# Making and Breaking Monetary Policy Rules: the Experience of African Countries

**Dominique Guillaume* and David Stasavage****

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**Abstract**: This paper analyses the experience with rule-based monetary policy in African countries which have participated in monetary unions (CFA Franc Zone, Eastern African Currency Board and Rand Monetary Area). We show that African countries have generally lacked the domestic political institutions which would allow individual governments to tie their hands by establishing such rules. Monetary unions have proved to be an alternative possibility for credible commitment to sound macroeconomic policies, but only in cases where exit from a union is made costly by the provision of side-payments (or sanctions) in other areas of regional co-operation, and only when governance structures have been designed so as to maximise chances for the enforcement of monetary rules. We conclude by making suggestions about the design of African monetary unions.

*Centre for the Study of African Economies; Oxford University; ** St. Antony's College, Oxford University. We are grateful to Chris Adam, A. Basu, M. Katz, L. Kuijs and Richard Mash for useful comments. D. Guillaume acknowledges the financial support of a EU TMR fellowship and D. Stasavage of a DFID grant. Part of this research was completed while D. Guillaume was a visiting scholar at the Research Department of the IMF.

Email: Dominique.Guillaume@economics.ox.ac.uk and David.Stasavage@economics.ox.ac.uk.

## 1. Introduction

In recent years, a consensus has emerged among economists that the main objective of a sound monetary policy should be to ensure price stability. For developed economies, the key element in a credible commitment to price stability is delegation of monetary policy to an independent central bank with a clearly specified inflation target, associated with sanctions when the target is not met (Persson and Tabellini, 1993). For developing countries, in contrast, the debate continues on what commitment mechanisms are both appropriate and feasible. While many IMF stabilisation programmes in Sub-Saharan Africa have recommended setting up an independent central bank, combined with a floating exchange rate regime (Schadler, 1995), others have argued, based on a number of failures with this institutional mix, that for many developing countries the only institutional framework which would ensure a credible commitment to pursue sound monetary and macro-economic policies may be to establish policy rules within the framework of a monetary union, possibly with the participation of advanced industrial countries (Collier, 1991; Cobham and Robson, 1994).

A credible commitment to pursue sound macro-economic policies is not only central to the success of structural adjustment reforms. It is also a main component of the risk associated with investment in Africa (King and Levine, 1993), which in turn affects the potential for growth (Sachs and Warner, 1997). A further argument in favour of regional monetary agreements is that the perceived risk associated with investing in Africa not only depends on the credibility of the policies pursued in the country where the investment is planned, but also on the stability of neighbouring countries and the credibility of their policies (Easterly and Levine, 1998).

Establishing rule-based monetary policy within the framework of a monetary union is not a new idea in Africa. At independence, many African countries choose to preserve monetary institutions of this sort which were inherited from the colonial era. The subsequent evolution of these institutions has shown considerable variation in terms of both the sustainability of monetary integration and the economic performance of member states. This provides us with a natural experiment for asking when and why rules are more effective. Drawing upon evidence from three African monetary unions, this paper evaluates several hypotheses concerning the conditions under which monetary rules lead to improved policy outcomes. The monetary rules we consider include the maintenance of exchange rate pegs with full convertibility between the unions' members, combined with strict limits on central bank lending to governments, and statutory minimum levels of foreign reserves.

Asking what conditions determine whether policy rules are effective first requires a method for assessing whether the presence of a rule led to a policy outcome which would have not have occurred in the absence of the rule. One way to deal with this issue is to gauge whether investors perceive a rule as being credible. For an exchange rate peg this would be the case to the extent that they demand similar risk premia on their local currency bonds as compared to their bonds denominated in foreign currency, adjusting for a potential parallel exchange rate premium. Unfortunately, the absence of well developed markets for government debt in the countries considered here precludes using this method. Moreover, while comparing yields on different assets can help indicate whether investors think a government will stick to an announced policy, it cannot shed light on the question whether a government would have stuck to the policy even

in the absence of a rule. To address this question, we need to examine whether policy rules survive in periods where we would otherwise expect policy to be reversed.

The basic argument presented in this paper is that in order for rules to be effective in tying governments hands, there must be obstacles to their reversal. Following Keefer and Stasavage (1998), we suggest that the ability of an individual government to credibly commit to a rule depends on the existence of checks and balances within a country's political institutions, so that no one individual or party has unrestricted power. Such checks and balances raise the cost of reversing a rule. In their absence, participation in a monetary union can be an alternative option for credible commitment, but only in cases where there are side-payments (or sanctions) in other areas of co-operation that raise the cost of exit. Governance structures of a monetary union must also be devised so as to maximise the likelihood of monetary rules being respected.

The remainder of the paper is as follows. Section 2 reviews several credibility problems inherent to monetary policy-making and the extent to which rules can serve as a means for governments to make a credible commitment to sound policies. Section 3 gives a brief overview of the different monetary regimes prevalent in Africa during the post-colonial period and their relative performance. Sections 4 to 6 evaluate our hypotheses based on evidence from the three monetary unions, the East-African Currency Board, the Franc Zone in Western and Central Africa, and the Common Monetary Area in Southern Africa.. Finally, section 7 draws a number of lessons for current initiatives based on past experience.

## 2. Rules and credibility

### *2.1 Factors that undermine credibility*

To assess when rule-based policies are instrumental in raising a government's credibility, it is useful to first review the circumstances under which a government may be tempted to deviate from sound policies.

The first credibility problem is time-inconsistency, highlighted in the seminal articles by Kydland and Prescott (1977) and Barro and Gordon (1983) which showed that governments which announce a monetary policy objective in one period may have an incentive to deviate from that policy in subsequent periods once private sector actors have formed their expectations and entered into wage and other contracts. For monetary policy, this problem exists even when one assumes a government that maximises social welfare. When one considers that governments in practice may be interested in retaining power even at the expense of sub-optimal economic policies, the possibility for time-consistency problems expands accordingly. For example, there may be incentives for governments to engage in surprise monetary expansions before elections.

A second credibility problem is that even if a current government is pursuing prudent macroeconomic policies, investors may fear that future governments will not have the same preferences. Collier and Gunning (1996) refer to this as the "rotten descendant problem". Persson and Svensson (1989) and Tabellini and Alesina (1990) show how a sitting government may accumulate less of a surplus if it believes that its successor is likely to have different preferences over the optimal level of public spending or over the type of public goods provided. Changes in

government can bring to the fore interest groups whose demands for subsidies lead to macroeconomic indiscipline. A common example of a powerful lobby in contemporary Africa are demobilised soldiers whose requests for transfers may conflict with a government's budgetary objective but whose interests often cannot be easily ignored. A lobby group may also have a positive effect on macro-economic policies as in cases where developing country agricultural exporters have political influence (Bates, 1981).

Either of the above two credibility problems may be exacerbated in countries which are prone to exogenous shocks. In an environment where such shocks are prevalent, it is likely to be more difficult for actors in the private sector to judge whether a government is adopting appropriate policies.[1] Exogenous shocks of both domestic origin (drought) and international origin (such as changes in world prices) have been shown to be particularly important in Africa (Eldabawi and Ndulu, 1996).

*Mechanisms that enhance credibility*

Apart from acquiring a reputation, which is a lengthy process, the common suggestion for governments facing credibility problems is to tie their hands, either by creating a policy rule or by delegating to an independent agent. Existing literature generally assumes that once in place, rules or delegation are immutable. It fails to ask when and why the obstacles to reneging on rules or delegation are likely to prove more formidable. While the focus of this paper is on monetary policy rules, we consider both rules and delegation in this section in order to also ask when delegation to an independent national central bank could be an alternative to monetary union as a source of credible commitment for African countries.

<u>Domestic obstacles to reneging</u>

One way for governments to enhance the credibility of monetary policy is to delegate to an independent central bank which places a greater weight than society at large on the goal of price stability, as opposed to stabilisation of output (Rogoff, 1985). In Rogoff's model however, the implicit assumption is that governments cannot easily reverse decisions to delegate. Walsh (1995) proposes a different solution of giving an independent central bank a contract whereby it pays a linear penalty for inflation above a certain target. The result would be to address the time-consistency problem without the increased variability in output which the Rogoff solution entails. This model suffers from the same weakness, however, in that it assumes that once written, a contract is respected by all parties concerned. Similarly, exchange rate pegs have often been proposed as a rule based credibility enhancing device with the unquestioned assumption that they cannot be easily reversed. Formal independence for central banks, inflation contracts for central bankers, or exchange rate rules are likely to remain a dead letter if they can be reneged on with little cost. Reinforcing this point, Cukierman's (1992) study shows that even though African countries score better than average on an index of legal central bank independence, it seems to have little bearing on their inflation performance.

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[1] This is above and beyond the increased technical difficulties in a shock-prone environment such as judging between temporary and permanent shocks. Although the effects of negative shocks are usually stressed, it is also important to recall that a positive shock may have an adverse effect on macro-economic policies if, in the case of a windfall, its temporary nature is not recognised (Collier and Gunning, 1997).

More recent work has emphasised that delegating or adopting a rule will not pose a constraint on a government's actions unless the decision to do so is more difficult to reverse than would be a reversal of the underlying macroeconomic policies which respect of the rule implies. Jensen (1998) revisits Rogoff's (1985) model for delegation to an independent central bank and includes a parameter for costs involved in firing a central bank governor. He does not ask what real-world conditions are more likely to be associated with this parameter, however. Moser (1996) and Lohmann (1998) go further by developing models where the degree of central bank independence depends not only on the formal granting of independence but also on the extent to which a countries political institutions make independence costly to revoke.[2] Keefer and Stasavage (1998) expand upon Moser and Lohmann's work to develop a more general theory of how the credibility of rules and of delegation depends upon the existence of checks and balances in a country's political institutions. Checks and balances are defined as situations where multiple decision makers are able to veto any decision to renege on a policy rule or on a decision to delegate. They distinguish between two general cases.

The first case is when a greater number of decision makers must be in agreement to change a rule than would be required to change underlying policies. For instance, an under-emphasised aspect of currency boards is that they generally require approval of a legislature rather than just the executive, as would most exchange rate policy choices. In some cases currency boards may require not just legislative approval, but a parliamentary super-majority. In Argentina, for example, the rate of parity between the peso and the US dollar is written into the country's constitution.

A second case is where the decision to renege on a policy rule *does not* require a greater number of decision makers to approve than is necessary for underlying policy decisions. Under these conditions, if a current government establishes a rule or delegates, then this decision cannot be reversed under future governments as long there are multiple decision makers and at least one decision maker from the previous government remains in a position to veto such a move.[3] This scenario is possible in political systems where there are regular changes in government, but changes in government do not always result in a complete replacement of decision makers. In political systems where regime changes are frequent, and they result in complete replacement of decision makers (as is more likely to be the case in autocracies), credible commitment will not be possible. Finally, in political systems where there is a very low frequency of regime change, governments will have much less incentive to delegate or to create a rule in the first place.

A situation where multiple decision makers can veto a policy proposal may apply in countries where there is a constitutional separation of powers between the executive and different houses of the legislature. It may also apply in countries with coalition governments of several different parties. It can even apply under conditions where the rule of law and constitutional prerogatives are not respected, as long as no one individual, faction, or party has all the levers of power under its control. A good example here is Thailand where independence of the Budget Bureau has been

[2] While not directly addressing the issue of delegation, Persson, Roland, and Tabellini (1997) is another contribution which emphasises the importance of checks and balances for economic policy outcomes.

[3] More specifically, Keefer and Stasavage (1998) suggest that under these conditions rules or delegation can help solve the rotten descendant problem but not the classic time-inconsistency problem in monetary policy.

preserved since the 1950s in a context where basic constitutional rules have often been flouted. This may be attributable to the fact that Thai governments have tended to be coalition governments, but some parties have been represented in several successive governments.

These hypotheses represent a modification of received notions in political economy where divided or coalition government is predicted to led to poor macro-economic policy performance (Alesina and Drazen (1991); Grilli, Masciandro, and Tabellini (1991)).

