Development Policy Research Unit
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Is Macroeconomic Policy Convergence necessary for a Sustainable SADC Free Trade Area?

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Industrial Strategy Project
REGIONAL INTEGRATION, ECONOMIC COOPERATION IN SOUTHERN AFRICA
D P R U

Foreword

The Development Policy Research Unit (DPRU), located within the University of Cape Town's School of Economics, was formed in 1990 to undertake economic policy-oriented research.

The aim of the unit's work is the achievement of more effective public policy for industrial development in South and Southern Africa.

The DPRU's mission is to undertake internationally recognised policy research that contributes to the quality and effectiveness of such policy.

The unit is involved in research activities in the following areas:

- Trade and Industrial policy
- Technology policy
- Labour market policy
- Industrial organisation

These policy briefs are intended to catalyse policy debate. They express the views of their respective authors and not necessarily those of the DPRU.

They present the major research findings of the **Industrial Strategy Project** (ISP). The aim of the ISP is to promote industrial development in the *Southern African Development Community* (SADC) through regional economic integration and cooperation. It is a three-year project that commenced in August 1998 and is funded by the International Development Research Centre (IDRC). Ultimately, this project will identify the policies and programmes that support regional interactions that contribute to the industrialisation of SADC national economies.

This policy brief is a shortened version of the following DPRU Working Paper:

Macroeconomic policy and trade integration in Southern Africa
Charles Harvey

Introduction

The aim of this paper is to determine if macroeconomic policy convergence among member countries of the Southern African Development Community[1] (SADC) is required for establishing and sustaining a free trade area (FTA). The paper also investigates whether a restraining mechanism is required in order to compel member countries to have compatible macroeconomic policies.

Benefits and challenges – free trade areas

The history of regional free trade areas in Sub-Saharan Africa is that most of them have either failed, or have stayed in existence on paper with very little actual progress towards their objectives. In light of the limited success of regional free trade areas, why do African countries keep trying to establish regional free trade areas? The table on the following page highlights some of the benefits and challenges facing free trade areas.

Might SADC succeed where other regional trade agreements have not?

Are there any reasons for thinking that a SADC free trade area might succeed where other such initiatives have failed?

The success of SADC depends on:

- *South Africa's commitment to and active involvement in the implementation of the SADC trade protocol*. South Africa's GDP is about 45% of the Sub-Saharan African total, and 74% of SADC's GDP. Clearly, the free trade area would be negligible without South Africa.

- *The joining of non-SACU members of SADC* if it is to be more than a reworking of SACU. Why would non-SACU members want to join SADC? It can be argued that the non-SACU members of SADC cannot afford to be excluded from the South African market, and will therefore choose to join a SADC free trade area for the following reasons:
    - To avoid incurring the cost imposed by the common external tariff of SACU
    - To reduce bilateral trade deficits with South Africa
    - To develop non-traditional exports

- *Prospects for economic convergence*. Some non-SACU manufacturing sectors in SADC already have the potential to access and compete with the South African market, for example Mauritius and Zimbabwe.

- *New investment to develop non-traditional exports*

[1] In this paper, discussion of SADC does not include the Democratic Republic of the Congo or the Seychelles

Table 1: Free Trade Areas: Benefits and Challenges	
Benefits	**Challenges**
Economies of scale African countries can gain access to somewhat larger markets than available domestically, by creating regional trading associations.Larger markets are more efficient than smaller markets.	Underdeveloped transport and communication networks. Also, much of GDP in Africa is still generated by subsistence activity, which generates no monetary demand; and an above average proportion of monetary demand is for basic consumer goods such as food and clothing, in which economies of scale are not significant.
Increased competition Increased competition increases efficiency levels, giving countries a better chance in the long run of being internationally competitive. It has been argued that it is more realistic for producers in the BLNS countries (Botswana, Lesotho, Namibia and Swaziland) to test their competitive ability in the South African market initially, whereas they would not be able to graduate to competition in global markets without this stepping stone being available.	Underdeveloped industrial sectors
Development of export competitiveness Opportunity to develop non-traditional exports, mainly manufactured goods	Low levels of investment (investment in non-traditional industrial sectors is crucial for countries to develop export sectors that are competitive)
Bargaining power Strengthening of political and economic bargaining power - greater voice in global economic negotiations	Agreement on a common position
Theory of economic convergence This theory states that when countries are in a free trading relationship, the lower the starting point in terms of gross national product (GNP) per head, the faster the rate of growth. There is evidence that the small members of SACU have grown faster than their neighbours.	Creation of a SADC free trade area may not necessarily have the same effect on economic growth on all new members, as it had on the smaller members of SACU. Existing manufacturing sectors could be driven out of business if they are unable to compete with imports from South Africa. Acceptance of the free trade area may disappear and lead to withdrawal before long term benefits can accrue.

