# Promoting Financial Integration in Africa
# A perspective from the East African Community

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# Outline

1. The East African Community: history and structure
2. Capital markets and cross-border linkages: a stock-take
3. East African Monetary Union
4. The regulatory challenge

# The EAC: an evolving project


- **KENYA, UGANDA, TANZANIA**

  **[1917 – 1977]**

  **[July 2000 - ]**

- **BURUNDI & RWANDA**

  **[July 2009 - ]**

- **SOUTH SUDAN, SOMALIA**

  **[2015 ?? - ]**

# Integration in the EAC: key milestones and recent analysis

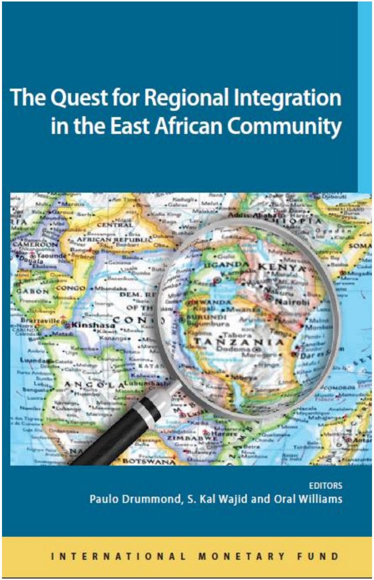
**East African Union: Four Key Steps**

**Customs Union (CET)**
- Protocol , 2000
- Implementation, 2005

**Single Market (labour and capital)**
- Protocol, July 2010
- Implementation, 2015(?)

**Monetary Union**
- Protocol ,December 2013
- Union by 2024 (?)

**Political Federation**
- ...with all deliberate speed...



# Monetary union and financial integration: the promise

- Real integration will drive financial integration....
- Monetary union eliminates exchange risk:
  - allows for deeper and more rapid integration of asset markets (money, debt and equity)
  - firms (and governments) can access deeper pools of savings
  - improved efficiency in allocation and better risk diversification (e.g. Asdrubali *et al* , 1996)
- Does not eliminate credit risk: markets are integrated but assets not necessarily perfect substitutes
- Directly addresses key financial constraints (small market size, high costs of intermediation)
- Forces attention on questions of governance

# The EAC: basic numbers

- A two-part union: "the big three" and the fringe

*Table 1: EAC Economic Structure 2013*

| | Kenya | Uganda | Tanzania | Rwanda | Burundi |
|---|---|---|---|---|---|
| GDP p.c. [PPP] | $2109 | $1334 | $1654 | $1379 | $737 |
| [decadal growth] | 1.6% | 4.3% | 4.9% | 7.1% | 0.2% |
| Structure (% GDP) | | | | | |
| Agriculture | 29.9 | 25.9 | 27.6 | 32.9 | 40.6 |
| Industry | 4.4 | 2.5 | 7.8 | 7.2 | 4.1 |
| Manufacturing | 10.4 | 9.1 | 10.2 | 5.9 | 9.1 |
| Services | 52.7 | 45.5 | 47.4 | 51.1 | 42.5 |
| Trade | 71.8 | 62.0 | 76.9 | 46.8 | 46.4 |

Source: WDI

# Real drivers of integration (1): trade flows

- Architecture for 'ever deeper union' gradually being put in place, but underlying integration still limited.
- Intra-EAC trade increasing but only slightly faster than aggregate trade and GDP

*Table 2: EAC Intra-regional and total trade*

| | | Exports | | | Imports | | |
|---|---|---|---|---|---|---|---|
| | | US$m | %Trade | %GDP | US$m | %Trade | %GDP |
| 2005 | Total | 5,873 | | 12.6% | 11,524 | | 24.7% |
| | Intra-EAC | 1,272 | 22% | 2.7% | 931 | 8.1% | 2.0% |
| 2011 | Total | 12,872 | | 15.2% | 32,919 | | 38.9% |
| | Intra-EAC | 2,706 | 21% | 3.2% | 2,258 | 6.9% | 2.7% |