International obstacles to reneging

For countries in which the domestic political institutions required for credible commitment are absent, joining an international agreement can act as a substitute by creating a situation similar to that described above, where an increased number of decision makers must agree to any decision to renege on a rule.[4] In order for international agreements to be effective, however, member states must also be willing to oppose any attempt by their neighbours to break the rules of the arrangement.

Moreover, for an international agreement to be effective, exit must be costly. That is, for a state wishing to pursue a different monetary and exchange rate policy than its partners, there must be significant and immediate cost involved in setting up a separate currency. These costs can include economic costs such as the administrative costs involved in setting-up a separate currency, the difficulty of running an independent monetary policy with a low level of foreign reserves, or increased debt servicing obligations.

A more important deterrent to exit may be the fear of sanctions from other member states. Countries which enter into international monetary agreements may have agreements with other member states in the domains of trade, finance, aid, or security. Continuation of these other forms of co-operation may be implicitly or explicitly linked to continued participation in the monetary agreement. For example, the French government's decision to abandon Keynesian inflationary policies in 1983 in order to remain in the EMS was undoubtedly influenced by the idea that an EMS departure would undermine other areas of EU co-operation.

The presence of co-operation in several different issue areas is also likely to increase the possibility for provision of side payments (or the threat of sanctions) so as to alter incentives for a state considering breaking a rule. Conversely, governments in a position to sanction their neighbour's actions in one area of co-operation may choose not to do so if it would cause great damage to other areas of co-operation. It has been observed that for the advanced industrial countries involved in international agreements like NAFTA and the Europe agreements (between the EU and Eastern European states), non-economic objectives, such as limiting immigration and preserving political stability, have been as important as the economic goal of promoting respect for certain economic policy rules in neighbouring states in order to generate trade and investment opportunities. For the developed country partners in such arrangements, if a developing country partner is hit with a severe economic shock, attempting to meet the two objectives in the short-

[4] A further step is to base an international agreement on delegation to an international agency whose decision makers will themselves be independent from control by any government, as will be the case in the European Central Bank. This is not applicable to the monetary unions considered in this paper, however, because ministerial representatives have dominated the governing boards of the monetary authorities.

term may be seen as undesirable if it is feared that a strict enforcement of the economic rules of an arrangement risks political collapse in the developing country followed by significant emigration for example.

To sum up, there is reason to believe that international constraints on reversal of commitments will be more effective when countries co-operate on multiple issues. At the same time, co-operation on multiple issues is no guarantee that it will be costly to exit or to break the rules of an arrangement. Because it would seem difficult at this stage to make firm predictions in this area, for the international arrangements considered in this paper a more limited effort will be made to identify *ex post* whether there was a country willing to provide the side-payments (or sanctions) necessary to make either exit or rule-breaking costly. We will also attempt to identify *ex ante* whether a union's governance structures should promote respect of monetary rules.

## 3. Monetary institutions in Africa

### *3.1 African monetary regimes*

Africa has one of the richest histories of monetary regimes. Since the 1960s, the full spectrum of regimes can be found, ranging from currency boards or monetary unions, to a single currency peg, to a peg to a basket of currencies, to a float within a pre-determined range with heavy intervention, to a pure float (Ghosh et al., 1997). In addition to this classification based on fixed vs. floating, other typologies of monetary regimes have distinguished between regimes with or without foreign exchange rationing or credit ceilings (Honohan and O'Connell, 1997). In this study we concentrate on those countries with a rule-based system characterised by a fixed exchange rate peg with full convertibility, strict limits on central bank lending to governments, and minimum legal levels of foreign reserves. More specifically, our focus is on the three groups of countries who have been part of an international monetary agreement: the East African Currency Board, the Franc Zone and the Rand Monetary Area.

The East African Currency Board (EACB), comprised Kenya, Uganda, and Tanzania. At independence, the three states decided to maintain the monetary arrangement set-up by the British colonial power with the possibility of enacting gradual reforms whereby the EACB would take on the functions of a central bank. After several years of effective functioning, however, in 1966 the EACB fell apart as each member country created its own central bank and currency. Each country subsequently attempted to preserve a rule-based monetary policy at the national level, characterised by a fixed peg to Sterling, current account convertibility, and limits on central bank finance of government deficits.

The composition of the Franc Zone has changed over time but at independence it comprised the five members of the Central African Monetary Area (CAMA) (Cameroon, the Central African Republic, Chad, the Republic of Congo, and Gabon) and the eight member countries of the West African Monetary Union (UMOA) (Benin, Burkina-Faso, Côte d'Ivoire, Mali, Mauritania, Niger, Senegal and Togo). Madagascar was also a member of the Franc Zone, although it had its own central bank. Three of these former French colonies left the CFA Zone in the 1960s and early 1970s (Mali, Madagascar and Mauritania, with the subsequent re-entry of Mali in 1968) and two non French-speaking countries entered the union more recently (Equatorial Guinea in 1985 and

Guinea-Bissau in 1997). In 1972-73, a major re-negotiation of the CFA arrangements took place and in 1994, following a decade of poor economic performance and real exchange rate over-valuation, the CFA franc was devalued by 50 percent. This was the first change in the CFA franc - French franc rate of parity since 1948.

The South-African rand already circulated freely in Lesotho, Swaziland and Botswana in the 1960s, but it became legal tender in the region when the Rand Monetary Agreement was signed in 1974. According to the agreement, the countries of the zone retained the right to create their own central bank and to issue their own currency, at par with the rand. Both Lesotho and Swaziland chose this option, followed by Namibia when it became independent in 1990. Botswana decided to leave the zone in 1976 to establish a more discretionary monetary policy.

### *3.2 Evolution of African monetary unions*

Economic performance

Most analyses of the economic performance of monetary regimes in Africa have focused on a comparison of CFA Zone countries with other African countries that have maintained floating exchange rate regimes. Table 1 confirms previous findings of lower inflation in CFA Zone. Long run evidence on growth is more mixed with higher GDP growth in the CFA countries until the beginning of the 1970s, strong performance among the oil-producing countries of BEAC between 1973 and 1985, and poorer performance in the CFA Zone when compared to other Sub-Saharan African countries between 1986 and 1993. While total investment increased in Sub-Saharan Countries outside the CFA Zone over the three periods, it decreased in the CFA Zone as a result of the crowding out of private investment and significant cuts in public investment after 1985. Lower growth in the later period has usually been attributed to less flexible exchange rate management in the face of rapidly deteriorating terms of trade and to a worsening of the fiscal stance which is also apparent in Table 1 (Devarajan and de Melo, 1992). As shown in Table 1, after 1973, net claims of the banking sector on government rose rapidly, even though the terms of trade evolved positively in the late seventies.

Table 2 shows that the performance of Tanzania and Uganda considerably deteriorated after the Eastern African Currency Board fell apart in 1966. Inflation and net credit to central government rose rapidly even though Uganda experienced an improvement in its terms of trade resulting temporarily in faster growth. Temporary rapid growth in investment in Tanzania can be attributed to the shift to socialist planning. Kenya’s stance after 1966 lies in sharp contrast to Tanzania and Uganda with a relatively good inflation record and continued restraint in terms of government borrowing from the banking sector.

Data for the Rand Monetary Areas countries presented in Table 3 shows relatively good inflation and fiscal performance. They also experienced relatively higher investment and growth rates, although these were somewhat reduced after 1977. Botswana is an exception to this pattern as performance improved considerably after it had left the RMA. One should note, however, that the relatively good terms of trade experienced by Botswana in the first period considered does not take into account the impact of massive droughts in the beginning of the seventies.

**Table 1. Economic performance in the CFA countries**
*(annual averages)*

| | | Inflation % | | | Budget Deficit % GDP | | | Change in Net Claims on Govern. % GDP | |
|---|---|---|---|---|---|---|---|---|---|
| | **60-73** | **73-85** | **86-93** | **60-73** | **73-85** | **86-93** | **60-73** | **73-85** | **86-93** |
| UMOA average | 3.7 | 10.9 | 3.9 | 0.0 | -8.0 | -6.3 | 1.5 | 3.9 | 3.6 |
| Côte d'Ivoire | 3.2 | 11.6 | 6.0 | n.a. | -7.1 | -12.0 | -2.6 | -0.4 | 8.8 |
| BEAC average | 4.1 | 12.2 | 8.4 | -2.6 | -2.1 | -8.4 | -1.2 | 4.5 | 8.4 |
| Cameroon | 5.4 | 11.7 | 5.7 | n.a. | 0.7 | -6.8 | -2.7 | 1.7 | 2.9 |
| Other SSA countries average* | 4.2 | 18.6 | 31.9 | -2.0 | -5.9 | -4.6 | -1.6 | 13.8 | 14.1 |

excluding EACB, RMA.
Sources: *International Financial Statistics*, *World Development Indicators*, IMF (1968; 1970).

**Table 1 (cont.) Economic performance in the CFA countries**
*(annual averages)*

| | | Gross Invest. % GDP | | | GDP Growth % | | | Commod. Index % Change | |
|---|---|---|---|---|---|---|---|---|---|
| | **60-73** | **73-85** | **86-93** | **60-73** | **73-85** | **86-93** | **60-73** | **73-85** | **86-93** |
| UMOA average | 13.8 | 21.2 | 16.3 | 3.8 | 3.2 | 2.0 | -0.7 | 1.3 | -1.2 |
| Côte d'Ivoire | 16.9 | 21.6 | 9.2 | 7.3 | 4.0 | -4.4 | 0.8 | 5.1 | -12.5 |
| BEAC average | 15.6 | 23.2 | 18.3 | 3.9 | 7.3 | 0.0 | 1.5 | 8.2 | -3.7 |
| Cameroon | 14.4 | 21.2 | 26.2 | 3.6 | 7.1 | -2.3 | 0.8 | 5.2 | -11.0 |
| Other SSA countries average* | 14.4 | 16.3 | 18.3 | 4.0 | 2.2 | 2.4 | 2.6 | 1.8 | -0.1 |

excluding EACB, RMA.
Sources: *International Financial Statistics*, *World Development Indicators*, IMF (1968; 1970) , Deaton and Miller (1997).

**Table 2. Economic performance in the EACB countries**
*(annual averages)*

| | | Inflation % | | Budget Deficit % GDP | | Change in Net Claims on Govern. % GDP |
|---|---|---|---|---|---|---|
| | **61-66** | **67-73** | **61-66** | **67-73** | **61-66** | **67-73** |
| EACB average | 3.3 | 7.5 | -4.4 | -5.2 | 0.1 | 2.8 |
| Kenya | 2.3 | 3.5 | -5.4 | -4.4 | -0.9 | 0.7 |
| Tanzania | 4.0 | 9.7 | -2.4 | -4.7 | -1.8 | 1.5 |
| Uganda | 3.4 | 9.3 | -5.4 | -6.4 | 2.9 | 6.1 |
| Other SSA countries average** | 3.6 | 4.7 | -0.6 | -2.9 | 0.9 | 3.5 |

** excluding CFA, RMA.
Sources: *International Financial Statistics*, *World Development Indicators*, IMF (1969).

**Table 2 (cont.) Economic performance in the EACB countries**
*(annual averages)*

| | | Gross Invest. % GDP | | GDP Growth % | | Commod. Index % Change |
|---|---|---|---|---|---|---|
| | **61-66** | **67-73** | **61-66** | **67-73** | **61-66** | **67-73** |
| EACB average | 12.2 | 17.6 | 5.4 | 5.8 | -0.5 | 1.3 |
| Kenya | 12.6 | 20.0 | 4.0 | 7.4 | -1.1 | -0.1 |
| Tanzania | 12.2 | 18.9 | 10.1 | -1.5 | -0.9 | 1.6 |
| Uganda | 12.1 | 13.8 | 3.9 | 11.5 | 0.4 | 2.4 |
| Other SSA countries average** | 14.9 | 13.7 | 4.2 | 3.8 | 0.7 | 4.6 |

** excluding CFA, RMA.
Sources: *International Financial Statistics*, *World Development Indicators*, IMF (1969), Deaton and Miller (1997).