- *The ability to reduce pressures towards disintegration.* The most common reason by far for the failure of established free trade areas is a belief, correct or not, that one country (usually the more economically advanced) is getting a larger share of the benefits than accrues to other members.

  Logically, the less advantaged members of a free trade area should choose to maintain it if they are better off than they would be without it, but in practice they do not if one member is perceived to gain more than the others. If that was the case for Kenya in the

East African Community, the expectation of it happening in a SADC free trade area must be several times stronger, because the economy of South Africa is not only totally dominant in size (roughly 75% of total SADC GDP), but is even more dominant in manufacturing capacity (nearly 85% of manufacturing capacity in SADC) and level of technical development. To make matters worse, South Africa already has large bilateral trade surpluses with other SADC members.

- Another possible reason for arguing that the dominance of South Africa in the Southern African economy might make a SADC free trade area an exception, to the record of failure of regional trading associations, is that *the one successful example is SACU*, which has existed for nearly 90 years. South Africa is of course even more dominant in SACU than it would be in a SADC free trade area.

Therefore, examining the reasons why SACU has survived might throw some light on the prospects for SADC. In particular, in the context of this paper, the relevance or not of macroeconomic policy convergence to the survival of SACU will be examined.

Success of SACU; prospects for SADC

Evidence suggests that the four smaller members of SACU have gained from membership, as suggested by the convergence of income per head.

Evidence of compatible macroeconomic policies in SACU

SACU has displayed evidence of macroeconomic policy convergence throughout it's history:

- Common currency
- Similar inflation rates
- Narrow fluctuating real bilateral exchange rates

Undoubtedly, the benefits within SACU were not hindered by the convergence of macroeconomic policy. What cannot be said is whether similar inflation rates and other evidence of macroeconomic policy convergence were *necessary* for BLNS to derive benefits from SACU.

The experience of SACU, therefore, does not help in deciding whether macroeconomic policy convergence is necessary for the success of a free trade area.

Will establishing a SADC free trade area require macroeconomic policy convergence?

There are strong arguments that a common currency area requires macroeconomic policy convergence. These arguments were accepted, for example, by the European Union in introducing the Euro. It does not seem to be necessary, however, for similar conditions to apply to the establishment of a free trade area. Again, the experience of the European Union supports this proposition, in that it was created, and proved sustainable, without macroeconomic policy convergence, and indeed with some quite weak currencies operating alongside very strong ones.

It may therefore be something of a coincidence that four out of the five countries in SACU are members of a common currency area; it did not do any harm, but it is difficult to argue that it was a necessary condition for the sustainability of SACU. On the basis of the analysis to this point, a SADC free trade area may well be *established*.

Will a SADC free trade area *survive* without macroeconomic policy convergence?

However, a SADC free trade area will not have much chance of surviving, because a significant number of the non-SACU members of SADC do not have the capacity at present to increase their exports to South Africa.

They would need, therefore, to attract the investment in new capacity that would make such export growth possible, and this *would* require convergent macroeconomic policy together with other necessary conditions.

It will be sufficient for the non-SACU members of SADC to attain inflation rates equal to or less than that of South Africa (and the rest of SACU). The actual inflation rate is probably less important than maintaining a low and stable rate over an extended period, or in some other way creating the expectation *in the minds of investors* that it will be stable.

What is the current degree of macroeconomic convergence in SADC?

Improved prospects for the survival of a SADC free trade area.........

A number of the non-SACU members have embarked on structural adjustment programmes. This has involved liberalisation of the trade account, and movement towards more realistic real exchange rates. However, not all non-SACU exchange rates are now market-determined, and there has been greatly varying progress in the reduction of rates of inflation, with some reversals.

.........but evidence of macroeconomic imbalance:

Inflation

Inflation has not followed a constant trend in SADC countries, for example, Mozambique's inflation was between 40% and 50% between 1980 and 1986, but was reduced to 5.5% in 1997, and prices actually fell (by 1.3%) in 1998. This achievement does not necessarily give Mozambique's macroeconomic policy considerable credibility, because there is always the possibility of policy being relaxed and inflation rising to previous levels.

From an investor's point of view, these unstable inflation rates can be perceived as evidence of macroeconomic imbalance.

