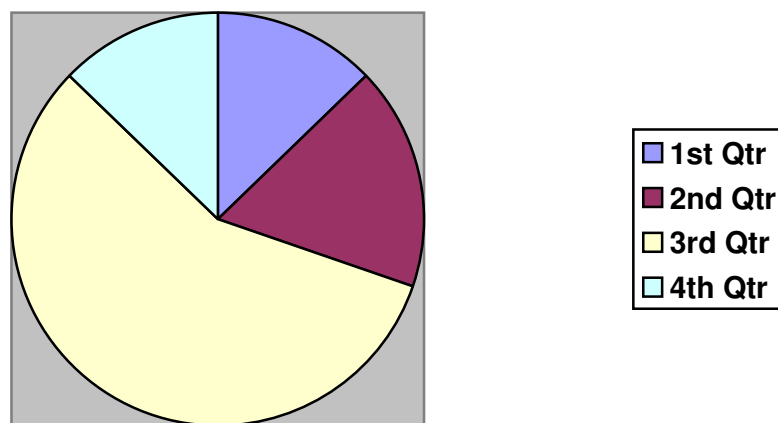
Figure 3.1: Africa's share of global GDP, 2001/2



[Source: Africa Institute of South Africa, 2001/2 (Africa at a glance: Facts and Figures)]

Figure 3.1 illustrates the allocation of global GDP as at 1999 standing at \$30 300 billion. The developing world's share of global GDP is 22 per cent and Africa's allocation is 1.8 per cent. This indicates a sluggish pace of economic growth in the whole of Africa as compared to world. The comparison is also bad with the developing world which has a GDP of \$600 billion of which Africa's share is only 8.5 per cent.

Figure 3.2: SADC share of Africa GDP, 2001/2



[Source: Africa Institute of South Africa, 2001/2 (Africa at a glance: Facts and Figures)]

In the sub regional context the southern African region has a bigger share in terms of continental GDP, with much of the contribution coming from South Africa.

Figure 3.2 indicates that from the continental GDP of \$560 billion, the sub-Saharan region's share is 89 per cent and from a Sub-Saharan GDP of \$329 billion southern Africa contributes 50 per cent, of which 40 per cent comes from South Africa. In the southern region, with a GDP of \$163 billion, South Africa's share is 80 per cent of which 20 per cent is contributed by other regional member countries.

Table 3.5: Real GDP growth in SADC (Percent), 1997-2007

COUNTRY	1997 - 2001	2002	2003	2004	2005	2006	2007
Angola	3.0	14.5	3.3	11.2	20.6	15.3	35.3
Botswana	8.2	5.6	6.3	6.0	6.2	4.2	4.3
Comoros	2.4	4.1	2.5	-0.2	4.2	1.2	3.0
DRC	2.4	4.6	0.8	3.6	7.7	6.4	3.7
Lesotho	0.5	2.8	3.0	3.8	3.7	5.6	5.1
Madagascar	4.6	-12.7	9.8	5.3	4.6	4.7	5.6
Malawi	1.6	2.1	3.9	5.1	2.1	8.5	5.7
Mauritius	5.7	1.5	3.8	4.7	3.0	3.7	4.1
Mozambique	9.2	8.2	7.9	7.5	7.8	8.5	6.8
Namibia	3.2	6.7	3.5	6.6	4.2	4.6	4.8
Seychelles	3.7	1.2	-5.9	-2.9	1.2	4.5	5.0
South Africa	2.5	3.7	3.1	4.8	5.1	5.0	4.7
Swaziland	2.8	2.9	2.9	2.1	2.3	2.1	1.2
Tanzania	4.4	7.2	5.6	6.7	6.8	5.9	7.3
Zambia	2.4	3.3	5.1	5.4	5.2	6.0	6.0
Zimbabwe	-2.4	-4.4	-10.4	-3.8	-5.3	-4.8	-5.7

[Source: IMF, 2007]

Table 3.5 shows the performance of SADC member states with regard to economic growth (real GDP growth). Rising growth rates is an important objective in an environment of high poverty levels, which applies to much of SADC. The table indicates high growth levels with the exception of Angola. The region has a mixed composition, including successful reformers, countries coming out of civil conflict, and mineral exporters.

Member countries with low growth levels demonstrated generally declining growth performance, and all had growth of less than 5 percent in 2005 and these countries are Mauritius, Namibia, Swaziland and Zimbabwe with its serious macro economic policy problems.

3.2.3 Exchange rate performance in the southern African region

The region is also confronted with the problem of currency convertibility into other international hard currency. The most acceptable or convertible currency in the region is the Rand which has also anchored the MMA which comprises of Lesotho, Namibia, South Africa and Swaziland.

All currencies in the region have depreciated against the US \$ and some have been devalued twice or more and there seems to be difficulty in having a sustainable equilibrium level to the US \$ in terms of the exchange rate. This is regarded as a serious drawback towards deeper regional financial integration or monetary union for the region.

Table 3.6 illustrates market exchange rates for the region and also shows the extent of exchange rate decline in the region for 2001. Table 3.6 also shows that currencies for the DRC and Angola have been devalued substantially whereas Tanzania, Seychelles, Lesotho, and Botswana have only double declined against the US dollar in the last ten years.

Table 3.6: Real effective exchange rates in SADC, 1997-2006

COUNTRY	1997	2002	2003	2004	2005	2006
	-					
	2001					
Angola	100.4	118.0	117.4	140.0	158.4	189.5
Botswana	97.3	109.3	115.0	110.2	107.1	104.0

Comoros	107.0	114.0	116.9	123.8	126.1	129.6
DRC	105.5	104.4	111.2	116.1	115.4	117.5
Lesotho	107.0	77.9	112.2	132.2	132.8	129.8
Madagascar	98.3	119.9	106.0	80.4	85.0	85.7
Malawi	105.8	109.3	80.4	73.3	75.2	73.2
Mauritius	95.1	91.6	89.5	87.2	82.6	81.6
Mozambique	97.2	90.5	97.7	83.5	85.3	85.6
Namibia	99.8	87.2	104.6	111.9	112.7	109.7
Seychelles	96.7	109.1	101.1	94.3	92.3	88.6
South Africa	104.0	73.9	97.3	107.6	108.5	104.1
Swaziland	97.9	88.3	102.8	113.2	113.2	112.0
Tanzania	98.8	90.8	75.0	67.7	65.7	62.6
Zambia	102.8	110.9	101.7	107.8	134.7	176.4
Zimbabwe	99.9	359.0	198.0	69.0	63.3	81.2

[Source: IMF, 2007]

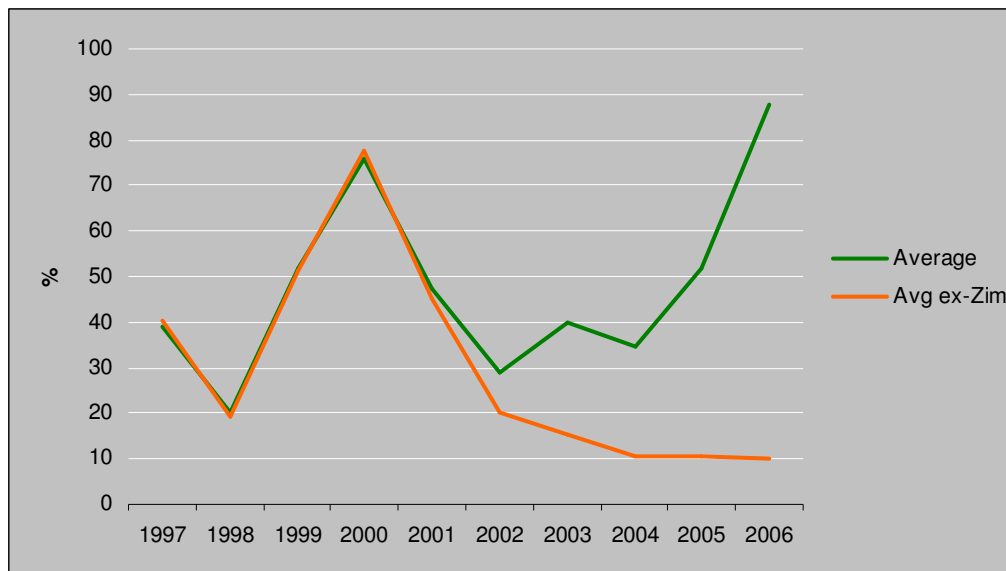
3.2.4 Inflation performance in the southern African region

Inflation performance is a fundamental macro economic measure of regional financial integration. The region's economic development and growth is affected adversely because of high and volatile inflation. There is a considerable variation in terms of inflation performance in the region, with no country attaining a single digit inflation rate in the last decade. Figure 3.3 below demonstrates the performance of SADC member states with regard to inflation from 1995 to 2006. In the region Tanzania, Mauritius and the SACU countries (Botswana, Lesotho, Namibia, South Africa and Swaziland) have lower inflation levels, and show a consistent downward trend in inflation over the period.

Angola, the DRC, Madagascar, Malawi, Mozambique, Zambia and Zimbabwe indicate high levels of inflation over 50 percent at some point in the past.

Nevertheless, even Angola and the DRC have managed to bring inflation down from very high levels very quickly. Zimbabwe has had a very high and rising inflation in recent years, with no sign of stabilisation on the horizon.

Figure 3.3: Average inflation rate in SADC, 1997-2006

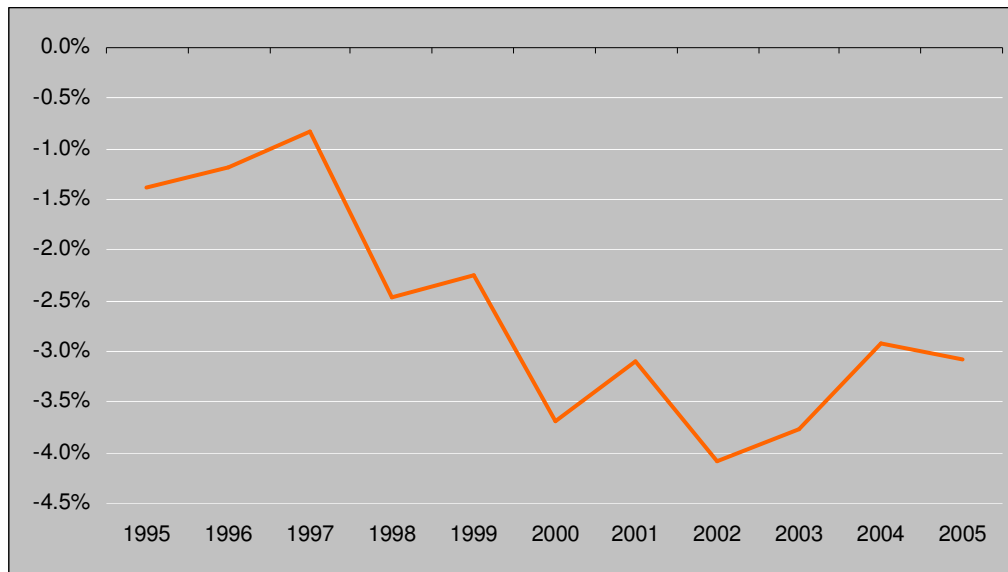


[Source: SADC, 2007]

3.2.5 Budget deficits in the southern African region

The region also suffered a setback arising from central government experiencing high level government budget deficits. Government finance dates are perhaps the poorest of all statistics for the countries of the region. Larger government deficits have undermined economic growth and development. However, in some countries structural adjustment programmes have improved the outlook and reduction in terms of deficits that have been made at a slow pace, but not in all the regional member countries.

Figure 3.4: SADC average fiscal deficit, 1995-2005



[Source: SADC, 2007]

Figure 3.4 above shows the performance of SADC member states with regard to fiscal deficits. There is some volatility in budget balance, especially with Botswana and Lesotho, but generally fiscal deficits are consistently low in the range of 0-5 per cent of GDP, with some budget surpluses, with the exception of Swaziland (out) and the DRC (in).

The High Deficit was demonstrated by Madagascar and Zimbabwe. Notwithstanding the general improvement in fiscal positions, many countries remain highly dependent upon donor grants to fund public spending, especially development (investment) spending (notably Madagascar, the DRC, Tanzania, Mozambique, Zambia and Malawi).

For this reason fiscal sustainability in these countries is, in the short-to-medium term at least, dependent upon continued access to donor funds, the availability of which is in some respects beyond the control of the recipient countries. There is also a wide variation across SADC states in the ability to raise domestic revenues,

with total fiscal receipts (including grants) ranging from 17 to 50 percent of GDP in 2005.

This reflects a number of factors, including economic structures (mineral economies tend to have higher revenue/GDP ratios due to the nature of minerals taxation), policy choices (some countries may choose a low tax regime in order to attract investment) and the efficiency of revenue collection systems.

Table 3.7: Government expenditure as percentage of GDP in SADC, 1997-2007

COUNTRY	1997 - 2001	2002	2003	2004	2005	2006	2007
Angola	58.3	46.5	43.9	38.5	33.3	37.3	37.5
Botswana	37.6	40.4	39.3	37.5	33.7	36.8	38.1
Comoros	21.4	24.1	21.5	20.1	19.9	21.8	24.1
DRC	34.1	35.5	29.3	28.6	23.7	26.5	31.2
Lesotho	49.6	49.5	44.3	43.2	50.2	44.6	45.5
Madagascar	18.4	16.4	20.2	26.0	21.0	22.3	20.9
Malawi	29.1	35.1	39.3	44.0	43.1	43.2	41.4
Mauritius	24.6	24.6	26.6	25.6	25.1	25.5	23.8
Mozambique	25.8	30.0	26.5	24.4	22.6	27.1	31.4
Namibia	35.8	34.2	35.9	34.7	34.1	35.1	37.4
Seychelles	54.2	57.5	46.6	50.7	49.2	61.4	50.1
South Africa	25.9	24.5	25.2	25.7	26.2	26.4	27.2
Swaziland	30.1	32.0	29.9	36.1	34.7	35.7	38.3
Tanzania	15.6	16.1	18.6	20.4	22.9	24.2	26.6
Zambia	29.6	31.3	30.9	26.6	25.7	22.8	24.4
Zimbabwe	34.7	20.7	25.3	41.5	49.6	53.5	66.6

[Source: IMF, 2007]

3.2.6 Degree of openness on current and capital account

There is great evidence that the region is not growing as it should because most of the regional countries are operating as closed economies with few levels of exports only few countries having a high degree of openness.

The more open the region is, the greater the region's trade output which will enhance financial sector development which will promote trade finance, investments flows, financial liberalisation and efficient regional financial integration.

The picture on the openness of capital account is misleading, because most countries in the region do not have active lending through commercial lending with the exception of South Africa and Botswana. As a result the inflows and outflows of donors and concessional capital make changes on the capital account (Economic Integration in Southern Africa, 1999).

The current account in most member countries in the region is also less open, with the exception of SACU member countries. Almost all the Southern African region countries have very low level of international reserves and this can also be illustrated by Table 3.8, which shows that there is insufficient finance to support short-term costs in enhancing investment and economic growth.

Table 3.8: Foreign exchange reserves as percentage of GDP in SADC, 1997-2007

COUNTRY	1997	2002	2003	2004	2005	2006	2007
- 2001							
Angola	1.3	0.6	0.9	1.6	2.4	3.9	3.0
Botswana	30.7	30.3	23.0	18.4	20.9	21.0	23.5
Comoros	7.3	12.4	10.9	10.5	7.7	7.3	6.8
DRC	0.7	0.7	0.2	0.6	2.9	2.5	2.7
Lesotho	7.0	5.6	4.9	4.3	4.4	5.8	6.6
Madagascar	2.6	4.2	2.8	2.9	2.9	4.0	4.1
Malawi	3.7	2.0	1.7	1.5	1.4	2.1	3.1
Mauritius	3.3	5.6	6.4	5.9	4.2	3.5	2.8
Mozambique	6.0	4.9	5.3	5.9	4.5	4.5	3.8
Namibia	1.7	2.6	2.0	1.6	1.4	1.9	1.9
Seychelles	0.8	1.4	1.4	0.6	0.7	1.3	0.8
South Africa	2.1	2.3	1.9	2.7	3.3	3.3	3.2
Swaziland	3.0	2.9	2.2	1.9	1.3	2.0	2.3
Tanzania	4.6	8.3	10.1	9.3	6.4	5.3	4.5
Zambia	1.3	4.1	1.7	1.7	2.5	3.0	3.2
Zimbabwe	0.9	0.5	0.5	0.5	0.6	0.8	0.9

[Source: IMF, 2007]

Table 3.8 illustrates the level of reserves for each country expressed as months of imports. Generally all the countries have a weak reserve position with the exception of Botswana.

The countries share the same problem in the region, and this creates a barrier for financial integration because of the lack of reserves which translates into a lack of

linkage between regional economies with international open economy in a form trade and capital flow. Much cohesion and coordination in the regional financial sector needs to be done to improve the position of the region.

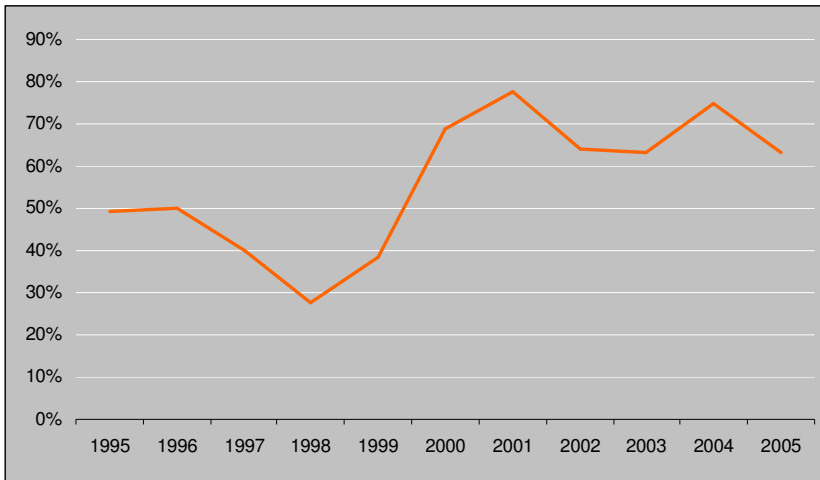
3.2.7 Level of indebtedness

The external debt situation is not positive for the region but there has been some improvement as compared to other regions. Some countries have external debt much higher than their GNP and only few countries have an external debt level of less 50 per cent of the GNP.

Botswana and Namibia have a national debt of 60 per cent of GNP and South Africa and Botswana have a lower external debt percentage of 10 per cent GNP. South Africa and Lesotho are the only two countries with external debt of less than 50 per cent of their GNP. However, Angola, the DRC and Zimbabwe are the worst performers in terms of indebtedness.

For the southern African region to succeed in terms of regional financial integration, the debt situation needs to be improved because it is also a critical macro economic convergence criterion for a monetary union for the region.

Figure 3.5: SADC average public debt, 1995-2005

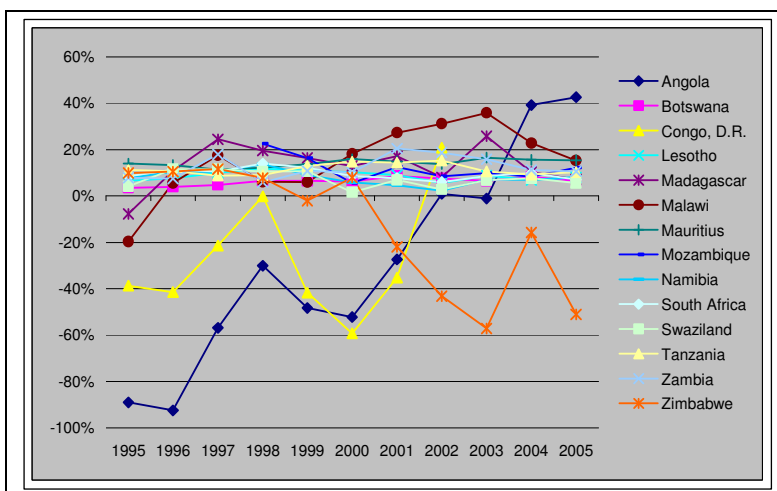


[Source: SADC, 2007]

3.2.8 Level of real interest rates

The other important macro economic parameter for regional financial integration is the level of real interest rates in the region. There is a wide spread of differences of interest rates and this arises from their inflation rate differentials.

Figure 3.6: SADC average interest rates, 1995-2005



[Source: Jefferis, 2007]

The macro economic framework is very critical and fundamental for regional economic and financial integration. However, on the one hand, the integration pace is subject to other factors, like political commitment and global developments.

Based on the broad macro economic analysis the conclusion that emerges is that there is extreme macro economic diversity, which prohibits convergence which will require substantial progression on various economic issues for regional financial integration to be realised in the foreseeable future.

3.3 The concept of regional financial integration

This concept of regional financial integration is closely related to economic integration. Apart from economic integration, other types of integration have been identified namely the preferential trade area, free trade area, custom union, common market, economic union and total economic integration. This section discusses regional financial integration as espoused mainly by Mongelli (2002:22).

As the scope of objectives for integration broadens, they also tend to include capital, financial, banking, fiscal and monetary issues, which give rise to financial integration or monetary integration. Theoretically a complete financial integration will be experienced in common markets or economic unions and total economic integration, such as the European Monetary Union.

In definition financial integration is a situation where there are open or competitive capital markets with the elimination of barriers to capital movements and a resultant gain on saving and investment. This could be categorised further into regional financial integration and international financial integration.

In many theoretical accounts, financial integration is defined and measured by applying the law of one price. Markets are well integrated when the price is the same in the whole market, which could be defined as a region.

The degree and depth of regional financial integration is weighted from diverse complementary angles which include the intensity of cross border financial flows, law of one price and also similarity in financial institutions, markets and financial system.

i. Cross border financial flows

Very importantly, financial integration should also illustrate a significant level of cross border financial and capital flows in the whole region. This capital and financial flow should be spread across the whole region.

The other important component for cross border financial flows is interstate risk sharing in the region. This allows risk sharing across the region which could result in the form of any capital or financial shock.

ii. Law of one price (Arbitrage test)

Concerning the arbitrage test, there is a clear theoretical understanding that financial integration could be assessed in terms of the law of one price which implies that financial and capital markets across the region are integrated if there are less arbitrage opportunities and less interest rate differential in the region.

Money markets across the euro area integrated very rapidly, after the introduction of the single currency and yield differentials among euro area government bonds have converged markedly (Mongelli, 2002: 20).

iii. Similarity in financial structures

Financial integration is also based on the extent of similarity or sharing of financial structure markets and systems. This also includes similarity or convergence on interest rates, instruments, transaction costs, legal structure, regulation, bank lending and other forms of markets.

Regional financial integration should encompass all other financial components, which will lead to convergence and less differentials in the region. The scope of regional financial integration should include fiscal, monetary and exchange rate policy and most importantly all aspects relating to banking, money and capital market, insurance equity market, regulatory, clearance and settlement issues (Irving, 2005:8).

3.3.1 Regional financial integration and capital mobility in the southern African Region

Capital flows in the emerging economies and under-developed economies has been a fundamental constraint for the economic development and economic growth for most of these countries. The OECD and other first world countries were the largest recipients of capital flows whereas Africa only benefited in the form of an aid fund.

The recent surge in global minute capital flows to developing economies has largely by-passed southern African and sub-Saharan Africa with the exclusion of South Africa. The region as a whole is not receiving as great a share and also the quality and type of capital flows are not derisible for economic development (Pigato, 2001:4).

There are constraining factors which deny southern Africa foreign capital flows which will be discussed in depth in the next section of this chapter. Regional financial integration constitutes a significant contribution for a wider influx of capital flows and for the development of the southern African region that will enhance economic growth for all the member countries.

3.3.2 Resurgence of capital flows in southern Africa

As a result of significant changes in political and macro economic management, developing countries are in upsurge for private capital flows of all kinds. Structural changes in the global and regional arena are the underlying influence of capital flows to the developing countries and southern African region.

The dynamic changes occurring at an international level are directing the progressive movement of capital flows to cross-border investment opportunities, which lead to regional and global financial integration.

The resurgence of capital flows in southern Africa is in particular borne by other factors such as deregulation and breakdown of barriers, technological change, and financial innovation which will enhance regional financial integration. Regional financial integration in southern Africa is expected to broaden and deepen over the next decade with an overwhelming inflow of net private capital flows because investment risks are declining, rates of return are improving and there is some efficiency in macro economic management in the region.

3.3.3 The structure of capital flows in southern Africa

The aggregate trend in private capital flows in southern Africa is also indicative of the difference and size in trends for different types of capital flows. An extensive analysis of these different types of flows portrays a comprehensive outlook into the factors that constrain massive private capital inflows in the southern region of

Africa. For many years after World War II, official capital flows and foreign direct investments were the only source of foreign capital available to developing countries (Pigato, 2001:2).

The composition and structure of private capital flows in the developing and emerging economics have changed quite significantly. The structure and composition of capital flows in the region will be weighed based on the four main categories of financial resources outlined by the World Bank.

- ❖ Net transfers of long-term debt or net long-term lending, are the net flows of debt disbursements with a maturity of more than one year, minus principal repayment.
- ❖ Foreign Direct Investment (FDI), defined as investment that is made to acquire a lasting management interest (normally 10 percent of voting stock) in an enterprise operating in a country other than that of the investor, the investor's purpose being to have an effective voice in the management of the enterprise.
- ❖ Portfolio equity flows which are the sum of country funds, depository receipts and direct purchases of shares by foreign investors.
- ❖ Grants are defined as legally binding commitments that obligate a specific value of funds available for disbursements for which no repayment is required (Brink, 2000:140).

3.3.4 Net transfers of long-term debt

The region has shown a low level of capital flows in the form of net transfers of long-term debt. There are underlying factors which constitute the inability to attract this type of capital flow. Unlike other developing regions, long term debts have remained either negative or very low for southern African countries. The underlying factor is that the region's creditworthiness ratings are very low because

of political risk, weak growth, poor macro economic performance and high levels of indebtedness.

3.3.5 Foreign direct investment

Despite all the negative factors constraining FDI, there have been modest improvements in the southern region of Africa and the continent as a whole. Total FDI flow grew from 4.5 billion US \$ from 1990 to 8 billion US \$ at the end of 1999. This reflects an increase of 44 percent of FDI, of which the southern Africa region is allocated an increase of 5 percent.

Despite all the constraints, most countries received a very modest amount of FDI, because countries in the region have addressed these weaknesses. For instance, in several countries we have experienced an end to civil instability, especially in Angola, the DRC, Mozambique, and Namibia with the exception of Zimbabwe and Swaziland which are experiencing civil conflict because of the monarchy rule structure. Similarly, all countries that improved their political and macro economic instability have enjoyed some progress in attracting model rate influx of capital flows (Africa Institute of South Africa: Africa at a Glance: Facts and Figures, 2003).

3.3.6 Portfolio equity flows

Africa is experiencing a relatively low level of portfolio investment flows as compared to other emerging economies around the world, with very small progressive signs of growing investor interest. The growing portfolio equity flows will usher more economic benefits into the region in the form of liquidity, incentives for privatisation and improvement of the financial infrastructure.

3.3.7 Grants

Apart from SACU countries, with the exception of Lesotho, the southern African region is excessively dependent on concessional resources such as grants or bilateral and multilateral credits for its external financing.

Generally, most of the countries in the region rely on bilateral or multilateral grants for external financing especially in financing economic development, for trade finance and imports.

Table 3.9: Grants received by SADC, 1997-2007

COUNTRY	1997	2002	2003	2004	2005	2006	2007
-							
2001							
Angola	1.2	0.3	0.7	0.0	0.1	0.1	0.0
Botswana	4.0	3.6	3.5	5.4	5.2	6.4	5.6
Comoros	3.3	2.1	0.6	1.3	1.9	3.6	3.3
DRC	0.3	0.2	0.2	0.0	0.0	0.0	0.0
Lesotho	16.8	16.9	15.4	19.4	20.2	24.2	20.0
Madagascar	1.0	0.2	2.6	3.8	1.3	1.2	0.8
Malawi	7.0	12.2	9.3	11.2	13.6	14.6	16.1
Mauritius	0.1	0.0	0.5	0.4	0.2	0.2	0.3
Mozambique	6.5	3.7	4.9	5.5	5.3	5.9	9.1
Namibia	11.6	8.5	9.8	11.5	10.7	13.9	16.3
Seychelles	2.0	1.8	1.5	2.0	1.6	-1.3	3.5
South Africa	-0.6	-0.5	-0.6	-0.8	-0.8	-1.0	-1.2
Swaziland	8.9	8.4	7.6	8.9	7.4	11.4	12.3
Tanzania	5.0	2.5	3.5	3.6	4.6	3.9	3.9
Zambia	1.8	2.5	1.5	0.4	1.8	1.2	1.4

Zimbabwe	1.0	0.1	0.4	0.5	0.6	1.1	0.3
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[Source: IMF, 2007]

Grants also play an important role in covering for countries' budgetary expenditure since their fiscal measures are not able to generate enough revenue. Table 3.9 illustrates the increasing dependence of concessional resource for the region. Generally most member countries are experiencing an increasing trend, with the exception of Botswana, Lesotho, and Swaziland.