**Table 3. Economic performance in the RMA countries**
*(annual averages)*

| | | Inflation % | | Budget Deficit % GDP | | Change in Net Claims On Govern. % GDP |
|---|---|---|---|---|---|---|
| | **68-76** | **77-93** | **68-76** | **77-93** | **68-76** | **77-93** |
| RMA countries° | 9.3 | 13.4 | -6.3 | -3.2 | 6.2 | 2.6 |
| South-Africa | 8.5 | 13.6 | -4.0 | -4.3 | 10.2 | 5.4 |
| Botswana | 10.7 | 11.4 | -12.4 | 9.1 | -13.4 | -34.8 |
| Other SSA countries average*** | 9.8 | 25.6 | -3.4 | -5.7 | 5.2 | 69.8 |

*** excluding CFA, EACB. ° Botswana was part of RMA countries until 1976. Data for Namibia was included from 1980 onwards.
Sources: *International Financial Statistics*, *World Development Indicators*, IMF (1973).

**Table 3 (cont.) Economic performance in the RMA countries**
*(annual averages)*

| | Gross Invest. % GDP | | GDP Growth % | | Commod. Index % Change | |
|---|---|---|---|---|---|---|
| | **68-76** | **77-93** | **68-76** | **77-93** | **68-76** | **77-93** |
| RMA countries° | 21.8 | 29.8 | 8.8 | 2.5 | 4.2 | 3.2 |
| South-Africa | 25.8 | 22.7 | 3.8 | 1.6 | 6.1 | 1.9 |
| Botswana | 31.4 | 27.9 | 16.7 | 10.2 | 1.9 | 6.5 |
| Other SSA countries average*** | 15.4 | 17.0 | 4.5 | 1.7 | 6.1 | -0.5 |

*** excluding CFA, EACB. ° Botswana was part of RMA countries until 1976. Data for Namibia was included from 1980 onwards.
Sources: *International Financial Statistics*, *World Development Indicators*, IMF (1973), Deaton and Miller (1997).

The political environment

Before considering more detailed evidence on the political environment in each of the three unions, it is possible to draw generalisations based on quantitative political data which has been increasingly used to make cross-country comparisons. We consider two issues here: the degree of political instability and the degree to which checks and balances pose a constraint on a country's executive.

Political instability in tables 4, 5, and 6 is proxied by the average frequency of *coups d'état* and of major cabinet changes over the period of reference. Whereas the RMA countries were remarkably stable according to our measure, both EACB and BEAC group of countries showed significant instability, according to these measures, during the initial period of rule-based policies (1960-66 for the EACB and 1960-73 for BEAC) which was nonetheless characterised by a credible commitment to monetary rules resulting in strong inflation and fiscal performance. While the number of cases here is obviously limited, this evidence runs contrary to the predictions of political economy models where political instability is necessarily associated with poorer performance.

As stressed in section 2, the existence of checks and balances in a country's political institutions will have a direct effect on the costliness of reneging on policy rules which are adopted by a single government. In cases where checks and balances are absent, joining an international arrangement may be the only way to credibly commit. In tables 7, 8, and 9, we use two variables to proxy for the degree of check and balances: the degree of political party fractionalisation and an index of constraints on the executive. Fractionalisation in the lower house of a country's parliament is measured on a 0 to 1.0 scale with an index which is calculated using the same formula frequently adopted for measuring concentration in industrial sectors. In countries where fractionalisation is high (tending towards 1.0) there will be a tendency for coalition governments to form. It is likely to be more costly to renege on policy rules within coalition governments, as suggested in section 2, because multiple decision makers must agree to such a change. The index of "executive constraints" developed by Gurr (1990) is a subjective indicator of the extent to which the executive in a country is constrained by features such as a constitution and a separate

legislature which can veto legislation. The index is scaled from 1 to 7, with 7 representing the highest degree of executive constraints.

It appears from the tables below that African countries for the period studied here have had an increasing tendency towards low party fractionalisation and low levels of constraints on the executive. This is most marked among the CFA states where levels of fractionalisation approaching zero reflect the emergency of single-party states and where executive constraints have averaged less than 3.0 on Gurr's scale. There is one major exception to this pattern. Uganda had a fairly high level of party fractionalisation during the 1961-66 period, combined with strong executive constraints. We will show in a more detailed fashion in the next section that this contributed to the credibility of Uganda's commitment to the East African Currency Board's rules.[5]

In sum, evidence on political instability and on political checks and balances suggests that African countries have generally not had the domestic political institutions necessary to make credible commitments on a unilateral basis. The fact that a number of countries have shown strong policy performance at one time or another despite high levels of political instability suggests that countries may have been able to credibly commit through their participation in international arrangements. It remains to be shown that exit from international arrangements for such states has been costly, and that governance structures have been designed so as to promote enforcement of monetary rules. Sections 4, 5, and 6 consider these questions for each of the three unions.

**Table 4. Political instability in the CFA countries**
*(annual averages)*

| | | Number Coups | | | Cabinet Changes | |
|---|---|---|---|---|---|---|
| | **60-73** | **80-85** | **86-93** | **60-73** | **80-85** | **86-93** |
| UMOA average | 0.033 | 0.077 | 0.048 | 0.35 | 0.42 | 0.43 |
| Côte d'Ivoire | 0.000 | 0.000 | 0.000 | 0.31 | 0.07 | 0.33 |
| BEAC average | 0.102 | 0.000 | 0.000 | 0.41 | 0.38 | 0.00 |
| Cameroon | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Other SSA countries average* | 0.076 | 0.056 | 0.024 | 0.45 | 0.46 | 0.47 |

excluding EACB, RMA.
Sources: Banks (1994).

[5] It should also be noted that the case of Botswana shows why the fractionalisation measure is an imperfect proxy for the presence of coalition government. Botswana had a higher degree of political party fractionalisation than the very low average level for other African countries, but this did not reflect a situation where there were frequent coalition governments. In fact, Botswana was ruled by one political party for the entire period under consideration here while it was the opposition which was fragmented into several different parties.

**Table 5. Political instability in the EACB countries** *(annual averages)*

| | | Number Coups | | Cabinet Changes |
|---|---|---|---|---|
| | **61-66** | **67-73** | **61-66** | **67-73** |
| EACB average | 0.000 | 0.055 | 0.53 | 0.11 |
| Kenya | 0.000 | 0.000 | 0.75 | 0.00 |
| Tanzania | 0.000 | 0.000 | 0.50 | 0.17 |
| Uganda | 0.000 | 0.167 | 0.60 | 0.17 |
| Other SSA countries average** | 0.086 | 0.065 | 0.59 | 0.29 |

** excluding CFA, RMA
Sources: Banks (1994).

**Table 6. Political instability in the RMA countries** *(annual averages)*

| | | Number Coups | | Cabinet Changes |
|---|---|---|---|---|
| | **68-76** | **77-93** | **68-76** | **77-93** |
| RMA countries° | 0.000 | 0.063 | 0.14 | 0.29 |
| South-Africa | 0.000 | 0.000 | 0.00 | 0.33 |
| Botswana | 0.000 | 0.000 | 0.00 | 0.00 |
| Other SSA countries average*** | 0.075 | 0.036 | 0.39 | 0.45 |

*** excluding CFA, EACB. ° Botswana was part of RMA countries until 1976. Data for Namibia was included from 1980 onwards.
Sources: Banks (1994).

**Table 7. Party fractionalisation and executive constraints in CFA countries** *(annual averages)*

| | | Party Fraction. | | | Executive Constraints | |
|---|---|---|---|---|---|---|
| | **60-73** | **80-85** | **86-93** | **60-73** | **80-85** | **86-93** |
| UMOA average | 0.016 | 0.039 | 0.026 | 2.6 | 2.1 | 2.6 |
| Côte d'Ivoire | 0.000 | 0.000 | 0.000 | n.a. | n.a. | n.a. |
| BEAC average | 0.058 | 0.052 | 0.066 | 2.7 | 1.8 | 2.4 |
| Cameroon | 0.000 | 0.000 | 0.000 | 2.9 | 2.1 | 2.3 |
| Other SSA countries average* | 0.147 | 0.136 | 0.077 | 2.7 | 2.6 | 2.2 |

* excluding EACB, RMA.
Sources: Banks (1994), Gurr (1990).

**Table 8. Party fractionalisation and executive constraints in EACB countries** *(annual averages)*

| | | Party Fraction. | | Executive Constraints |
|---|---|---|---|---|
| | **61-66** | **67-73** | **61-66** | **67-73** |
| EACB average | 0.193 | 0.039 | 5.1 | 2.8 |
| Kenya | 0.222 | 0.033 | 4.5 | 3.3 |
| Tanzania | 0.000 | 0.000 | 3.0 | 3.0 |
| Uganda | 0.452 | 0.084 | 7.0 | 2.3 |
| Other SSA countries average** | 0.134 | 0.161 | 3.0 | 2.2 |

** excluding CFA, RMA.
Sources: Banks (1994), Gurr (1990).

**Table 9. Party fractionalisation and executive constraints in RMA countries**
*(annual averages)*

| | | Party Fraction. | | Executive Constraints |
|---|---|---|---|---|
| | **68-76** | **77-93** | **68-76** | **77-93** |
| RMA countries° | 0.289 | 0.182 | n.a. | n.a. |
| South-Africa | 0.405 | 0.376 | n.a. | n.a. |
| Botswana | 0.352 | 0.396 | n.a. | n.a. |
| Other SSA countries average*** | 0.142 | 0.133 | 2.3 | 2.51 |

*** excluding CFA, EACB. ° Botswana was part of RMA countries until 1976. Data for Namibia was included from 1980 onwards. Sources: Banks (1994), Gurr (1990).

## 4. The East-African Community (1960-1973)

### *4.1 Rules and governance structure: 1960-1966*

In 1919 a new monetary authority was formed to issue a common currency, the East African shilling, within the British colonies of Kenya, Uganda, and Tanganyika (later Tanzania).[6] The East African Currency Board (EACB), for which the offices were based in London, exchanged East African shillings for British Sterling without restriction at a fixed rate. The Board initially refrained from any lending to either commercial banks or to territorial governments. Interestingly, even if the clear objective of the British officials which ran the Board was to accumulate a stock of foreign assets at least equal to the value of all local currency in circulation, the statutes of the Board did not specify a legal minimum for reserves. This figure was determined at the discretion of the British Secretary of State for the Colonies, who had the ultimate authority for Board decisions. When foreign reserves rose above the amount deemed necessary, dividends could be issued to the territorial governments.

During the years immediately preceding and following independence, the EACB evolved considerably towards fulfilling many of the duties of a central bank. Beginning in 1955 the Board was authorised to back a small portion of its foreign reserves (£10 million) with local government securities denominated in East African shillings that were issued by territorial governments. This limit was gradually raised, to £20 million in 1957, to £25 million in 1963, and to £35 million in 1964. Beginning in 1960, the Board was authorised to engage in a limited amount of crop refinancing to commercial banks (up to £5 million Sterling). This limit was subsequently raised to £10 million in 1962. These were short-term loans for which repayment was required within the year. The crop finance facility also allowed the Board to act as a lender of last resort to commercial banks in difficulty. If it had been fully used, the £45 million fiduciary issue (from 1964 onwards) would have equalled more than 50% of the currency in circulation (Kratz, 1966). Finally, the EACB also began assisting in operating Treasury bill markets in each of the newly independent countries.

[6] British Somaliland and Aden were also members but the former withdrew before independence and the latter remained a British colony until the 1970s.