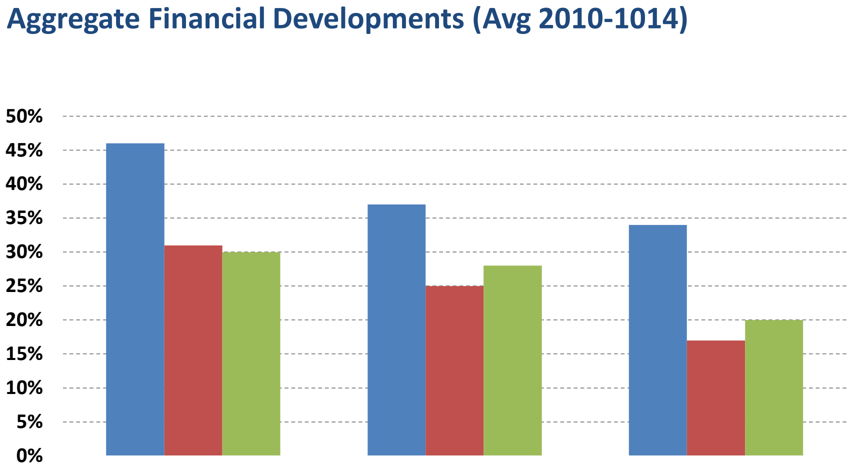
**Source**: EAC Statistics Database

# EAC integration on the real side (2): labour markets

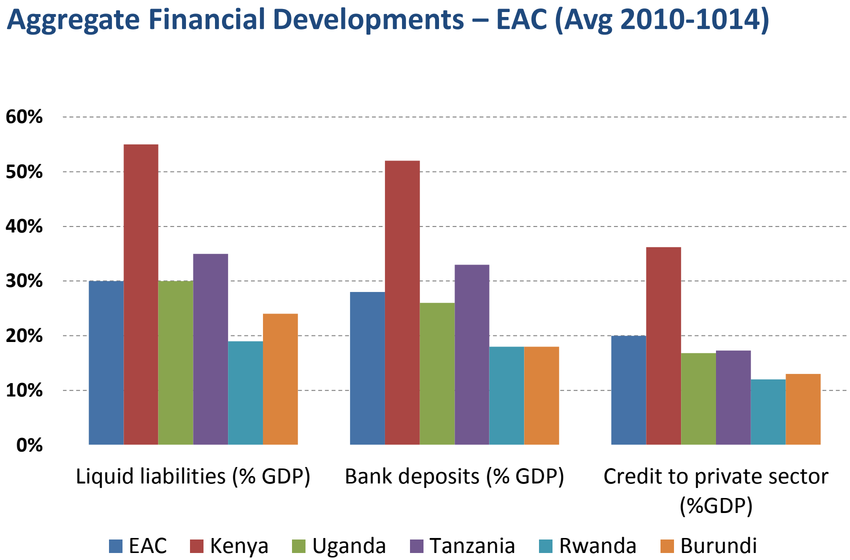
- No comprehensive labour maket data...
- ...but evidence from WB remittance data of growing labour movements between Kenya and Uganda
- Single market provisions still being rolled-out elsewhere (e.g. Tanzania lagging)
- Strong potential for labour movement (skilled and unskilled) – e.g. common language

# EAC integration on the real side (3): capital markets

- EAC financial sectors similar to those elsewhere in SSA – but still small and lagging other developing countries



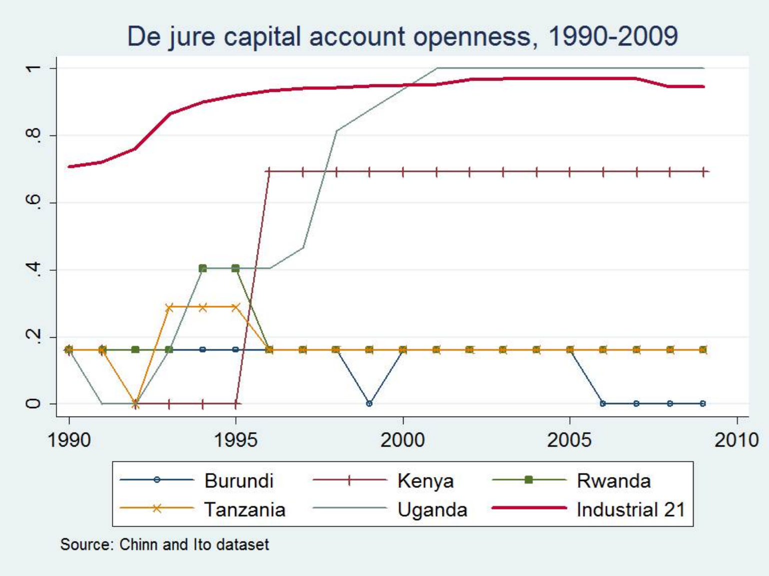
# Kenya dominates on all counts



# Capital account liberalization

- Differential progress on capital account liberalization
- 'Full liberalization' in Uganda (since 1997) and Rwanda (2010)
    - signalling effects?
- 'de facto' full liberalization in Kenya
- 'Partial' Tanzania (although easily circumnavigated via on-shore forex assets)
- Very limited in Burundi

# Capital account openness



# Capital markets: debt

- Debt overwhelmingly short-dated and public-sector dominated
- Ownership highly concentrated