On the whole the region has shown a negative picture in terms of capital flows, which is the result of wide range factors which need to be addressed in order to instil a positive investor sentiment.

The southern African region must commit itself in progressively improving the economic environment through opening their economies, deregulation, infrastructural development and increasing in economic growth in order to benefit from all types of capital flows.

The region should devise a strategy of reducing dependency on concessional foreign grants which will entail progressive fiscal measures, increases in savings, promotion of domestic investment and promotion of foreign investment in productive enterprises.

3.4 Factors influencing capital flows in southern Africa

Capital flows in Africa and emerging economies have been inadequate and this also deferred the price of financial integration in the regions. Capital flows in developing countries are now accounting for 40 percent of global FDI compared with 15 per cent in 1990, and their share of global portfolio equity flows is now almost 30 per cent compared with 2 per cent before the start of the decade (World Bank, 2004).

The southern African region has also benefited from this flow, and has received modest amounts of capital flows. This improvement in terms of capital flows influx is contributed to mainly by stable political and macro economic changes and financial reforms taking place in region.

Although there is a whole basket of factors which impact on the capital flows, the influence in capital flows influx is mainly driven by structural changes in the international financial market, structural changes in the regional financial markets, growing levels of investment, deregulation in financial markets, financial innovations, technological and infrastructural development.

3.4.1 Structural changes in the international financial markets

The structural changes in the global international financial markets are directed and influenced by the effects of globalisation. This includes the economic and political changes in the global arena.

There has been continuous liberalisation of financial markets and capital accounts transactions in both industrial and developing market economies around the world.

The financial multilateral success of the European Monetary Union also triggered certain dynamics for the international financial markets. The international financial crises also triggered some structural changes which impacted on capital flows to the developing economies. Some of the financial crises are:

- i. East Asian crisis in 1997
- ii. Financial crisis in USA in 1998
- iii. Banking crises in Japan in 1998
- iv. Asset price shock in USA in 2000

- v. Banking crises in Turkey in 2001
- vi. Debt crises in 2001

The structural changes in the global financial scene have improved the upsurge for more capital flows and broadened the composition to developing countries and the southern African region. Consequently regional financial integration in southern Africa is expected to deepen and broaden over the coming decade and this will give a foundation to global financial integration.

3.4.2 Domestic and regional changes in southern Africa

The political and macro economic stability is growing among the member countries in the region, with the exception of Zimbabwe. This has also led to a change in perception for institutional investors to invest in the region. Notwithstanding the risks of investing in the region being high, the political and economic reforms have led to improvements to the region's creditworthiness, decline in investment risk and higher expected rates of return.

The improved economic performance of many emerging market countries played a key role in enhancing their access to international financial markets. In addition, the privatisation they have undertaken and more generally, the opening of their economies to international trade and capital flows, have also contributed to their greater access to capital markets.

Domestically and regional capital flows in the region are directly and indirectly being affected by structural change in the form of opening markets, minimal regulation, infrastructure and other macro economic factors which create incentives for international investors to invest in southern Africa.

3.4.3 Growing investment opportunities

Although the risks of investing in emerging markets remain relatively high, investors have begun to respond to the relatively higher expected rates of return in southern Africa, based on the progressive decline in risks resulting from improvements in political and macro economic policy reforms. The second factor behind the growing investment in the region is the investor's incentive and desire for portfolio risk diversification.

3.4.4 Deregulation in the financial sector

Deregulation and liberalisation of the financial service sector around the world has also opportuned a flow of capital to emerging economies in our region. Globalisation has contributed to the general abolishment of restrictions of capital accounts and also capital flows in the form of exchange controls. Regional initiatives, in deregulating our financial markets, have facilitated the increase in capital flows in our region.

3.4.5 Financial innovation

New instruments and market developments in the region, have also contributed to the increase in capital flows. Most African countries have always been behind, regarding financial developments. Regional cooperation is supporting the development of new financial instruments, activities, systems and market structures in line with international financial innovations. This could include option, treasury instruments and new markets and indexes. The innovation is relatively slow in the region, but is mainly driven by information from financial houses exploring business opportunities in the region and also cross border investments by South African financial institutions in Africa.

3.4.6 Technological and infrastructural development and advances

Technological and infrastructural development is crucial for positive investment, and influx of capital flows in Africa and the southern sub-region. Although progress in terms of technology and infrastructural development is mainly visible in South Africa, gradual development is influenced by the progressive cooperative projects in the financial sector through SADC, MMA and COMESA.

The most important success is the development and harmonisation of the payment, clearance and settlement system. The southern region of Africa requires technological and infrastructural developments to facilitate the influx of capital flows in the region, to facilitate regional and global financial integration. Communication and information technology can help southern African countries to lower costs and increase productivity. The rising use of cell phones, for example, facilitates access to financial services and the deepening of financial markets. While access to these technologies in the region is still below the world average, the region is slowly catching up (Amponsah, 2001:14).

CHAPTER 4: THE CONSTRAINTS, COSTS AND BENEFITS OF REGIONAL FINANCIAL INTEGRATION IN SOUTHERN AFRICA

4.1 Introduction

The effect of globalisation on the world financial system is evident and poses a challenge to most emerging African economies and regions. Globalisation has been a key underlying factor for the upsurge and increase in integration of financial markets at regional and international level.

Many developing countries around the world are also positioning themselves by dismantling restrictions, deregulating their markets and improving the macro economic and political environments by increasing the degree of financial integration.

The potential for achieving the substantial benefits of regional financial integration is unlikely to be realised if all the barriers for integration in southern Africa are not reduced. This chapter will focus on the constraints, costs and benefits associated with financial integration in southern Africa. It looks at all domestic and international constraints, costs and benefits for the region and finally the degree or measurement of regional financial integration is also discussed (Mongelli, 2002:33).

The recent surge and pace of regional financial integration in southern Africa has been curtailed by a number of factors. The constraints are the underlying factors for poor financial market development, capital flows and most importantly for poor regional financial integration. These barriers have been classified into two main categories by nature, which are domestic or regional and international constraints.

These factors together had made it difficult for the region to develop progressively in terms of financial integration, with the exception of South Africa, Botswana and Mauritius.

The main factors constraining financial integration in the region are the political and macro economic environment which could be simplified into political instability, lack of market openness, regulation and liberalisation of markets, infrastructure, economies of scale, low economic growth, slow privatisation, low reserves, low investments, capital flows and poor macro economic performance in terms of inflation, public deficits, public debt, balance of payments and exchange rates.

With many Asian and Latin American countries growing rapidly and moving far ahead of most African countries in terms of putting in place the financial infrastructure needed to enhance regional financial integration, most African regions and most importantly the southern African region, will have to undertake speedy financial sector policy and structural reforms to foster sound regional financial integration.

Some benefits associated with regional financial integration

There are many countries in the world, especially in Africa, the Caribbean and the Pacific, which are too small to justify having their own markets with all the paraphernalia of support facilities as well as the liquidity, width and depth that financial markets need in order to function properly (Teunissen, 1998:94).

The need for and benefit of regional financial integration is paramount because regional capital, banking and financial markets would make the region more competitive, efficient and cost-effective than any singular national financial market, in the financial global arena.

The possible benefits of regional financial integration are twofold, firstly in the form of real economic growth and secondly in the diversification of capital and asset markets, which would reduce the risks and costs of investment. Apart from boosting growth with increased opportunities for risk diversification, financial integration could bring gains in the form of investment, which would increase growth and more capital flow that will afford the southern African region more economic muscle to compete in the global financial markets.

The risks of regional financial integration

Financial markets and private capital flows are becoming intra regionally concentrated, particularly in Europe, East Asia and more recently, increasingly in Latin America. Furthermore, as Africa is still in its infancy in financial integration, much attention has to be paid to dealing efficiently with macro economic and financial issues in order to prevent or contain currency and capital market crises in the region.

Sound and stable financial integration is needed to avoid any contagion effects, and the real economic and financial costs that might have negative spill over effects on the southern African region. The degree of risk associated with regional financial integration would depend mainly on the strength of macro economic policies, the soundness of the banking sector and the strength of institutional arrangements in the region.

The main, profound risks of regional financial integration, according to Coleman (1999:9) could be in the form of serious adverse private capital flow reversals which could be attributed to international investors becoming more discerning about the region and by the authorities' attempts to restrict capital flight by exerting more controls leading to the loss of investor confidence.

The other important risk (Mills, 1998:25) is the greater volatility which could be experienced by the national economy emanating from the other regional member

countries. Financial integration could therefore magnify shock or the costs of policy mistakes and lead to greater instability in the region.

Proper planning and coordination by means of a regional institutional policy framework is unavoidable, because most of the member countries of the southern African region lack a strong macro economic banking sector, and institutional underpinnings to contain vulnerability or potential instability and reversals of private capital flows.

The failures in financial regional integration have a damaging long term regional effect in terms of regional trade and investment interests, according to Teunissen (1998:87).

Constraints on regional financial integration in southern Africa

Most African and developing economies still lag behind in the establishment of the rigorous preconditions needed for successful regional financial integration. A number of factors are seen as constraints to financial integration, ranging from political instability to poor micro-and macro economic fundamentals.

First generation regional integration arrangements among developing countries failed to raise efficiency because of relatively low demand elasticity, relatively large differences in production costs and income levels, divergent rates of industrial development, low levels of infrastructural integration or intra regional trade, non-complementary production resources and divergent macro economic factors (Teunissen, 1998:87).

Teunissen (1998) lists other important impediments such as shaky banking systems, poor financial infrastructure, undeveloped financial markets, a weak regulatory framework, poor human capital, slow privatisation and corruption. Macro economic factors could be the broad policy issues such as the exchange

rate, monetary issues, fiscal issues and trade, which could pose problems for efficient financial integration if they are not properly managed.

Overcoming the constraints to financial regional integration in southern Africa

With the emergence of capital markets developing into continental blocks in Europe, America and Asia, it is most likely that the future relationship between African countries and these blocks would be based largely on commercial and economic competitiveness. It is important therefore that Africa should consider that the most important response would be an effective mobilisation of Africa's own regional and sub regional economic and financial integration to achieve rapid structural transformation and high levels of productivity and competitiveness.

In Africa, regional financial integration is the only viable strategy for the optimal development of all the countries of the continent as well as in the world as a whole (Asante, 1997:32). The African continent is encountering various obstacles that erode the integration process of smaller nations into sub regional blocks.

Integration effects could be achieved if policy harmonisation and coordination were properly managed. These also include transforming and aligning the existing integration units, such as COMESA and SADC. Regional infrastructural cooperation should be promoted to enhance productivity and growth. The development of commodity markets and capital markets is very important for regional consumption and investment respectively. This has to be supported by a good regional banking and financial system. Financial integration in developing countries could be improved by efficient macro economic management. Continued good performance in this area would be crucial for the southern African region to retain strong integration and interdependency with world capital markets (Hansohm, 2002:4).

Institutional integration arrangements have to be reinforced in order to overcome the difficulties of financial integration. A strong supra national institution would

allow the implementation and monitoring of integration. This would in fact sanction authority on compliance with policies and non-implementation of treaties by regional member countries. Political commitment is important by member countries and this would allow them to implement treaty provisions (Bourenanc et. Al., 1992:174).

Proper integration strategies should be implemented to overcome constraints to realising the benefits of regional financial integration. The achievement of regional financial integration would drive medium and long-term development strategies consistent with increasing the participation of the southern Africa region in the world economy.

4.2 Regional constraints to financial integration in southern Africa

The economic health of the southern African region has been troubled with a significant number of illnesses and has been marked by short-lived recoveries, and to some extent this has constrained the region in its efforts for regional financial integration.

The regions' member countries have, in the past few decades, moved from stagnation to declining economic growth with inflation reaching triple and double digit levels. Poor performance in terms of public debt, public deficits and most importantly adverse situation on balance of payment accounts are common.

The sub regional efforts through PTA / COMESA, SACU, MMA and SADC have done a sterling job in responding to the challenges of regional financial integration and have given rise to some development strategies to overcome these regional constraints.

Notwithstanding the robust positive performance of South Africa, Botswana, Mauritius and the other member countries of MMA, Lesotho, Namibia and Swaziland, also responded positively to the challenges facing the region.

The fundamental barriers in the region for financial integration (Pigato, 2001:4) are outlined, as:

- ❖ Macro economic instability
- ❖ Poor political environment
- ❖ Closed market structures
- ❖ Poor agricultural development
- ❖ Over regulation of markets
- ❖ Slow privatisation pace
- ❖ High country risk rating for member countries
- ❖ Dependence on donor funds as a source of capital flow
- ❖ Lack of financial innovation
- ❖ Technological development
- ❖ Exchange rate risk
- ❖ Non- convertibility of currencies.

4.2.1 International constraints to regional financial integration

Recent developments in the international arena indicate that the new world order revolves around the theme of globalisation and calls for emerging economies and the southern African region to pull nations together politically and economically by positioning themselves for the pressures and globalisation problems which might be prohibitive to regional development. The southern African region has to commit itself collectively by enhancing regional financial integration arrangements, which would result in a regional economic block with a common currency.

Despite the surge in regional economic cooperation and integration, the region is confronted with a whole basket of international constraints, which creates structural problems impacting on the pursuit of regional financial integration. The most important international factors which constrain regional financial integration (Pigato, 2001:6) are:

- ❖ Financial crises
- ❖ Liberalisation of financial markets and capital accounts
- ❖ International political instability
- ❖ Investors' perception about Africa and the region
- ❖ Risk profile
- ❖ Financial innovation
- ❖ Capital flows
- ❖ Less international financial integration.

In summary, the international structural changes are impediments for regional financial integration in southern Africa. Although less progress has been made, much more concerted efforts need to be instilled to transcend the region into a sound financial integrated block like the Euro. This will enhance access to international financial markets by southern Africa as a unit.

4.3 The costs for regional financial integration in southern Africa

The arrival of EMU has sparked a new wave of interest in cooperation and integration in the continent of Africa. The increase in regional financial integration attempts is indicative of some positive prospects towards the formation of an African Economic Union.

As a result, financial integration is perceived as an appropriate vehicle for sound regional economic development, which could advance to a full economic integration for the continent. Regional financial integration could contribute as a

building block towards a continental, African Economic Union. The study has identified a number of costs which needs to be sacrificed in netting the benefits of regional financial integration and resulting in a formidable regional economic integrated block. These costs are discussed in depth in this chapter.

The costs of attaining regional financial integration in southern Africa cannot be ignored and are taken into consideration in the development of regional economic integration.

Regional financial integration involves some costs especially during the various formation phases and these factors force member countries to take proactive initiatives by adopting strategies which would maximise benefits and reduce costs.

4.3.1 Macro economic instability

The size of the integrated financial markets will increase costs in terms of controlling or aligning the macro economic benchmarks of inflation, economic growth, deficits, public debt, interest rates and the balance of payments, unless some market control measures are marshalled uniformly in the whole region. This could be done through a supranational institution or through a country agency in scaling down asymmetric disturbances in the region.

Regional financial integration could also result in transferring the responsibility for setting monetary policy, exchange rates and national accounts to some agency. This implies that the domestic monetary authorities loses control of macro economic issuing, affecting the national economy which can also create some macro economic instability.

4.3.2 Volatility and capital flows

Despite the large potential benefits, there is widespread concern among policymakers that growing financial integration and increased reliance on capital flows might render emerging markets more susceptible to volatility, including large reversals in capital flows (World Bank, 2004).

Regional financial integration also brings about costs in the form of volatility and capital flows because of the financial market risks shared by the region. Dominant economies like South Africa, Botswana and Mauritius will lose their financial market sovereignty and also inherit the adverse credentials of other regional member countries like Angola, the DRC and Zimbabwe through association or affiliation.

International confidence and investor confidence may plummet and every member country would suffer in this scenario, particularly those that previously had reasonably stable economies.

Capital flow reversals could also be experienced during the various phases of regional financial integration. Although there has been some improvement in terms of capital flows in the region this could be reversed in the short-term. Regional financial integration can give rise to greater volatility through new sources of shocks in the regional economy. It could also magnify the effects of domestic shocks.

The main international sources of volatility are changes in asset return and contagion effects, whereas on the domestic side the volatility is generated mainly from real and policy shocks. Regional financial integration can enlarge the size or the costs of policy mistakes, leading to greater instability for the southern African region as a whole. The southern African region must progress vigorously in

establishing stable macro economic conditions that will attract more capital flow and reduce the risks associated with volatility and large reversals.

4.3.3 Regional financial contagion

The other important cost related to regional financial integration in southern Africa is referred to regional contagion. Regional financial contagion occurs when an economic or financial shock occurs in one country in the region and has spill over effects to the other regional member countries because all the countries share similar regional economic fundamentals or are exposed to common external shocks.

Regional financial contagion will affect all the regional countries because the shocks will be transmitted through trade or financial channels since all the member countries in the region share similar fundamental economic conditions and policies.

Experience suggests that such contagion will be either short-lived or lasting depending on the reaction and intervention of the regional economic authorities and the possible change in investor sentiment in revaluating the whole regional economic outlook and performance.

Financial contagion may occur when a country suffers massive capital outflows triggered by a perceived increase in country risk by international investors. This brings forth vulnerability of a country's currency, or more generally, a loss of confidence in the country's economic prospects, as a result of developments elsewhere in the region (Agenor, 2001:16).

4.3.4 Increase in depth of systemic risk

The banking and financial system plays an important role in the process of regional financial integration and is one of the main channels through which the benefits of financial integration materialise. Banks are dominant pillars in financial intermediation in developing countries and therefore they influence intermediation of a large proportion of private capital flows directly or indirectly. The transition towards greater financial integration also involves risks for the regional economy in general in southern Africa.

The southern African regional banking sector will be adversely affected by increased macro economic volatility and by structural changes in the banking system, resulting from competition and exposure to new sources of risk.

The process of regional financial integration will expand and increase the size and nature of the systemic risk which could result in serious financial distress and crises in the southern African region. Prudent bank regulation and supervision should be centred on proactively. Capital adequacy, supervision and recapitalisation, which are outlined in the Basle II. Systemic risks will pace itself with the speed of financial integration in the region.

Regional financial integration exposes the domestic country to more sources of external disturbances and increases the speed at which the shocks are transmitted across the whole regional banking sector. The activities and associated risks in the region create an increase in the depth of the systemic risk in southern Africa.

National or regional regulatory authorities must proactively reduce all these risks and challenges which pose a threat to a regional banking sector to be exposed to greater depth of systemic risks. Regional regulators must also cooperate with

international regulators and other regulatory agencies in an endeavour to reduce the transaction costs and systemic risks and to promote regulatory convergence.

According to Borio (2003), there are two commonly held views of systemic risk. The first prospective systemic risk arises from widespread financial distress developing primarily from the failure of individual institutions, spreading through a variety of contagion mechanisms and affecting the whole financial system more generally.

The second view point on systemic risk is seen as vulnerability of the financial system with an uprising of a sudden shock, which is amplified by the endogenous response of market participants precipitated mainly by structurally illiquid portfolios, liquid liabilities and the threat of deposit runs (Borio, 2003:5).

4.3.5 Loss of national financial sovereignty

Regional financial integration is also normally characterised with a loss of national financial sovereignty. Generally, in the build up process of regional financial integration, national financial sovereignty is transferred to some agency or supranational body, but by the same token the poor financial countries will benefit by inheriting the new regional financial status, which is highly dependant on the success of the various phases of integration.

These countries, like Angola, the DRC, and Zimbabwe will also inherit credibility from other financially credible countries like South Africa or from the new regional financial integration scheme. The financial sovereignty includes a number of financial aspects; *inter alia*, convertibility of currency, the structure of the various financial markets, exchange rate policy, tax systems, bond market rating and monetary policy strength.

Even during the formation of the European Monetary System, some countries, for example Germany, lost status as one of the leading financial powerhouses to a trade-off for a supra regional financial sovereignty. By the same token, countries that performed well in the financial sector would also forsake that national financial sovereignty in the wake of financial integration. South Africa, which acted as the model in the southern African region on various multilateral arrangements like MMA, is a likely candidate for such a trade-off.

4.4 The benefits of regional financial integration in southern Africa

This section focuses on the long term benefits derived from a well-managed regional financial integration; with the emphasis on the best-case scenario. Generally speaking the virtues of regional financial integration include a wide range of macro economic and financial benefits, which are sometimes difficult to distinguish because of their interrelatedness.

On the macro economic level, the benefits of regional financial integration are summarised as benefits arising from trade, production and consumption, growth, transfer of technology and managerial know-how.

The other benefits arising from regional integration are closely associated with the financial sector, and include increases in investment, savings, enhanced financial systems and financial sector development, competition, mobilisation of financial resources; currency convertibility, reductions in transaction costs, risk diversification and price stability, increases in savings and investment, financial system efficiency and stability and mobilisation of financial resources.

4.4.1 The macro economic benefits of regional financial integration

The macro economic benefits of regional financial integration will be discussed against the macro economic virtues, which will deliberately result in macro economic stability and economic growth and development for the region as a whole.

Fundamentally, these benefits include the following macro economic variables; trade, production, consumption, economic growth and transfer of technology and managerial skills.

4.4.1.1 An increase in trade

Regional financial integration enhances gain in terms of an increase in trade, be it at a cross-border level or at an international level. At the regional level intra regional trade will expand because of the free flow of goods and services resulting from a total removal of tariff and non-tariff barriers for a regional trading block. Greater intra regional trade will occur, because of sector cooperation in the region in the form of investments, infrastructural development, communication, transportation, and agriculture, industrial and mining cooperation, which will make progressive improvements in terms of production capacity. This will result in greater regional trade.

Short-run adjustments are usually less costly because the multiplier effect of the disturbances on output and the price level are smaller. With increased international trade arising from integration, the economies of participating countries become more open in terms of the share of its exports in GNP. The more open the economy, the larger the export and import elasticity and the

smaller the induced charges in domestic spending because of the leaks to the external sector when an exchange rate is fixed.

Table 4.1: Trade balance as percentage of GDP in SADC, 1997- 2007

COUNTRY	1997- 2001	2002	2003	2004	2005	2006	2007
Angola	35.9	38.7	28.9	38.6	48.0	41.9	37.6
Botswana	11.8	11.9	10.8	8.5	17.3	15.2	14.5
Comoros	-15.9	-12.5	-12.4	-17.1	-20.8	-22.7	-22.4
DRC	46.6	52.0	50.2	53.3	60.2	65.6	48.0
Lesotho	-65.5	-56.4	-47.7	-44.2	-40.1	-36.5	-39.8
Madagascar	-3.2	-2.6	-3.5	-10.1	-11.3	-8.8	-8.1
Malawi	-3.7	-14.7	-14.5	-16.3	-27.2	-19.0	-15.6
Mauritius	-8.3	-4.4	-5.8	-6.3	-11.3	-13.2	-15.3
Mozambique	-16.7	-17.9	-14.5	-9.0	-10.9	-6.4	-10.7
Namibia	-5.7	-6.6	-10.3	-5.1	-4.4	0.4	-0.5
Seychelles	-31.5	-20.0	-13.0	-22.2	-41.4	-35.6	-55.2
South Africa	2.8	4.3	2.1	-0.1	-0.5	-2.5	-3.0
Swaziland	-8.2	7.6	5.4	5.9	2.8	2.5	1.8
Tanzania	-8.0	-7.1	-6.3	-7.6	-9.0	-13.3	-15.0
Zambia	-5.0	-6.9	-7.0	-0.5	0.1	10.7	8.4
Zimbabwe	1.3	-0.1	-1.0	-6.5	-8.6	-0.8	0.0

[Source: IMF, 2007]

Table 4.2: Exports as percentage of GDP in SADC, 1997-2007

COUNTRY	1997-2001	2002	2003	2004	2005	2006	2007
Angola	75.2	6.3	69.6	69.7	77.7	74.1	70.1
Botswana	50.1	47.8	44.2	45.7	52.6	55.3	53.3
Comoros	15.1	15.7	15.7	12.7	12.5	11.7	12.3
DRC	76.4	81.5	79.3	84.3	86.4	91.0	77.6
Lesotho	31.1	55.3	49.6	54.3	49.3	50.6	46.0
Madagascar	25.5	16.0	23.1	32.6	26.5	27.7	26.0
Malawi	27.2	23.9	26.6	28.4	26.7	23.0	21.6
Mauritius	60.8	63.1	58.4	55.5	57.3	60.5	58.4
Mozambique	17.9	29.0	28.2	30.9	32.6	38.6	36.8
Namibia	45.4	42.9	37.2	41.0	40.9	46.6	47.4
Seychelles	71.0	77.8	95.1	97.8	98.7	115.8	137.7
South Africa	26.7	33.0	28.1	26.7	27.5	29.8	30.8
Swaziland	79.7	94.9	82.9	82.7	80.8	80.1	80.5
Tanzania	14.4	15.3	16.7	20.4	22.2	24.2	24.6
Zambia	29.0	28.6	29.0	38.2	34.3	38.4	42.3
Zimbabwe	33.5	6.5	17.6	42.6	42.7	34.5	9.9

[Source: IMF, 2007]

Table 4.3: Imports as a percentage of GDP in SADC, 1997-2007

COUNTRY	1997- 2001	2002	2003	2004	2005	2006	2007
Angola	74.1	62.2	63.1	53.7	51.7	52.5	54.4
Botswana	41.9	36.3	33.5	37.6	35.5	40.6	39.4
Comoros	35.0	30.8	31.8	32.6	34.7	37.3	38.0
DRC	57.8	53.9	53.7	57.3	50.1	45.2	48.9
Lesotho	97.7	114.7	100.8	100.7	94.9	90.6	84.4
Madagascar	32.4	22.6	32.1	47.5	40.2	39.4	37.1
Malawi	38.4	51.4	49.7	53.5	63.7	50.9	45.4
Mauritius	63.0	58.7	57.4	55.0	61.6	67.3	66.8
Mozambique	35.7	47.8	44.0	39.2	42.6	42.6	46.9
Namibia	54.2	48.1	48.1	43.8	44.5	44.5	46.5
Seychelles	84.3	84.1	84.0	95.8	125.7	136.5	176.1
South Africa	24.3	29.1	25.8	27.0	28.4	33.2	34.5
Swaziland	97.4	95.2	80.9	84.3	84.8	86.1	86.8
Tanzania	25.1	22.6	23.5	26.2	30.4	36.6	39.5
Zambia	40.0	42.0	41.5	42.6	37.4	30.2	36.8
Zimbabwe	33.8	7.2	20.7	51.3	53.7	37.0	10.2

[Source: IMF, 2007]

Table 4.4: Principal exports as percentage of total export earnings in SADC, 2001/2

Angola	Petroleum 88, diamond 12
Botswana	Diamond 79, copper/nickels
Lesotho	Manufactures 75, food 4
Malawi	Tobacco 62, textiles 10, tea 9
Mozambique	Prawn 24, electricity 23, cashew nuts 12
Namibia	Diamonds 33, fish 26, metal ore 13
South Africa	Manufactures 57, mineral / metal 30
Swaziland	Beverages 25, sugar 11, wood pulp 10
Zambia	Copper / cobalt 57, electricity 40
Zimbabwe	Tobacco 34, manufactures 32, gold 10

[Source: Africa Institute of South Africa - Africa at a Glance: Facts and figures, 2003]

Southern African regional integration will enhance intra trade in the region as indicated by the expected product output of the various member countries. Regional financial integration will enlarge and expand the domestic market and create more export and import trade with other international countries. For example, South Africa's trading partners are mainly Germany, the US, and the UK in terms of imports and exports. These markets will be exploited by other regional member countries the in event of an integrated southern African region. Already SACU and COMESA / PTA countries are enjoying the benefits of trade arising from these regional trade initiatives.