In 1960 the governance structure of the EACB changed radically, as the British government essentially withdrew from direct involvement with Board decisions. The EACB offices were moved from London to Nairobi, and the representation on the Board was changed so that all but one of the 7 seats were given to representatives from the three African member territories, the permanent secretaries from the Ministries of Finance of Kenya, Uganda and Tanganyika, the Financial Secretaries of Zanzibar and Aden, and the Secretary General of the East African Services Organisation, an institution created to administer regional co-operation in areas such as transport, who was also made chairman of the EACB. In keeping with much of the spirit of the arrangement, there is no record of written voting rules on the EACB board, but in practice, the Kenyan, Ugandan, and Tanzanian representatives each held a veto (see below). From this point on, the only member of the UK administration on the EACB was a technical advisor from the Bank of England. Legally the UK Secretary of State for the Colonies remained the ultimate authority for EACB decisions, but there is no indication of direct interventions by the Secretary of State in EACB affairs at this time. In fact, private correspondence from the UK Colonial Office makes clear that the UK government had every intention of revising the EACB statutes as soon as possible so that this responsibility could be removed from the Secretary of State.[7]

*4.2 Operations of the EACB: 1960-1966*

There is evidence that the relatively good fiscal and inflation performance of Tanzania and Uganda between 1960 and 1966 would not have taken place if it were not for the existence of EACB's limits on lending to governments, and if this rule had not been backed up by a Kenyan veto of any increases in fiduciary limits which it saw as unwarranted.

Tanzania's government made numerous demands for increasing fiduciary limits in order to obtain finance for its first Five Year Development Plan for which foreign sources of funding had fallen short of original estimates. In cases where the EACB was not forthcoming with finance to make up the gap, Tanzania was forced to scale back certain investments (IMF, 1969). As seen below, from the end of 1962 on, the Tanzanian government found itself frequently at or near its limit for borrowing from the EACB. On occasions, periodic increases in the limit provided further breathing room. These increases had been planned as part of a gradual reform program whereby the EACB would begin to operate more like a central bank. The Kenyan government vetoed attempts to make excessive hikes in the limit above those which were seen as prudent.[8]

The Ugandan government also found itself in periodic borrowing difficulties with the EACB. As early as 1963, documents show that Ugandan representatives were complaining about the "uncompromising" attitude of the EACB.[9] In Uganda fiscal pressures seem to have come as much from demands for increased current spending as for development spending. The Ugandan government apparently had more success in finding private investors to fund portions of its initial development plan (IMF, 1969). Table 1 shows that Uganda also found itself at its borrowing limit from 1964 on, whereas the Kenyan government itself rarely borrowed more than 50% of its fiduciary limit.

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[7] de Loynes papers December 10, 1962 (OV7/82 614/3).
[8] The best direct evidence on the attitude taken by the Kenyan government is from 1964 and 1965. (de Loynes papers (OV7/63 609/5, OV7/64 610/1).
[9] de Loynes papers 14 May 1963 (OV7/61 609/3).

Tanzanian and Kenyan positions on lending limits were also reflected in discussions about future reforms of the EACB. In 1962 the Tanzanian government commissioned a staff member of the German Bundesbank to conduct a study on central banking arrangements in East Africa. The official proposed establishing a federal central bank system similar to that which existed in Germany and the USA, but he remained vague about the degree of control which regional banks would be allowed to have over monetary policy. Records of private meetings subsequent to the presentation of the report show that the Kenyan Minister of Finance preferred strong central control, while the Tanzanian Minister of Finance argued for substantial autonomy for the national central banks. The rationale behind creating national banks was clearly to provide more possibility to use central bank lending to government in order to fund development projects.

In the end, Kenya's opposition to excess increases in EACB lending limits help suggest why the rules were binding, but this doesn't explain why Uganda and Tanzania did not choose to exit the EACB earlier. To do so we need to consider the broader context of regional integration in East Africa as well as domestic political institutions in each of these states.

**Table 10. Use of fiduciary allocations by East African Currency Board governments**
*Stock of loans outstanding in million £ sterling*

| | Dec 61 | June 62 | Dec 62 | June 63 | Dec 63 | June 64 | Dec 64 | June 65 | Nov 65 | Apr 66 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Kenya** | | | | | | | | | | |
| *used* | 4.8 | 3.8 | 3.8 | 3.8 | 3.6 | 3.5 | 3.5 | 3.5 | 4.5 | 3.5 |
| *total* | 5.6 | 5.6 | 5.6 | 5.6 | 7.0 | 7.0 | 9.9 | 9.9 | 9.9 | 9.9 |
| **Tanzania** | | | | | | | | | | |
| *used* | 4.5 | 4.7 | 5.6 | 5.1 | 6.4 | 4.7 | 8.1 | 6.2 | 8.6 | 2.6 |
| *total* | 5.6 | 5.6 | 5.6 | 5.6 | 7.0 | 7.0 | 9.9 | 9.9 | 9.9 | 9.9 |
| **Uganda** | | | | | | | | | | |
| *used* | 5.5 | 5.1 | 4.9 | 3.6 | 5.9 | 3.7 | 8.9 | 9.5 | 10.0 | 9.8 |
| *total* | 5.6 | 5.6 | 5.6 | 5.6 | 7.0 | 7.0 | 9.9 | 9.9 | 9.9 | 9.9 |

Sources: Kratz (1966), EACB reports.

### *4.3 Obstacles to exiting the EACB: 1960-66*

There were two main obstacles to Tanzania and Uganda exiting the EACB. For Tanzania, while there were no checks and balances in its political system of the sort that could have raised the cost of exit, there was an incentive not to exit the EACB as long as its government believed that integration in areas other than money would result in significant benefits for Tanzania. For the Ugandan government, there was both the incentive of potential gains in other areas of integration, as well as the fact that until 1964 its prime minister was constrained by significant checks and balances.

The common market which had existed between the three East African territories during the colonial period was preserved at independence. Tanzania in particular hoped to extract concessions from Kenya in exchange for maintaining free trade, it was thought that these

concessions might come in the form of subsidies, perhaps via a regional development bank, through direct transfers, or at a minimum through the allocation of rights to produce certain industrial products to each state.[10] There may also have been a hope of deriving benefits from the political federation, which the three East African governments in 1963 announced their intention of creating. Members of the Ugandan government, and its Prime Minister in particular, also hoped that political federation with Kenya might provide access to increased development finance.

The problem for the sustainability of the EACB was that Kenya was ultimately not willing to agree to the sort of regional subsidies which the Tanzanian government in particular was demanding. The Kenyan and Ugandan delegations agreed to extend limited trade privileges to Tanzania, but only on the proviso that in exchange Tanzania would formally agree to preserve a common currency. The Tanzanian government did not agree to this demand, and from the late Spring of 1964 there were rumours of a Tanzanian unilateral initiative to set up a separate currency.[11] In February 1965 the Ugandan government also changed its position, as it made a unilateral decision that it would create its own state bank which effectively spelled the end of the common currency.

The absence of checks and balances also explains why the Tanzanian and Ugandan governments choose to exit. In Tanzania, its President, Julius Nyerere, was bent on using monetary finance to dramatically increase government spending. Tanzanian political institutions placed no checks or balances on Nyerere's ability to achieve this goal. There was a one party government where the TANU party held all the levers of power. Aside from the Presidency, TANU dominance included control of the totality of seats in the single house of parliament.[12] Within the TANU party, Nyerere's authority was uncontested. Outside the party, the one challenge to his rule came from a brief army mutiny in 1963, but this quickly failed, and there does not appear to have existed a powerful military faction in politics which placed a constraint on the President.[13] Tanzania remained in the EACB as long as Nyerere believed further political integration within the EACB might provide additional sources of finance for government spending.

In strong contrast with Tanzania, during the first years of independence Uganda's Prime Minister, Milton Obote, was constrained by several political checks and balances. It was only after these checks on his power disappeared in the second half of 1964 that it was possible for the Ugandan government to take a different line on monetary issues. At independence, the UPC under Obote

[10] Tanzania's President believed that Kenya was enjoying a disproportionate benefit from the common market since it was running a significant trade surplus with Tanzania.

[11] Bailey (1964), who was himself a participant at the meetings in question, records that in February 1964 the Tanzanian Finance Minister stated that unless the common market could be kept on Tanzanian terms, that is with separate currencies and selected trade barriers, the Tanzanian government would dissolve all forms of association. The trade restrictions agreed to included (1) a transfer of activity by certain firms present in all three markets in order to favour Tanzania, (2) suspended exports on certain products from Kenya, (3) allocations of future industries to individual countries. As a result of this third clause Tanzania obtained the dubious reward of having the sole right to produce Land Rovers in the East African Common Market.

[12] This dominance was the result of free and open elections in 1962. Another party sponsored by the colonial administration fared miserably in the elections as did a more ephemeral all Muslim party.

[13] For a brief account of this period see Jackson and Rosberg (1986).

was only able to form a government thanks to an alliance of convenience with the KY party.[14] Although this alliance seemed an inherently unstable one to many observers, given the UPC's status as a party of northerners and the KY's base in the South of the country, it provided the power sharing necessary for credibility of Uganda's commitment to the rules of the EACB. As part of this alliance, the Kabaka was made President of Uganda (although with limited powers) and several ministries including the Ministry of Finance were allotted to the KY party.[15] The KY party seems to have favoured gradualism when it came to reforming or replacing the EACB.[16] There is also direct evidence that a moderate faction of the UPC favoured continued monetary integration precisely because of the greater restraint which this could provide.[17] This situation changed towards the end of 1964, as thanks to defections from other parties, Obote was able to form a single party majority. It is noteworthy that this split was followed within a few short months by the Ugandan government's statement that it intended to set up a state bank.

### *4.4 Rules and governance structures at the national level 1966-1973*

Following the break-up of their currency union, all three East African countries initially retained their fixed peg to sterling as well as full current account convertibility, but they son abandoned the fixed peg following sterling's devaluation against the dollar in 1967. They also subsequently restricted convertibility of their new currencies (Gulhati, 1983).

The new national central banks were not particularly independent in that ministerial representatives had substantial influence on their governing boards, but each government did establish rules to either limit central bank lending to governments or to specify a minimum level of reserves. The Kenyan central bank statute adopted a limit on central bank credit to government which was only slightly higher than its limit under the EACB (£12 million as opposed to £9.9 million).

The Bank of Uganda Act limited direct advances to 15% of estimated current revenues for the financial year in which the advances were made, and furthermore all advances were to be repaid within 3 months. Although the statutes placed no limit on holdings by the Bank of government securities of more than 12 months in maturity, the statutes did effectively limit credit to government and commercial banks by requiring a minimum level for foreign reserves of 40% of demand liabilities. Since the Ugandan government was already close to this limit in 1966, in theory it should have had little possibility for borrowing from the central bank in the short term.

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[14] At independence, there were three main political movements in Uganda: the UPC controlled by Obote, the Democratic Party, and the Kabaka Yekka, a royalist party which supported autonomy for the former kingdom of Buganda, led by its king, the Kabaka. Underlying these three parties were a series of major fault lines in Ugandan society: (1) between Nilotic speakers in the North and Bantu in the South and West; (2) between Catholic and Protestant; (3) between the Baganda ethnic group which had been favoured for posts in the colonial administration, and the rest of population.

[15] On Ugandan party politics during this period see the excellent history in Mutibwa (1992) as well as Sathyamurthy (1975).

[16] First hand accounts from the period suggest that the Ugandan Finance Minister during this period deliberately followed a stalling strategy in order to keep the EACB status quo from breaking up (de Loynes papers, May 24, 1963 (OV7/83 615/1) and August 28, 1963 (OV7/84 615/2).

[17] *East African Standard,* 30 June 1965.

In Tanzania, the Bank of Tanzania Act stipulated that the Bank could directly purchase government securities equivalent to not more than 25% of the government's average annual current revenues over the preceding 3 fiscal years. It was also possible for the Bank to make advances to government equivalent to not more than 20% of revenues, but any advances had to be repaid in full within 300 days. The 45% of revenue which could be loaned through these two facilities was greater than Tanzania's fiduciary limit under the EACB (which represented 32% of revenue based on an average of fiscal 1963/64 and 1964/65), but the EACB fiduciary allocations were of unlimited duration while this was not the case for direct advances under the new system. The Bank of Tanzania statutes also established a minimum level of foreign reserves equivalent in value to four months of imports.