*Table 3: Debt Market Indicators (2011)*

| | Kenya | Uganda | Tanzania | Rwanda | Burundi |
|---|---|---|---|---|---|
| **Bond Markets ( stock as % GDP)** | | | | | |
| T.Bills | 6.5 | 3.6 | 2.2 | 1.7 | 8.5 |
| T.Bonds | 20.8 | 4.5 | 8.1 | 0.5 | 0.0 |
| Corporate | 2.4 | 0.3 | 0.4 | 0.03 | 0.0 |
| **Ownership (share of marketed debt)** | | | | | |
| Banks | 53 | 77 | 41 | 83 | 65 |
| Cent. Bank | 0 | 5 | 0 | 0 | 24 |
| OFIs | 38 | 17 | 25 | 2 | 10 |
| Other | 9 | 1 | 34 | 15 | 1 |

**Source:** Yabara (2014, forthcoming)

# Capital markets: equity

- Close cooperation between capital market authorities
- Some cross-listing (principally banking institutions)

*Table 4: Equity Market Indicators (2011)*

| | Kenya | Uganda | Tanzania | Rwanda | Burundi |
|---|---|---|---|---|---|
| **# of companies** | | | | | |
| | 55 | 13 | 15 | 2 | n.a |
| **Market capitalization (% GDP)** | | | | | |
| | 46% | 12% | 16% | <0.1% | n.a. |
| **Turnover Ratio** | | | | | |
| | 8.8 | 1.0 | 0.7 | <0.2 | n.a. |

**Source:** Yabara (2014, forthcoming)

# Evidence on EAC cross-border integration

- Strength of cross-border abitrage estimated by examining co-movement of asset returns relative to Kenya (Yabara, 2014).
  - How much mean-reversion in (risk and maturity-matched) speads across EAC markets?
  - How much convergence in the variance of return?
- 'Significant but slow' arbitrage in T.Bill and interbank markets for short-dated assets
  - half-life from 7 months in Tanzania to 32 months in Burundi
  - significant reduction in half-life post-2007.
  - Nothing in longer-dated bond markets (problems of comparability) and strong evidence of convergence in variance of returns.

# EAMU and the preparations for deeper financial integration

- Monetary Union Protocol signed in December 2013...but with limited enthusiasm on the part of some members...
  - Eurozone experience has cast a long shadow (for good and ill)
  - Targets set for unification in 2024
  - 'Variable Geometry' provisions (min of 3 members)
  - Very tight convergence and 'stability and growth' provisions (arguably not well targeted)
  - Many details still to be worked out.

# The transition to EAMU

- Extended *convergence phase* with partner states following domestically anchored IT regimes around tight fiscal convergence path
- Short *conversion phase* of tight exchange rate committments immediately prior to union.
- During transition :
  - development of cross-border payments systems (EA Cross-Border Payment System)
  - gradual emergence of 'shadow' supranational institutions as pre-cursor to EA Central Bank
  - development of regulatory structures

# The regulatory challenge

- Regulatory structures still very rudimentary in EAC
- But *big* opportunity to develop appropriate systems for the region
- Financial system still highly bank-centred
- All countries (except Burundi) have introduced risk-based banking supervision and are moving to comply with the Basel Core Principles.
    - but systems are linked through cross-country ownership of banks => vulnerable to crises through contagion.
    - limited regulation of 'shadow banking' / NBFI sector => risk of regulatory arbitrage
- Need for substantial investment in information exchange and common legal frameworks

# Regulation: micro-structural and macro-prudential

- Home-bias regulation and 'regulatory capture' (especially on FDI inflows)
- Common legal frameworks and cooperative supervisory colleges
- Focus on off-balance sheet as systems move from 'originate-to-hold' to 'originate-to-distribute'
- Thus, HLFIs and TBTF concerns not yet present (at regional level at least).

# Anticipating macro-prudential requirements (a move towards a full Banking Union)?

- "You can't make the system safe by making each bank safe"
  - (recall, all Irish banks passed the European stress tests in Summer 2010!).
- Macro prudential seeks to provide incentives to internalize the social costs of financial crises (without over-constraining the system)
- Risk-price endogenous so macro-pru must be counter-cyclical (lean against underpricing of risk in boom times)

# Elements of an EAC macro-prudential framework

- Public money for systemic risks only (SIFIs)
- Ex ante burden sharing
- "wall of money" committments from EACB
- single-supervisory mechanisms to see off regulatory capture

# Is the 'best the enemy of the good'

- Basel III not binding on LICs but are LICs choosing to voluntarily adopt Basel III?
  - to signal credibility / secure credit ratings
- Risks of premature adoption:
  - regulatory capacity underdeveloped
  - drives out foreign firms (set back to develop long-term and SME lending?)
  - high cost regulation creates incentives for 'regulatory arbitrage'

# Conclusions and extensions

- NOT YET COMPLETE

# References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