Table 4.5: SADC trading partners by share of imports and exports, 2001/2002

Angola	Imports	Portugal 16, SA 10, US 10
	Exports	US 49, China 14
Botswana	Imports	SA 77, Switz. 7. UK 3
	Exports	UK 67, Switz. 18 SA 10
Lesotho	Imports	SA 90
	Exports	SA 65, US 33
Malawi	Imports	SA 43, Zim, 14, UK 5
	Exports	SA 16, Germany 16, US 15
Mozambique	Imports	SA 35, US 4, Japan 4
	Exports	SA 16, Zim 15, Spain 13
Namibia	Imports	SA 80
	Exports	SA
South Africa	Imports	Germany 15, US 14, UK 10
	Exports	UK 9, Germany 7 US 7
Swaziland	Imports	SA 84, EU 15
	Exports	SA 65, EU 12 Mozambique 11
Zambia	Imports	SA 55, Zim 9, UK 6
	Exports	S. Arabia 13, Japan 10
Zimbabwe	Imports	SA 41, UK 7 Germany 5
	Exports	SA 13, UK 10 Germany 9

[Source: Africa Institute of South Africa - Africa at a Glance: Facts and figures, 2003]

Table 4.5 shows that the industrial countries of Europe continue to be southern Africa's main trading partner. South Africa's role in the region, especially as a supplier of trade, is evident in the sense that all member countries import from

South Africa and export to South Africa with exception of Botswana, Zimbabwe, Malawi, Swaziland, Namibia, Lesotho and Mozambique.

Regional integration will enhance, facilitate and encourage more regional sharing of trading partners as is already the case with the SACU and MMA members.

4.4.1.2 Production

On the production side, integration permits greater specialisation and allocation of production resources to their most cost effective uses independent of location, thereby improving regional sectoral cooperation. Production gains from regional financial integration occurs as a result of rationalisation of production sectors, which expands and maximises investment flows and integrates regional production to achieve economies of scale. 'A regional market has to establish stable prices for raw materials and manufactured goods; this cannot be achieved without monetary stability and exchange rate certainty' (Nellis, 1983:89).

4.4.1.3 Consumption

Regional financial integration will also increase and spread consumption across the region as a whole through the openness of their economies. Consumption will be enhanced by free movement of production resources, which in turn creates the free mobility of goods and services across regional borders.

OECD examines the degree of similarity in the structure of consumption across EU area countries. An index of similarity in consumption is compiled based on the correlations of various components of real consumption in each country, which shows a very high similarity in most countries except for Spain. The structure of consumption has increased in virtually all EU countries (Mongelli, 2002:22).

For this reason, regional financial integration will subject all member countries in southern Africa to similar asymmetric disturbances because the member countries' economies will converge into homogenous macro economic structures which will induce similar consumption structures in the region.

4.4.1.4 Economic growth

The most important contribution of regional financial integration is higher economic growth, which should contribute positively to the development of the southern African economy. Regional financial integration has the ability to draw upon the regional pool of resources that financial openness accentuates and turns into economic growth.

Another channel through which regional financial integration affects the rate of economic growth is through its impact on the total factor productivity. The openness of the region's economies and more liberalisation will enhance capital flow. This should lead to an increase in economic growth that tends to accentuate the development of domestic and regional equity markets. This in turn enhances factor productivity in the region.

A further growth benefit outlet would be experienced when the region has aligned the exchange rates, reducing the risks associated with currency movements. This should contribute to economic growth and help to avoid any misallocation of resources. It could also help the single market to function smoothly and benefit producers and consumers.

4.4.1.5 Transfer of technology and managerial skills

Regional financing integration has the capacity to increase capital flows, which in turn paves the way for the attainment of the mobilisation of human capital in the form of technological and managerial skills.

According to Prasad et al. (2003), southern Africa's estimate including South Africa's enrolment of engineers in 1995 was only 12 per cent, compared to 9 per cent for Korea and 22 per cent for Philippines. Asia accounts for 86 percent of RED scientists and engineers in the developing world and only 0.3 per cent of sub-Saharan Africa.

Financially integrated economies seem to attract a disproportionately large share of FDI inflows, which have the potential to generate technology spillovers and to serve as a conduit for management skills transfer, which results in an increase in productivity, in turn boosting economic growth (Prasad et al., 2003:25).

4.5 The financial sector benefits of regional financial integration

Fundamentally, regional financial integration is always associated with benefits for the financial sector's development and stability. This section summarises the discussions of the financial sector gains arising from sound regional financial integration.

The financial sector benefits associated with regional financial integration are, *inter alia*, price stability, increases in savings and investment, efficiency and financial system stability, financial sector development and enlargement, mobilisation of financial resources and finally enhancing financial sector competitiveness.

4.5.1 Price stability

An important benefit of regional financial integration is price stability, which ensures the realisation of macro economic and other financial benefits. The full benefits of regional financial integration will be realised only if appropriate stability-oriented policies are deployed in the macro economic and financial sector.

Price stability in a financially integrated region will enhance access to broader and more transparent financial markets and increase the availability of external financing, realising negative reputation gains for those members with a history of high inflation that benefit from an anti-inflationary anchor (Mongelli, 2002: 33).

Monetary policy will make its contribution towards the attainment and maintenance of price stability, while other economic policies must be implemented to ensure that the opportunities of an integrated southern Africa are fully realised.

4.5.2 Increase in savings and investment

Most developing countries and regions are under-performing with regard to the level of savings and investment; this of course contributes to various financial setbacks for these economies. The southern African region suffers from an acute shortage of savings and investment which is fundamental for the development of regional financial systems and increasing the possibility of regional financial integration and linkages to global financial markets.

Chapter two of the study has exhibited the adverse reactions of low savings and investment in southern Africa. The restoration of macro economic stability throughout the region will rectify the current instability and financial distress and this will eradicate the probability of escaping the vicious cycle of low savings and investment. In a financially closed economy, investment must be funded by domestic savings. The two variables are matched by movements in the real interest rate which is the cost of borrowing and return on savings.

Financial integration, whether on the national or the international level, serves as the link between local savings and local investment, allowing savings to run as surely and instantly where it is most wanted, and where there is most to be made of it, as water runs to find its own level.

4.5.3 Efficiency and financial system stability

Regional financial integration reduces financial disturbances through the various financial and macro economic policies with the eventuality of enhancing efficiency and financial system stability in the region. The region will instil discipline in the various financial markets and other financial sectors of the region that will reduce the accentuated weaknesses and financial shocks in the southern African region.

Regional financial integration leads to a greater increase in financial openness, which contributes to efficiency and stability in the financial sector. Financial openness may increase the breadth and depth of domestic markets and lead to an increase in the degree of efficiency of the financial intermediation process, by lowering costs and excessive profits associated with monopolistic markets, thereby lowering the cost of investment and improving resource allocation (Agenor, 2001:11).

4.5.4 Financial sector development and enlargement

Financial sector development and enlargement is created automatically through regional financial integration. The region's financial markets will develop in order to attract international financial integration attempts by the rest of the world.

A deepening regional financial system in the wake of financial integration also enhances growth through the efficient allocation of resource which translates into further financial deepening. More innovation in terms of markets and financial instruments will develop, which will create access to international financial institutions.

Empirical evidence indicates that regional financial integration is strongly associated with greater financial deepening of investments and faster productivity growth as the resultant benefits.

4.5.4.1 Mobilisation of financial resources

The region's financial resources will foster and increase financial efficiency in the wake of financial integration in southern Africa. The EU can bear testimony to this fact. Various member countries' resources are under-utilised especially in terms of market and skills development. Only South Africa is regarded as the main financial sector which is integrated with the global world. Financial integration will create more opportunities for the mobilisation of financial resources in these under-developed economies of the region.

4.5.4.2 Enhancing financial sector competitiveness

Another potential source of benefit for financial integration can be found in the financial sector competitiveness of all financial markets across the region. This could result from a stable currency, reduction in transaction costs and risks, alignment of exchange rates, a common pool of foreign reserves and a sound regulatory and financial market environment.

The southern African region needs to rectify its credit rating, which is normally based on a number of factors like political risk, weak growth, export performance, macro economic instability and high levels of indebtedness.

This chapter analysed the constraints, costs and benefits of regional integration in southern Africa and recommended some measures and approaches in dealing with these barriers and costs. It also illustrated the significant benefit for the southern African region and took some evidence from the European Monetary Union.

CHAPTER 5: INTEGRATION OF THE FINANCIAL SECTOR IN SOUTHERN AFRICA

5.1 Introduction

Financial market integration has grown rapidly during the late 1980s and 1990s due to the increase in pace of the globalisation of investments seeking higher rates of return and the opportunity of diversifying risk globally. Many developing countries are encouraging capital flows by dismantling financial controls and deregulating their domestic financial markets.

The increase in the degree of integration of global financial markets is accompanied by an increase in the development of economic integration groupings. Integration with neighbouring countries can produce economies of scale when competing with other regions of the world. It can be one way that countries could ensure that the best use is made of the resources, capabilities and abilities within their region (Mboweni, 1999:1).

In the world of increasing interdependence, and with global financial markets, the question of addressing regional financial integration is becoming more urgent. This chapter analyses the nature of financial market integration in southern Africa, looking mainly at the various issues pertaining to the integration of the banking sector in the region.

5.2 Integration of the banking sector in southern Africa

Regional financial integration is principally dependent on the integration of the banking sector since banking is the main source and conduit of finance. The banking sector is primary in the development of other financial markets since it

has the capacity to mobilise savings and investment, which gives promise for financial instruments and market innovation.

Sound bank regulation and supervision enhances the prospects of a healthy financial system which boosts the financial integrity and stability of the region as a whole. The chapter analyses the possibility of integrating the banking sector in southern Africa. It also looks at structural issues, regulatory frameworks and strategies for increasing the pace of bank sector integration in the region.

5.2.1 The size and structure of the banking sector in southern Africa

The southern African region has a less than enviable reputation because acute banking and financial problems confront the regional banking sector. Generally, in most regional member countries the banking sector is severely crippled by extreme financial distresses. This contributes to financial and macro economic instability. The banking sector has failed to play a positive role in financial intermediation and as an agent for the allocation of financial resources in the region.

The structure of the banking sector is characterised mainly by government ownership in some countries, low financial depth, low liquidity, a poor supervisory framework, and a low level of sophistication in terms of the market operation. However, financial and banking development and innovation is growing in the region (SADC, 2007).

The southern African region is characterised by the co-existence of private and state ownership, with the exception of South Africa. The private banking sector is primarily dominated by foreign and South African banks that have made considerable inroads in the region. They have expanded their operations

continentally beyond the SACU and MMA borders. The South African banks are actually accelerating the pace of regional financial market integration.

Table 5.1: International ranking of African banks, 1999

COUNTRY	BANK	RANKING 1999
SA	Stanbic	157
SA	ABSA Group	193
SA	Nedcor	231
SA	First rand Bank	257
SA	NBS Boland Bank	274
SA	Investec Group	352
Morocco	Credit populaire du Merc	413
Morocco	B. Marocainedu Commece Exterieur	543
Nigeria	First Bank of Nigeria	369
Morocco	Bonque Commerciale du Moroc	629
Tunisia	Baque Nationale Agricole	864
Morocco	Wafabank	700
Nigeria	Union Bank of Nigeria	708
Mauritius	Mauritius Commercial Bank	861
Kenya	Kenya Commercial Bank	950

[Source: Bank Survey Africa, 2002]

The regional banking sector is still under-developed when compared to its global banking counterparts, again with the exception of South Africa. The South African banking sector is tapping into the whole continent and is very competitive regionally and internationally.

Table 5.1 illustrates the ranking of the key international banking players in the African context. The table indicates that six southern African banks rank among the top 300 in Africa and internationally. In the regional context, the Mauritius Commercial Bank is also ranked among the top banks in Africa.

The region generally appears to be well capitalised and profitable based on their healthy capital adequacy ratios and returns on assets. The banking market is broadly dominated by lending in the following areas: foreign loans, retail, bills, public sector, mortgage, instalment, equities and corporate banking. The banking sector also overlaps into other financial sectors like insurance, unit trusts, financial services and micro lending.

There is great potential for integration in the banking sector, most importantly with the setting of common regional standards. Regional harmonisation in terms of bank regulation and supervision should be promoted to establish a common regulatory and supervisory framework at the regional level.

5.2.2 The integration costs of the banking sector

Regional financial integration in southern Africa will usher profound benefits for regional economic growth and development. However, there will be significant costs associated with the integration of the banking sector in the region. These costs would put pressure on the banking sector in the region. The severity of the pressure will depend mostly on the integration processes and the intensity across the region might vary because of the strength of the domestic banking sector during the pre-integration phase.

A number of costs have been identified by Cabral et al. (2002:45) for the general bank sector:

- i. Increased competition in banking
- ii. Reduction in bail outs
- iii. Increase in mergers and acquisitions
- iv. Pressures in regulators and legislators
- v. Increase in operational costs
- vi. Sinking profit margins

- vii. Technological costs
- viii. Skills development and training costs
- ix. Increase in legal costs (e.g. validation of conducts).

5.2.3 Supervisory and regulatory framework in the southern Africa region

Taking into account the diverse nature of the banking sector in the region, much more concerted efforts should be made to develop a rigorous framework for bank regulation and supervision. This creates greater scope for the regional integration of the banking sector, where southern Africa can serve as an anchor in the process of harmonising and lifting less developed countries to global banking standards.

Regional initiatives should set rigorous common regional standards. This would allow the regulatory and supervisory authorities to pay special attention to compliance and monitoring policies and procedures that would enhance the development of the banking sector. A sound regional framework will develop and strengthen the southern African financial system. The regional banking sector will be able to handle cross-border problems and lobby regional syndication of larger lending activities. This would reduce high exposure to a few large borrowers.

5.2.4 Regional integration of bank regulation and supervision in southern Africa

Regional integration of bank regulation and supervision in southern Africa has predominantly been carried out under the auspices of the SADC and ESAF umbrella. The initiatives of establishing a common regional set of standards and supervisory practices are urgent in enhancing a sound and prudent regional framework.

The ESAF Annual Report (2000) details some basic projects that had been undertaken to date on regional regulatory and supervisory activities. They are now discussed individually.

i. Compliance with core principles of effective banking supervision

All ESAF member countries which are all SADC countries inclusive of Kenya, which endorsed the Core Principles for effective Bank Supervision and have declared their intention to implement the Core Principles within a reasonable time frame.

ii. Harmonisation of accounting and audit standards

The Eastern, Central and Southern African Federation of Accountants (ECSAFA) was established with the objective of harmonising the accounting and audit standards on a broader basis. Member countries implemented the International Accounting Standard 30 (IAS 30).

iii. ESAF training programmes

Various training programmes were installed to address the training and skills needs for the region. The courses were facilitated by the IMF, Financial Stability Institute and South African Reserve Bank.

iv. Off-site and on-site surveillance model

The off-site and on-site supervisory model was developed by the World Bank for the implementation in the region of which great progress has been made to date.

v. ESAF Website and standard data collection

ESAF Website was launched on 31 March 2000, which enables the distribution of information and documentation in the region. The website is

interactively used for the publication of statistical information which is collected through the D1 900 forms.

vi. Harmonisation of provisioning standards

Harmonisation in this area is of cardinal importance because it is used to identify common standards of provisioning for identically perceived risks in the banking book for banking supervisors of the region.

vii. Deposit-insurance scheme for the region

Progress is made in the development of the regional legal framework of deposit insurance scheme.

viii. Research projects

Various research projects have been conducted on a continuous basis on various regulatory and supervisory issues.

ix. Regional harmonisation of business application and technological architecture of banking supervision

The region is developing business applications and technological architecture for the region, with the intention of harmonising supervisory legislation, regulations, procedures and systems at national and regional level.

x. Harmonisation of e-banking supervision standards

The ESAF Secretariat developed a guideline in dealing with e-banking in the region as it is becoming a worldwide issue (ESAF Annual Report, 2000).

5.2.5 The role of South African banks in integrating the banking sector in southern Africa

The South African banking sector is emerging as a force to be reckoned with because of their growth, and extension into Africa and international markets. Most

of the big four banks are making acquisitions and developing branch networks into Africa, especially in the southern African region South African banks dominate in the MMA, SACU and SADC territories.

Globalisation has contributed to encouraging some SA-based banks like Investec to list on the London and New York Stock Exchanges and some foreign based banks to invest in Africa.

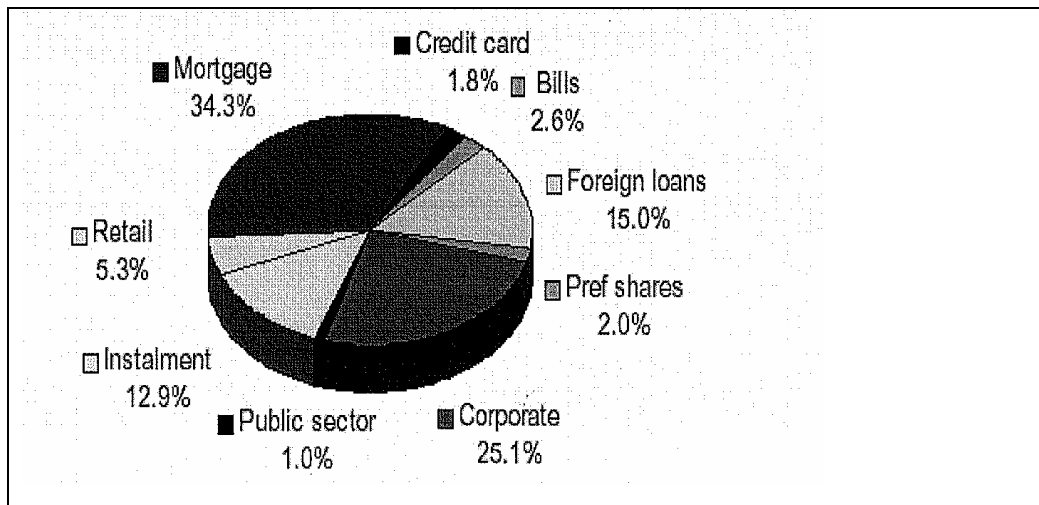
The South African banking system is well developed and largely established according to the Western European model, due to the countries colonial history. The South African banking sector is astute and highly rated. It is considered to have a prudent regulatory and legal infrastructure and well developed accounting standards and disclosure practices.

The industry structure is dominated by four large banks. There are, however, 58 licensed deposit-taking institutions of which 33 are domestically owned, 8 foreign owned, 2 mutual banks and local bank branches of foreign banks.

In addition there are 55 foreign bank representative offices in the South African banking sector, which create linkages with the international markets (SARB, 2002: 79–85).

The banking sector is offering a wide range of comprehensive banking products and services, which include mortgage, credit, retail, foreign loans, instalment sale, public sector and corporate banking services.

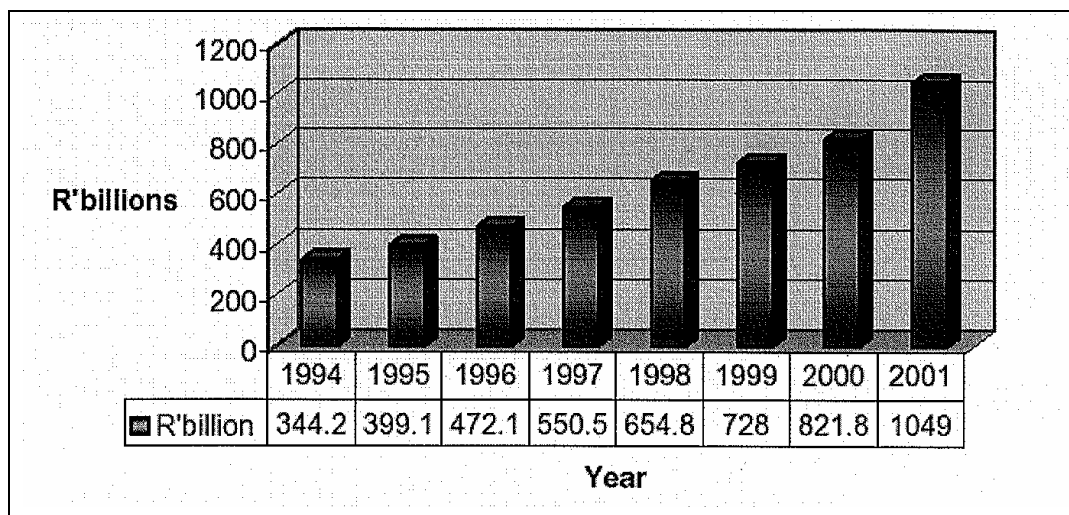
Figure 5.1: SA banks' credit extension by type, 2001



[Source: Bank Survey Africa, 2002]

The banking sector is relatively stable with an increase in general asset growth. The total banking assets base is standing at R1 049, 3 billion as at December 2001.

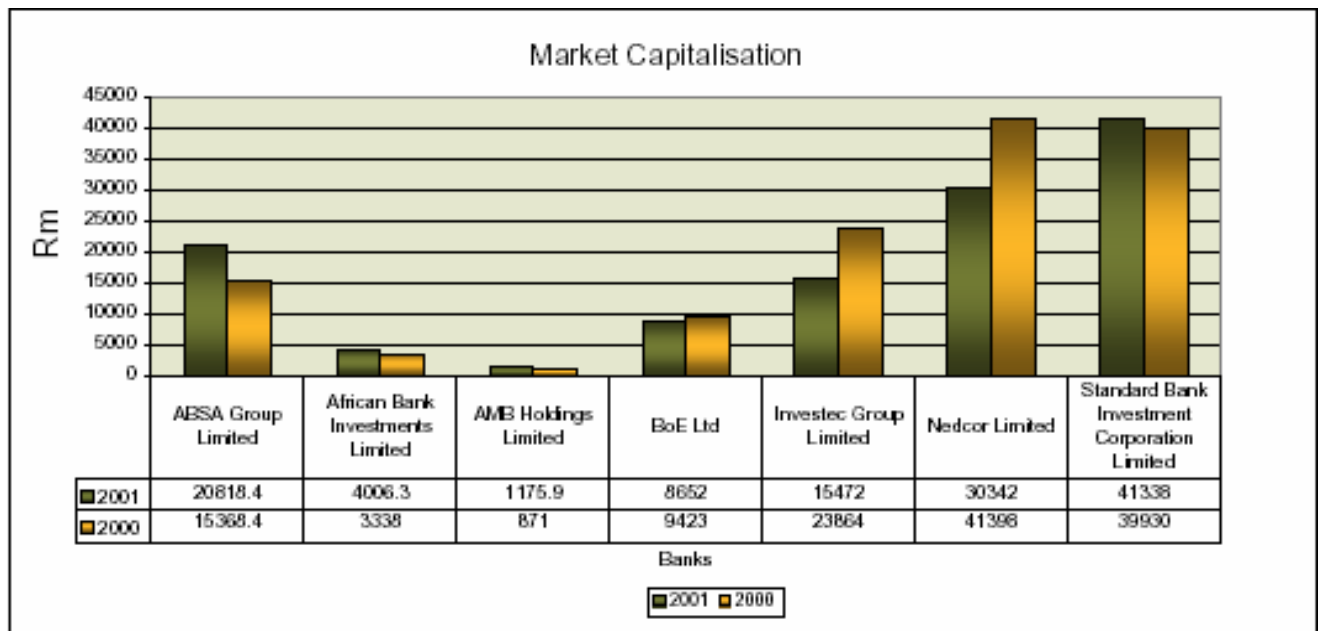
Figure 5.2: SA banks' total assets, 1994-2001



[Source: Bank survey Africa, 2002]

Figure 5.2 illustrates the growth pattern in terms of bank assets in South Africa between 1994 and 2001. Total banking asset growth was 70 percent between 1994 and 2001. The bank sector capitalisation steadily improved. This is demonstrated by the performance of the top seven banks in South Africa.

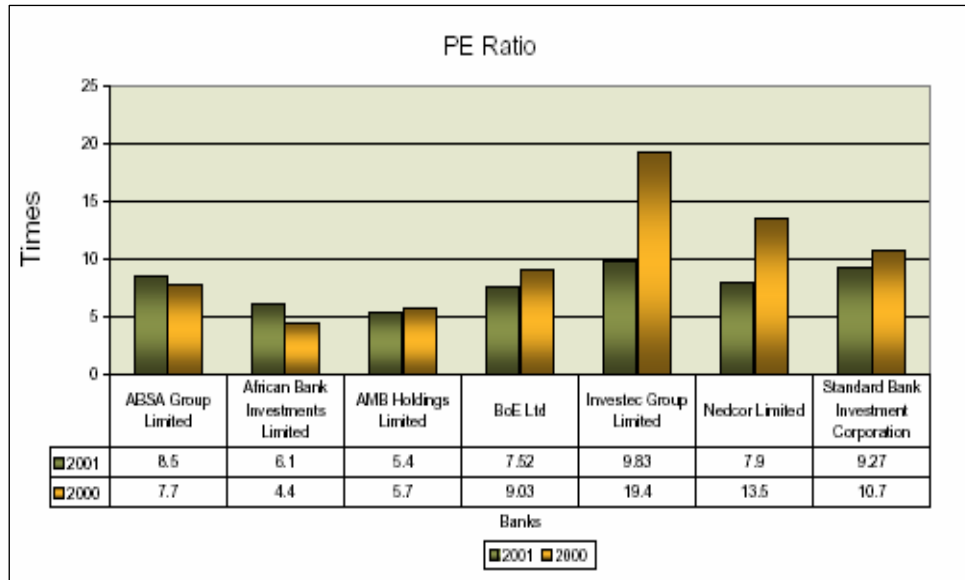
Figure 5.3: SA banks' market capitalisation, 2000/1



[Source: Bank Survey Africa, 2002]

The industry is relatively well in terms of return on investments for the shareholders. This could also be illustrated by looking at the individual PE ratios for the period 2000 to 2001. The average PE ratio was 10 for 2000 and 2001 respectively. This also indicates that BOE, Investec, Nedcor, AMB and Stanbic experienced decline in their respective PE ratios for 2001.

Figure 5.4: SA banks' PE ratio, 2000/1



[Source: Bank Survey Africa, 2002]

The South African banks have shown good profitability although there are lots of challenges which need to be overcome. The banks in South Africa are also receiving accolades in terms of good credit ratings reflected by their current ratings on the national scale of South Africa.

Table 5.2: International ranking of African banks, 2000/1

Bank	Ranking**	
	2001	2000
Standard Bank Investment Corporation	146	159
Nedcor Bank	158	204
ABSA Group	250	203
FirstRand Banking Group	300	316
Investec Bank	331	343
Boe Bank	455	422
Mercantile Lisbon Bank Holding Ltd	n/a	983

[Source: Bank Survey Africa, 2002]

Table 5.2 indicates that the six top banks in South Africa are ranked among the top 1000 banks in the world in 2001. Generally, all top SA banks are ranked among the top 300 in the world. The stability of the South African banks will contribute significantly in the integration of the banking sector and other financial markets in the long term.

Table 5.3: Credit ratings of African banks, 1999

Locally registered banks and other financial institutions	Long-term rating	Short-term rating	Outlook
Absa Bank	ZaAA-	ZaA1+	Stable
African Bank	ZaBBB+	ZaA2	Stable
BOE Bank	ZaA	ZaA1	Positive

FirstRand Bank	ZaAA-	ZaA1+	Stable
Gensec Bank	ZaAA-	ZaA1+	Stable
Imperial Bank	ZaA	ZaA1	Stable
Investec Group	ZaA+	ZaA1	Stable
IOTA Financial Services	ZaBBB-	ZaA3	Stable
Mercantile Bank	ZaBBB-	ZaA3	Stable
Mettle	ZaBBB	ZaA2	Stable
Nedcor Investment Bank	ZaA	ZaA1	Stable
PSG Investment Bank	ZaBBB+	ZaA2	Stable
Safrich Financial Services	ZaBB+	ZaB	Stable
Securities Investment Bank	ZaBBB	ZaA2	Stable

[Source: Bank Survey Africa, 2002]

The South African banking sector is also ranked highly against other international institutions. This is illustrated by their ranking based on the dollar equivalent of the bank's BIS Tier 1 capital.

5.3 Overview of clearance, settlement and payment systems in southern Africa

The clearance, settlement and payment systems are a critical component in the integration of the banking sector and other financial markets. It enhances efficiency and also reduces risks associated with financial markets. Africa is lagging behind the world with regard to financial infrastructure architecture when it comes to the continent's improvement of financial markets.