### *4.5 Operation of rules at the national level 1966-1973*

Rules limiting central bank finance of government deficits at the national level proved much less effective at constraining governments than had been the case under the EACB. In Uganda, the statutes of the central bank were easily modified to suit the government's increased demands for both current and capital expenditures. These increased demands were a direct product of Prime Minister Obote's mounting difficulties in retaining power (Mutibwa, 1992). In 1968 the statutes of the central bank were reformed to allow government representatives to have more direct influence on the bank. In 1970 a law was passed to enlarge the scope of foreign reserves (for purposes of calculating the reserve floor) to include "any external fund, facility, or drawing rights which the Minister considers acceptable". This was followed in June 1971 by a decree removing the official floor on foreign reserves altogether. This same decree raised the limit on temporary advances to government.[18] These rule changes facilitated expansions in central bank credit to government, the net flow of which reached 3.7% of GDP during fiscal 1970-71 alone during the final stages of the Obote government.[19]

In Tanzania, from 1967 the socialist economic program advocated by Nyerere was centred upon an increasing role of state owned enterprises in the economy and involved substantial increases of capital expenditures (Kimei, 1987). Although a significant share of these deficits was financed by external grants and borrowing, the domestic financing component had also to increase substantially. Unlike in Uganda, this was made possible not by altering the rules limiting central bank finance of government, but instead through making the limits irrelevant by nationalising the banking sector and by the grouping of existing commercial banks within a new entity, the National Bank of Commerce. This allowed for indirect channelling of credit from the central bank to the government and public sector entities more generally. Credit to the public sector from the state owned National Bank of Commerce expanded at an annual average rate of 245% in real terms between 1966 and 1973 (Kimei, 1987), whereas until 1978, direct credit from the Bank of Tanzania to the government remained within the prescribed limits. It was only at this point that rules were changed to accommodate increased fiscal pressures.

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[18] Bank of Uganda annual reports.
[19] Bank of Uganda annual reports

In Kenya, the government borrowed relatively little from the central bank and pursued a prudent monetary policy, as evidenced by its inflation performance. Fiscal policy also showed substantial stability.

### *4.6 Obstacles to the reversal of rules at the national level: 1966-73*

Evidence on the structure of political institutions after 1966 in the three East African states supports the hypothesis that an absence of checks and balances makes it relatively easy for governments to change policy rules. Tanzania after 1966 continued to be dominated by a one party government which controlled the Presidency as well as all seats in the legislature. Its President remained unchallenged within his own party during the period under consideration here. Uganda after 1966 took several successive steps towards one-party rule, followed by extra-constitutional rule once Prime Minister Obote unilaterally revised the constitution. Obote was replaced by a coup d'état in 1971 led by Idi Amin.

Like its two neighbours, Kenya's political institutions after 1966 were also characterised by a relative absence of checks and balances, but the situation was different to the extent that it's ruling party was supported by a group which had a strong interest in the maintenance of macro-economic discipline. The Kenyan political scene was dominated by the KANU party which had close ties to the Kikuyu agricultural elite, a group of export producers which benefited from conditions of low inflation and an absence of real exchange rate overvaluation.[20] One might think that the Kikuyu exporters would have benefited from the creation of policy rules that ensure that future Kenyan governments were obliged to follow disciplined macroeconomic policies. However, as predicted in section 2, because political instability in Kenya at this time was very low, there was probably little perceived need to adopt such a constraint out of fear that KANU might be replaced by a different government. By 1966 the KANU government had no major challengers. As a result, the government was able to make moves to increase discretionary control over monetary policy (through a more flexible exchange rate), without fear of sub-optimal outcomes.

## 5. The Franc Zone

### *5.1 Rules and governance structure 1960-1973*

Like their Anglophone neighbours, the French colonies of Western and Central Africa also had monetary institutions where a single currency was shared between several territories. There was a fixed peg to the currency of the colonial power and strict limits on monetary financing of government deficits. One key difference between the Franc Zone and the East African Currency Board is that instead of assuring convertibility for the CFA franc through a 100% reserve cover, convertibility for the CFA francs has been assured through a guarantee by the French Treasury. When foreign reserves are positive they are deposited in an "operations account" at the French

[20] See Bates (1981).

Treasury.[21] If reserves fall to zero, the French Treasury guarantees convertibility by allowing an overdraft on the accounts.

The counterpart to the guarantee of the French government has been that it is allowed to participate in the formulation of monetary policy within each of the Franc Zone's two monetary unions in order to see that the guarantee does not become a source of moral hazard. The monetary arrangements agreed to by Franc Zone governments upon independence in 1960 involved substantial delegation of control over monetary policy to the French government. The French government held a third of the seats on the governing board in each of the two central banks, the BCEAO (for UMOA) and the BEAC (for CAMA). Instead of being transferred to Africa as in the EACB case, both central bank offices also remained in Paris, and the director general position of each bank was held by a French civil servant.

Contrary to common belief, the initial rules limiting BCEAO and BEAC lending to member governments were actually more strict than those which existed under the East African Currency Board. Under agreements signed in 1962, a government could borrow from the BCEAO up to a maximum of 10% of the previous year's revenues, but the loan was limited to 240 days duration.[22] In 1968 this limit was raised to 15%. Provisions for central bank lending to government evolved more slowly for the BEAC, but by 1967 its statutes in this area were harmonised with those of the BCEAO. Apart from these alterations, the statutes of the two Franc Zone central banks and the statutes governing the monetary relationship with France remained unchanged until the early 1970s. In addition to rules limiting central bank financing of governments, both unions at independence also established a statutory minimum level of foreign reserve holdings. When foreign exchange reserves of either bank fell below 20% of demand liabilities, the governing board was to be convened to take adjustment measures. If foreign exchange reserves fell below 10% of demand liabilities, discount rates were to be raised automatically and significant reductions in refinancing to individual countries were to be implemented (IMF, 1963).

### *5.2 Operations of the Franc Zone: 1960-1973.*

During the initial independence period all but three Franc Zone states chose to remain in their respective monetary union.[23] Mali exited in 1962 (only to return in 1968), Mauritania exited in 1973, and Madagascar exited in 1973.

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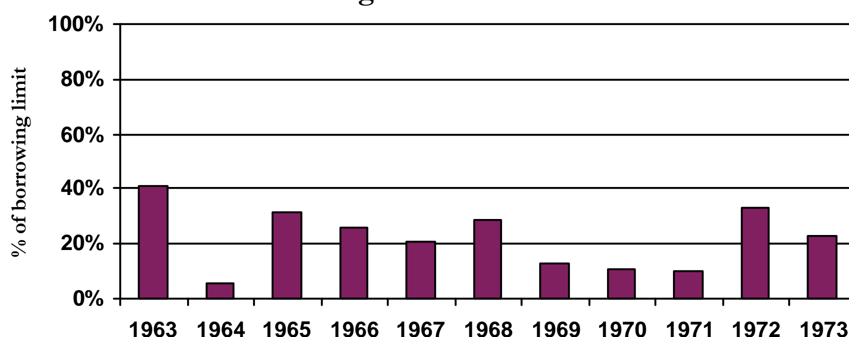
[21] Since 1973 the CFA member states have had the right when reserves are positive to keep 35% of their holdings in accounts outside the French Treasury.

[22] This 10% could come in the form of either direct advances or rediscount of treasury bills held by commercial banks with less than six months to mature. The 10% limit was reduced by an amount equivalent to commercial bank holdings of treasury bills. In addition, commercial banks holdings of Treasury bills were limited to 10% of their average deposit liabilities during the preceding 12 months (IMF, 1963).

[23] Guinea left the union at independence in 1958, but because this is a study of the effectiveness of monetary commitments in countries where governments made an initial choice to adopt a monetary rules, Guinea is not included.

**Figure 1: stock of direct government borrowing from BCEAO**




Source: Bhatia (1985).

The particularly good inflationary and fiscal performance of the countries that remained in the Franc Zone during this period was the result of strict compliance with the rules of their central banks and conservative monetary policies where lending to governments remained far below statutory limits. As shown in Figure 1, BCEAO lending to governments only once reached more than 40% of the statutory limit. This aggregate figure does not reflect the fact that several of the smaller CFA states, like Benin, borrowed up the maximum amount allowed by the rules, but there were no clear cases of violations. BCEAO's foreign reserve coverage ratio during this period remained significantly higher than the 20% minimum stipulated by statute. The BEAC pursued similar policies, and the operations accounts for the two banks at the French Treasury remained in constant surplus.

The initial post-independence period was one of very stable demand for the principal exports of the CFA states with no major terms of trade shocks. Even so, there is evidence that as in East Africa, governments were constrained by central bank borrowing rules. Major shortfalls in the foreign financed component of development plans for many CFA states necessitated the cancellation or deferral of numerous public investment projects.[24] In Senegal the public finance component of the development plan for 1965/66 - 1966/67 amounted to only 37% of original projections. The shortfall was equivalent to 5.6% of GDP per year. In Niger during the Second Development Plan (1965-68), foreign financing was only 38% of expectations. These gaps between anticipated and actual foreign finance were in part attributable to delays in implementation rather than a simple lack of funds, but there seems to have been a significant degree of simple overestimation of available foreign resources. In the absence of a rule limiting government borrowing from the monetary authorities, these shortfalls might well have been financed by monetary means, as is suggested by the increasing number of complaints lodged by governments about the lending limits of the two central banks (IMF, 1970).

[24] In some cases the French government provided small budgetary subsidies and remained directly responsible for certain categories of expenditure in the newly independent countries. The last full separation between the French Treasury and the Treasury of a CFA state (the Central African Republic) did not occur until 1970 (de la Fournière, 1970).

*5.3 Obstacles to exit from the Franc Zone: 1960-73*

Evidence on the obstacles to exit from the Franc Zone during the first thirteen years of independence is consistent with the hypotheses laid out in section 2. While the CFA states generally lacked checks and balances in their political institutions, they received a number of side-payments from co-operation with France in areas other than money, such as military affairs, aid, and intelligence support. As the hypotheses would predict, the only states to leave the Franc Zone were those which were eager to break off all forms of co-operation with France.

At the national level, there is little evidence that CFA governments at independence had the sort of checks and balances in their political systems which could have made it costly to arrive at a decision to exit the Franc Zone. Francophone governments had generally adopted constitutions modelled on that of the French Fifth Republic which gave the executive considerable authority to take decisions without parliamentary consent.[25] In many cases this executive dominance was increased by subsequent constitutional amendments that expanded possibilities for rule by decree. Irrespective of formal constitutional considerations, the trend in countries such as Cameroon, Côte d'Ivoire and Senegal during the early 1960s was for leaders to move quickly to establish unrestricted executive power through purges of opposing factions or parties.

In the absence of domestic checks and balances, side-payments from other areas of co-operation kept Franc Zone states which were disenchanted with monetary policy from establishing separate currencies. Unlike in East Africa during 1960-66, however, these side-payments came from the former colonial power. Regional co-operation on trade issues was far less developed among the CFA states, as they quickly implemented tariff barriers against neighbouring states. One key reason for this general development was that the two largest economies in each of the two Franc Zone unions (Côte d'Ivoire and Cameroon) expressed little interest in joining a regional trade arrangement or a regional political federation, out of fear that such an arrangement would entail significant financial transfers to smaller states. Agreements with the French government, however, covered non-monetary issues such as bilateral aid, military support, and intelligence support. In Senegal, for instance, French military and intelligence support helped weigh in favour of President Senghor in his conflict with a political rival in 1963. In Côte d'Ivoire and Gabon, France played a similarly prominent role involving permanent stationing of French troops. If side payments from France had not been so prominent, it seems doubtful whether the Franc Zone would have been so effective, as more governments might have chosen to leave.