Inflation in SADC countries, 1980-98

	1980-89	1990-95	1996	1997	1998
South Africa	14.6	11.8	7.4	8.5	7.0
Other SACU					
Botswana	10.8	12.5	9.8	8.6	6.7
Lesotho	13.8	12.9	9.3	8.5	7.8
Namibia	13.0	11.8	8.0	8.8	6.2
Swaziland	14.2	12.7	12.5	9.7	7.5
Non-SACU SADC					
Angola	-	870.3	905.3	111.2	91.1
Malawi	16.8	30.8	37.6	9.1	29.7
Mauritius	11.2	8.2	6.6	6.8	4.7
Mozambique	45.1	47.5	45.0	5.5	- 1.3
Tanzania	30.1	28.9	19.7	16.1	12.8
Zambia	38.4	117.7	46.3	24.8	31.6
Zimbabwe	12.8	25.9	21.4	18.7	31.8

Notes:
(1) Figures for 1980-89 and 1990-5 from CREFSA, 1998, which used IFS, World Bank, EIU and central bank annual reports. (2) Figures for later years from IFS, except those in square brackets which are from other sources, mostly EIU Country Reports, and may not therefore be comparable.

Budget deficits

Although SADC countries have at times suffered from imported inflation, the most common cause has been budget deficits financed by central banks.

There is considerable exchange rate volatility – bilateral real exchange rates against the rand of the non-SACU members of SADC have displayed large short term fluctuations. The tendency of exchange rates to eventually return to some sort of equilibrium, if it still exists, is insufficient to establish favourable investment conditions [Harvey & Hudson, 1993].

Grants in the form of foreign exchange make it possible to increase supply by paying for more imports. However, heavy dependence on grants to reduce budget deficits may not be sustainable.

Aid and aid conditionality

The credibility of macroeconomic stability in those SADC members heavily dependent on aid, depends on how likely it is that current levels of donor support will be sustained. That depends, in turn, on recipient countries adhering strictly to both economic and political conditions.

The conditions may have been introduced for good reasons, but from the point of view of creating a favourable investment climate it increases the ways in which IMF/World Bank agreements can break down. In turn, this has made investment more risky, and frequently so risky that little or no foreign investment has taken place. Loan default - Both Zambia and Zimbabwe have had IMF and World Bank support withdrawn for failing to meet this short term conditionality (that is the repayment of loans frequent intervals).

External indebtedness

The highly indebted economies will find it difficult to take advantage of a new trading arrangement due to the overhang of external debt.

Present value of external debt as a percentage of GDP, 1996

SACU		*Non-SACU SADC*	
South Africa	18	Angola	310
Other SACU		Malawi	76
Botswana	[14]	Mauritius	45
Lesotho	33	Mozambique	411
Namibia	[11]	Tanzania	114
Swaziland	[19]	Zambia	161
		Zimbabwe	67

Sources: World Bank World Development Report 1998/99: 230-1; figures in square brackets are external debt as a percentage of GNP from World Bank *Global Development Finance 1999*.

Relevance of macroeconomic convergence to sustaining a SADC FTA

Despite, the unfavourable investment conditions in many of the SADC economies, a ***SADC free trade area may succeed because of the opportunity for growth and recovery.***

The currently very rundown economies in SADC need every possible opportunity to help them to recover, and grow past the levels (of income per head, delivery of public services, and quality of infrastructure) that they reached 10 or 20 years ago. One of those opportunities would be the opening up of the South African market because:

- South Africa can serve as a potential export market and a potential source of manufacturing investment
- South African firms are far more likely to invest in such countries as Malawi and Zambia than non-regional investors (Some South African investment has taken place in recent years, notably in Malawi, Mozambique and Zambia, but relatively little of this investment is directed at exporting to South Africa.

This potential contribution will be of little use if the SADC free trade area is abandoned quickly by those countries which perceive either that they have gained little, or that most of the gains have gone to South Africa.

The problem then is to find some way of making a SADC free trade area reasonably attractive to all its members *in the short term*, in order to give longer term benefits a chance of being achieved.

A way must be found quickly to generate new investment capable of exporting to South Africa (and to a much lesser extent to the rest of SADC). It cannot wait for individual countries to sustain sound policies for long enough to establish their individual credibility. Those individuals SADC countries with a past history of instability would need many years of macroeconomic stability to achieve the credibility necessary for investment, acting on their own.

What can governments do?

Governments should not

- invest themselves directly in export-oriented manufacturing because African economic history makes it unlikely that government investments in manufacturing will be anything but a disaster.

- direct investment to areas where it would not willingly go, whether within a single country, as for example "border" firms in South Africa, or within a regional trading area, as history shows that it does not work. The firms themselves struggle to make a profit without any subsidy, and multiplier effects do not emerge.

Some action is possible

- investment in infrastructure

- The South African government has also raised the limits under exchange control rules of outward investment by South African companies in SADC. Nevertheless, it is difficult for the South African government, donors or domestic governments to induce private sector investment in the SADC periphery if other conditions are fundamentally unfavourable, or if favourable conditions are seen to be unstable and therefore lack credibility.