The African continent, together with the various sub regions should implement synchronised clearance, settlement and payment systems to reduce systemic risk. This would also develop sound links with the various banking sector role players, regionally, continentally and with rest of the world.

The clearance, settlement and payment systems in southern Africa are also characterised by manual systems as compared to electronic and Real Time Gross Settlement (RTGS) systems in the developed world. Only six countries, namely South Africa, Malawi, Mauritius, Namibia, Tanzania and Zimbabwe are on the RTGS system. Tanzania is using both the manual and electronic systems because of its infrastructural deficiency.

Table 5.4: Payment systems in SADC

COUNTRY	MANUAL	ELEC- TRON- IC	RTGS	AGENT	INTERNA- TIONAL
Angola	X			Central Bank	S.W.I.F.T
Botswana	X	X		Central Bank	S.W.I.F.T
Lesotho	X			Central Bank	S.W.I.F.T
Malawi			X	National Payment Council	S.W.I.F.T
Mauritius			X	Central Bank	S.W.I.F.T
Mozambique	X			Central Bank	S.W.I.F.T
Namibia			X	Central Bank	S.W.I.F.T
South Africa			X	Central Bank	S.W.I.F.T
Swaziland		X		Central Bank	S.W.I.F.T
Tanzania		X		Non Central Bank	S.W.I.F.T
Zambia		X		Central Bank	S.W.I.F.T
Zimbabwe		X	X	Central Bank	S.W.I.F.T

NB. Manual – manually operated system RTGS – Real Time Settlement System
Electronic.

[Source: Payment Systems in Southern African Development Community, 1999]

Table 5.4 illustrates the structure of the payment systems in the southern African region today, indicating the type of system, the agent overseeing the system and also indicating the usage of S.W.I.F.T., which is the international settlement link.

5.3.1 Barriers to integrating clearance, settlement and payment systems in southern Africa

5.3.1.1 Legal framework

Many southern African member states in the region do not have specific legislation to govern their own payment systems. More efforts should be made in developing domestic legal frameworks. This would be harmonised with other payment system legal frameworks in the region. The process should include all dynamic changes and all payment system participants in the region.

5.3.1.2 Communication and power supply infrastructure

The region is also experiencing an integration barrier arising from the lack of reliable communication infrastructure and power supply in most member states. The regional authorities should encourage development of telecommunications infrastructure and power supply in ensuring that the regional payment system is developed within a safe and efficient framework.

5.3.1.3 Effects on inflation costs

The region's economic situation is characterised by adverse conditions, in terms of inflation, economic growth and financial stability. In an environment of high inflation and unstable exchange rates, the development and modernisation of payment systems is likely to be constrained by increasing costs of software, hardware and labour.

5.3.1.4 Dominance of the banking system by a few large South African banks

The region's banking system is dominated by SA banks, which might pose problems for cooperating in the integration or development of new payment systems. This may be because of the complacency benefits of their current systems, which would indirectly influence the choice and development of the regional payment system.

5.3.1.5 Great disparity in technologies used by banks in the region

The region experiences great disparity in terms of technologies used in its payment systems. This varies from country to country and overlaps in the regional borders. This creates a barrier to integrating the systems since different technologies are applied and are difficult to interface. The development of integrated payment systems should incorporate all these disparities in their operating technologies.

5.4 Integration initiatives on the clearance, settlement and payment systems in southern Africa

The integration initiatives of the payment systems in the region are mainly undertaken through the PTA Clearing House, MMA and SADC multilateralism arrangements. The PTA Clearing House has been operating since 1984 and provides clearance, settlement and payment facilities for eleven countries in the region. They are Angola, Lesotho, Malawi, Mozambique, Swaziland, Tanzania, Zambia and Zimbabwe (Economic Integration in Southern Africa, 1993:164).

The MMA also makes provision for the clearance, settlement and payments of transactions between South Africa, Lesotho, Namibia and Swaziland. Integration initiatives for the clearance, settlement and payment system in the region would be insufficient without making mention to SADC'S contribution.

Significant progress has been made by the Committee of Central Bank Governors (CCBG) in SADC, in coordinating the regional integration of payment systems. The projects are outlined below:

- The SADC have completed a document, Guide to Developing a Strategic Framework for Payment System Modernisation in 1997 which serves as a guide handbook to assist member countries in reforming their payment systems.
- Vision and Strategic Framework documents, which describe the strategic framework for the modernisation of SADC countries' payment systems.
- Payment Systems in the Southern African Development Community. This is a statistical document on Payment Systems in SADC which was completed in 1999, popularly known as the Green Book.
- Assistance to SADC member countries with the development of clearing and settlement systems. The SADC Payment System Project Team has continuously provided assistance to member countries in various aspects of the development of clearance, settlement and payment systems.
- National Payment System legal framework. The SADC have initiated a project in the drafting of a model National Payment Systems Act that is currently in progress of completion.

5.5 Integration strategy for clearance, settlement and payment systems in southern Africa

In essence, the strategy for the development of the clearance, settlement and payment systems in the region should establish adequate machinery in promoting financial market integration. The system should encourage the use of national currencies in the settlement of transactions between member countries in the region.

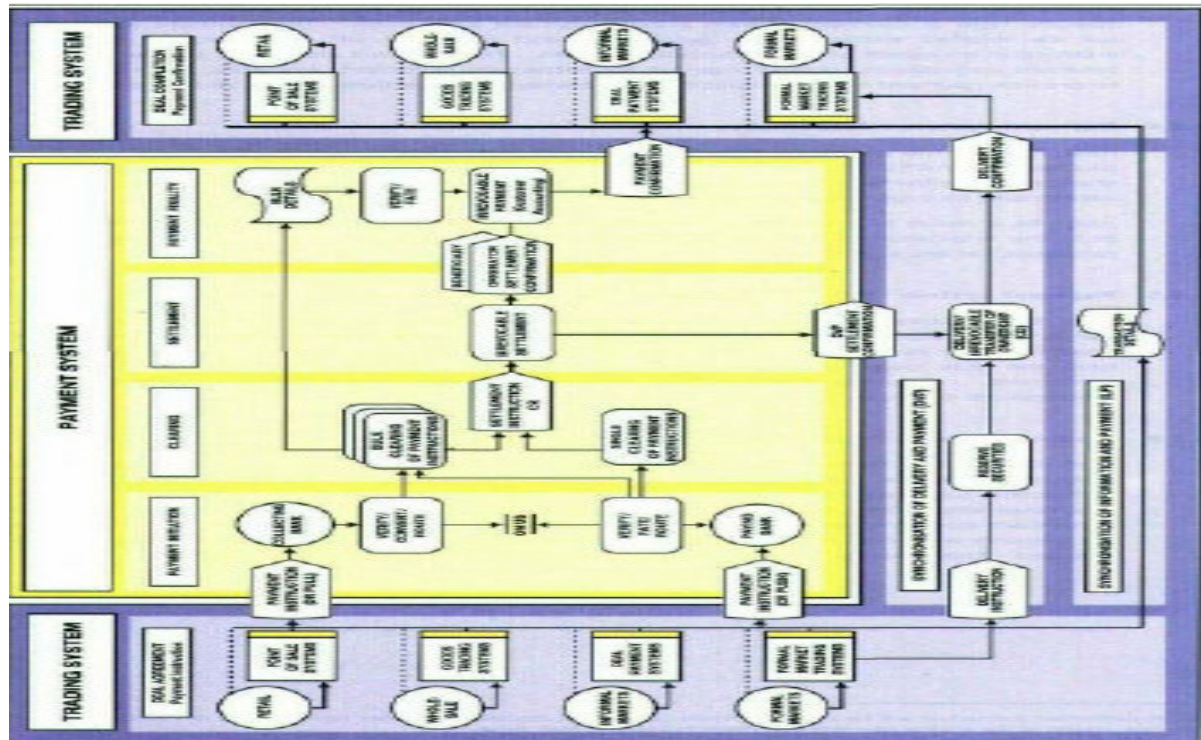
- ❖ The integration of the clearance, settlement and payment systems should have an impact on the member countries, with some potential gains (Economic Integration in Southern Africa, 1993:166), which may include:
 - Reduction in monetary reserves
 - Reduction in correspondent balances
 - Minimising the transaction costs
 - Speeding up the growth of intra regional payments

The regional payment system should be developed with a view of reducing a range of risks, which could be broken down to credit risks, liquidity risks, legal risks, operational risks and systemic risks. The payment system for the region should be based on the BIS Core principle, which set standards for reliability and security. The BIS Core principles for systemically important systems are outlined by the Committee on Payment and Settlement Systems (2000) as follows:

- ❖ The system should have a well-founded legal basis under all relevant jurisdictions.

- ❖ The system's rules and procedures should enable participants to have a clear understanding of the system's impact on the financial risks they incur through their participation.
- ❖ The system should have clearly defined procedures for the management of credit risks and liquidity risks.
- ❖ The system should provide prompt final settlements on the day of value preferably during the day and at a minimum at the end of the day.
- ❖ A system in which multilateral netting takes place should, at a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single settlement obligation.
- ❖ Assets used for settlement should preferably be a claim on the central bank, where other assets are used; they should carry little or no credit or liquidity risks.
- ❖ The system should ensure a high degree of security and operational reliability with contingency arrangements.
- ❖ The system should provide a means of making payment, which is practical for its users and efficient for the economy.
- ❖ The system should have objective and publicly disclosed criteria for participation, which permit fair and open access.
- ❖ The system's governance arrangements should be effective, accountable and transparent.

Figure 5.5: Overall payment process in SA



[Source: South African National Payment System, 1995.]

The regional authorities should design a regional payment system that has the capacity to function efficiently.

- ❖ The system process should include the following critical components in sequence (SADC: Guide to Development a Strategic Framework for Payment System Modernisation, 2002:20):
- ❖ Deal agreement
- ❖ Payment initiation
- ❖ Clearing
- ❖ Settlement
- ❖ Payment finality
- ❖ Synchronisation of delivery and payment
- ❖ Synchronisation of information

- ❖ Deal completion

5.6 Integration of the equity market in southern Africa

The integration of financial markets would be inadequate without the harmonising and integration of the equity markets in the region. This is fundamental in developing the base of other derivative markets and also channelling capital plans in the southern region of Africa.

Equity markets' development has sound long-term benefit for economies in their development stages because the equity markets can mobilise long-term savings for financing long-tenured investments, provide risk capital (equity) to entrepreneurs, encourage broader ownership of firms and improve the efficiency of resource allocation through competitive pricing mechanisms (Emenuga, 1997: 157).

The integration of equity markets will enhance sound benefits for the whole region in terms of financial market development. This section looks at a general overview of capital markets in the region and the obstacles in integrating equity markets. A discussion is also envisaged on the regulating framework, cooperation, initiatives and finally recommendations on the integration strategy of equity markets in the region.

Most of the stock exchanges in Africa range from the larger South African and Egyptian exchanges that were established in the 1880s to smaller exchanges in Uganda and Mozambique only in the past four years (African Stock Market Handbook, 2003: 1).

The southern African region has much more stock exchanges when compared with the African region. Out of 18 exchanges in Africa, 50 percent are established in the region. Southern African region indices, weighted by country market

capitalisation, have outperformed most development and emerging markets indices. The cumulative returns in the past five years in US dollars for southern Africa have been 43 in comparison to -3.9 percent for the S&P 500 and -15.5 percent for the UK FTSE 100 (African Stock Market Handbook, 2003: 1).

5.6.1 Overview of the equity market in southern Africa

The equity markets in Africa as a whole have a diverse and contrasting nature. The continent has 20 operational stock exchanges out of 53 countries, with small market capitalisation. The equity markets in southern Africa are now discussed at the hand of the African Stock Markets Handbook (2003:20).

Southern African stock markets are gradually developing with the aid of South Africa, which boosts market capitalisation to over 180 billion US \$. Out of the 20 stock exchanges, 50 percent are located in the southern region of Africa. These include Botswana, Malawi, Mauritius, Mozambique, Namibia, South Africa, Swaziland, Tanzania, Zambia and Zimbabwe.

Stock Exchanges in southern Africa are still lagging behind in terms of growth and development, but increasing positive developments in the region enhanced by privatisation, macro economic developments and developments in other financial markets like insurance and banking sector.

Southern African stock exchanges also face a number of challenges in entering the growth phase. The most critical impediments include a wider dissemination of information on these markets, lack of sound and robust electronic trading systems, capital restrictions, poor settlement systems and a sound regulatory framework. The other critical obstacle is an unliberalised market structure which discourages market participation by the foreign investor community.

5.6.1.1 Market size

The southern African stock markets have a peculiar feature, in that there are very few companies listed in their markets and none listed in some countries.

The number of listed companies in the region is very small by international standards; with the exception of South Africa which has the biggest and most advanced stock market.

Table 5.5: Number of companies listed on stock exchanges in SADC, 1992-2002

Country	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Botswana	11	11	11	12	12	12	14	15	16	16	19
Malawi	-	-	-	-	1	3	6	6	7	7	8
Mauritius	22	30	35	40	40	40	40	41	40	40	40
Mozambique	-	-	-	-	-	-	-	-	-	-	-
Namibia	3	4	8	10	12	13	15	14	13	13	13
South Africa	683	647	640	640	626	642	668	668	616	542	472
Swaziland	3	4	4	4	6	4	5	7	6	5	5
Tanzania	-	-	-	-	-	-	2	4	4	4	5
Zambia	-	-	-	2	6	7	9	9	9	9	11
Zimbabwe	62	62	64	64	64	64	67	70	69	72	77
Africa total	1771	1785	1811	1875	1784	1818	2078	2279	2273	2233	2213
Southern Africa	773	747	762	772	767	784	826	834	780	708	650

[Source: Liquid Africa, S&P Emerging Market Handbook, 2003]

Most of the listed companies in the southern African region are foreign owned firms and this indicates the lack of financial sovereignty and underdevelopment of financial markets in the region. The phenomenon arises from the fact that the commercial sector is still dominated by the government as well as structural

problems such as entrepreneurial skills, capital resources, technological developments and the liberalisation of financial markets. The growing pace of liberalisation, privatisation and regional integration will nurture the development and growth of the stock markets in the region.

Table 5.6: SADC stock listed on various stock exchanges in SADC and abroad

Market	Index	Weighing	Local currency	Us currency
Botswana	DCI	13%	8.8%	41.4%
Malawi	-	-	-	-
Mauritius	SEMDEX	10%	27.2%	30.8%
Mozambique	-	-	-	-
Namibia	NSX Local	2%	-38.8	-15.8%
South Africa	JSE overall	-	-7.4%	27.9%
Swaziland	-	-	-	-
Tanzania	-	-	-	-
Zambia	LuSE	2%	24.9%	9.9%
Zimbabwe	ZSE	11%	122.1%	-52.2%
UK	FTSE-100	-	-22.5%	-14.2%
US	S&P 500	-	-22.4%	-22.4%

[Source: Liquid Africa, S&P Emerging Markets Handbook, 2003]

5.6.1.2 Market liquidity

The southern African equity market dwarfs the others in terms of market capitalisation, turnover, and new issue volumes. However, it remains illiquid by international standards. Stock market liquidity refers to the ease of buying and selling shares in the market. Liquidity is very important for a number of reasons,

namely economic growth, market development and more financial instrument innovations.

Generally, investors are not interested in illiquid markets because an exit cannot be made at the desirable time. The more liquid the stock market is, the more it commands investor's interest and creates more access to debt, and equity and shares become easily acceptable as collateral for bank lending, which boosts credits and investments (Emenuga, 1997:161).

The quality of liquidity in the regions stock markets lacks which also affects the turnover ratio, which is a measure of the value of shares traded relative to the total market capitalisation.

Table 5.7: Market capitalisation of SADC stock exchanges in US dollars, 1992-2002

Country	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Botswana	295	261	377	398	326	614	724	1052	978	1269	1717
Malawi	-	-	-	-	15	110	148	161	212	152	107
Mauritius	424	842	1578	1562	1693	1754	1849	1643	1335	1061	1324
Mozambique	-	-	-	-	-	-	-	-	-	-	-
Namibia	21	28	201	189	473	689	429	691	311	151	201
South Africa	103537	171942	225718	280526	241571	232069	170252	262478	204952	139750	182616
Swaziland	111	297	338	339	471	129	85	95	73	127	146
Tanzania	-	-	-	-	-	-	236	181	233	398	695
Zambia	-	-	-	19	195	705	301	280	236	217	231
Zimbabwe	628	1433	1828	2038	3635	1969	1310	2514	2452	7972	11689
Southern Africa total											
Africa Total	113423	184845	249334	309471	283317	281251	225772	325419	260777	195202	244672

[Source: African Stock Market Handbook, 2003]

Table 5.8: Value of SADC stock traded in US dollars, 1992-2002

Country	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Botswana	15	20	31	38	31	59	70	38	47	65	62
Malawi	-	-	-	-	-	-	10	6	9	21	3
Mauritius	10	39	86	69	81	142	104	78	74	109	59
Mozambique	-	-	-	-	-	-	-	-	-	-	-
Namibia	-	-	18	3	41	24	13	22	22	8	129
South Africa	7767	13049	15607	17048	27202	44722	58347	72917	77494	69626	76792
Swaziland	-	-	2	-	2	378	-	-	-	10	-
Tanzania	-	-	-	-	-	-	-	7	40	8	19
Zambia	-	-	-	-	3	8	3	12	8	53	2
Zimbabwe	20	53	170	150	255	539	186	227	279	1530	131
Southern Africa total											
Africa total	18140	13910	17928	21189	30966	53353	65677	85677	91171	77228	85825

[Source: Liquid Africa, S&P Emerging Market Handbook, 2002]

5.6.2 The integration obstacles in the equity markets in southern Africa

The stock markets in the region are characterised by relatively small capitalisation and liquidity levels. Southern African stock exchanges confront a number of challenges before they could be integrated regionally and globally. The most critical impediments include a number of issues like slow privatisation, openness and market barriers, financial market development, market infrastructure and regulatory regimes.

5.6.2.1 Slow pace of privatisation

Privatisation of public assets is a cardinal conduct in channelling capital in the private sector and also increasing private sector activities in the development of economies in many developing countries. Privatisation creates opportunities for developing stock markets through the public offering of the privatised shares. The pace of privatisation in the past decade has slowed.

SADC governments have embarked on privatisation programmes for unleashing the economic potential of the region and also attracting new capital investments with transference of technical capacity to safeguard long-term employment in the region.

5.6.2.2 Openness and market barriers

The regional economies are still constrained by the openness to international markets and certain market barriers like exchange controls are also obstacles for some member countries' economies to trade internationally, which also slows the pace of financial development in the region.

5.6.2.3 Regulation and supervision

A sound regulatory and supervisory environment is very important in the development and integration of stock exchanges. The region must harmonise or align their regulatory and supervisory standards required for the efficient operation for stock exchanges and this includes registration of securities, monitoring market activities, licensing and ensuring compliance with approved global practices and conduct.

The existence of sound regulatory and supervisory frameworks enhances the confidence of internal and external investors in the regions' capital markets. The committee of SADC stock exchanges has initiated many projects in promoting quality regulation and supervision of capital markets for the region.

5.6.2.4 Market Infrastructure

The stock exchanges in the region are also experiencing obstacles in terms of developing the systems and regional integration because of inadequate market infrastructure. This includes the under developed trading on un-automated trading systems, telephone lines and insufficient existence of electronic communication. The market infrastructure hinders the harmonisation of trading systems across countries in the region.

5.6.3 The regulatory framework of the stock markets in the region

The stock exchanges in the region operate under diverse market conditions and each stock exchange has its own peculiar set of rules which governs its market operation with the purpose of regulating the securities markets. They also ensure fair play and transparency by all market participants.

The prudence of stock exchange regulation not only enhances market activities but most importantly, it maintains and improves market integrity which will encourage market participation and capital flows in the region.

The primary function of the regulators is threefold, namely:

- Promoting investors' interests and enhancing their confidence in the capital market;
- Ensuring orderly, fair and equitable dealing in securities;

- Promotion of growth and development of capital markets (Emenuga 1997:163).

Table 5.9: Regulatory institutions of stock exchanges in SADC

Country	Stock Exchange	Market Regulatory
Botswana	Botswana Stock Exchange	Botswana stock exchange committee
Malawi	Malawi Stock Exchange	Stock exchange committee
Mauritius	Stock Exchange of Mauritius	Financial Services commission
Namibia	Namibian stock exchange	
South Africa	Johannesburg stock exchange	Financial service board
Swaziland	Swaziland stock market	Capital markets development unit
Tanzania	Dar-es-Salaam stock exchange	Dar-es-Salaam stock exchange
Zambia	Lusaka stock exchange	Securities exchange Commission
Zimbabwe	Zimbabwe stock exchange	Zimbabwe stock exchange committee

[Source: African Stock Market Handbook, 2003]

The region's stock exchanges are all regulated by their own agencies with different sets of rules which need to be harmonised to encourage cross border listings and the development of an integrated supervisory institution for the region.

The development of effective regional securities and exchanges enhances the quality of regulation and supervision of the capital markets and boosts the confidence of internal and external investors in the capital markets in the southern African region.

The regulatory framework should enhance integrity of the regional stock markets by attracting foreign portfolio investment and reducing the potential costs associated with regional financial integration. This objective is only realised when critical regulatory issues are properly managed and this includes ensuring disclosure of all material information, eradicating insider trading and improving corporate governance.

5.6.4 Cooperation on equity markets in the region

There is a growing development of stock exchanges in Africa and southern Africa, which also requires the continent and regional blocks, like southern Africa, to respond to the globalisation challenges and regional integration initiatives of stock exchanges which will increase capital flows and bring long term macro economic benefits.

Some of the benefits of regional cooperation of stock markets in the region are:

- Expansion of investment opportunity of southern African investors and companies;
- Availability of a broader range of stocks to the region and African investors;
- Reduction of risk on investments through diversification of country macro economic risks.

At the continental level coordination and cooperation of stock exchanges have been undertaken by the African Capital Market Forum (ACMF), which was established in July 1996 and the Association of African Securities Markets (Emenuga, 1997:180).

The southern African integration initiatives of stock exchanges have accelerated very rapidly within the SADC framework, with the vision of harmonising the operations of stock exchanges in the region by 2006. The SADC Committee of Stock Exchanges was formed in January 1997 with membership comprising of countries with stock exchange in Southern Africa, Namibia, Botswana, Mauritius, Mozambique, Swaziland, Tanzania, Malawi, Zambia and Zimbabwe (Regional Economic Review: 2000:86).

- i. The aims and objectives of the committee intends increasing cooperation and links in operations, communication, regulations, technical skills, development and other areas on SADC stock exchanges to (Regional Economic Review, 2000:86)
- ii. Maintain and improve market integrity and promote markets that are fair, efficient and transparent with proper price discovery
- iii. Increase the liquidity of trading in equities, bonds, derivatives and other financial instruments
- iv. Enforce legislation and rules to protect participants and investors
- v. Render SADC securities markets more attractive to local and international investors
- vi. Improve the operational capacity of SADC stock exchanges
- vii. Advocate and lobby for private sector led marked integration
- viii. Building cooperation between the SADC stock exchanges and their regulators;
- ix. Establish a forum through which SADC regional policy makers can consult the regions' existing securities markets before planning further development within this field.

By the year 2006, the stock exchanges in the region would have established an integrated real-time network of the regions' national security markets with a seamless clearing and settlement, compatible with international systems across the region.

Much progress has been made to date regarding the integration of SADC stock exchange. The Johannesburg Stock Exchange (JSE) has played a pivotal role in the regional cooperation initiatives by providing some of the stock exchanges because of its expertise and since it acts as a rapporteur to the International Federation of Exchanges (FIBV) sub-committee on emerging markets in the southern African region (Economic Integration in Southern Africa, 1993).

Some of the successful projects undertaken to date by the SADC Committee of Stock Exchanges are:

- ❖ The harmonisation of listing requirements for issuers identical to the JSE requirements almost completed
- ❖ Harmonisation of procedures for clearing and settlement which is at the advanced stage of implementing a central depository system for the region

The JSE offered Namibia its trading system (Jet trading system) at cost to SADC countries of which Namibian Stock Exchange installed the system in 1998. There are also cross listings of shares on different exchanges in the region. Rationalisation of entry level examination for stockbrokers is improving their expertise in the region's financial markets (Regional Economic Review, 2000:87).

In addition, the JSE has offered technical assistance and continues to disseminate important information to other SADC exchanges. Notwithstanding some of the obstacles that hinder development and integration of exchanges, much progress has been achieved to enhance the critical mass necessary for the development of financial markets in Southern Africa. The region has been confronted with problems that obliterated the chance of close cooperation between regional exchanges.

There are some fundamental obstacles, which include:

- i. A lack of institutional investors in the region;
- ii. Lack of capital to improve the operational capacity of stock exchanges;
- iii. Slow pace of implementing the appropriate regulatory framework for effective functioning of financial markets in the region;
- iv. Unliberalised financial markets which also operate within severe exchange control exposure.

5.6.5 Integration strategy for equity markets in southern African region

As noted in this chapter, the southern African stock exchanges in general are very small and under-developed in terms of world standards. This requires rigorous efforts in designing and implementing the integration strategy for the region.

The SADC Committee of stock exchanges has made profound progress in the establishment of an integration stock exchange for the region and harmonisation of stock exchanges. However, there are several ways in which the stock exchanges could be harmonised and integrated for the development of regional financial sector.

The integration strategy could be based on the following strategic framework. Firstly, all member countries should liberalise their financial markets and also completely abolish exchange controls to allow cross boarder capital flows and cross listings in the region. This includes the following:

- ❖ harmonisation of listing requirements and operational procedures of the stock
- ❖ increasing technological cooperation and also implementing a uniformed trading system for the region
- ❖ harmonisation of taxes, investment policies and guidelines and transaction costs
- ❖ development of dual or multiple listings of stock in the national stock exchanges.

Creation of international linkages with other global stock exchanges encourages affiliation by regional countries to the International Federation (FIBV), of which currently the JSE is the only member.



Development of cooperation and assistance to regional countries without stock exchanges sharing infrastructural capacity and human capital development through continuous training and skill development would not lead to sound financial integration.

CHAPTER 6: MONETARY POLICY INTEGRATION IN SOUTHERN AFRICA

6.1 Introduction

This chapter begins with a description of the concept of monetary policy integration followed by a discussion of the benefits and costs of monetary policy integration. Thereafter, global experiences of monetary integration, with special reference to the European monetary integration and the West African Monetary Union (UMOA), are discussed. In the final part of the chapter, the southern African monetary integration process is explored and analysed and conclusions are drawn on the monetary policy integration strategy for southern Africa. The chapter analyses southern Africa's macro economic performance against the monetary integration macro economic framework targets and compares southern Africa's performance against the monetary integration targets of the European Union.

6.2 The concept of monetary policy integration

Any financial integration process would be incomplete or disintegrated if monetary integration were not attained. Global experience indicates that in most regions financial integration is mainly achieved with the establishment of regional monetary integration initiatives. The emergence of the EMU has sparked a new wave of interest in monetary integration in Asia, other regions around the world and Africa. Since the inaugural meeting of the OAU in 1963 and the current integration initiatives like NEPAD, there have been many regional financial and monetary integration initiatives on the African continent.

In theory, monetary integration can be defined as a set of legal arrangements that two or more sovereign countries enter into to unite more closely their monetary systems. The degree of integration distinguishes or characterises the nature of the monetary integration formation. The other traditional approach of dealing with monetary integration is through the “optimal currency area’ (OCA) approach.

An optimal currency area is defined as the optimal geographic domain of a single currency, or of several currencies, whose exchange rates are irrevocably pegged and might be unified. The single currency or the pegged currencies can fluctuate only in unison against the rest of the world (Mongelli, 2002:17).

The OCA properties may include mobility of all factors of production, economic openness, and diversification in production, consumption, fiscal- and political integration.

Monetary integration advances an element of sharing among members, especially in terms of costs and benefits. It also fosters internal and external balance and may serve to protect a country from external shocks.

6.2.1 The benefits of monetary policy integration

The theoretical construct of an optimum currency area is based on the concept of a sizeable geographic area with sufficient labour mobility such that the residents can enjoy potential welfare gains by fixing their exchange rate or adopting a common currency (Mundell, 1961).