While French diplomatic and military support was the side-payment which kept many governments in the Franc Zone, each of the three cases of departure from the Zone came as part of an effort by governments to end not only monetary co-operation but also military and intelligence co-operation with France. In fact, in two of the three cases, France had historically given military and diplomatic support to the political opponents of the parties which decided to exit when they gained control of government. In Madagascar, the French government had remained a staunch supporter of President Philibert Tsiranana up to his resignation in 1972. The military government which succeeded him made tactical moves to develop a different support base among the island's growing nationalist movement. Madagascar's exit from the Franc Zone in 1973 occurred at the same time that the Malagasy government negotiated a French withdrawal

[25] Provided Prime Minister and President were from the same party, as was almost always the case.

from military bases on the island. There are strong indications that this overall break with France was engineered as a way for the new government to gain support from groups in the island's interior who had been marginalised under the previous government.

In 1962 the Malian government decided to create its own currency after a series of disputes with the BCEAO over requests for extensions of credit to government and public enterprises (Julienne, 1987). Underlying this dispute over lending, however, was the fact that the French colonial administration had given strong support to the PSP party, but an opposing party gained power at independence. Modibo Keita's government made a number of moves to establish close diplomatic relations with Soviet bloc governments, and its decision to leave the Franc Zone was accompanied by a distancing of overall relations with France. Likewise, Mali's return to the Franc Zone was made possible by a coup that toppled the Keita government.

Mauritania's exit from the Franc Zone in 1973 also occurred as part of a broader political break with France, although it was less brutal than that which occurred in both Madagascar or Mali. At independence Mauritania was not recognised by North African states like Morocco and Algeria which laid claim to portions of its territory. In order to balance against these threats, Mauritania's President studiously cultivated links with Paris. In the early 1970s, however, a growing nationalist movement in this predominantly Arab speaking country prompted a change of strategy, as the Mauritanian government was able to negotiate accords with Morocco and Algeria while deliberately distancing itself from Paris. Exit from the Franc Zone occurred during this transition.[26]

### *5.4 Changes to CFA rules and governance structures in 1973*

By the early 1970s, representatives from a number of the smaller CFA states, especially Niger and Benin, began to call for a revision of their monetary agreements with France. Chief among their demands was increased central bank finance for development projects (both public and private) (Julienne, 1987). This was no doubt triggered by the fact that for many countries, foreign aid flows for investment projects had been less than desired. There was also a sentiment that the monetary arrangements were biased in favour of France. France was able to benefit from having the totality of foreign reserves for the two central banks deposited with the French Treasury, while it had never been obliged to use resources to guarantee convertibility since the two operations accounts had never been in deficit.[27] Finally, there was a very understandable lack of satisfaction at the fact that the French government dominated decision making within the two central banks.

One outcome of the reforms agreed to in 1973 was that limits on central bank credit to governments were raised, but to only 20% of the previous year's revenues. This was less than had been hoped for. However, a number of new facilities were created for the two central banks to extend refinancing credits at subsidised rates in order to fund development projects. While previous statutes had been quite explicit in counting indirect credit from the central banks to

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[26] *Le Monde,* 30 November, 1972.

[27] This was a somewhat dubious claim seeing as the reserves were remunerated at market rates, and they never amounted to a sum large enough to aid in defending the French franc against speculative attacks.

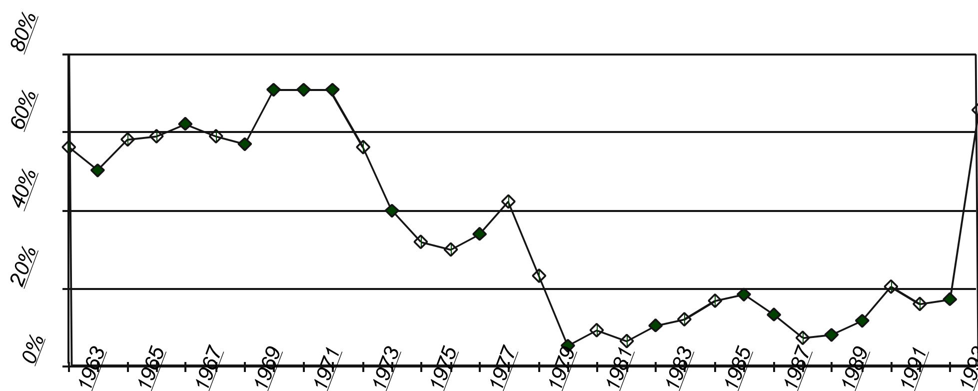
governments via commercial banks towards the borrowing ceiling, the new statutes of both banks were more vague on this critical point. The rule stipulating automatic increases in discount rates and cuts in refinance ceilings when either central bank's reserves fell below 10% of sight liabilities was also loosened, as adjustment measures were now left up to the discretion of the governing boards.

Loosening of monetary rules was accompanied by major changes in the governance structures of the two central banks. France gave up the director general position of each central bank, and its participation on the two governing boards was reduced to 2 votes out of 16 for the BCEAO and 3 votes out of 13 for the BEAC, while the other seats were given to finance ministry officials of the member countries. Unfortunately, no attempt was made to select a governing board for either BCEAO or BEAC which would be comprised of independent individuals. For the BCEAO, a deal between Côte d'Ivoire and Senegal (the two largest countries), resulted in Côte d'Ivoire's securing the right to choose the BCEAO governor in exchange for installation of the bank's headquarters in Dakar, Senegal. The two largest states in BEAC, Gabon and Cameroon, engineered a slightly different compromise as the new statutes specified that the governor of the BEAC would be named by Gabon but that Cameroon be given 4 seats on the governing board. There four seats were in many cases sufficient to block any attempt at lowering rediscount ceilings to Cameroonian commercial banks.

The one key aspect of the pre-1973 statutes which was not altered was France's unconditional guarantee of convertibility for the currency issued by each central bank.

### *5.5 Operations of the Franc Zone: 1973-1994*

Unlike the 1960-73 period, where terms of trade were stable and pressures to obtain increased finance stemmed more from the gap between anticipated and actual investment funding for development projects, the period 1973-93 was characterised by large terms of trade shocks. Here one needs to consider the reaction of CFA states to both positive and negative shocks. The CFA states generally failed to respond to temporary increases in commodity prices by adopting counter-cyclical policies such as reducing their stock of borrowing at the central bank. In fact, just the opposite was often the case as increases in revenue permitted increased borrowing since ceilings on borrowing from the central banks were calculated as a percentage of revenue. The drastic decline in BCEAO's foreign reserve coverage after 1973 during a period of improving terms of trade is good evidence of this phenomenon (figure 2 below). The CFA states also failed to respond effectively to negative terms of trade shocks, and especially to those which many countries suffered after 1985. As shown in Table 1 (Section 3.2.), the two largest CFA states, Côte d'Ivoire and Cameroon, were the hardest hit during this period. Heavy reliance by both governments on taxes on international trade for revenue combined with downward nominal rigidities in reducing the public sector wage bill (the main component of expenditures) led to increased fiscal deficits.




Sources: Bhatia (1985), IFS, BCEAO.

While inflation performance of the Franc Zone countries after 1973 continued to be superior to that of other African states, it became increasingly difficult during the 1980s and 1990s to argue that participation in the unions served as an effective constraint on member states. Rules establishing a minimum level of foreign reserves were broken and rules limiting central bank lending to governments were either broken or easily circumvented.

There were several major direct violations by Côte d'Ivoire, Benin and Mali, of the rule limiting borrowing to 20% of revenues, but even so, direct lending from the two central banks never constituted a principal source of deficit finance. Instead, the accumulation of deficits took place through pressuring commercial and development banks (which were wholly or partially state-owned) into lending to relieve fiscal pressures. The BCEAO and BEAC then engaged in heavy refinancing of these credits and paid little heed to the solvency of the banks they were lending to. Though refinancing of these credits was cheap (as it took place at heavily subsidised rates), it led to an important crowding out of private credit demand for investment as the total amount of credit available was limited.[28] According to the statutes of both BCEAO and BEAC, some of this indirect lending should have counted towards a government's borrowing ceiling, but it seems clear that this was often not applied. Excess indirect lending to governments was made possible by the institutional changes of 1973 which had created a panoply of new possibilities for central banks to lend at subsidised rates to the private sector. The indirect financing of fiscal deficits defeated the purpose for which the refinancing facilities of the central banks had been created, namely to be sources of development finance. The end result was not surprisingly a major financial crisis in which commercial banks failed and governments were forced to assume responsibility for these debts. Cameroon, Côte d'Ivoire, Senegal and Benin were the four states where problem bank credits represented the largest share of GDP.[29]

[28] Two other important sources of financing for governments which did not involve breaking the Franc Zone's rules were to run arrears with domestic suppliers and creditors and to increase their foreign borrowing. See Stasavage (1997) for an overview of these borrowing sources.

[29] Non-performing loans for which the Ivoirian government assumed responsibility were equivalent to 12.7% of GDP. In Cameroon, Senegal, and Benin the figures were 6.9%, 10.9%, and 7.4% of GDP respectively. The figures might have been higher for Cameroon except for the fact that the financial sector restructuring which occurred was

The rule establishing minimum foreign reserve levels of 20% of sight liabilities should also have limited the expansion of both direct and indirect credit to governments, but in both unions member governments used the latitude provided by the 1973 statutes to avoid taking adjustment measures. In the case of the BCEAO, when gross foreign reserves fell below 20% of sight liabilities the governing board is required to meet to consider what action to take. BCEAO's discount was raised but this was not completely effective since most of BCEAO lending to commercial banks was given through directed credit schemes. BCEAO's ratio of gross foreign assets to sight liabilities remained under the statutory minimum of 20% for almost the entire period from 1980 to 1994. In the case of the BEAC, gross foreign assets did not fall below the minimum until 1986, but when they did the BEAC governing board delayed in taking action.

### *5.6 Obstacles to violations of Franc Zone rules: 1973-1994*

As suggested above, the poor performance of the CFA states during this period can in part be attributed to the way in which rules governing central bank lending to governments and minimum foreign reserve levels were weakened in 1973. For example, it was now much easier to circumvent limits on lending to governments by borrowing indirectly. Even so, it remains to be explained why there were also many cases of direct violations of the rules. The absence of effective obstacles to violations of monetary rules resulted from the changes made in the voting weights on the two central bank governing boards in 1973 and from the fact that the French government proved unwilling to use its influence in other areas of co-operation (like aid) to see that monetary rules were respected.

The two largest economies in the CFA Zone, Cameroon and Côte d'Ivoire, might have been in an ideal position to exert pressure on other member states to see that rules regarding minimum levels of foreign reserves and direct lending to governments were respected and that possibilities for indirect lending to governments were controlled. In the end, Côte d'Ivoire's control of the governorship of BCEAO and Cameroon's holding four seats on BEAC's governing board were instead used to block any attempts to enforce monetary rules. Both Côte d'Ivoire and Cameroon were among the hardest hit by the negative terms of trade shocks which began in 1986, and rather than undertake fiscal policy adjustments they chose to take advantage of their dominant position on the governing boards to utilise all possible lending facilities at the two central banks. After the deterioration of terms of trade in 1985, Cameroon received the entirety of the net increase in refinancing credit between end-1985 and end-1987 of the BEAC (*La Zone Franc*, annual reports). In UMOA, Senegal and Côte d'Ivoire received nearly 90% of the credits from the subsidised lending facility between 1984 and 1989. Côte d'Ivoire was also largely responsible for UMOA's falling below the foreign reserve floor of 20% of demand liabilities, since from the late 1980s other UMOA states (with the exception of Senegal) held very high levels of reserves.[30]

less comprehensive than in the other three states.

[30] By 1990, Senegal had a balance of foreign reserves of -882 million French francs and Côte d'Ivoire had a balance of -6568 million French francs while all the remaining UMOA countries had a positive balance. Had seigniorage had not been distributed through subsidised loans, the attribution of seigniorage dividends (divided equally according to BCEAO rules) could have partially compensated Burkina Faso and Togo for the cost of holding reserves. Moreover, interest payments on the negative external position of Côte d'Ivoire and Senegal were rescheduled on very favourable terms.

