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

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**

<table>
<thead>
<tr>
<th>Year</th>
<th>Total</th>
<th>Exports</th>
<th>Imports</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>US$m</td>
<td>%Trade</td>
<td>%GDP</td>
</tr>
<tr>
<td>2005</td>
<td>Total</td>
<td>5,873</td>
<td>12.6%</td>
</tr>
<tr>
<td></td>
<td>Intra-EAC</td>
<td>1,272</td>
<td>22%</td>
</tr>
<tr>
<td>2011</td>
<td>Total</td>
<td>12,872</td>
<td>15.2%</td>
</tr>
<tr>
<td></td>
<td>Intra-EAC</td>
<td>2,706</td>
<td>21%</td>
</tr>
</tbody>
</table>

**Source:** EAC Statistics Database
EAC integration on the real side (2): labour markets

- No comprehensive labour market 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

Aggregate Financial Developments (Avg 2010-1014)
Kenya dominates on all counts

Aggregate Financial Developments – EAC (Avg 2010-2014)
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

De jure capital account openness, 1990-2009

Source: Chinn and Ito dataset
Capital markets: debt

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

Table 3: Debt Market Indicators (2011)

<table>
<thead>
<tr>
<th></th>
<th>Kenya</th>
<th>Uganda</th>
<th>Tanzania</th>
<th>Rwanda</th>
<th>Burundi</th>
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</thead>
<tbody>
<tr>
<td><strong>Bond Markets (stock as % GDP)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>T.Bills</td>
<td>6.5</td>
<td>3.6</td>
<td>2.2</td>
<td>1.7</td>
<td>8.5</td>
</tr>
<tr>
<td>T.Bonds</td>
<td>20.8</td>
<td>4.5</td>
<td>8.1</td>
<td>0.5</td>
<td>0.0</td>
</tr>
<tr>
<td>Corporate</td>
<td>2.4</td>
<td>0.3</td>
<td>0.4</td>
<td>0.03</td>
<td>0.0</td>
</tr>
</tbody>
</table>

**Ownership (share of marketed debt)**

<table>
<thead>
<tr>
<th></th>
<th>Kenya</th>
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<th>Rwanda</th>
<th>Burundi</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks</td>
<td>53</td>
<td>77</td>
<td>41</td>
<td>83</td>
<td>65</td>
</tr>
<tr>
<td>Cent. Bank</td>
<td>0</td>
<td>5</td>
<td>0</td>
<td>0</td>
<td>24</td>
</tr>
<tr>
<td>OFIs</td>
<td>38</td>
<td>17</td>
<td>25</td>
<td>2</td>
<td>10</td>
</tr>
<tr>
<td>Other</td>
<td>9</td>
<td>1</td>
<td>34</td>
<td>15</td>
<td>1</td>
</tr>
</tbody>
</table>

**Source:** Yabara (2014, forthcoming)
Capital markets: equity

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

<table>
<thead>
<tr>
<th># of companies</th>
<th>Kenya</th>
<th>Uganda</th>
<th>Tanzania</th>
<th>Rwanda</th>
<th>Burundi</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>55</td>
<td>13</td>
<td>15</td>
<td>2</td>
<td>n.a</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Market capitalization (% GDP)</th>
<th>Kenya</th>
<th>Uganda</th>
<th>Tanzania</th>
<th>Rwanda</th>
<th>Burundi</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>46%</td>
<td>12%</td>
<td>16%</td>
<td>&lt;0.1%</td>
<td>n.a</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Turnover Ratio</th>
<th>Kenya</th>
<th>Uganda</th>
<th>Tanzania</th>
<th>Rwanda</th>
<th>Burundi</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>8.8</td>
<td>1.0</td>
<td>0.7</td>
<td>&lt;0.2</td>
<td>n.a</td>
</tr>
</tbody>
</table>

**Source:** Yabara (2014, forthcoming)
Evidence on EAC cross-border integration

- Strength of cross-border arbitrage estimated by examining co-movement of asset returns relative to Kenya (Yabara, 2014).
  - How much mean-reversion in (risk and maturity-matched) spreads 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 commitments 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” commitments 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

- Drummond, P., S.K.Wajid and O.Williams (eds) The Quest for Regional Integration in East Africa (IMF, 2014)