Such monetary integration makes possible a number of macro economic benefits to the region in the form of speedy adjustments to unemployment and balance of payment imbalances. The other benefit of monetary integration is price stability, because maintenance of price stability is also associated with significant efficiency gain that results in long term benefits to growth for the whole region. Positive

growth prospects are associated with the elimination of separate currencies. Growth could increase because of broader productive investment and a deeper integrated financial sector.

Other benefits may include high labour mobility, which facilitates equalisation of wages, restoration of employment equilibrium in the event of asymmetrical demand shocks in the region.

Intra regional trade intensity and openness of an economy act as shock transmitters, thereby reducing the need for giving up independent monetary policy in the event of a monetary union. The institutional and structural features of the member countries will to a large extent determine the costs and benefits of forming a monetary union.

Monetary integration also benefits the region by lowering transaction costs between member countries. This is demonstrated by the fact that there will be one single currency and no longer a need to exchange currencies, no exchange rate costs and no need to insure against currency fluctuations within region.

Finally, monetary integration creates the opportunity for lower interest rates to exist. The exchange rate stability is assured and this leads to lower interest rates for the whole region because of the non existence of risk premiums.

Greater economic certainty is experienced in a monetary integration region, because prices and revenues are more stable and this improves the quality of production, investment and consumption decisions in the region.

Monetary integration has been adopted and supported because of some long-term benefits arising from the establishment thereof. This has also contributed to the world-wide acceptance and formation of monetary integration structures in the recent past.

The success of monetary integration depends mainly on the openness and size of the economies forming the monetary union, product diversification, similar inflation rates and the depth of economic integration in the region.

6.2.2 The costs of monetary policy integration

The success of monetary integration is determined by how the integration authorities and structures deal with and manage all the cost issues. These are critical challenges which need to be resolved in order for the benefits of monetary integration to be realised.

The most typical costs of monetary integration are the following (Mongelli, 2002:33):

❖ **Loss of national sovereignty**

One of the arguments against the establishment of a monetary union or joining of a monetary union is said to be the loss of monetary sovereignty. This actually entails the capacity and the ability to engage domestic monetary policy to achieve domestic economic objectives. The loss of monetary sovereignty might be a small price to pay as long as monetary integration will yield definite economic and welfare benefits in the form of lower transaction costs, elimination of exchange rate risk and higher productivity.

Monetary integration leads to a loss of control over monetary policy by member states, which implies that member states will be unable to use monetary policy as a means to control internal or divergent economic difficulties such as high inflation or a high unemployment rate.

❖ Loss of monetary policy autonomy

The loss of monetary policy autonomy explicitly implies that member countries will be unable to utilise their monetary policy instruments as a measure to control domestic economic difficulties which might result in less control over high inflation and unemployment.

❖ Constraints on fiscal policies

Monetary integration also constrains member countries in respect of fiscal policy decisions. Monetary union implies that member countries will be limited in the use of deficit financing through sale of debt, and tax revenue and borrowing will be constrained due to crowding out. Domestic government spending certainly will be limited and constraining the domestic economy in its capacity to absorb new issues of short term public debt in the event of a funding crisis.

6.3 Global experiences of monetary integration

There has been a growing trend and a wide range of monetary integration initiatives around the world which have been triggered mainly by globalisation and the eagerness of countries to open their economies to more opportunities beyond their borders. The most familiar monetary integration institution which has demonstrated the success of regional financial and economic sustainability, post monetary integration, is the European Monetary Union. The success of the Euro has given rise to more regional cooperation and integration of economies on a bilateral and multilateral platform. The African continent is following suit as is exhibited by regional integration initiatives in the various sub regions of the continent.

6.3.1 The European monetary integration

The European Union is an unparalleled example in the current and past processes of regional integration. The European Monetary Union was established in 1999 by eleven European countries after the adoption of the Maastricht Treaty which laid out the objectives and principles of this regional integration initiative.

The EMU has quite a long history which profiles the various phases which it has gone through, from economic integration to monetary integration. The intensified existing economic links contributed to better coordination, and the harmonisation and establishment of a monetary union with a denouncement of domestic currencies by a unilateral link. The process involved the transfer of authority over monetary policies to a supranational institution, the European Central Bank (ECB). However, member states kept their political autonomy and maintained responsibility over the remaining macro economic policies.

6.3.2 History of European integration

The European monetary integration was proposed as early as the fourteenth century, but it was not until the period of reconstruction after the Second World War that it was put into practice.

It was only in 1958 when the Treaty of Rome was ratified that monetary issues were of common concern, especially in relation to exchange rate policy.

The most fundamental event was the completion of the Werner report in 1970, which detailed a proposal on a three stage approach towards monetary union, leading eventually to fixed exchange rates and a common monetary policy.

All the major stages towards the European Monetary Union occurred between 1970-2002, until such time as the Euro currency was in circulation and regarded as a legal tender to all member countries.

Table 6.1 below illustrates the chronology of events which led to the establishment of the EMU as from October 1970 to January 2002.

Table 6.1: Chronology of European economic integration

DATE	EVENT
July 1952	European Coal and Steel Community (ECSC) is established
July 1958	European Economic Community (EEC), and European Atomic Energy Community are established
January 1973	Denmark, Ireland and the United Kingdom join the three European Communities
January 1981	Greece joins the three European Communities
January 1986	Spain and Portugal join the three European Communities
November 1986	The single European Act is adopted
January 1993	The Treaty on European Union which was signed in February 1992, enters into force
January 1995	Austria, Finland and Sweden join the European Union
May 1999	The Treaty of Amsterdam which was signed in June 1997, enters into force
January 2002	Euro banknotes and coins were put into circulation
February 2003	The Treaties are further amended by the Treaty of Nice, which was signed in 2001 to pave the way for an enlarged European Union
May 2004	The Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia join the European Union, bringing the total number of Member

	States to 25.
June 2004	The EU Member States agree on a Treaty establishing a Constitution for Europe

[Source: The EMU, ECB and the Euro, 2007]

Table 6.1 above outlines the chronological events which led to the EMU dating from July 1952 to June 2004. The EMU was created within the framework of the European Community (EC), which itself had increased significantly since its inception in 1952. The EU now has 25 member countries, with the most recent addition of ten central and eastern European and Mediterranean countries. These member countries will join the EURO at a later stage after meeting all the necessary conditions of adopting the Euro.

6.3.2.1 Phases of European monetary integration

The European Monetary union was designed to follow a three pronged sequential stages:

❖ Stage 1

This phase occurred during the period of 1990 – 1993 and this was characterised mainly by the establishment of a single market which allows for the free movement of factors of production within Europe.

❖ Stage 2

The second stage occurred during 1994 – 1998 and it was characterised by the establishment of the European Monetary Institute. This stage was dedicated towards technical financial preparation with the intent of establishing a single currency. This included all aspects relating to financial system architecture, which is inclusive of fiscal and monetary policy.

❖ Stage 3

This phase began on 1 January 1999 with the irrevocable fixing of exchange rates, transfer of monetary policy powers to the European Central Bank (ECB) and the introduction of a single currency.

6.3.2.2 The EMU institutional structures

The EMU was coordinated mainly through a number of fundamental institutions namely (ECB Compendium, 2002:5):

- ❖ The European Commission (EC) is the executive body of the European Union (EU). It is also responsible for initiating legislation proposals and give recommendations on all policy issues.
- ❖ The European parliament (EP) is composed of representatives of all member countries and has the power to dismiss the EC. It also approves the EU budget and gives opinions on legislative matters.
- ❖ The European Court of Justice, which comprises fifteen judges and nine advocates are tasked with ruling on legal matters, hearing applications and ensuring coherence to the European law. There are also a number of internal structures with the ECB and other peripheral institutions and committees that contribute to the coordination and efficient management of the EU.
- ❖ The European Central Bank (ECB) is a primary independent economic institution of the EU tasked with the goal of achieving and maintaining price stability. The ECB has two main decision making bodies which govern the EC Council and Executive Board.
- ❖ The governing council is responsible for the formulation of guidelines and takes decisions to ensure performance of tasks entrusted to the ECB. It is also responsible for the formulation of monetary policy in the region.
- ❖ The Executive Board of the ECB is responsible for the following:

- Preparing meetings of the Governing Council
- Implementing monetary policy and decisions in accordance with the guidelines
- Managing the day to day activities of the ECB
- Assuming certain delegated powers from governing council which may include regulatory powers.

6.4 African experience of monetary integration

In Africa's colonial and past-colonial era monetary cooperation between different countries was widespread, but only few emerged into successful partial monetary integration formations. The failure of these integration attempts could be explained by a number of factors ranging from divergent ideologies, languages, colonial heritage, national interests and country rivalry. Despite all the set-backs, the West African Monetary Union (UMOA) or CFA zone and Multilateral Monetary Agreement (MMA) are testimony to success stories in Africa on monetary integration and have also delivered macro economic stability.

6.4.1 The West African Monetary Union (UMOA)

The UMOA, constituted by the seven West African countries, Benin, Burkino Faso, Ivory Coast, Mali, Niger, Senegal and Togo, came into existence on 10 January 1994 (Medhora, 1997:215).

All seven countries use the CFA franc as a common currency; however, UMOA countries have retained their principal economic stabilisation policies like fiscal, trade and monetary policies. MOA was later transformed into UEMOA to harness greater harmonisation of economic policies in the region.

The UEMOA brought some benefits to the region which includes the use of a fully convertible currency backed by the G-7 countries, risk free investment within the franc zone, economies of scale resulting from the issuance of a common currency and the existence of an independent central bank that can pursue consistent policies without fear and prejudice.

6.4.2 Institutional framework of the UMOA

The UMOA's institutional framework consists of two main structures, the Conference of Head of States and the Council of Ministries, who oversee the Central Bank of UMOA (BCEAO). The Conference of the Head of States comprises of Political Heads of each country and the Council of Ministries is constituted of finance ministries of each member country. The BCEAO is headed by the Council of Ministries who has input in the decision making process of the bank.

6.4.3 UMOA and monetary policy

Monetary policy announcements and decisions are deemed to be in the hands of an independent apolitical technocratic central bank, the BCEAO. The goal of monetary policy has mainly dealt with inflation stabilisation in the region.

6.4.4 The UMOA and seigniorage

Seigniorage is the command over real resources that a central bank captures by issuing "high powered" money. This monetary seigniorage is then used for central bank operating costs, retained, or returned to the public via dividends to the national treasury or via subsidised lending to designated sectors (Medhora, 1997:221).

How seigniorage is distributed depends on the legal provisions of the UMOA statutes. The allocation is based on an agreed formula by member countries. In the UMOA the profits are allocated equally amongst members since all members have contributed equally in terms of external reserves.

6.4.5 UMOA and external reserves

The pooling of external reserves is an integral part of monetary integration. The contribution of external reserves by member countries in the UMOA was very equitable. Each member was required to pledge 65 percent of its external reserves to an operations account managed by the BCEAO and it is maintained with the French Treasury in Paris.

6.4.6 UMOA and external convertibility

In the UMOA, the CFA franc was pegged to the French franc at an exchange rate of 50 CFA francs to 1 French franc. The French Treasury guarantees full convertibility of the CFA franc since it stands surety for it, unconditionally.

6.5 Monetary integration developments in southern Africa

The Multilateral Monetary Agreement (MMA) is one of the oldest and most successful integration initiatives in southern Africa. This integration establishment was formed in 1974 by three signatory members, namely South Africa, Swaziland and Lesotho. The MMA was later called the Rand Monetary Area and in 1992 it became known as the Common Monetary Area (CMA), after Namibia became a member.

The objective of the MMA was sustained economic development of the CMA with equitable benefits for all members. All four member countries have their own

central banks and are responsible for their own monetary policy. The Rand is the legal tender in all four member countries but other member currencies are not legal tenders in South Africa. The Rand is pegged at 1:1 to other member countries' currencies. However, there is always mutual consultation on monetary issues and no restriction on the transfer of funds among members.

Table 6.2: Common Monetary Area milestones

Year/Period	Major Events
1961	Informal Monetary Union under British ruling: pound as common currency
1961-1974	Countries become independent (except Namibia) The Rand replaces the pound as common currency still informal arrangement
1974	South Africa, Botswana, Lesotho and Swaziland sign the RMA treaty
1976	Botswana exits RMA and sets its own monetary policy. However it keeps linked to the Rand (60 to 70 per cent) through a currency basket
1986	South Africa, Lesotho and Swaziland sign the trilateral agreement CMA, replacing the RMA. Additional provisions concerning capital account liberalisation, intra-zone fund transfers and seigniorage compensations are made
1992	Namibia, which became independent in 1990, joins the CMA

[Source: Grandes, 2003]

6.5.1 The institutional framework of the MMA

The MMA is mainly managed and coordinated by the central banks of the member countries to facilitate and ensure continued compliance with the MMA and to reconcile different interests in the formulation of monetary and foreign exchange policies of the CMA.

The South African Reserve Bank (SARB) is the key player in terms of the execution of monetary and exchange rate policies through its Monetary Policy Committee (MPC). All other matters arising from the MMA are decided by the CMA commission, which is the executive body established from representatives and advisors of member countries.

6.5.2 The MMA and monetary policy

The MMA has its own unparalleled arrangements when compared to other integration establishments around the world, especially on monetary policy issues. Monetary policy issues in the MMA are distinct from the EMU and other monetary integration models around the world. This is now discussed at the hand of seigniorage, external debt reserves and currency convertibility.

6.5.3 The MMA and seigniorage

Seigniorage is a source of revenue for the Treasury, which can contribute to the country's fiscus. Developing economies rely heavily on income from seigniorage, especially in Africa. The division of income from seigniorage is a contentious issue in the formation of a monetary union in Africa.

In accordance with the objectives of the MMA, Namibia and Lesotho share in the returns from seigniorage to the extent that the Rand is used as a legal tender in their territories. Returns are shared according to an agreed formula. Swaziland is excluded from this arrangement because of a Bilateral Agreement of 1986 by which the Rand ceased to be legal tender in Swaziland. However, in reality, the rand is still accepted as a legal tender for convenience in the retail sector.

6.5.4 MMA and external reserves

The contacting parties to a large extent share a common pool of foreign exchange reserves under the control of the SARB and under the control of the South African authorised dealers in foreign exchange (banks). The central banks and authorised dealers in foreign exchange in the member countries have access to the foreign exchange market in South Africa under the MMA; SARB will on request make the required foreign exchange available.

6.5.5 MMA and currency convertibility

The rand is an anchor currency in MMA and has both a dominant influence in the sub-regional trade, investment flows and inflation rate. The currencies of these countries have been pegged to the South African rand at par since their introduction and their currencies are freely convertible into the rand with the exception of Swaziland (Stuart, 1992:80).

6.6 Macro economic convergence in the European Monetary Union (EMU)

There have been major improvements in the Euro area with regard to macro economic convergence targets, especially towards the end of 1990. The average rate of the Harmonised Index of Consumer Prices (HICP) (inflation) has fallen

from 2.2 to 1.3 percent for most of the member states with the exception of Greece. Long term interest rates have been falling throughout the EU to reach average levels around 5 percent. Exchange rates have in general remained broadly stable. Significant reductions in fiscal deficits were experienced in the region and are currently at an average of 2.45 percent of GDP. The average debt ratio stands at 72 percent of GDP, which is higher than the reference level.

6.6.1 Choice of macro economic convergence targets in the EMU

The EU has selected and adopted some key macro economic convergence targets as outlined in Table 6.3. The criteria were applied in a strict manner with the sole view of committing the member states towards an efficient monetary union.

The rationale for these targets is to ensure that only member states which have economic conditions that are conducive to the maintenance of price stability and the viability of the European currency area should participate. The targets constitute a coherent and integrated strategy and all member countries should be on the same footing before accession to monetary integration is granted. The macro economic convergence targets should be consistent, transparent and simple.

The target on the price and long term interest rates convergence are based on the average of the three best performing countries in terms of inflation, as the price performance of the countries with the lowest rates of inflation. On the fiscal target the reference values and indicators underlying the developments are considered. In respect of debt, the reference value is 60 percent of GDP. Exchange rate targets are based on the principle that member countries should not devalue their currencies against any other member state currency.

Table 6.3: Macro economic convergence targets for the EMU

Description	Target
Inflation (HICP)	Not exceeding 1.5% of the three best performing member states
Long term interest rates	Not exceeding 2% of the performing member states
Fiscal deficits	Not exceeding 3% of GDP
Public debt	60% of GDP
Exchange rate	Not devalue the currency against any currency of the member states

[Source: Grandes, 2003]

6.7 Performance of the European Union (EU) prior to the establishment of the EMU

The performance of the EU prior to the establishment of the EMU, is summarised in Table 6.4 below, and discussed in the proceeding paragraphs.

Table 6.4: Macro economic convergence performance of the EMU, 1997

Country	Inflation (%)	Interest rate (%)	Trade balance (% of GDP)	Public Debt (Billion EURO)
Belgium	1.6	6.7	-3.3	130.6
Denmark	2.2	7.4	-1.4	70.2
Germany	1.3	6.3	-4.0	60.8
Greece	8.4	15.1	-7.9	110.6
Spain	3.8	9.5	-4.4	67.8

France	2.1	6.6	-4.0	56.4
Ireland	2.1	7.5	-1.6	74.7
Italy	4.7	10.3	-6.6	123.4
Luxembourg	1.3	7.0	0.9	7.8
Netherlands	1.2	6.3	-2.6	78.7
Austria	1.7	6.5	-4.3	71.7
Portugal	3.0	9.4	-4.0	71.1
Finland	0.9	7.4	-3.3	61.3
Sweden	1.6	8.5	-3.9	78.1
United Kingdom	3.0	8.0	-4.6	56.3

[Source: Convergence report, 1998]

❖ Inflation (HCIP)

In the EU fourteen member countries (Belgium, Demark, Germany, Spain, France, Ireland, Italy, Luxembourg, Netherlands, Austria, Portugal, Finland, Sweden and the United Kingdom) had average HICP inflation rates below the reference value. The reference was calculated by using an unweighted arithmetic average of the rate of HICP inflation in the three countries with the lowest inflation rates, plus a 1.5 percentage point. The reference value was 2.7 percent. Greece's HICP inflation was 5.2 percent lower than the average when compared with all the member states before the finalisation of monetary integration. Generally all member states recorded relatively similar inflation rates before the establishment of the Euro.

❖ Interest rate

In the Euro area all the member states had average long term interest rates below the reference value. (Reference value is 7.8 percent). Over the periods 1990 to 1997, long term interest rates were broadly similar in a number of countries, namely Belgium, Germany, France, Luxembourg, Netherlands, Austria, Denmark and Ireland. The pace of convergence of interest rates for

Finland and Sweden was lacking behind. Spain, Greece, Italy and Portugal's interest rates were declining steeply below the reference value. A different trend in relation to long term interest rates was experienced in the United Kingdom. The long term interest rates had been declining throughout the EU to reach a low EU average of 5 percent.

❖ **Trade balance**

Much progress had been achieved in fiscal deficits across the EU, and in a few countries budget surpluses were experienced. The EU-wide fiscal deficit ratio had declined to 2.4 percent of GDP. During the period under review only three countries recorded surpluses, viz. Denmark, Ireland and Luxembourg. Eleven member states achieved or maintained deficits at or below the reference value percentage as specified by the treaty. They were Belgium, Germany, Spain, France, Italy, Netherlands, Austria, Portugal, Finland, Sweden and the United Kingdom. Greece was the only state that recorded a deficit of 4 percent, which is above the reference value.

❖ **Public debt**

The debt to GDP ratio for the EU as a whole was declining before the integration of the EU. However, overall conditions necessary to maintain an environment conducive to non-inflationary growth had improved. The average debt ratio was 72.1 percent of GDP.

❖ **Exchange Rate**

During the period under review only three currencies remained outside ERM, which are the Greek drachma, Swedish krona and pound sterling. On occasion several currencies traded outside a range close to the central rates with a maximum deviation limited to 3.5 percent. But generally there was a widening trend in terms of interest rates convergence.

6.8 Macro economic convergence development in southern Africa

There are a number of motivations behind the commitment to macro economic convergence. One such motivation is recognition that economic instability in one or more countries in the region, as has been the case historically, had negative effects both on the countries themselves and the region more generally, through spill over effects. Hence the most basic component of macro economic convergence is to achieve macro economic stability across the region, thereby avoiding instability in terms of high inflation, unstable currencies, and other forms of macro economic imbalance.

6.8.1 Performance of member countries on the targets

The SADC countries' macro economic performance has improved markedly in recent years, such that throughout most of the SADC region macro economic stability has been achieved with the exception of Zimbabwe, the DRC and Madagascar. The general outlook in the region is one of reduced inflation, reduced fiscal deficits, a reduced debt burden and improved debt sustainability, and more sustainable balance of payments.

Economic growth performance has also improved. A number of factors underlie this improved macro economic performance. These include much improved policy formulation and implementation, the impact of ongoing structural and institutional reforms, greater trade openness and improved trade performance, as well as debt relief and the end of civil conflict.

6.8.2 Choice of macro economic convergence targets in southern Africa

The selection of macro economic convergence criteria are key in ensuring that member countries' economies commit to the establishment of a monetary union with the eventual achievement of price stability in the region. The targets have to be realistic, transparent and easy to measure. Non compliance precludes member states from accession into the union. However, a balance should be struck between the target period of achieving the goals and the stringency of the targets as this will enhance the credibility of the region.

❖ Inflation

In principle, inflation is the key indicator of macro economic convergence, and is arguably the most important of the four chosen indicators. Low inflation cannot be achieved on a consistent basis in the absence of stability-oriented macro economic policies, and the achievement of low inflation therefore indicates that other policies are being implemented in a manner that is supportive of macro economic stability. More generally, high inflation is an indication of macro economic imbalances in an economy. Inflation is also relatively easy to measure, and in most countries data is readily available, at high frequency (monthly).

Core inflation measures are not readily available in SADC countries (only SA has a publicly available measure). There are also different ways of measuring core inflation (exclusion of specific items, trimming etc.), and no general agreement on which method is the most appropriate. There is also a more general problem of inconsistent inflation measures across countries. This was resolved in Europe by the adoption of the Harmonised Index of Consumer Prices (HICP), which is used for monetary policy purposes, but which co-exists with other, country-specific inflation measures.

There is also the more general problem of inconsistent inflation measures across countries. The 2008 target of single digit inflation is not especially onerous, and should be achievable by all SADC members except for Zimbabwe. The 2012 target of 5 percent is tough but achievable, and indeed some countries have already achieved inflation at this level. The 2018 target of 3 percent would require a shift to a different level of macro economic performance – this level of inflation has not been achieved by any African country to date.

❖ **Fiscal balance**

Fiscal balance (the budget deficit/surplus) is an important contributor to macro economic stability. While the quality of measurement of the fiscal balance is improving, due in part to improved government accounting systems and reduced usage of quasi-fiscal (off budget) expenditure, there are nevertheless a number of problems that make monitoring of performance difficult. It is important to have consistency across countries over the treatment of key items, such as privatisation receipts, other asset sales, and government lending, and improvements in this area, as well as improved forecasting, are important.

In many SADC member states, grants form an integral part of overall revenues, and without grants, many projects would not proceed and expenditure would be lower; hence a fiscal balance calculated without grants would not be meaningful.

The 2008 target of a deficit of less than 5 percent of GDP is reasonable, but the 2012/2016 target of 3 percent of GDP may be too tight. The figure appears to have been borrowed from the European Union's Maastricht Treaty, but it is not clear that this makes it relevant to SADC (and many have argued that it is inappropriate to the EU).

❖ **Public debt target**

In principle, the level of public debt is an important determinant of and contributor to macro economic, fiscal, and balance of payments stability in SADC. In sub-Saharan Africa, debt is not homogeneous, as it varies by currency (domestic or foreign), source (commercial or concessional), and duration (short or long term). The macro economic impact of debt works through several channels, and depends on the type of debt. For instance, domestic debt does not have a direct balance of payments impact, but may have a crowding out impact in domestic financial markets, and *vice versa* for foreign debt.

In Europe (Maastricht Treaty), a single indicator was adopted for public debt, and was arguably more appropriate as public debt was homogeneous, i.e. generally denominated in domestic currency and issued in commercial terms, hence the debt service burden was closely related to the total outstanding debt. The benchmark of 60 percent of GDP that was chosen in Europe may have represented a suitable benchmark for debt sustainability. Hence the focus on debt levels alone in the SADC macro economic convergence criteria may be misleading. Debt of 60 percent of GDP could be sustainable if, for instance, most of this debt is concessional and exports are strong.

❖ **Current account deficit**

The current account deficit (CAD) is one of the most commonly used indicators of external stability and sustainability. However, while the CAD is important, it is difficult to define what a sustainable level is. For instance, a country with low savings and high investment will have a relatively high CAD, which may be good if it is due to a high level of productive investment based on long-term foreign financing. Whether a given level of the CAD is sustainable depends on various factors.

❖ **Exchange rate target**

One of the stated objectives of the SADC macro economic convergence programme is to provide the foundation for the eventual adoption of a single currency. The attainment of monetary integration is mainly based on the pursuance of exchange rate convergence for the region because of the critical nature as a prerequisite for a monetary union. There are very wide divergences between economies in SADC in terms exchange rates in the region.

The other challenge in southern Africa is that exchange rate convergence is difficult to measure, but one approach is to consider the level of volatility in regional exchange rates and the extent to which they move together considering the divergent economic conditions of the region, which are mainly characterised by growing trends of volatility.

6.8.3 The criteria for selection of macro economic convergence targets

Main macro economic targets

The SADC focuses on four main macro economic variables: inflation, fiscal balance, public debt, and the current account of the balance of payments. The specific targets to be achieved in terms of these four variables are progressively stricter over the period from 2008 to 2018, and are set out in Table 6.5 below.

Table 6.5: SADC macro economic convergence targets

Year	2008	2012	2018
Indicators			
Inflation annual rate	<9.5%	<5%	<3%
Fiscal Deficit/GDP	<5%	<3%	<1%

Public Debt/GDP	<60%	<60%	<60%
Current Account/GDP	<9%	<9%	<3%

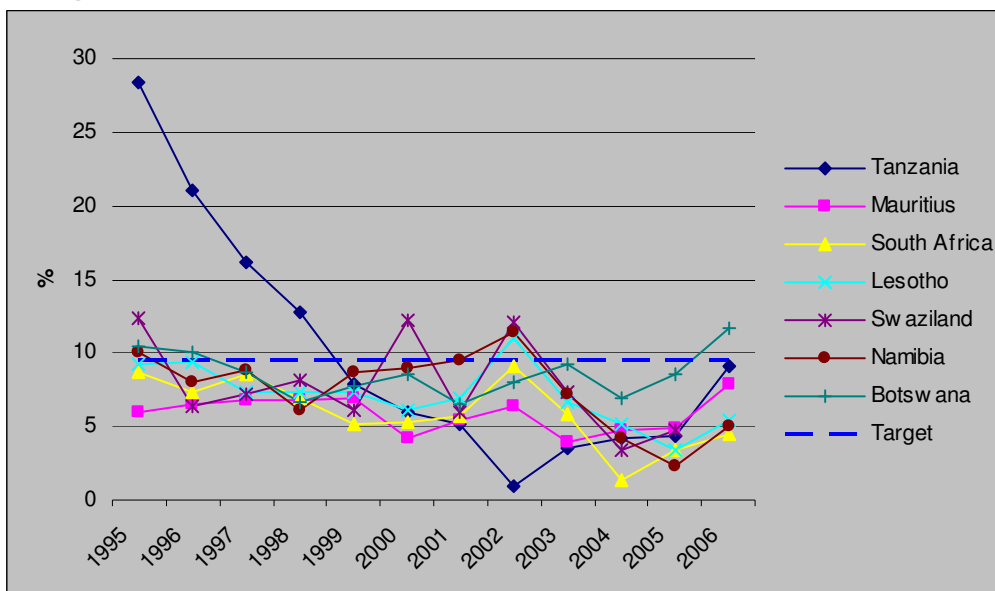
[Source: SADC, 2007]

6.8.4 Performance of SADC countries in terms of macro economic convergence targets

❖ Inflation rate

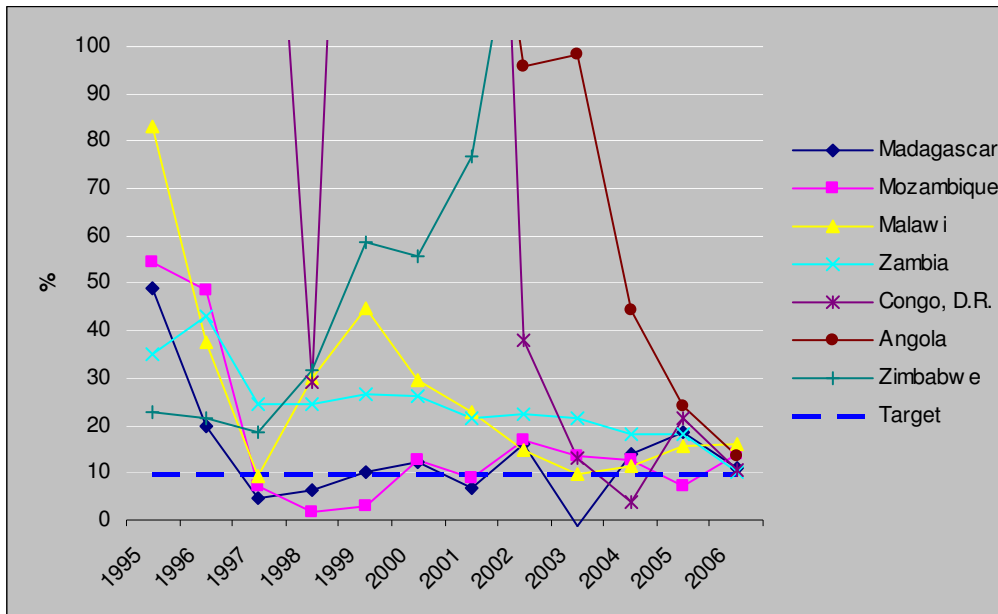
All of the countries in this group have had very high inflation (over 50 percent) at some point in the past. Nevertheless, even Angola and the DRC have managed to bring down inflation from very high levels quickly, and by 2006 almost all countries in this group had inflation below or close to the SADC target. The exception is Zimbabwe, who has had high and rising inflation in recent years, with no sign of stabilisation on the horizon. Figures 6.1 and 6.2 illustrate inflation performance by member countries in the SADC region in terms of high and low inflation performers respectively.