Even with the attitude taken by Cameroon and Côte d'Ivoire, one might have expected the French government to make more of an effort to see that monetary rules in UMOA and BEAC were respected. One problem here was that the 1973 reforms had drastically reduced France's presence within the two central banks. Before 1973, given its control of the director general's position as well as one-half of the governing board seats in BEAC (one-third in BCEAO), France and one or two other states could form a majority coalition to require adjustment measures. After 1973 the minimum number of countries necessary to form such a majority coalition increased substantially.

Even with its reduced presence within the two central banks, the French government could have certainly exerted leverage on the CFA states through side-payments (or sanctions) in other areas of co-operation like aid and security. Just the opposite took place, as the French government chose to privilege short-term political stability for CFA regimes over prudent macroeconomic policies and compliance with central bank rules. There is some evidence that French officials present on the governing boards of the two central banks took little action in the face of clear violations and circumventions of policy rules (Stasavage, 1997). Instead, French non-project aid, extended virtually without conditionality, was considerably expanded over the period 1986-1993 to help compensate for French imposed restrictions on BCEAO and BEAC credit after 1989. French non-project aid to BCEAO governments reached a total of 2.1% of the BCEAO states GDP in 1993, and 2.0% of the BEAC states GDP. More than 80% of this aid went to Cameroon and Côte d'Ivoire alone. This ambiguous attitude of France towards the enforcement of monetary rules reflected internal conflict of interests within the French government. With the realignment of coalitions in France in 1993 triggered by the arrival of the Balladur government, French policy changed. The Balladur government showed far less concern for the short-term political stability of certain Francophone African regimes.[31]

## 6. The Rand Monetary Area

### *6.1 Rules and governance structure*

The Rand Monetary Agreement (RMA) signed by Botswana, Swaziland, Lesotho and South Africa in 1974 formalised the *de facto* currency area which had existed between these states, based on the South African rand. Shortly after the agreement was signed, however, Botswana left the RMA. According to the RMA agreement, the rand circulated as legal tender in the zone, but Swaziland and Lesotho retained their right to issue their own currencies. The agreement also provided for the countries to establish their own central banks. Swaziland established an independent monetary authority in 1974, converted to the Central Bank of Swaziland in 1979, and issued its own currency, the lilangeni, pegged at par to the South African rand. The monetary authority of Lesotho was established in 1979 and converted to the Central Bank of Lesotho in 1982. Lesotho introduced the loti in 1980 which was fixed at par with the South African rand.

Free movements of capital together with a peg to the rand provided free access to South African financial markets but meant that interest rates in the smaller countries were set according to the rates of the South African Reserve Bank and that no independent monetary was possible. Foreign

[31] *Le Monde,* 23 September, 1993; 20 January 1994. For a more detailed discussion see Stasavage (1997).

reserves were held with the South African Reserve Bank. The smaller countries were also compensated by South Africa for the loss of seignorage resulting from the use of the rand and their international reserves were remunerated at market rates of interest.

In 1986 the Trilateral Monetary Agreement supplanted the Rand Monetary Agreement, and established the Common Monetary Area (CMA). The new agreement provided for the signing of bilateral agreements between South Africa and the two partner countries. Conditional credit was made available from the South African Reserve Bank. Swaziland suspended the use of the rand as legal tender and Lesotho took over the management of its own international reserves. When Namibia became independent in 1990, it signed an agreement with South Africa that also provided for Namibia’s participation in the CMA, the circulation of the South African rand as legal tender, and for the establishment of Namibia’s central bank. Namibia began to issue its own currency (the Namibian dollar) at par with the rand in September 1993.

The CMA committee also provided for consultative meetings on monetary policy, but in practice the rand monetary policy has been determined by the South African Reserve Bank. Until 1979 the rand was pegged to either Sterling or the US dollar. Contrary to the CFA Zone, capital movements outside the zone were strictly controlled. In 1979, a dual exchange rate system was introduced with the financial rand rate applying to non-resident transactions and direct investment.[32] The South African Reserve Bank directly intervened on the other rate, the commercial rand. The two exchange rates were only unified in 1995.

### *6.2 Operations of the RMA-CMA*

Since 1979, monetary policy in South Africa has been relatively independent of political control, due no doubt in part to the fact that central bank governors have a ten year term of office. A dual objective of stabilising the dollar price of gold and maintaining price stability has been pursued and the result has been a relatively good inflation record. This low inflation was relatively rapidly passed through to the smaller RMA countries (Tirongo, 1998). Membership of the RMA has left little room for independent fiscal and monetary policies in Lesotho and Swaziland. Monetary policy has closely followed South Africa with interest rates broadly in line with those of South Africa, but some discretion was exercised through the use of a lower discount rate and liquidity requirements.

### *6.3 Obstacles to exit from the CMA: Lesotho and Swaziland*

Since Swaziland's independence its political system has provided for few checks and balances on executive authority. The same has been true for Lesotho since 1970 when its ruler, Prince Jonathan, declared a “holiday from politics” and abrogated the constitution. While the governments of Lesotho and Swaziland might at one point or another have sought to loosen their monetary ties with South Africa so as to pursue more independent monetary policies, agreements

[32] In 1983, following recommendations of the de Kock Commission (1984), the financial rand was abolished and capital controls on non-resident lifted. The sharp drop in gold prices in 1983 and the debt crisis in 1985 resulted in a steady decline of the rand and by 1985, the dual control system was re-established.

with South Africa in other areas helped give them an incentive not to do so. The Southern African Customs Union (SACU), signed between South Africa, Botswana, Lesotho and Swaziland in 1910 establishes free movements of goods and the right of transit among members as well as a common external tariff structure determined by South-Africa. When the agreement was re-negotiated in 1968, South Africa agreed to compensate the partner countries for the loss of fiscal discretion, the price increasing effect of the customs unions, implicit protection for South African industry, and the industrial polarisation of the tariff structure. The compensation agreed upon in 1968 was set to 42 percent of the respective share of customs revenue. In addition, since 1977 SACU has also included a stabilisation factor to counteract variations in payments. As a result, SACU transfers represent an important of government's receipts for both Lesotho and Swaziland. Finally, the two countries also gain in that they receive large remittances from labour working in South Africa.

### *6.4 Evolution of monetary rules in Botswana: post-1976*

While membership in the Southern African Customs Union apparently helped deter Lesotho and Swaziland from breaking their monetary links with South Africa, the Botswanan government exited the CMA in 1976, and yet it remained a member of SACU. In 1976, Botswana issued its own currency, the pula, and dropped out of the RMA all together. The Pula was initially linked to the US dollar at a rate which maintained parity to the rand. Beginning in 1980, the pula was pegged to a basket of currencies including the rand, the Zimbabwe dollar, and the SDR as a proxy for trade with the rest of the world. Since the 1990s, the pula has been floated, but in practice, it has been informally pegged to the rand. Since Botswana left the RMA, it has conducted several discretionary revaluations and devaluations to mitigate the impact of droughts and positive terms of trade shocks to its diamond sector. Two other main departures from the RMA involved the imposition of strict capital controls and the obligation to keep all reserves within the central bank rather than with commercial banks.

### *6.5 Botswana's policy performance*

Botswana's departure from rule-based monetary policy regime was not accompanied by a deterioration in macro-economic performance. The government actually became a significant net creditor to the central bank as part of an overall strategy of building up foreign reserves as a macro-economic response to Botswana's diamond boom of the early 1970s. When a severe drought hit Botswana in 1982, the accumulated reserves were able to serve as a buffer. Thus, quite arguably Botswana's good economic performance can be attributed more to the prudent macro-economic policies of the BDP, and its solid political base, rather than to the simple fact that it enjoyed a diamond boom (Harvey and Lewis, 1990). As shown by Sachs and Warner (1997), all other things being equal, countries with abundant natural resources have actually had poorer growth performance than states with fewer resources, precisely because they so often adopt the wrong policies in the face of natural resource booms.

In practice, Botswana's ability to conduct an independent monetary policy from South Africa has been limited. Its inflation record closely follows South African performance, as nearly the totality of South Africa price movements are passed through to Botswana's price index within a year

(Atta et al., 1996). The discretion that Botswana could exercise in this area was also exercised at the cost of imposing heavy capital controls and restrictions on commercial bank reserve holdings.

### *6.6 Accounting for Botswana's policy performance*

Botswana's departure from the CMA is not consistent with the hypotheses laid out in section 2 to the extent that it was able to leave the CMA without having to also forego the benefits it derived from the Southern African Customs Union. Normally, we would expect this selective exiting to be rare. From the point of view of its domestic political institutions, however, the Botswanan decision to opt for discretionary policies and the preservation of prudent macro-economic policy is consistent with our hypotheses. Botswana's political system has been characterised by a number of constitutional limitations on executive authority and a relatively democratic system, and so in practice there has been the sort of checks and balances which could guarantee a credible monetary policy. Botswana also has a remarkably low level of political instability (see Table 6, Section 3.2.), giving its government little incentive to establish a rule so as to ties the hands of a future government. Finally, as in Kenya its politics have been dominated by a group with an immediate interest in the maintenance of prudent macro-economic policies.

During the early 1960s two political parties struggled for control of Botswana: the BPP whose politics have been described as "radical, anti-colonial, and nationalistic" and the BDP which was more moderate and had close ties to the country's cattle producing elite (Colclough, 1980). It is commonly argued that Botswana's liberal economic policies have been greatly influenced by this group (Picard, 1987). Since independence, as a result of open elections the BDP has held a sizeable majority in the national assembly. Botswana's constitutional system provides for no extensive separation of powers, although there is a second house of parliament, the house of chiefs, which has veto power over constitutional issues. In this political context it seems likely that a rule-based monetary policy regime was adopted by the BDP government at independence, because it was far from ensured that it would be able to resist pressures for adopting more radical macro-economic policies. This mechanism suited the principal political supporters of the BDP who favoured prudent macro-economic policies. By the time of the establishment of Botswana's national currency in 1976, however, the BDP was essentially unchallenged as a political force. Under these conditions, as in Kenya, the BDP government had little incentive to retain a rule-based regime which had no effect other than to reduce Botswana's ability to adjust to external shocks.

## 7. Drawing lessons from the past

Several important regional initiatives are now taking place in Africa. In East Africa, a new treaty paving the way for a common market followed by a monetary union was released in April 1998. In 1994, the states of the West African Monetary Union signed a treaty creating the West African Economic and Monetary Union, which was followed in 1995 by the negotiation of a treaty creating the Central African Economic and Monetary Union. Both treaties have as their objective the establishment of a common market based on a customs union, the harmonisation of indirect tax legislation, and the co-ordination of economic policies between member countries through

regional surveillance procedures (Clement et al., 1996). In 1997, the countries of the Southern African Development Community[33] (SADC) signed a treaty creating a Free Trade Area. There are currently discussions on whether to extend the Common Monetary Area to the SADC countries. There are also various initiatives for the enhancement of regional co-operation like the Cross Border Initiative (CBI) launched in 1993 which provides a framework for the harmonisation of trade barriers, investment regulations, domestic banking and payments systems. Finally, the Lomé agreement between the European Union and the African, Caribbean and Pacific countries will be re-negotiated in 2000. It has been proposed that the new agreement should provide a framework for the enhancement of regional co-operation within Africa along the lines of the NAFTA agreement (European Union, 1997; Collier, 1991; Collier and Gunning, 1996).

While it is beyond the scope of this paper to evaluate each of these initiatives, the case studies conducted in the preceding sections can help shed light on some critical issues. We start by reviewing the results of the previous sections and present several implications of our work for policy. We then consider the literature on optimum currency areas and the potential counter-arguments against integration which it provides. Finally, we consider several issues in the institutional design of a monetary union.