The most effective government action, whether by individual governments or by a regional institution, would be to speed up the process by which sound macroeconomic policy (supposing that it has been established) acquires medium and long term credibility.

Conclusion

SADC governments must create a regional agency of restraint, by voluntary negotiated agreement, with credible sanctions against breaking its rules. The most obvious sanction would be loss of membership. Of itself, this might not be very threatening. However, if it meant exclusion from the South African market and South African investment, then it might be effective.

In other words, SADC as a free trade area would have to develop a mechanism for constraining macroeconomic extravagance, not necessarily in order to *establish* a free trade area, but in order for it to have a chance of being *sustained*.

It would be absolutely essential that a SADC agency of restraint, and its sanctions, be negotiated and accepted through conviction by the SADC member governments. Forcing governments into such an arrangement, whether using the muscle of the IMF or the regional dominance of South Africa, would not work

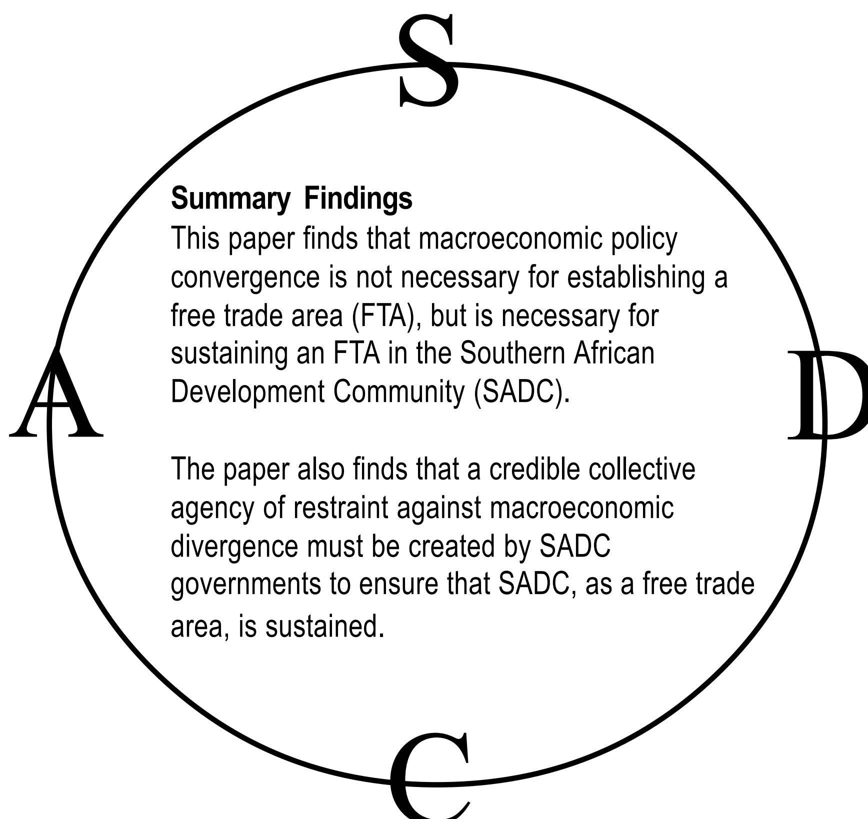
This is essential for the non-SACU members to have a chance of attracting the investment that would enable them to take advantage of intra-SADC trade. Otherwise, a SADC free trade area will swiftly collapse.

Macroeconomic policy convergence may not be strictly necessary for countries within a regional trading arrangement to trade with each other using their existing economic capacity. The argument of this paper is that macro convergence around low rates inflation, with stable real exchange rates, *is necessary* where member countries do not have the economic capacity to take immediate advantage of new trading opportunities.

The potential benefits of a regional free trade area can only be secured if a *credible collective agency of restraint* is established by the SADC governments themselves.

Other mechanisms might be able to contribute. For example, some form of partial investment guarantee to reduce the risks of South African investment in the SADC periphery could be positive. Such a scheme might attract donor support.

The Development Policy Research Unit (DPRU) aims to undertake high quality policy-relevant research; to maintain and develop effective networks with government, civil society and the research community in Southern Africa; to engage in training and teaching activities and to participate directly in the process of formulating, implementing and evaluating policy.



Summary Findings

This paper finds that macroeconomic policy convergence is not necessary for establishing a free trade area (FTA), but is necessary for sustaining an FTA in the Southern African Development Community (SADC).

The paper also finds that a credible collective agency of restraint against macroeconomic divergence must be created by SADC governments to ensure that SADC, as a free trade area, is sustained.

For any information on the DPRU and its programmes, see our regularly updated web site at:

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