Figure 6.1: SADC low inflation countries



[Source: SADC, 2007]

Figure 6.2: SADC high inflation countries

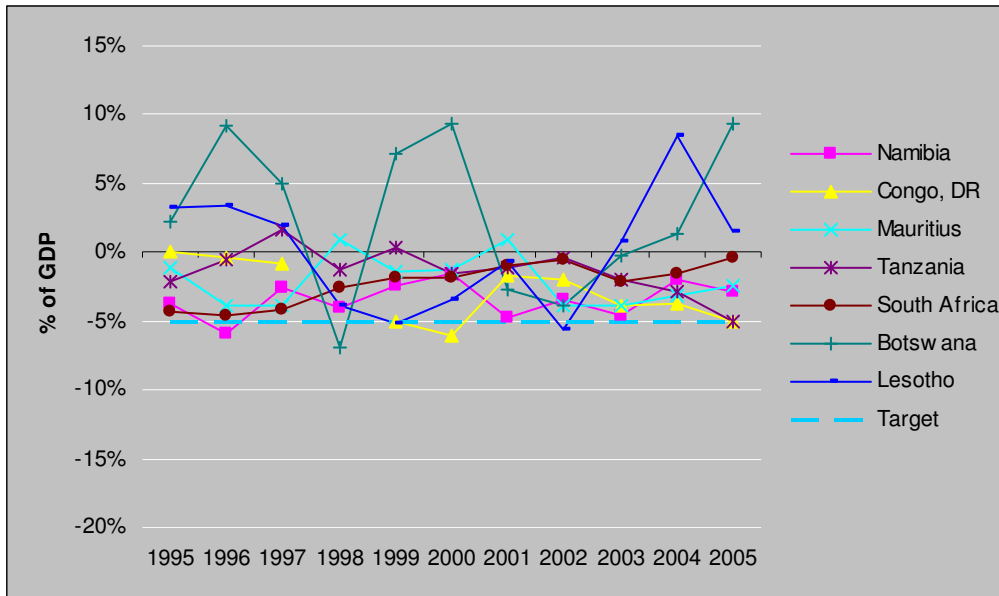


[Source: SADC, 2007]

❖ **Fiscal deficit**

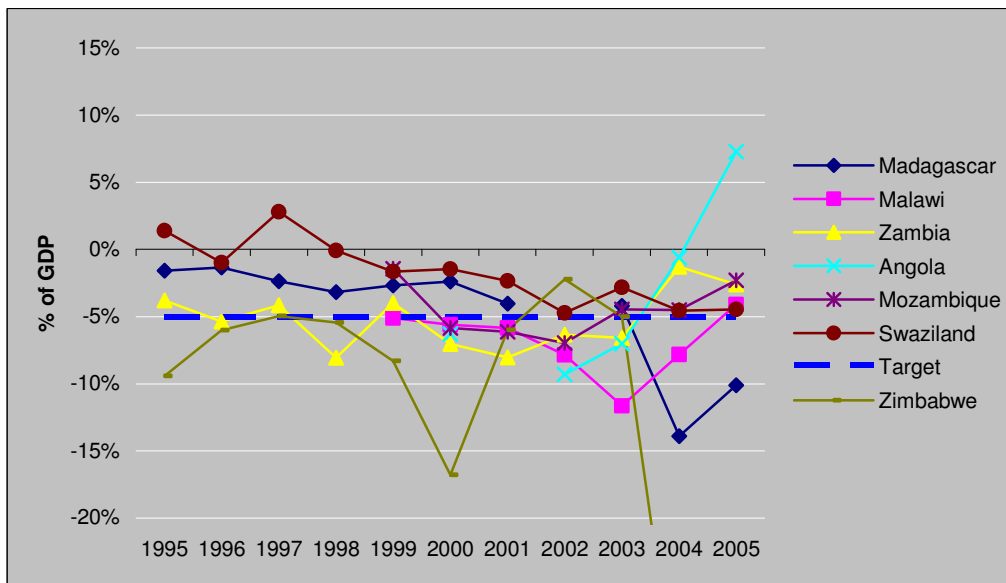
In regard to fiscal deficits from 1995 to 2005, SADC member countries may be divided into Low and High performers, relative to the 2008 SADC budget deficit target of less than 5 percent of GDP. The Low performance group shows some volatility in budget balance, especially Botswana and Lesotho, but generally fiscal deficits are consistently below the SADC target and fall into the range of 0-5 percent of GDP, with some budget surpluses. The composition of the Low group is similar to that of the Low Inflation group, with the exception of Swaziland (out) and DRC (in).

Figure 6.3: SADC low deficit countries



[Source: SADC, 2007]

Figure 6.4: SADC high deficit countries



[Source: SADC, 2007]

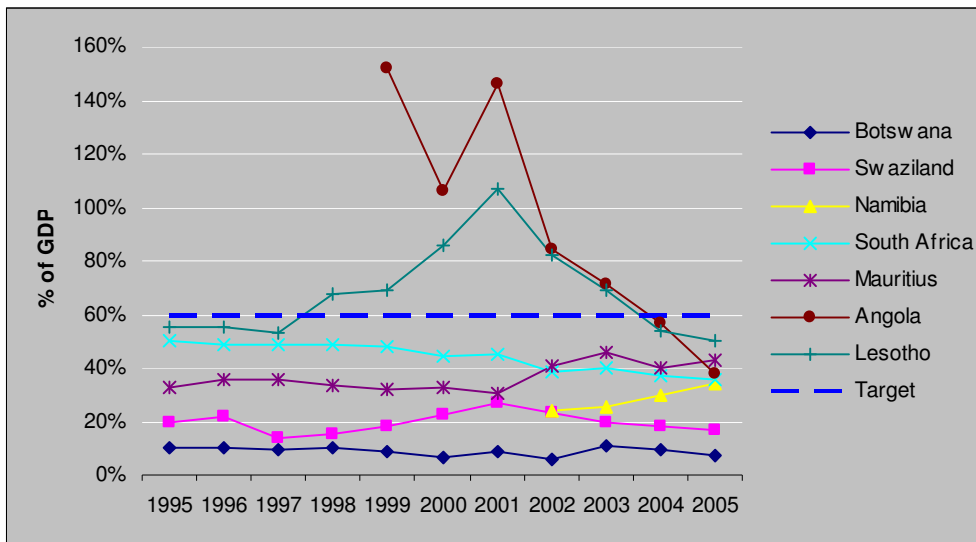
The High Deficit group in general demonstrates a period of worsening deficits, at least until recently, falling within the range of 0-15 percent of GDP.

Notwithstanding the general improvement in fiscal positions, many countries remain highly dependent upon donor grants to fund public spending, especially development (investment) spending (notably Madagascar, DRC, Tanzania, Mozambique, Zambia and Malawi). Hence fiscal sustainability in these countries is, in the short-to-medium term at least, dependent upon continued access to donor funds, the availability of which is in some respects beyond the control of the recipient countries.

❖ **Public debt**

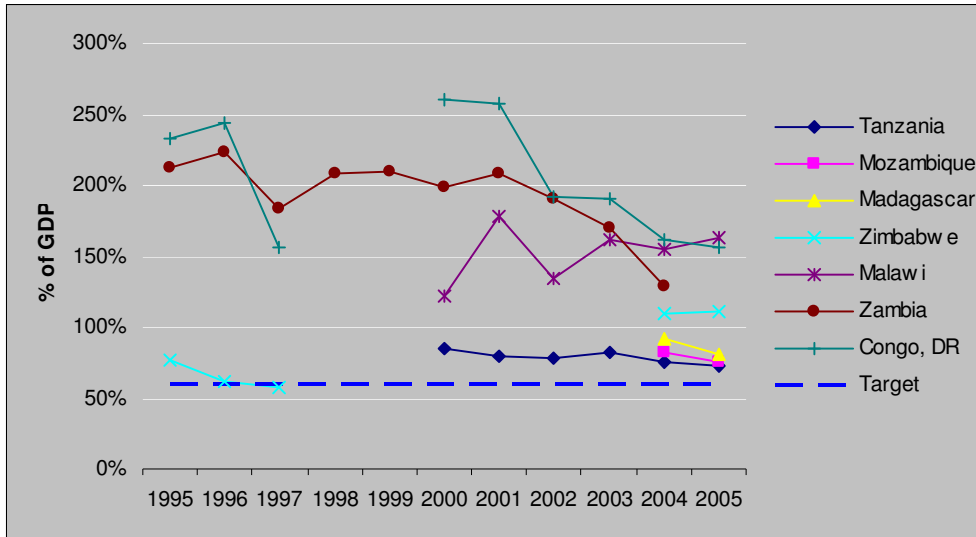
In regard to public debt, performance of SADC member states (1995 to 2005), may be divided into Low and High performers, relative to the 2008 SADC public debt target of less than 60 percent of GDP. Low and High public debt performers are illustrated in Figures 6.5 and 6.6 respectively.

Figure 6.5: SADC low public debt countries



[Source: SADC, 2007]

Figure 6.6: SADC high public debt countries

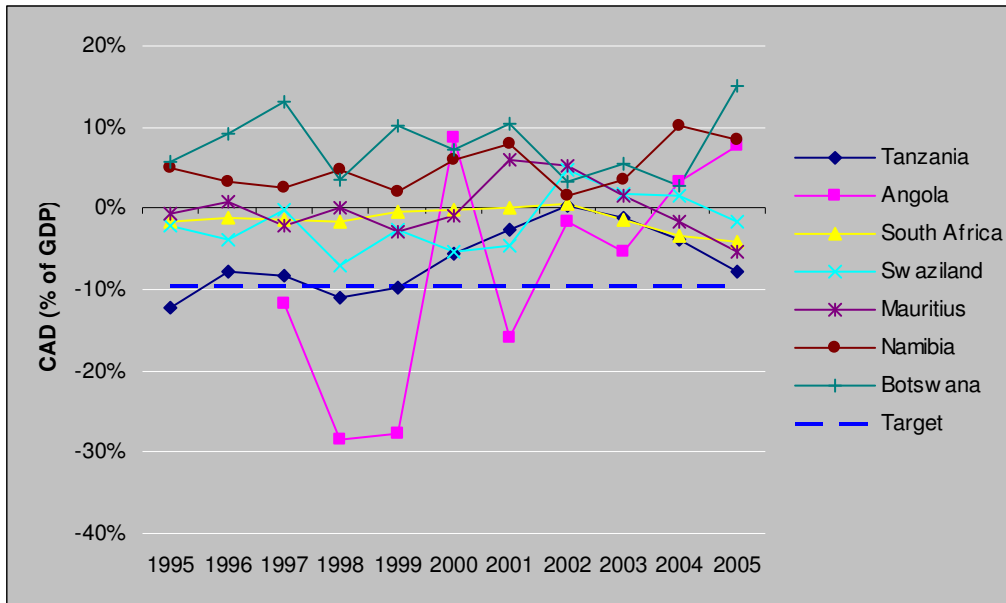


[Source: SADC, 2007]

❖ **Current account**

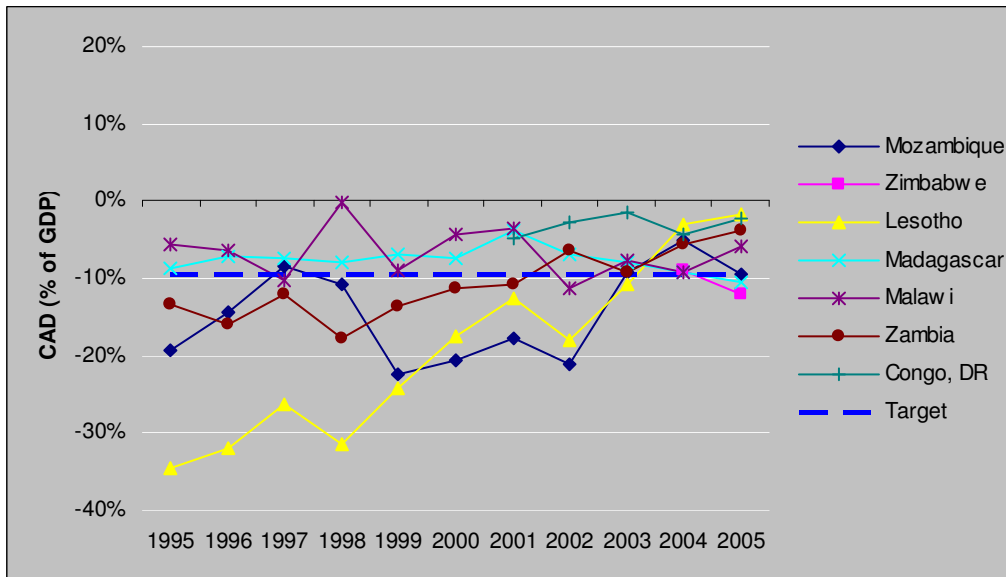
The Low current account deficits (CAD) group includes SACU (excluding Lesotho) plus Mauritius and Angola. Most of these countries have consistently had low deficits, or surpluses in the case of Botswana and Namibia. The exception is Angola which has had a volatile record, recently benefiting from high oil prices.

Figure 6.7: SADC low current account deficit countries



[Source: SADC, 2007]

Figure 6.8: SADC high current account deficit countries



[Source: SADC, 2007]

The High CAD group shows a more volatile and less consistent record. In some countries, the CAD has been improving (Zambia, Mozambique and Lesotho) while in others it has been relatively stable.

6.8.5 Performance of CMA countries against the SADC targets

The EU experience of monetary integration reflects the critical role of macro economic convergence as a prerequisite for the establishment of a fully fledged monetary union. The macro economic requirements for membership into the EMU commit member countries to strict macro economic targets.

Taking cognisance of the CMA's regional political and economic conditions, and given the diversity in the structure of the economies, it may be difficult for these economies to converge with respect to specific indicators, mainly, external balances and budget deficits.

The EU's rather difficult experience with the maintenance of budgetary discipline amongst all member states serves as an important reminder of the challenges that are to be confronted particularly during periods of economic slowdown. With respect to budget deficits, the EU's stability and growth impact on its near-automatic penalties against countries that have excessive budget deficits is difficult to maintain.

❖ Inflation

As shown in the accompanying Table 6.6 below, the inflation rates of the four RMA countries have converged to a considerable extent. For example, over the period from 2001 to 2007 the difference between the highest and lowest average inflation rate recorded in the region was only 3 percentage points per annum.

Table 6.6: Consumer prices (annual percent change) in CMA, 1997-2007

Table 6.6: Consumer prices (annual percent change) in CMA, 1997-2007							
COUNTRY	1997-2001	2002	2003	2004	2005	2006	2007
Botswana	2.9	6.3	0.6	0.3	2.0	5.3	1.5
Lesotho	7.2	12.5	5.0	5.0	3.4	6.1	6.0
Namibia	8.4	11.3	7.2	4.1	2.3	5.1	5.9
South Africa	6.4	9.2	5.8	1.4	3.4	4.7	5.5
Swaziland	7.2	11.7	7.4	3.4	4.8	5.1	5.8

[Source: IMF, 2007]

This is not surprising, given the fixed exchange rate between the participating countries and the extent of trade between them. The average inflation rate in the RMA countries ranges between 3 and 12 percent between the period 2001–2003 and much of an improvement was experienced between 2004–2007 with inflation rates averaging from 3 to and 6 percent. The CMA member countries are within the target range prescribed in terms of the SADC macro economic convergence targeting.

❖ Budget deficit

The CMA states group shows some volatility in budget balance, especially Botswana and Lesotho, but generally fiscal deficits are consistently below the

SADC target and fall into the range of 0-5 percent of GDP, with some budget surpluses. Deficits have been reduced significantly due to control on fiscal and capital expenditure, tax reforms and privatisation of state owned enterprises.

Table 6.7: Budget deficits in CMA, 1997-2004

Country	1997-2001	2002	2003	2004
Botswana	9.8	9.8	9.3	5.6
Lesotho	62.4	65.5	44.0	35.1
Namibia	3.3	5.6	3.0	4.8
South Africa	3.4	4.2	3.0	2.4
Swaziland	14.5	13.3	18	14.6

[Source: IMF, 2007]

❖ **Public debt**

It is important to note that CMA member states' public debt, notably for Botswana, Mauritius, Namibia and South Africa, remained stable at relatively low levels in relation to GDP. This is illustrated in Table 6.8 below. Lesotho is the exception when it comes to evaluating public debt in relation to GDP of 66 percent in 2007. Swaziland, also a small economy, managed to contain its debt in relation to GDP and brought it down to 14 per cent of GDP by 2007.

Table 6.8: Public debt (percent of GDP) in CMA, 1997-2007

COUNTRY	1997-2001	2002	2003	2004	2005	2006	2007
Botswana	10.2	7.5	5.3	4.5	4.0	3.7	3.3
Lesotho	60.8	75.5	170.6	188.9	71.2	57.8	66.3
Namibia	2.8	4.5	5.4	5.4	5.6	6.0	6.0
South Africa	3.4	4.5	3.0	2.3	2.1	2.0	1.9
Swaziland	17.4	24.7	18.5	21.5	15.7	14.8	14.3

[Source: IMF, 2007]

❖ Long term interest rates

Interest rates in the CMA member states vary below 20 per cent. This is due to a tight monetary policy aimed at reducing inflation and is anchored by South Africa's inflation targeting framework. Target range rates vary between 5 and 15 per cent on average. This is far better than most of the SADC countries and shows some convergence by CMA member states in relation to interest rates.

6.8.6 Performance of SADC countries against the EU targets

Measuring SADC's performance in terms of the EU macro economic convergence targets makes for an interesting comparison. It should be noted that SADC's main trading partner is the EU, and that SADC stands to gain from striving toward the macro economic convergence targets of the EU. Having similar macro economic

convergence parameters would mean less volatility in the exchange rates between SADC and the EU, would foster improved planning of production activities and place trade and investment between SADC and the EU on a sound footing.

The EU countries have been aligned economically in terms of their macro economic convergence targets, and the accession partners are following suit. On first inspection of SADC's performance in terms of the EU convergence targets, it is clear that SADC, ten years after the EU convergence targets had been set, still are not close to meeting those benchmark targets set ten years ago for EU convergence.

Although the SADC has set its own macro economic convergence targets which might be considered to be softer due to the state of economic developments in the region, this might prolong and make it difficult for the SADC to achieve their monetary integration objectives.

Table 6.9 below illustrates a very a simple comparative performance analyses of the two regions in terms of macro economic convergence benchmark.

Based on the comparative analysis of benchmark convergence figures in Table 6.9, between EU and SADC countries, EU members maintained an average rate of inflation of 2.59 per cent (1997) and SADC members an average of 53.37 per cent (2007). The SADC average is nowhere close to its convergence target of below 9.5 per cent for 2008. On an individual country analysis, Botswana, Lesotho, Mauritius, Mozambique, Namibia, South Africa, Swaziland and Tanzania conform to the inflation target for 2007. This represents eight out of a total of 14 SADC countries. When the EU benchmark for inflation convergence is applied, i.e. not exceeding 1.5 per cent of the three best performing members, only four SADC countries out of a total of 14 conform to this inflation benchmark. In regard to the 2008 current account deficit benchmark for SADC, countries performed much better, in that 12 of the 14 SADC members have current account deficits below 9 per cent of their respective GDPs.

Table 6.9: Comparison on macro economic convergence between SADC and EU

European Union Macro economic Convergence Performance in 10 years (1997)					SADC Macro economic Convergence Performance 10 years later (2007)				
Country	Inflation	Interest rate	Trade balance	Public Debt	Country	Inflation	Interest rate	Trade balance	Public Debt
Belgium	1.6	6.7	-3.3	130.6	Angola	23.0		7.3	37.6
Denmark	2.2	7.4	-1.4	70.2	Botswana	8.6		3.2	7.3
Germany	1.3	6.3	-4.0	60.8	Congo DRC	21.3		-5.0	156
Greece	8.4	15.1	-7.9	110.6	Lesotho	3.4		1.5	50.5
Spain	3.8	9.5	-4.4	67.8	Madagascar	48.5		-10.1	80.2
France	2.1	6.6	-4.0	56.4	Malawi	15.4		-4.1	164
Ireland	2.1	7.5	-1.6	74.7	Mauritius	4.9		-2.4	42.8
Italy	4.7	10.3	-6.6	123.4	Mozambique	6.4		-2.3	75.6
Luxembourg	1.3	7.0	0.9	7.8	Namibia	2.3		-2.9	33.8
Netherlands	1.2	6.3	-2.6	78.7	South Africa	3.4		-0.4	35.8
Austria	1.7	6.5	-4.3	71.7	Swaziland	4.8		-4.5	16.7
Portugal	3.0	9.4	-4.0	71.1	Tanzania	4.4		-5.0	72.1
Finland	0.9	7.4	-3.3	61.3	Zambia	15.9		-2.6	129
Sweden	1.6	8.5	-3.9	78.1	Zimbabwe	585		-65	111
United Kingdom	3.0	8.0	-4.6	56.3					

Source: Convergence report, 1998

In terms of public debt, the EU and SADC may be compared far easier as the benchmark for convergence in both cases is below 60 per cent of GDP. Of the 15 EU members, only 3 of a total of 15 (20 per cent) conformed to the public debt benchmark. In SADC, in 2007, 7 out of a total of 14 (50 per cent) of members conformed to the public debt requirement of 60 per cent of GDP.

6.8.7 Prospects of achieving the SADC targets

On the basis of recent macro economic performance and trends, as well as on country forecasts, it is possible to make an assessment of the likely achievement of the 2008 SADC targets by SADC member countries. Looking at 2005 data (the most recent year for which a comprehensive dataset is available), it is possible to identify problem areas insofar as reaching the SADC benchmark convergence figures. Table 6.10 provides an illustrative summary of all SADC countries and distinguishes between qualifying and non-qualifying benchmark figures for all SADC member countries.

Table 6.10: SADC performance against macro economic convergence targets, 2005/2007

Country	Inflation	Fiscal Deficit	Public Debt	Current Account	Growth
<i>Convergence Targets</i>	<9%	<5% of GDP	<60% of GDP	<9% of GDP	
Angola	23.0	7.3	37.6	22.9	18.2
Botswana	8.6	3.2	7.3	15.1	8.4
Congo DR	21.3	-5.0	156	-2.2	6.5
Lesotho	3.4	1.5	50.5	-1.8	1.2
Madagascar	18.5	-10.1	80.2	-10.4	4.7
Malawi	15.4	-4.1	164	-5.9	2.1
Mauritius	4.9	-2.4	42.8	-5.4	2.6
Mozambique	6.4	-2.3	75.6	-9.4	6.2
Namibia	2.3	-2.9	33.8	8.4	3.2
South Africa	3.4	-0.4	35.8	-4.2	4.9
Swaziland	4.8	-4.5	16.7	-1.6	1.8
Tanzania	4.4	-5.0	72.1	-7.9	6.9
Zambia	15.9	-2.6	129	-3.8	4.3
Zimbabwe	585	-65	111	-12.0	-4.3
<i>Key:</i>	<i>Meets 2008 target</i>		<i>Does not meet 2008 target</i>		

[Source: Jefferis, 2007 – as adapted]

The performance against the 2008 macro economic convergence targets as at 2005 was as follows:

- 8 out of 14 countries (57 per cent) met the inflation target
- 12 out of 14 countries (85 per cent) met the fiscal target

- 7 out of 14 countries (50 per cent) met the public debt target; 12 out of 14 countries (85 per cent) met the current account deficit target.

The macro economic performance of most SADC countries has improved remarkably in recent years, such that most of the SADC region demonstrated exceptional fiscal discipline, as is evident from the stable macro economic data. The general picture is one of reduced inflation, reduced fiscal deficits, reduced debt burdens and improved debt sustainability, and more sustainable balance of payments.

Growth performance has also improved. A number of factors underlie this improved macro economic performance. These include much improved policy formulation and implementation, the impact of ongoing structural and institutional reforms, greater trade openness and improved trade performance, as well as debt relief and the ending of civil conflict in many of the SADC countries.

Member countries in SADC are still heavily donor dependent for the financing of public sector investment projects, budgetary supplements and balance of payments stability. Considerable reforms are still needed to improve domestic revenue generation capacity and thereby reduce donor dependence and vulnerability to changes in aid flows and short term capital flows.

The main achievements by SADC countries has been with respect to the convergence of macro economic outcomes; however, if the process is to be continued and deepened there will need to be greater convergence of policies. While some countries have been following similar policies, this has not been by design (in terms of policy coordination), but the result of similar conditionality

being imposed by multinational institutions, or independent choices of 'best practice' policies.

The more deliberate choices of common policies across countries has stemmed from a programme of trade integration rather than macro economic convergence. However, the adoption of common monetary and exchange rate policies, which would be the central component of policy convergence, needs to be carefully assessed prior to implementation.

Performance on growth in many countries has improved, but there is still a long way to go to achieve the level of growth that would lead to a rapid reduction in poverty in the region. Further progress in removing the impediments to growth and boosting the rate of investment is probably the most important economic imperative facing the SADC region at present.

Finally, the well reported on instability and economic chaos in Zimbabwe is evident from the performance of the Zimbabwean economy over recent years. It is probably the only country that is creating a huge vacuum in the SADC monetary armour. It is also doubtful that meaningful progress toward monetary macro economic stabilisation or convergence and integration should be continued without Zimbabwe, mainly because of the high level of economic integration between Zimbabwe and South Africa in particular.

Unless there is drastic and meaningful political and economic reform, Zimbabwe will continue to undermine the region's prospects of achieving higher growth and investment, and would continue to negatively affect other SADC members through spill over effects. Amongst other things, the Zimbabwe problem illustrates the

difficulties associated with agreeing to a programme of macro economic convergence without the accompanying mechanisms for dealing with member states that do not adhere to the accompanying commitments. South Africa, as a key player in SADC, has also recently displayed signs of political instability insofar as political announcements, xenophobic violence and its silent diplomacy on the Zimbabwean political and economic crises are concerned.

6.9 Monetary integration challenges for southern Africa

The main challenges for southern Africa are to intensify the pace of integration and harmonisation. The southern African region has to implement sound macro economic and prudent fiscal and monetary policies that would facilitate the reduction of inflation and interest rates, deficits, debt and free capital flows through the liberalisation of exchange controls.

Monetary integration challenges in southern Africa can be summarised under three main categories which are macro economic, fiscal and exogenous challenges.

6.9.1 Macro economic policy challenges

❖ Economic growth

The overall economic growth in the region is very low because of factors like high levels of inflation, lack of intensive foreign direct investment, low levels of productivity, dominance of unskilled labour, loss of competitiveness and reliance on few dominant countries such as Botswana, South Africa and Mauritius for wealth creation, which results into financial instability.