### *7.1. The credibility of monetary policy rules*

The evidence we have presented shows that monetary policy rules can allow a state to make a credible commitment to prudent macro-economic policies, but only under certain conditions. Policy makers recommending establishment of monetary rules (or fiscal policy rules for that matter) might benefit from first asking whether the political institutions of the country in question are characterised by the checks and balances necessary for a government to be able to credibly commit on its own. When checks and balances are absent, regional agreements may be the only real possibility for credible commitment. But in order for these to be effective, it will need to be costly to exit from any union, and other states must be willing and able to veto potential transgressions of policy rules.

Countries in each of the three cases considered have generally lacked the sort of checks and balances in their political institutions which we suggest are necessary for credible commitment at the national level. This provides further confirmation for the intuition in Collier (1991) that many African governments have generally lacked the domestic political prerequisites for making credible commitments in the area of macroeconomic policy. Little separation of powers has existed between executive and legislature, governments for much of the period considered here were ruled by single parties, and changes in governments have often extra-constitutional in nature, resulting in a complete replacement of decision makers. While the existence of checks and balances in a country's political system is not synonymous with a system with multiple political parties, there is likely to be a fairly high correlation between the two. The re-emergence of multi-party systems in African countries may over time improve possibilities for governments to make credible commitments at the national level, but this development is likely to take time.

[33] SACU countries plus Mozambique, Angola, Zimbabwe, Zambia, Malawi, Mauritius, Tanzania and Zaire.

In the absence of domestic checks and balances, side payments originating from co-operation on other issues have in many cases proved sufficient to dissuade some governments from exiting a monetary union even when they would have preferred to adopt an independent monetary policy. This characterised Tanzania and Uganda between 1960 and 1965, a number of Franc Zone states between 1960 and 1973 as well as the RMA countries. Two policy recommendations can be derived from these observations. First, while African integration schemes have often suffered from a tendency to be over-ambitious and to recommend integration in a plethora of different areas, there does seems to be a strong logic to accompanying monetary integration with trade integration and sectoral agreements such as the Cross-Border Initiative. Second, the European Union in particular might play an important role by establishing a link with African regional monetary unions and by making this co-operation part of the revised Lomé accords.

A word of caution, however, is that even if it is costly to exit a monetary union, monetary integration will not allow states to credibly commit unless other participants are ready and able to veto attempts to break policy rules. In the East African Currency Board, Kenya vetoed attempts by Uganda and Tanzania to raise limits on central bank lending to governments. In the Franc Zone, France vetoed such efforts between 1960 and 1973. Between 1973 and 1994 neither France nor the largest states in the CFA Zone played this role.

### *7.2 Optimal currency area considerations*

A strong argument against monetary integration for African countries is that they do not constitute optimum currency areas as first defined by Mundell (1969). The transaction cost benefits of removing exchange rate volatility within an area are likely to be small for countries which trade relatively little with one another, as is the case for each of the unions considered here. In contrast, the loss of the nominal exchange rate instrument has the potential to represent a very significant cost for African countries due to the susceptibility of their economies to asymmetric shocks. The empirical evidence supports the idea that existing monetary agreements in Africa do not constitute optimum currency areas (Bayoumi and Ostry, 1997). Even in the Rand Monetary Area where Jenkins and Thomas (1998) found evidence of relative convergence in the eighties, output disturbances were hardly correlated.

The adverse effects of large asymmetric shocks are reinforced by the difficulty in implementing real adjustments. Migration of labour from smaller, often landlocked economies, towards the wealthier and larger economies can be substantial.[34] But labour flows from the larger economies to the smaller ones are unlikely to be sufficient to compensate for a negative shock occurring in the larger economies. With large public sector wage bills which are difficult to compress, downward price rigidities have proved significant. Fiscal transfers are another possibility for dealing with asymmetric shocks, but these are unlikely to be practical for African economies, given that they are difficult to operate even in a context like the European Union. As a result of the asymmetry of shocks, the burden put on smaller countries which are less affected by external shocks might also be excessive if the necessary nominal adjustment for the larger economies is larger, as was the case in CFA Zone at the beginning of the 1990s.

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[34] For example, in 1981, remittances amounted to 52,5% of exports of goods and services and 19,9% of imports of good and services in Burkina Faso.

The problems highlighted by the optimal currency areas literature are exacerbated for African monetary unions which adopt an external peg. In he CFA Zone, the peg to the French franc has the obvious appeal of borrowing credibility from the French monetary authorities, but it also strengthens the asymmetric character of shocks as French monetary policy is immune to shocks arising in the Western and Central monetary unions. In the second half of the 1980s, negative terms of trade shocks were reinforced by the appreciation of the French franc resulting from the "franc fort" policy of the French Central Bank. With the de facto peg to the Euro after January 1999, shocks in the African communities will be even more asymmetric to the conduct of monetary policy by the European Central Bank (Hadjimichael and Galy, 1997). Pegging to the Euro will shift the problem of exchange rate fluctuations to the stability of the US dollar-Euro exchange rate and the potential strength (or weakness) of the later. One argument usually put forward for the choice of the Euro is that the European Union is the main trading partner of African countries. A counter-argument is that the main currency of reference for African countries is still the dollar as most of their export commodities are traded in USD. An intermediate solution might be to peg to a basket of currencies, but Ghosh et al. (1996) find that such pegs often provide less credibility.

In sum, optimal currency area considerations would suggest that African countries should not form monetary unions, and these unions should not adopt single-currency pegs for their currencies. This is the exact opposite of what credibility considerations would suggest. One obvious recommendation which this leads to is that African countries participating in a monetary union need to make every possible effort to facilitate regional flows of labour, goods, and capital, and they should also reduce nominal rigidities in their economies. Monetary integration may itself have a dynamic effect by helping to stimulate intra-regional flows (Frankel and Rose, 1996), but the example of monetary integration in the CFA Zone, where intra-regional trade has remained stagnant, shows that this process if far from inevitable.

The problem with optimum currency area theory is that it assumes that if a government retains the nominal exchange rate as a policy instrument, it will only devalue (or revalue) when the action is warranted by economic considerations (Eichengreen, 1994). In fact, recent literature shows that factors such as political instability can greatly increase the likelihood that a country will devalue, independent of whether economic considerations warrant such a move (Klein and Marion, 1996). Many African countries have been plagued by political instability. In extreme cases, governments may gain nothing from retaining the nominal exchange rate as a policy tool, because in an environment of low monetary policy credibility devaluation will simply start a wage inflation spiral. In such contexts the potential advantages of monetary integration would become evident.

### *7.3. Designing an optimal framework*

Once a decision to push forward with monetary integration is made, there are a number of institutional design issues to deal with. We consider four here: whether to adopt an external peg, what sort of limits to place on central bank credit to government, how to apportion voting powers on a central bank governing board, and finally what sequence of steps to follow in moving towards monetary union.

A first suggestion is that when monetary unions adopt external pegs, these should be seen as Bretton Woods type arrangements which allow devaluation in cases of "fundamental disequilibria" rather than being immutable. This has the potential to weaken the credibility enhancing effect of an exchange rate peg, but there are other potential institutional sources of credibility in a monetary union, including the independence of the regional central bank, limits on central bank lending to governments, and the fact that within a union individual countries cannot devalue unilaterally.

A second suggestion is that countries should consider the establishment of rules limiting central bank lending which minimise incentives for countries to engage in pro-cyclical policies during commodity booms. Current rules in the CFA Zone actually intensify the adverse effects of shocks by encouraging pro-cyclical policy. By raising export tax receipts, positive terms of trade shocks increase the credit ceiling of a government with the central bank instead of forcing it to save a portion of any windfall. Thus, Côte d'Ivoire in the second half of the 1970s launched massive public investment programs which it could not sustain when the good days were over.[35] Conversely, a country hit by a negative terms of trade shock will be forced to proceed to an even greater real adjustment than would otherwise be required. One way to solve this would be for countries simply not to borrow up to their limit during good times so as to leave themselves more room for manoeuvre when negative shocks occur. In practice this has not happened in the CFA Zone since 1973, nor did it occur under the East African Currency Board.

One way to minimise this pro-cyclical aspect would be to set lending limits in terms of some absolute figure, but this would need to be regularly revised unless inflation was kept extremely low. A further possibility, is that a counter-cyclical element could be integrated into rules limiting central bank lending. The direct credit ceiling could be initially determined as a proportion of either a three-years average of government revenue or some absolute figure and subsequently be raised or lowered in inverse proportion to a country's terms of trade index.[36] At the same time, a minimum reserve requirement for a union's foreign reserves would be maintained, as is now the case in the CFA Zone, in order to ensure that the extension of credit to countries hit by adverse terms of trade shocks is covered by the potential savings accrued in other countries. This system would be more complex than simply setting limits for the stock of lending as a percentage of some aggregate, but it would be based on figures which are readily available and which would be difficult for governments to falsify. If necessary, intra-year adjustments t lending limits could also be made.

An additional feature of limits on central bank credit is that the experience of the CFA countries has shown that limits only on direct credit to governments are not sufficient and should be extended to cover indirect credit, particularly in the absence of well-developed and liquid domestic financial markets, and external borrowing. It would also be useful to follow Cottarelli's (1993) recommendation that specific measures be included in a central banks states to deal with cases where credit ceilings are broken. In such instances he recommends a provision for a freeze on all central bank payments to the government.

[35] These investment programs were, of course, not principally financed by central bank borrowing.

[36] This would only introduce a pro-cyclical component for terms of trader shocks. Another potentially important asymmetric shock in African countries are droughts.

A third institutional design issue relates to the potentially adverse effects caused by the hegemony of a dominant regional power as highlighted by the evolution of the CFA monetary unions and of the Common Monetary Area. Preferences of the larger economy are indeed likely to prevail in the conduct of monetary policy. This will be less of a problem when the larger economy has established a strong reputation of prudent monetary policy, but it is especially problematic to the extent that the larger country has low credibility and itself needs to be able to "tie its hands" through the regional arrangement. Adopting an external peg to a currency like the Euro would have the advantage of limiting the larger economy's capacity to dominant monetary policy, although as noted above this would also have certain disadvantages. Another possibility is to establish appropriate governance structures for regional central banks. In the CFA Zone, rules were overturned when the dominant country either chose the governor of the central bank (BCEAO) or was able to single-handedly block central bank board votes (BEAC). To guarantee independence for the central bank, we suggest a system where the dominant country in a union might nominate the governor, but this choice would then need to be unanimously approved by other members. The governor should also have a not too long period of office (say 4 to 5 years) and should only be re-appointable once. Finally, were the monetary unions more closely linked to the EMU, an observer of the ECB with no voting power might sit on the board.

A fourth design issue involves the sequence of steps to follow for countries considering deepening their level of monetary integration. Past experience suggests that it is important to adopt a voluntary scheme on a country by country basis and to involve the private sector, two key elements of the current relative success of the Cross-Border Initiative. Pegging to an external currency might also put limits to the design of the scheme, thereby facilitating an agreement, when one country dominates a region. Monetary integration should also be accompanied by the creation of an unified inter-bank market, the harmonisation of payments systems, the abolition of exchange restrictions and the adoption of a common regulatory and banking supervision authority, all of which are essential elements of a common monetary policy meant to rely increasingly on indirect instruments. As shown by the experience of the CFA countries, it is, however, important to realise that the establishment of a common market for goods and services need not to precede the creation a monetary union.

A final remark with regard to monetary unions involves the need for governments to provide more than just a stable macro-economic environment. As highlighted by the experience of CFA countries until 1973, rules can help governments make a credible commitment to stable monetary and fiscal policies, but this does not guarantee increased private investment and lead to a virtuous cycle where governments obtain a higher long term rate of growth than if they had attempted to fund development projects through seignorage. To the extent that there are other aspects of an economy which make investors wary, such as inadequate protection of property rights or inadequate infrastructure, investment will be deferred and no virtuous cycle will take place. Under these conditions pressures may grow to adopt more lax macro-economic policies for the short-term benefits they can provide.

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