❖ Foreign direct investment

The region's risky overall economic environment imposes a challenge to the inflow of foreign direct investment and long run investment levels. FDI inflows to the region are low when compared to other developing regions around the world, mainly due to high political and economic uncertainty, with the exception of a few member states. Investment needs are large due to the level of economic development required by the region.

❖ Exchange rate

The slow progress with structural reform in many of these economies increases the risk associated with exchange rates volatility. Regional competitiveness may also be eroded by weaker exchange rates in the region. The South African rand plays an informal role of an anchor currency for the region, which makes it vulnerable to external shocks.

Because of consistently high inflation differentials between SADC and EU countries (SADC's main trading partner), the real effective exchange rate is expected to continue to experience extreme volatility. In terms of the balance of payments model, consistent trade deficits also lower foreign exchange reserves that depreciate the currency. Managing the future SADC exchange rate of a SADC monetary union thus poses particular challenges.

6.9.2 Fiscal policy challenges

❖ Tax system

The southern African region has a diverse tax structure with a low tax base which constrains growth in the region. Tax collection in the region is also difficult for most of the member countries. Effective tax collection and a strong tax base are

among the requirements for fiscal sustainability and socio-economic stability in the SADC region. This would be required for fuelling growth and economic development. Very few countries like South Africa, Botswana and Mauritius, have sound revenue administration and collection measures. However, there still needs to be some harmonisation of tax systems in the southern African region. Divergent tax systems and rates give rise to tax shifting, whereby firms could well manipulate their financial flows, utilising tax arbitrage opportunities to shift their tax obligation toward lower tax base countries in the region.

❖ **Public spending**

The region requires substantial public expenditure to meet spending pressure to support growth and alleviate poverty. Most of the member states face a problem of rigid expenditure structures that limits potential growth spending, especially investment spending in infrastructure.

❖ **Public debt**

The member states in the region have relatively large deficits that are accompanied by high levels of public debt, which increase the region's vulnerability to external shocks. Many member states have high inflation rates, well above the convergence target rate, which increases further macro economic vulnerability.

❖ **Government revenue**

The region has low levels of revenue to GDP ratios, which makes it difficult to provide basic services to the citizens of the region. This might lead to some social and political instability. Generally most member countries rely heavily on grants and donations.

6.9.3 Other challenges for monetary integration in southern Africa

❖ Political instability

The southern African region has a history of political instability, which contributes negatively to macro economic and fiscal performance. The political uncertainty in Zimbabwe and undemocratic conditions in other countries like Swaziland pose a serious challenge for capital flows in the region and for the region's economic credibility.

Because of the way in which countries in the SADC region are interdependent and integrated economically, any form of political instability, violence, crime, xenophobia, civil unrest, etc., creates immediate ripple effects throughout the region, usually, starting with large short term capital withdrawal, adverse exchange rate movements and adverse policy responses, e.g. high interest rates. Experience has shown that SADC members generally have limited capacity to counter such adverse exogenous shocks that steer SADC countries off course insofar as the achievement of convergence targets is concerned.

❖ International developments

The region is susceptible and vulnerable to any exogenous shocks due to lack of resilient macro economic and fiscal policies. International developments such as the credit crunch in the US, increasing oil prices and inflationary pressures from other trading blocks always have an adverse impact on the region. When drawing a comparison internationally, some countries have shown some resilience to the world-wide supply shocks from oil and food price inflation. Other countries have been shown to exhibit a high propensity to absorb the international oil and food price inflation, while some have shown a much lower propensity to absorb these price shocks in internal inflation figures.

6.10 Summary

This chapter analysed SADC's performance both in terms of the southern African macro economic integration benchmark and against that of southern Africa's main trading partner, the EU. Southern Africa, and SADC in particular, still face many challenges in respect of reaching these monetary integration objectives. Chief among the challenges are political instability in the southern African region, a reliance on foreign donor money to maintain stability, heterogeneous economic structures, and poor integrated monetary systems infrastructure and policy cohesion among SADC member countries.

CHAPTER 7: SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

7.1 Summary

In Chapter 1, an introduction to the study is set out, which outlines the importance and motivation for the study. The hypothesis and objectives are clearly specified as well as the research methodology and a brief summary of the structure of the study and outline of chapters.

Chapter 2 provides the theoretical background of economic integration. Economic integration encompasses the formulation and application of common regional trade, exchange and labour markets. Common fiscal and monetary policies at the regional level will lead to the development of a common currency and a single central bank or monetary authority. This would regulate the monetary environment within which national governments could function. Economic integration also allows movement of all factors of production and technology within the region (Rwegasira, 1996:15).

Generally, economic integration is defined as a state or process that derives its importance from the potential for its participants to achieve a variety of common goals more effectively by joint or integrated action as opposed to unilateral effort.

Some economists define it as “a state of affairs or a process involving the combination of separate economies into a larger economic region” (Asante, 1997:19). This could include all measures that aim at abolishing discrimination among the member countries of the unit, with the formation and application of

coordinated and common economic policies to achieve various economic and welfare objectives. In some studies the concept of economic integration is used interchangeably with economic regionalism or economic union. Economic Integration could also be defined as “the design and implementation of a set of preferential policies within a regional grouping of countries aimed at the encouragement of the exchange of goods and factors between members of the group” (Mills & Handley, 1998:2).

Apart from economic integration there is also trade integration, which takes place through the establishment of either a preferential trade area or free trade area. Other forms of economic integration are custom unions, common markets, economic unions and total economic integration. Financial integration is a situation where there are open or competitive capital markets with the elimination of barriers to capital movements and a resultant gain in saving and investment (Van den Bergh & Sahajwala, 1989:15). This could be categorised further into regional financial integration and international financial integration. Monetary integration revolves around the integration of monetary policies, the exchange rate system and a single currency.

Monetary integration or monetary unions require the convertibility of member country’s currencies and a central monetary policy, unified financial markets, capital market integration, identical rates of inflation, the harmonisation of fiscal systems, regional development and the coordination of economic policies among member countries (Javanovic, 1997:43).

The chapter also examines various economic integration models around the world; most specifically the European Economic Community integration model. Various forms of economic integration are also studied which is followed by an investigation of the steps of economic integration.

The specific steps of economic integration covered in the chapter are: preferential trade area (PTA) is a form of economic integration, which is described by the existence of lower tariffs and intra-regional trade in goods and services originating in member countries; a free trade area (FTA) is described by the non-existence of tariffs on goods and services from other members leaving open the possibility for each member of structuring and applying its own regime of tariffs to goods or services imported from outside the FTA; a custom union (CU) involves free trade among member countries but applies uniformed external tariffs with members ceding sovereignty to a single unified customs administration or applying their own different tariff regimes alongside a common external tariff; a common market (CM) arises when a customs union abolishes non-tariff barriers to trade to allow free trade among members. This also involves greater harmonisation of trade, exchange rates, fiscal and monetary policies. This requires some form of internal exchange rate stability and full internal currency convertibility; an economic union (EU) is an agreement by member countries on a common currency and a unified monetary policy which conforms to specified convergence criteria and parameters within which national fiscal policy can operate; a political union (PU) represents the ultimate stage or form of integration in which the legislative and judicial processes of member states are either unified or federated under agreed arrangements.

According to Balassa (1961), five main stages are identified and defined as the outcome of policy decisions taken by regional inter governmental forums and/or supranational institutions in order to affect the depth and breath of regional integration.

A political union has many elements, but usually depicts the existence and emergence of a political community based on trust, loyalty and common

principles. It has four elements of integration namely institutional union, policy integration, attitudinal integration and security integration. Total economic integration (TEI) represents an economic union with all the relevant economic policies conducted at the supranational level, possibly in compliance with the principle of subsidiarity. Both supranational authorities and supranational laws need to be in place.

The chapter also explores the various regional economic cooperation agreements which have led to economic integration in Southern Africa. Economic cooperation exists in the region national states with varying degree of rigour and intensity. Numerous bilateral and multilateral treaties on economic issues, varying by sector have been agreed to, between countries of the region in Southern Africa. Economic cooperation has resulted in the formation of the following multilateral organizations of economic integration in southern Africa with different objectives and treaties that is; PTA, SACU, CMA, SADC, ECOWAS and ESAF.

Chapter 3 reviews economic integration around the world; much focus is placed on the economic integration in Africa. The economic ranking of many African countries is appalling because of various political and socio economic hurdles. Many African country economies are dilapidated in terms of growth and development. The economic status could be pictured by an adverse outlook in terms of declining growth, double-digit inflation, dependence on aid, poverty, no savings, low investment, high levels of unemployment, high deficits and under utilisation of production resources.

Tremendous efforts have been taken to address some of these problems after the colonial era, to emancipate their economies through economic cooperation and economic integration.

Various initiatives were taken, but mainly in trade and sectoral cooperation and much fewer efforts were made in the financial sector. There is some evidence of monetary and financial cooperation in the western African region and also other regions in the form of currency boards.

The inception of the EMU has sparked a new wave of interest in economic and financial integration in Africa. The formation of an African Economic Community may provide some foundation to empower the African continent in developing technical, technological, political, economic and financial infrastructure to address numerous problems on the continent.

Throughout the continent of Africa vigorous efforts had been made to promote economic development and regional integration, but much needs to be done to address financial issues which will enhance much monetary, fiscal and financial harmonisation with the eventuality of realising an African Monetary Union.

In light of the above, this chapter discusses the concept of financial integration and all issues of financial integration such as the development of various financial markets, instruments, and risks and benefits pertaining to this subject.

These economic integration initiatives can be analysed and classified in the following sub regions that is West, East, North, Central and the southern African Sub region. The benefits of economic integration are also studied which are followed by impediments towards economic integration.

The chapter closes with various ways of measuring economic integration starting with the theoretical approaches of measurement. The methods of measurement which are covered in this study are the Optimum Currency Area and the African integration index methods.

Chapter 3 continues with an investigation of the concept of financial integration and, more specifically, regional financial integration in southern Africa. A further analysis ensues on the theoretical approaches to and the benefits and risks of financial integration. Regional macro economic indicators are analysed, followed by an investigation of financial integration progress in southern Africa. Capital flows in the region, structural changes in the international financial markets and regional changes in financial market developments in southern Africa are covered in this chapter. Evidence of substantial misalignment of macroeconomic indicators among the different economic regions in Africa, and between major trading partners in the EU exists and was uncovered in the analysis of this chapter.

The most important finding made in Chapter 3 is that the EU economies, possesses much more depth (volume of production and trade) than Africa and its regions. In this regard, and although Africa's regions are generally doing far better in regard to fiscal and financial management, they lack the financial resources to manage external debt more effectively and efficiently.

In Chapter 4 it is found that the effect of globalisation on the world financial system is evident and poses a challenge to most emerging African economies and regions. Globalisation has been a key underlying factor for the upsurge and increase in integration of financial markets at regional and international level.

Many developing countries around the world are also positioning themselves by dismantling restrictions, deregulating their markets and improving the macro economic and political environments by increasing the degree of financial integration.

The potential for achieving the substantial benefits of regional financial integration is unlikely to be realised if all the barriers for integration in southern Africa are not reduced. This chapter will focus on the constraints, costs and benefits associated with financial integration in southern Africa. It looks at all domestic and international constraints, costs and benefits for the region and finally the degree or measurement of regional financial integration is also discussed (Mongelli, 2002:33).

The recent surge and pace of regional financial integration in southern Africa has been curtailed by a number of factors. The constraints are the underlying factors for poor financial market development, capital flows and most importantly for poor regional financial integration. These barriers have been classified into two main categories by nature, which are domestic or regional and international constraints.

These factors together had made it difficult for the region to develop progressively in terms of financial integration, with the exception of South Africa, Botswana and Mauritius.

The main factors constraining financial integration in the region are the political and macro economic environment which could be simplified into political instability, lack of market openness, regulation and liberalisation of markets, infrastructure, economies of scale, low economic growth, slow privatisation, low reserves, low investments, capital flows and poor macro economic performance in terms of inflation, public deficits, public debt, balance of payments and exchange rates.

With many Asian and Latin American countries growing rapidly and moving far ahead of most African countries in terms of putting in place the financial infrastructure needed to enhance regional financial integration, most African

regions and most importantly the southern African region, will have to undertake speedy financial sector policy and structural reforms to foster sound regional financial integration.

In regard to the benefits of financial integration it was found that the possible benefits of regional financial integration are twofold, firstly in the form of real economic growth and secondly in the diversification of capital and asset markets, which would reduce the risks and costs of investment. Apart from boosting growth with increased opportunities for risk diversification, financial integration could bring gains in the form of investment, which would increase growth and more capital flow that will afford the southern African region more economic muscle to compete in the global financial markets.

In regard to the risks of regional financial integration, Chapter 4 finds evidence that financial markets and private capital flows are becoming intra regionally concentrated, particularly in Europe, East Asia and more recently, increasingly in Latin America. Furthermore, as Africa is still in its infancy in financial integration, much attention has to be paid to dealing efficiently with macro economic and financial issues in order to prevent or contain currency and capital market crises in the region.

Sound and stable financial integration is needed to avoid any contagion effects, and the real economic and financial costs that might have negative spill over effects on the southern African region. The degree of risk associated with regional financial integration would depend mainly on the strength of macro economic policies, the soundness of the banking sector and the strength of institutional arrangements in the region.

The main, profound risks of regional financial integration, according to Coleman (1999:9) could be in the form of serious adverse private capital flow reversals which could be attributed to international investors becoming more discerning about the region and by the authorities' attempts to restrict capital flight by exerting more controls leading to the loss of investor confidence.

The other important risk (Mills, 1998:25) is the greater volatility which could be experienced by the national economy emanating from the other regional member countries. Financial integration could therefore magnify shock or the costs of policy mistakes and lead to greater instability in the region.

Proper planning and coordination by means of a regional institutional policy framework is unavoidable, because most of the member countries of the southern African region lack a strong macro economic banking sector, and institutional underpinnings to contain vulnerability or potential instability and reversals of private capital flows.

The constraints (barriers) that need to be overcome in regional financial integration attempts in Africa, are mainly macro economic instability, a poor political environment, closed market structures, poor agricultural development, over regulation of markets, slow privatisation pace, high country risk rating for member countries, dependence on donor funds as a source of capital flow, lack of financial innovation, technological development, exchange rate risk and non-convertibility of currencies.

On the international front, the main barriers to regional financial integration are (from an international perspective towards Africa), financial crises, liberalisation of financial markets and capital accounts, international political instability, investors'

perception about Africa and the region, poor risk profile, financial innovation, capital flows, and less international financial integration.

Insofar as financial (and regional economic integration) have progressed, evidence is found of marginal, but healthy improvements in inter-regional trade and international trade, which served to strengthen financial flows to and from Africa. Substantial gains still ought to be made, but evidence suggests that the gains from trade could be extremely helpful in the development of Africa's regional economic and financial integration.

Chapter 5 investigates the financial integration attempts in southern Africa and the progress and performance is evaluated. Financial market integration has grown rapidly during the late 1980s and 1990s due to the increase in pace of the globalisation of investments seeking higher rates of return and the opportunity of diversifying risk globally. Many developing countries are encouraging capital flows by dismantling financial controls and deregulating their domestic financial markets.

The increase in the degree of integration of global financial markets is accompanied by an increase in the development of economic integration groupings. Integration with neighbouring countries can produce economies of scale when competing with other regions of the world. It can be one way that countries could ensure that the best use is made of the resources, capabilities and abilities within their region (Mboweni, 1999:1).

In the world of increasing interdependence, and with global financial markets, the question of addressing regional financial integration is becoming more urgent. This chapter analyses the nature of financial market integration in southern Africa,

looking mainly at the various issues pertaining to the integration of the banking sector in the region.

This Chapter included integration in various markets for financial services, i.e. the banking sector, clearance settlement and payment systems, the bond market and integration of the equity markets. The chapter also makes a study of barriers to financial integration and finally focuses on the regulatory framework required for sound financial integration.

The region generally appears to be well capitalised and profitable based on their healthy capital adequacy ratios and returns on assets. The banking market is broadly dominated by lending in the following areas: foreign loans, retail, bills, public sector, mortgage, instalment, equities and corporate banking. The banking sector also overlaps into other financial sectors like insurance, unit trusts, financial services and micro lending.

There is great potential for integration in the banking sector, most importantly with the setting of common regional standards. Regional harmonisation in terms of bank regulation and supervision should be promoted to establish a common regulatory and supervisory framework at the regional level.

South Africa has a well developed financial and banking sector and is set to lead the financial integration process insofar as the regulatory and supervision tasks are concerned. The South African banking sector is emerging as a force to be reckoned with because of their growth, and extension into Africa and international markets. Most of the big four banks are making acquisitions and developing branch networks into Africa, especially in the southern African region. South African banks dominate in the MMA, SACU and SADC territories.

Globalisation has contributed to encouraging some SA-based banks like Investec to list on the London and New York Stock Exchanges and some foreign based banks to invest in Africa.

The South African banking system is well developed and largely established according to the Western European model, due to the countries colonial history. The South African banking sector is astute and highly rated. It is considered to have a prudent regulatory and legal infrastructure and well developed accounting standards and disclosure practices.

The industry structure is dominated by four large banks. There are, however, 58 licensed deposit-taking institutions of which 33 are domestically owned, 8 foreign owned, 2 mutual banks and local bank branches of foreign banks.

In addition there are 55 foreign bank representative offices in the South African banking sector, which create linkages with the international markets (SARB, 2002: 79–85).

Whatever one's take is on South Africa's role in the financial integration process, it is clear that the process of regional financial integration starts with cooperation in different areas of setting up uniform payments and clearance systems, risk management systems etc. To this extent, much progress has been made on the technical front. However, financial prudence of the regional financial systems would ultimately depend on the vigour of policing and substantial training.

Chapter 6 begins with a description of the concept of monetary policy integration followed by a discussion of the benefits and costs of monetary policy integration. Thereafter, global experiences of monetary integration, with special reference to the European monetary integration and the West African Monetary Union

(UMOA), are discussed. In the final part of the chapter, the southern African monetary integration process is explored and analysed and conclusions are drawn on the monetary policy integration strategy for southern Africa. The chapter analyses southern Africa's macro economic performance against the monetary integration macro economic framework targets and compares southern Africa's performance against the monetary integration targets of the European Union.

The concept of monetary policy integration

Any financial integration process would be incomplete or disintegrated if monetary integration were not attained. Global experience indicates that in most regions financial integration is mainly achieved with the establishment of regional monetary integration initiatives. The emergence of the EMU has sparked a new wave of interest in monetary integration in Asia, other regions around the world and Africa. Since the inaugural meeting of the OAU in 1963 and the current integration initiatives like NEPAD, there have been many regional financial and monetary integration initiatives on the African continent.

The OCA properties may include mobility of all factors of production, economic openness, and diversification in production, consumption, fiscal- and political integration.

Monetary integration advances an element of sharing among members, especially in terms of costs and benefits. It also fosters internal and external balance and may serve to protect a country from external shocks.

The benefits of monetary policy integration

The theoretical construct of an optimum currency area is based on the concept of a sizeable geographic area with sufficient labour mobility such that the residents

can enjoy potential welfare gains by fixing their exchange rate or adopting a common currency (Mundell, 1961).

Such monetary integration makes possible a number of macro economic benefits to the region in the form of speedy adjustments to unemployment and balance of payment imbalances. The other benefit of monetary integration is price stability, because maintenance of price stability is also associated with significant efficiency gain that results in long term benefits to growth for the whole region. Positive growth prospects are associated with the elimination of separate currencies. Growth could increase because of broader productive investment and a deeper integrated financial sector.

Other benefits may include high labour mobility, which facilitates equalisation of wages, restoration of employment equilibrium in the event of asymmetrical demand shocks in the region.

Intra regional trade intensity and openness of an economy act as shock transmitters, thereby reducing the need for giving up independent monetary policy in the event of a monetary union. The institutional and structural features of the member countries will to a large extent determine the costs and benefits of forming a monetary union.

Monetary integration also benefits the region by lowering transaction costs between member countries. This is demonstrated by the fact that there will be one single currency and no longer a need to exchange currencies, no exchange rate costs and no need to insure against currency fluctuations within region.

Finally, monetary integration creates the opportunity for lower interest rates to exist. The exchange rate stability is assured and this leads to lower interest rates for the whole region because of the non existence of risk premiums.

Greater economic certainty is experienced in a monetary integration region, because prices and revenues are more stable and this improves the quality of production, investment and consumption decisions in the region.

The success of monetary integration depends mainly on the openness and size of the economies forming the monetary union, product diversification, similar inflation rates and the depth of economic integration in the region.

The costs of monetary policy integration

The success of monetary integration is determined by how the integration authorities and structures deal with and manage all the cost issues. These are critical challenges which need to be resolved in order for the benefits of monetary integration to be realised.

The most typical costs of monetary integration are loss of national sovereignty, loss of monetary policy autonomy, and constraints to fiscal policies.

Global experiences of monetary integration

There has been a growing trend and a wide range of monetary integration initiatives around the world which have been triggered mainly by globalisation and the eagerness of countries to open their economies to more opportunities beyond their borders. The most familiar monetary integration institution which has demonstrated the success of regional financial and economic sustainability, post monetary integration, is the European Monetary Union. The success of the Euro has given rise to more regional cooperation and integration of economies on a

bilateral and multilateral platform. The African continent is following suit as is exhibited by regional integration initiatives in the various sub regions of the continent.

The European monetary integration

The European Union is an unparalleled example in the current and past processes of regional integration. The European Monetary Union was established in 1999 by eleven European countries after the adoption of the Maastricht Treaty which laid out the objectives and principles of this regional integration initiative.

The EMU has quite a long history which profiles the various phases which it has gone through, from economic integration to monetary integration. The intensified existing economic links contributed to better coordination, and the harmonisation and establishment of a monetary union with a denouncement of domestic currencies by a unilateral link. The process involved the transfer of authority over monetary policies to a supranational institution, the European Central Bank (ECB). However, member states kept their political autonomy and maintained responsibility over the remaining macro economic policies.

African experience of monetary integration

In Africa's colonial and past-colonial era monetary cooperation between different countries was widespread, but only few emerged into successful partial monetary integration formations. The failure of these integration attempts could be explained by a number of factors ranging from divergent ideologies, languages, colonial heritage, national interests and country rivalry. Despite all the set-backs, the West African Monetary Union (UMOA) or CFA zone and Multilateral Monetary Agreement (MMA) are testimony to success stories in Africa on monetary integration and have also delivered macro economic stability.

The West African Monetary Union (UMOA)

The UMOA, constituted by the seven West African countries, Benin, Burkino Faso, Ivory Coast, Mali, Niger, Senegal and Togo, came into existence on 10 January 1994 (Medhora, 1997:215).

All seven countries use the CFA franc as a common currency; however, UMOA countries have retained their principal economic stabilisation policies like fiscal, trade and monetary policies. MOA was later transformed into UEMOA to harness greater harmonisation of economic policies in the region.

The UEMOA brought some benefits to the region which includes the use of a fully convertible currency backed by the G-7 countries, risk free investment within the franc zone, economies of scale resulting from the issuance of a common currency and the existence of an independent central bank that can pursue consistent policies without fear and prejudice.

Monetary integration developments in southern Africa

The Multilateral Monetary Agreement (MMA) is one of the oldest and most successful integration initiatives in southern Africa. This integration establishment was formed in 1974 by three signatory members, namely South Africa, Swaziland and Lesotho. The MMA was later called the Rand Monetary Area and in 1992 it became known as the Common Monetary Area (CMA), after Namibia became a member.

The objective of the MMA was sustained economic development of the CMA with equitable benefits for all members. All four member countries have their own central banks and are responsible for their own monetary policy. The Rand is the legal tender in all four member countries but other member currencies are not legal tenders in South Africa. The Rand is pegged at 1:1 to other member

countries' currencies. However, there is always mutual consultation on monetary issues and no restriction on the transfer of funds among members.

Macro economic convergence in the European Monetary Union (EMU)

There have been major improvements in the Euro area with regard to macro economic convergence targets, especially towards the end of 1990. The average rate of the Harmonised Index of Consumer Prices (HICP) (inflation) has fallen from 2.2 to 1.3 percent for most of the member states with the exception of Greece. Long term interest rates have been falling throughout the EU to reach average levels around 5 percent. Exchange rates have in general remained broadly stable. Significant reductions in fiscal deficits were experienced in the region and are currently at an average of 2.45 percent of GDP. The average debt ratio stands at 72 percent of GDP, which is higher than the reference level.

Choice of macro economic convergence targets in the EMU

The EU has selected and adopted some key macro economic convergence targets as outlined in Table 6.3. The criteria were applied in a strict manner with the sole view of committing the member states towards an efficient monetary union.

The rationale for these targets is to ensure that only member states which have economic conditions that are conducive to the maintenance of price stability and the viability of the European currency area should participate. The targets constitute a coherent and integrated strategy and all member countries should be on the same footing before accession to monetary integration is granted. The macro economic convergence targets should be consistent, transparent and simple.

The target on the price and long term interest rates convergence are based on the average of the three best performing countries in terms of inflation, as the price performance of the countries with the lowest rates of inflation. On the fiscal target the reference values and indicators underlying the developments are considered. In respect of debt, the reference value is 60 percent of GDP. Exchange rate targets are based on the principle that member countries should not devalue their currencies against any other member state currency.

Macro economic convergence development in southern Africa

There are a number of motivations behind the commitment to macro economic convergence. One such motivation is recognition that economic instability in one or more countries in the region, as has been the case historically, had negative effects both on the countries themselves and the region more generally, through spill over effects. Hence the most basic component of macro economic convergence is to achieve macro economic stability across the region, thereby avoiding instability in terms of high inflation, unstable currencies, and other forms of macro economic imbalance.

Performance of member countries on the targets

The SADC countries' macro economic performance has improved markedly in recent years, such that throughout most of the SADC region macro economic stability has been achieved with the exception of Zimbabwe, the DRC and Madagascar. The general outlook in the region is one of reduced inflation, reduced fiscal deficits, a reduced debt burden and improved debt sustainability, and more sustainable balance of payments.

Economic growth performance has also improved. A number of factors underlie this improved macro economic performance. These include much improved policy formulation and implementation, the impact of ongoing structural and institutional

reforms, greater trade openness and improved trade performance, as well as debt relief and the end of civil conflict.

The criteria for selection of macro economic convergence targets

Main macro economic targets

The SADC focuses on four main macro economic variables: inflation, fiscal balance, public debt, and the current account of the balance of payments. The specific targets to be achieved in terms of these four variables are progressively stricter over the period from 2008 to 2018, and are set out in Table 6.5.

Performance of SADC countries in terms of macro economic convergence targets

Inflation rate

All of the countries in this group have had very high inflation (over 50 percent) at some point in the past. Nevertheless, even Angola and the DRC have managed to bring down inflation from very high levels quickly, and by 2006 almost all countries in this group had inflation below or close to the SADC target. The exception is Zimbabwe, who has had high and rising inflation in recent years, with no sign of stabilisation on the horizon. Figures 6.1 and 6.2 illustrated inflation performance by member countries in the SADC region in terms of high and low inflation performers respectively.

Fiscal deficit

In regard to fiscal deficits from 1995 to 2005, SADC member countries may be divided into Low and High performers, relative to the 2008 SADC budget deficit target of less than 5 percent of GDP. The Low performance group shows some volatility in budget balance, especially Botswana and Lesotho, but generally fiscal deficits are consistently below the SADC target and fall into the range of 0-5

percent of GDP, with some budget surpluses. The composition of the Low group is similar to that of the Low Inflation group, with the exception of Swaziland (out) and DRC (in).

The High Deficit group in general demonstrates a period of worsening deficits, at least until recently, falling within the range of 0-15 percent of GDP. Notwithstanding the general improvement in fiscal positions, many countries remain highly dependent upon donor grants to fund public spending, especially development (investment) spending (notably Madagascar, DRC, Tanzania, Mozambique, Zambia and Malawi). Hence fiscal sustainability in these countries is, in the short-to-medium term at least, dependent upon continued access to donor funds, the availability of which is in some respects beyond the control of the recipient countries.

Public debt

In regard to public debt, performance of SADC member states (1995 to 2005), may be divided into Low and High performers, relative to the 2008 SADC public debt target of less than 60 percent of GDP. Low and High public debt performers were illustrated in Figures 6.5 and 6.6 respectively.

Current account

The Low current account deficits (CAD) group includes SACU (excluding Lesotho) plus Mauritius and Angola. Most of these countries have consistently had low deficits, or surpluses in the case of Botswana and Namibia. The exception is Angola which has had a volatile record, recently benefiting from high oil prices.

The High CAD group shows a more volatile and less consistent record. In some countries, the CAD has been improving (Zambia, Mozambique and Lesotho) while in others it has been relatively stable.

Performance of CMA countries against the SADC targets

The EU experience of monetary integration reflects the critical role of macro economic convergence as a prerequisite for the establishment of a fully fledged monetary union. The macro economic requirements for membership into the EMU commit member countries to strict macro economic targets.

Taking cognisance of the CMA's regional political and economic conditions, and given the diversity in the structure of the economies, it may be difficult for these economies to converge with respect to specific indicators, mainly, external balances and budget deficits.

The EU's rather difficult experience with the maintenance of budgetary discipline amongst all member states serves as an important reminder of the challenges that are to be confronted particularly during periods of economic slowdown. With respect to budget deficits, the EU's stability and growth impact on its near-automatic penalties against countries that have excessive budget deficits is difficult to maintain.

Inflation

As was shown in Table 6.6, the inflation rates of the four RMA countries have converged to a considerable extent. For example, over the period from 2001 to 2007 the difference between the highest and lowest average inflation rate recorded in the region was only 3 percentage points per annum.

This is not surprising, given the fixed exchange rate between the participating countries and the extent of trade between them. The average inflation rate in the RMA countries ranges between 3 and 12 percent between the period 2001–2003

and much of an improvement was experienced between 2004–2007 with inflation rates averaging from 3 to and 6 percent. The CMA member countries are within the target range prescribed in terms of the SADC macro economic convergence targeting.

Budget deficit

The CMA states group shows some volatility in budget balance, especially Botswana and Lesotho, but generally fiscal deficits are consistently below the SADC target and fall into the range of 0-5 percent of GDP, with some budget surpluses. Deficits have been reduced significantly due to control on fiscal and capital expenditure, tax reforms and privatisation of state owned enterprises.

Public debt

It is important to note that CMA member states' public debt, notably for Botswana, Mauritius, Namibia and South Africa, remained stable at relatively low levels in relation to GDP. Lesotho is the exception when it comes to evaluating public debt in relation to GDP of 66 percent in 2007. Swaziland, also a small economy, managed to contain its debt in relation to GDP and brought it down to 14 per cent of GDP by 2007.

Long term interest rates

Interest rates in the CMA member states vary below 20 percent. This is due to a tight monetary policy aimed at reducing inflation and is anchored by South Africa's inflation targeting framework. Target range rates vary between 5 and 15 per cent on average. This is far better than most of the SADC countries and shows some convergence by CMA member states in relation to interest rates.

Performance of SADC countries against the EU targets

Measuring SADC's performance in terms of the EU macro economic convergence targets makes for an interesting comparison. It should be noted that SADC's main trading partner is the EU, and that SADC stands to gain from striving toward the macro economic convergence targets of the EU. Having similar macro economic convergence parameters would mean less volatility in the exchange rates between SADC and the EU, would foster improved planning of production activities and place trade and investment between SADC and the EU on a sound footing.

The EU countries have been aligned economically in terms of their macro economic convergence targets, and the accession partners are following suit. On first inspection of SADC's performance in terms of the EU convergence targets, it is clear that SADC, ten years after the EU convergence targets had been set, still are not close to meeting those benchmark targets set ten years ago for EU convergence.

Although the SADC has set its own macro economic convergence targets which might be considered to be softer due to the state of economic developments in the region, this might prolong and make it difficult for the SADC to achieve their monetary integration objectives.

Based on the comparative analysis of benchmark convergence figures in Table 6.9, between EU and SADC countries, EU members maintained an average rate of inflation of 2.59 per cent (1997) and SADC members an average of 53.37 per cent (2007). The SADC average is nowhere close to its convergence target of below 9.5 per cent for 2008. On an individual country analysis, Botswana, Lesotho, Mauritius, Mozambique, Namibia, South Africa, Swaziland and Tanzania

conform to the inflation target for 2007. This represents eight out of a total of 14 SADC countries. When the EU benchmark for inflation convergence is applied, i.e. not exceeding 1.5 per cent of the three best performing members, only four SADC countries out of a total of 14 conform to this inflation benchmark. In regard to the 2008 current account deficit benchmark for SADC, countries performed much better, in that 12 of the 14 SADC members have current account deficits below 9 per cent of their respective GDPs.

In terms of public debt, the EU and SADC may be compared far easier as the benchmark for convergence in both cases is below 60 percent of GDP. Of the 15 EU members, only 3 of a total of 15 (20 per cent) conformed to the public debt benchmark. In SADC, in 2007, 7 out of a total of 14 (50 per cent) of members conformed to the public debt requirement of 60 per cent of GDP.

Prospects of achieving the SADC targets

On the basis of recent macro economic performance and trends, as well as on country forecasts, it is possible to make an assessment of the likely achievement of the 2008 SADC targets by SADC member countries. Looking at 2005 data (the most recent year for which a comprehensive dataset is available), it is possible to identify problem areas insofar as reaching the SADC benchmark convergence figures. Table 6.10 provided an illustrative summary of all SADC countries and distinguished between qualifying and non-qualifying benchmark figures for all SADC member countries.

The performance against the 2008 macro economic convergence targets as at 2005 was as follows:

- 8 out of 14 countries (57 per cent) met the inflation target
- 12 out of 14 countries (85 per cent) met the fiscal target

- 7 out of 14 countries (50 per cent) met the public debt target; 12 out of 14 countries (85 per cent) met the current account deficit target.

The macro economic performance of most SADC countries has improved remarkably in recent years, such that most of the SADC region demonstrated exceptional fiscal discipline, as is evident from the stable macro economic data. The general picture is one of reduced inflation, reduced fiscal deficits, reduced debt burdens and improved debt sustainability, and more sustainable balance of payments.

Growth performance has also improved. A number of factors underlie this improved macro economic performance. These include much improved policy formulation and implementation, the impact of ongoing structural and institutional reforms, greater trade openness and improved trade performance, as well as debt relief and the ending of civil conflict in many of the SADC countries.

Member countries in SADC are still heavily donor dependent for the financing of public sector investment projects, budgetary supplements and balance of payments stability. Considerable reforms are still needed to improve domestic revenue generation capacity and thereby reduce donor dependence and vulnerability to changes in aid flows and short term capital flows.

The main achievements by SADC countries has been with respect to the convergence of macro economic outcomes; however, if the process is to be continued and deepened there will need to be greater convergence of policies. While some countries have been following similar policies, this has not been by design (in terms of policy coordination), but the result of similar conditionality

being imposed by multinational institutions, or independent choices of 'best practice' policies.

The more deliberate choices of common policies across countries has stemmed from a programme of trade integration rather than macro economic convergence. However, the adoption of common monetary and exchange rate policies, which would be the central component of policy convergence, needs to be carefully assessed prior to implementation.

Performance on growth in many countries has improved, but there is still a long way to go to achieve the level of growth that would lead to a rapid reduction in poverty in the region. Further progress in removing the impediments to growth and boosting the rate of investment is probably the most important economic imperative facing the SADC region at present.

Finally, the well reported on instability and economic chaos in Zimbabwe is evident from the performance of the Zimbabwean economy over recent years. It is probably the only country that is creating a huge vacuum in the SADC monetary armour. It is also doubtful that meaningful progress toward monetary macro economic stabilisation or convergence and integration should be continued without Zimbabwe, mainly because of the high level of economic integration between Zimbabwe and South Africa in particular.

Unless there is drastic and meaningful political and economic reform, Zimbabwe will continue to undermine the region's prospects of achieving higher growth and investment, and would continue to negatively affect other SADC members through spill over effects. Amongst other things, the Zimbabwe problem illustrates the

difficulties associated with agreeing to a programme of macro economic convergence without the accompanying mechanisms for dealing with member states that do not adhere to the accompanying commitments. South Africa, as a key player in SADC, has also recently displayed signs of political instability insofar as political announcements, xenophobic violence and its silent diplomacy on the Zimbabwean political and economic crises are concerned.

Monetary integration challenges for southern Africa

The main challenges for southern Africa are to intensify the pace of integration and harmonisation. The southern African region has to implement sound macro economic and prudent fiscal and monetary policies that would facilitate the reduction of inflation and interest rates, deficits, debt and free capital flows through the liberalisation of exchange controls.

Monetary integration challenges in southern Africa can be summarised under three main categories which are macro economic, fiscal and exogenous challenges.

This chapter analysed SADC's performance both in terms of the southern African macro economic integration benchmark and against that of southern Africa's main trading partner, the EU. Southern Africa, and SADC in particular, still face many challenges in respect of reaching these monetary integration objectives. Chief among the challenges are political instability in the southern African region, a reliance on foreign donor money to maintain stability, heterogeneous economic structures, and poor integrated monetary systems infrastructure and policy cohesion among SADC member countries.

7.2 Conclusions

Current state of southern African financial integration

The Southern African Development Community (SADC) has a variety of policies in place to promote regional economic integration amongst member states. The motivation and outline of these policies is set out in the Regional Indicative Strategic Development Plan (RISDP), approved in 2003, while specific commitments are set out in the various protocols. The SADC Trade Protocol, for instance, sets out legally binding commitments to member states in respect of a Free Trade Area, to which they have to conform by 2008.

The programme outlines key targets for regional economic integration which are stipulated as follows: The programme has seven targets with a time line of achieving these targets over a stipulated timeframe, and which will lead to the adoption of a regional currency in 2018. The attainment of an FTA is to be achieved in 2008, followed by the completion of an SADC Custom Union completed by 2010. By 2015 the SADC Common Market should be completed, which will be followed by the achievement of macro economic targets and the convergence of other financial policy indicators, including external reserves/import cover; central bank credit to government ratios; savings; investment; payments systems interconnection; currency convertibility; dual and cross listing of regional stock exchanges and liberalisation of exchange controls between member states.

Overall, it can be concluded that considerable progress has been made with regard to macro economic stabilisation, and hence convergence in the SADC region in recent years. The SADC macro economic convergence targets are increasingly being integrated into the macro economic frameworks of member states. Nevertheless, several very real challenges remain that will require

concerted efforts to address if the process is to make further progress and completed successfully.

Remaining obstacles to financial integration in southern Africa

The potential of achieving substantial benefit from economic integration in the southern African region exists. This study has found that a myriad of economic benefits have already been derived from various forms of economic integration. The next step toward integration is financial and monetary integration. On the road to economic integration, macro economic convergence is a necessary precondition.

The performance against the 2008 macro economic convergence targets as at 2005 were as follows:

- 8 out of 14 countries (57 per cent) met the inflation target
- 12 out of 14 countries (85 per cent) met the fiscal target
- 7 out of 14 countries (50 per cent) met the public debt target
- 12 out of 14 countries (85 per cent) met the current account deficit target.

The macro economic performance of most SADC countries has improved remarkably in recent years, such that most of the SADC region demonstrated exceptional fiscal discipline, as is evident from the stable macro economic data. The general picture is one of reduced inflation, reduced fiscal deficits, reduced debt burdens and improved debt sustainability, and more sustainable balance of payments.

Growth performance has also improved. A number of factors underlie this improved macro economic performance. These include much improved policy formulation and implementation, the impact of ongoing structural and institutional reforms, greater trade openness and improved trade performance, as well as debt relief and the ending of civil conflict in many of the SADC countries.

Member countries in SADC are still heavily donor dependent for the financing of public sector investment projects, budgetary supplements and balance of payments stability. Considerable reforms are still needed to improve domestic revenue generation capacity and thereby reduce donor dependence and vulnerability to changes in aid flows and short term capital flows.

The main achievements by SADC countries have been with respect to convergence of macro economic outcomes; however, if the process is to be continued and deepened there will need to be greater convergence of policies. While some countries have been following similar policies, this has not been by design (in terms of policy coordination), but the result of similar conditionality being imposed by multinational institutions, or independent choices of 'best practice' policies.

The more deliberate choices of common policies across countries has stemmed from a programme of trade integration rather than macro economic convergence. However, the adoption of common monetary and exchange rate policies, which would be the central component of policy convergence, needs to be carefully assessed prior to implementation.

Performance on growth in many countries has improved, but there is still a long way to go to achieve the level of growth that would lead to a rapid reduction in poverty in the region. Further progress in removing the impediments to growth and boosting the rate of investment is probably the most important economic imperative facing the SADC region at present.

Finally, the well reported on instability and economic chaos in Zimbabwe is evident from the performance of the Zimbabwean economy over recent years. It is probably the only one country that is creating a huge vacuum in the SADC monetary armour. It is also doubtful that meaningful progress toward monetary macro economic stabilisation or convergence and integration should be continued without Zimbabwe, mainly because of the high level of economic integration between Zimbabwe and South Africa in particular.

Unless there is drastic and meaningful political and economic reform, Zimbabwe will continue to undermine the region's prospects of achieving higher growth and investment, and would continue to negatively affect other SADC members through spill over effects. Amongst other things, the Zimbabwe problem illustrates the difficulties associated with agreeing to a programme of macro economic convergence without the accompanying mechanisms for dealing with member states that do not adhere to the accompanying commitments. South Africa, as a key player in SADC, has also recently displayed signs of political instability insofar as political announcements, xenophobic violence and its silent diplomacy on the Zimbabwean political and economic crises are concerned.

7.3 Recommendations

This section provides a number of recommendations flowing from both the results of the analysis and comparative study of Chapter 6 and the literature study. The recommendations therefore combine those recommendations found in literature and that the researcher supports, as well as those flowing from the results of the analysis performed in this thesis.

7.3.1 Recommendations following from the literature study

➤ *Achieving financial integration in southern Africa*

The following are recommended to remedy and improve SADC monetary integration:

Macro economic policy integration

- Improvement in macro economic policy coordination and harmonisation is required to foster healthy economic growth and development in the region. Healthy economic growth and development requires sound debt to GDP ratios and low core inflation.
- The southern African region should also encourage and improve linkages with other trading blocks and optimise on economic partnership agreements and strategic alliances within the World Trade Organisation.
- Other SADC member countries should subscribe to SACU to develop a broader uniform custom market that will yield an improved international trade environment, and food security for the region.

Banking sector integration

- A broader banking sector should be developed that would capacitate liquidity in the banking sector. Robust financial systems should be developed for the region with more programmes that will reduce financial risks and encourage more capital flows and FDI.

Development of a clearance, settlement and payment system

- The payment clearance settlement systems must be harmonised and integrated on real time basis.
- This should also be integrated with other financial centres around the world in various financial sectors.

Financial and capital market integration

- The region must fast track the development of capital markets in the region by improving liquidity of trade in equities, bonds, and other financial instruments. Liberalisation of financial markets is key to attract local and international investors.
- Regional financial regulatory and legal frameworks should be standardised.

Enlargement of the RAND Zone

- The Rand could be considered as the anchor currency for other southern African (SADC) regional member states in order to build confidence in the exchange rate of the region. Reforms of the Rand Zone agreement should be encouraged with fair and stricter measures for the benefit of all member countries and ensuring the region can contain exogenous economic shocks with resilience.

7.3.2 Recommendations from the analysis and results

➤ *Achieving macro economic convergence targets for southern Africa*

The criteria for the choice of macro economic convergence targets

The macro economic convergence targets were selected based on the number of factors capable of expediting the realisation if monetary integration in the region.

These criteria were the following:

- ❖ Economic development
- ❖ Financial structure of the region
- ❖ Macro economic diversity
- ❖ Political and economic stability
- ❖ Trade links
- ❖ Regional competitiveness
- ❖ Timeframe for the targets
- ❖ Level of readiness by member countries for financial and monetary integration.

The choice of targets

The strategy towards the achievement of the macro economic convergence in the region is based on the choice of realistic targets and a within a reasonable time frame considering the economic conditions in the southern African region. A two-pronged target approach, i.e. primary and secondary targets, is recommended.

Primary macro economic convergence targets

Table 7.1: Recommended main macro economic convergence targets

Indicators	2010	2015	2020
Inflation Rate	6%	4%	4%
Fiscal Deficit	6%	5%	3%
Public Debt	70%	65%	60%
Current Account	10%	10%	5%

[Source: SADC, 2007 (as adapted)]

Theoretically, inflation is the core underlying indicator of macro economic convergence, and is arguably the most important of the four chosen indicators. Low inflation cannot be achieved on a consistent basis in the absence of stability-oriented macro economic policies, and the achievement of low inflation therefore indicates that other policies are being implemented in a manner that is supportive of macro economic stability.

Generally, high inflation is an indication of macro economic imbalances in an economy. Inflation is also relatively easy to measure, and in most countries data is readily available, at high frequency (monthly). The recommended target for inflation for southern Africa should be pitched at lower levels in order to accelerate financial and monetary integration. This will reduce laxity in committing to the attainment of other macro economic convergence targets.

It is firstly recommended that the EMU approach in regard to inflation targeting be adopted. This means that the approach to be followed is firstly aligned with that of SADC's main trading partner – a requirement for external stability. Secondly, that SADC adopts the approach that members conform to a target of not less than a 1.5 per cent deviation from the weighted average of the top three performing members. The suggested targets for the top three members are average inflation rates of per cent for 2010, 4 per cent for 2015 and thereafter. In relation to the 6 per cent target for 2010, other members would therefore have to achieve at least a 7.5 per cent rate of inflation to come within the range to conform to the convergence criteria.

What makes the adoption of fixed inflation targets particular challenging, is the global supply shocks in relation to oil and food price inflation, together with the hyperinflation in Zimbabwe. It is therefore further recommended that these fixed targets should be reviewed annually and brought in line with some external international set of indicators in order to adapt to world economic conditions. The EMU macro economic indicators might serve as a best practice benchmark against which to review a southern African monetary union convergence targets.

Debt in SADC, and sub-Saharan Africa more generally, is not homogeneous, as it varies by currency (domestic or foreign), source (commercial or concessional), and duration (short or long term). The macro economic impact of debt works through several channels, and depends on the type of debt. For instance, domestic debt does not have a direct balance of payment impact, but may have a crowding out impact in domestic financial markets, and *vice versa* for foreign debt.

The economic burden of debt servicing depends on the currency denomination, the interest rate and term structure of debt. More generally, domestic and foreign

debts have different risk profiles. A single debt indicator therefore needs to be carefully interpreted and supplemented by other data to capture these channels.

In Europe (Maastricht Treaty), a single indicator was adopted for public debt, and was arguably more appropriate as public debt was homogeneous, i.e. generally denominated in domestic currency and issued on commercial terms, and hence the debt service burden was closely related to total of debt outstanding.

The benchmark of 60 per cent of GDP that was chosen in Europe may have represented a suitable benchmark for debt sustainability there. In Africa, however, the most advanced analysis of debt sustainability stemmed from the HIPC programme, which focused on debt sustainability (particularly in balance of payments terms), and not debt levels. The recommended debt benchmark from 70 per cent in 2010, 65 per cent in 2015 and 60 per cent in 2020 is recommended for the southern African region.

Fiscal balance (the budget deficit) is an important contributor to macro economic stability. While the quality of measurement of the fiscal balance is improving, due in part to improved government accounting systems and reduced usage of quasi-fiscal (off budget) expenditure, there are nevertheless a number of problems that make monitoring of performance difficult. Deficit targets should range from 6 per cent of GDP in 2010, 5 per cent 2015 and 3 per cent in 2020. Africa has been successful in negotiating debt relief of historic debt, supplemented by international transfers. If Africa can successfully rid itself of corruption and adopt prudent fiscal management, it should not be too difficult to achieve the adopted targets of reducing the debt burden as percentage of GDP. At present, southern Africa collectively wastes too many valuable financial resources on servicing foreign debt. South Africa serves as a perfect example of how foreign debt as a

percentage had been successfully reduced as percentage of GDP and how it had freed scarce financial resources available for use elsewhere in the economy.

The current account deficit (CAD) is one of the most commonly used indicators of external stability and sustainability. However, while the CAD is important, it is difficult to define what a sustainable level is. The CAD is integrally linked to savings, investment and capital flows, through the national account identity. For instance, a country with low savings and high investment will have relatively high CAD, which may be good if it is due to a high level of productive investment based on long-term foreign financing. The benchmark of 10 per cent in 2010, 2015 and a target of 5 per cent for 2020 are recommended for the southern African region.

Secondary macro economic convergence targets

To accelerate the pace of integration and foster more regional economic stability the following secondary macro economic convergence targets are recommended for attaining efficient regional integration in southern Africa. The secondary macro economic convergence targets are outlined on Table 7.2 below which comprises of economic growth, external reserves, central bank credit, domestic savings and domestic investment.

Indicators	2010	2015	2020
Economic Growth	8%	7%	8%
External Reserves	4%	6%	6%
Central Bank Credit	10%	7%	5%
Domestic Savings	25%	25%	30%
Domestic Investment	35%	30%	30%

[Source: SADC, 2007 (as adapted)]

➤ ***Recommended monetary policy strategy for southern Africa***

A number of monetary policy strategies are or have been pursued by central banks around the world and the choice of a particular monetary policy strategy depends on a wide array of factors.

The choice of strategy should meet a number of criteria namely:

- ❖ Effectiveness – ability to meet the objective of monetary policy
- ❖ Transparency
- ❖ Accountability
- ❖ Medium term focus
- ❖ Consistency with independence on monetary authority

However, other factors like financial architecture, economic development and structural outlook also need to be considered before making a choice on a particular strategy. The strategy options for pursuing monetary policy are interest

rate targeting, nominal income targeting, exchange rate targeting, targeting monetary aggregates and inflation targeting.

Most countries in southern Africa opted for monetary targeting strategies with the exception of South Africa, Namibia, Swaziland and Botswana. South Africa applied monetary targeting in the 1990s. The choice of nominal interest rate targeting, exchange rate targeting and nominal income targeting would not be ideal for the region because of a number of structural factors like lack of capital, undeveloped financial systems, small open economies, low exports and undeveloped financial infrastructure.

A strategy capable of delivering the monetary policy goal in the region would either be monetary targeting or inflation targeting. A hybrid strategy could fall somewhere along the spectrum of inflation or monetary targeting.

South Africa is the only country pursuing price stability through an inflation targeting strategy and this might be difficult for some regional members to adopt because of numerous structural factors which preclude other member countries to adopt inflation targeting. Secondly, inflation targeting can only be pursued if most member countries are successful in containing inflation to a single digit level. The southern African region's monetary policy strategy should be a combination of monetary targeting and inflation targeting which will accommodate the structural divergences of the member countries.

The primary goal of monetary policy for southern Africa

The ultimate objective of monetary policy in the region is price stability. This is based on the number of arguments and most importantly the economic developments attained in most countries globally though maintaining price stability.

Fundamental arguments in favour of price stability:

- It allows changes in relative prices to be more easily observed and measurable
- It assist investors in making sound investment decisions, for example, because if they know the price stability will be maintained in the future they will not demand an “inflation risk premium” to compensate them for the risks associated with holding assets over the longer term
- Price stability reduces the likelihood of unnecessary hedging activities against inflation
- Price stability also eliminates the real costs entailed when inflation exacerbates the distortion impact of tax and social security systems
- Finally price stability prevents the considerable and arbitrary redistribution of wealth and income that arises in inflationary as well as deflationary environments.

In countries all over the world, developed or developing economies are mostly pursuing price stability as the main objective of monetary policy. The ECB treaty defines their primary objective of monetary policy as price stability and this is also applicable for the UMOA and other regional monetary integration arrangements around the globe.

It might be appropriate for the southern African region to adopt price stability as the primary objective of monetary policy and besides that, taking into account the benefits of this goal most countries in the region are pursuing price stability.

In conclusion, the pursuance and maintenance of price stability makes an enormous contribution to the broader economic goals, such as a higher standard of living, high level of economic activity and better employment rate.

This could be supported by economic evidence in most economies, economic theories and historical facts that demonstrate that lower inflation enhances economic growth in real terms in the long run.

Operational framework for monetary policy

The design of the operational framework for the conduct of monetary policy in southern Africa will be determined mainly by the monetary policy strategy chosen for the region. The framework should provide the regional central bank with the means through which the ultimate objective of monetary policy could be achieved.

The framework would have to outline how the operating target, intermediary target, monetary policy instruments, procedures in which the structural position of the banking system and liquidity could be influenced. This will enhance better pursuance and effective execution of monetary policy.

The monetary policy framework will encompass the monetary policy instruments, operation target, monetary policy strategy, intermediate targets and price stability as the chosen ultimate goal. However, the actual specific numerical targets would have to be agreed on by member countries taking into account the prevailing conditions.

Institutional framework

The institutional framework of monetary policy will be established by the legal provisions outlined and agreed upon by member countries. The institutional

framework would have to have similar structures like the European Monetary System but with different formations or outlook.

The institutional framework of monetary policy would comprise of the Southern African Central Bank and the National Central Banks (NCBS) of all the southern African member states. The regional central bank will be independent from political influence in pursuing the primary objective of price stability and the national central banks will serve as its supporting agents and would be represented on Board of the Southern African Central Bank.

Monetary policy integration in the southern Africa is already at an advanced stage especially within the pegged exchange rate regime of the CMA with South Africa assuming anchor responsibility in the formulation and implementation of monetary policy.

As a way of enhancing a wider participation in the whole region, more member countries, especially in SADC, should align their monetary policy framework with that of South Africa or should adopt an inflation targeting framework gradually as monetary policy framework. They will also facilitate and pave the way for the establishment of a monetary union which implies the establishment of a supranational central bank for the region.

Exchange rate policy convergence

Macro economic convergence more generally also requires policy convergence, in the sense that countries should follow similar, and consistent, macro economic policies. To a certain extent that has been achieved, with most countries in the region pursuing fiscal restraint, debt reduction, and monetary policy focused on low inflation.

However, there still remains wide divergence in monetary and exchange rate policies. Countries with fixed exchange rates, pursuing monetary integration are Lesotho, Namibia and Swaziland whereas South Africa, Tanzania, Malawi, Mozambique, DRC, Mauritius, Madagascar and Zambia follow a managed floating system.

A complete macro economic convergence would require common policies based on the other financial targets in the region, especially on exchange rates, passive monetary policy at a national level by member countries and an active monetary policy by a supra national monetary policy authority for the region.

The exchange rate and balance of payments

The existence of a single external value for the southern African region has some implications and consequences to all the member countries' national fiscal policies because there will also be common external trade and current account balances.

This is as a result of the regional supra national central bank taking responsibility of the monetary policy on behalf of the national economies in pursuing and maintaining price stability and other related objectives such as current account and exchange rate policy stability.

Monetary integration theory observes and recognises that a monetary union's current account and exchange rates are key as long as their levels do not depart from normal accepted limits. Any errors by supra national fiscal policy authority should be corrected by making adjustments to the deficit and surpluses for the region.

➤ *Final remarks*

With the exception of South Africa, Botswana and Mauritius the other SADC member countries still need much more aggressive pursuit of financial development supported by strong macro economic policies. SADC has to commit all the member countries to improve their macro economic policies, which would assist in overcoming some of the major barriers for financial and monetary integration.

The regional institutional framework should be developed with the eventuality of taking responsibility in the coordination of macro economic policies for the region. Realistic targets and timelines should be honoured in order to realise the ultimate goal of a financially integrated southern Africa. Macro economic convergence targets should be stricter for the realisation of low levels of inflation and growth in the southern African region.

This should also be supplemented by wider policy convergence on exchange rate and fiscal policy issues. The political instability in the region has a damaging effect on the credibility of the region, which impacts on the economic development of the region in terms of trade, employment, business cycles, foreign direct investment and capital flows. The current situation in Zimbabwe has a negative effect on regional stability and regional economic growth. The overdependence of the region on South Africa should be reduced in order to commit other member states to develop their own economies for the benefit of the whole SADC region.

One conclusion that can be drawn from the European experience is that full monetary integration is the final result of a long process of previous economic cooperation, harmonisation and coordination in many areas including exchange rate coordination itself: the customs union, the single market for goods, services



and production factors, etc. In particular, nominal, sustainable and durable macro economic convergence is a precondition for monetary integration. Unless southern Africa gets its act together in terms of stabilising its political-economic environment, it would be tainted with an unstable macro environment, even in the years to come. It would also digress even further from the macro economic aggregates attained by its major trading partner, the EU and stand the real risk of experiencing regression in terms of its ability to create wealth for its nation.

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