

Institution: University of Oxford
Unit of Assessment: 24B Development Studies
Title of case study: Improving macroeconomic policy-making in East Africa
<p>1. Summary of the impact</p> <p>Research at Oxford by members of the International Growth Centre (IGC), funded by the Economic and Social Research Council (ESRC) and the Department for International Development (DFID), has played an important role in shaping two key areas of monetary and exchange rate policy formulation in East Africa.</p> <p>Research on <u>food prices and inflation</u> in Tanzania is providing the technical basis for the discussions of the Monetary Policy Committee (MPC) of the Bank of Tanzania, and has contributed to current thinking by the African Development Bank (ADB) on policy responses to global food price volatility in East Africa.</p> <p>Work on <u>exchange rate policy</u> has helped shape the Draft Protocol on East African Monetary Union currently being negotiated between the East African Community (EAC) partner states (Kenya, Uganda, Tanzania, Rwanda and Burundi).</p>
<p>2. Underpinning research</p> <p>This research is concerned with understanding the positive and normative aspects of how the structural economic characteristics of low-income countries influence the efficacy of monetary and fiscal policy in these countries.</p> <p>The underpinning analysis was initiated by a team led by Christopher Adam (Professor of Development Economics, Oxford Department of International Development). The initial work was developed with Stephen O’Connell (Swarthmore College and Centre for the Study of African Economies, Oxford), while the latter was on sabbatical leave in Oxford; as well as with Catherine Pattillo (Centre for the Study of African Economies, Oxford, 1994–96); and Edward Buffie (Indiana).</p> <p>The research programme continued through collaboration with colleagues at the International Monetary Fund and under an ESRC project award held jointly with Paul Collier (Professor of Economics and Public Policy, Blavatnik School of Government, Oxford) and David Vines (Professor of Economics, Oxford Martin School and Department of Economics).</p> <p>Since 2009, the research has been supported by the LSE-Oxford International Growth Centre (IGC) (www.theigc.org), an economic research network funded by DFID. The mission of the IGC is to promote sustainable growth in developing countries by providing demand-led policy advice based on frontier research. Christopher Adam is the research director for the Tanzanian country programme and coordinator of the IGC’s work on regional macroeconomic issues in East Africa.</p> <p>The research highlights the central role of: the volatility of domestic production, particularly in agriculture, and of external trade conditions; the absence of deep domestic asset markets and the consequent widespread prevalence of credit rationing; and low and/or limited policy credibility [See Section 3: R1, R2]. The researchers develop analytical models with these features to explore how conventional monetary, exchange rate and fiscal policy rules require modification for low-income countries. This analysis suggests, among other things, that when the fiscal and monetary authorities have a reasonable degree of credibility – as is arguably the case in Africa at present – the thinness of domestic debt markets means central banks should run a much more managed exchange rate policy than would be suggested by conventional models calibrated to OECD or middle-income/emerging market structures. This body of research has been published in leading economics journals [R1–R4].</p> <p>This analytical research has been supplemented more recently by detailed empirical analysis on</p>

monetary policy and inflation in Tanzania [R5, R6]. Since the mid-1990s, Tanzania has adopted a floating exchange rate with a money-targets approach as its chosen anchor for inflation. Whilst this has worked well in the past, there are concerns that financial innovation and an increasingly open capital account are undermining the efficacy of this approach to inflation control, and that the authorities should be moving to a conventional inflation-targeting regime.

This empirical research on the monetary transmission mechanism and the structural determinants of inflation in Tanzania suggest that such policy stances may have unanticipated negative consequences. The research continues to evolve both with the IGC in Tanzania and through direct collaboration with staff from the IMF research department under the aegis of the DFID-IMF programme *Macroeconomic Research in Low-income Countries*, which commenced in the second half of 2012. It is this body of research that has led to the IGC-Tanzania being asked to serve as an advisor to the Monetary Affairs Committee (MAC) of the East African Community, leading to work by Oxford researchers on exchange rate options in the transition to monetary union [R7].

3. References to the research

[R1] Buffie, E, C S Adam, S O'Connell and C Pattillo (2008) 'Riding the Wave: Monetary Responses to Aid Surges in Low-Income Countries'. *European Economic Review* 52 (8): 1378–95.

[R2] Adam, C S, D L Bevan and G Chambas (2001) 'Exchange Rate Regimes and Revenue Productivity in Sub-Saharan Africa'. *Journal of Development Economics* 64 (2): 173–213.

[R3] Adam, C S, E Buffie, S O'Connell and C Pattillo (2004) 'Exchange Rate Policy and Management of Official and Private Capital Flows in Africa'. *IMF Staff Papers* 51 (S1):126–60.

[R4] Buffie, E, S O'Connell and C S Adam (2010) 'Fiscal Inertia, Donor Credibility, and the Monetary Management of Aid Surges'. *Journal of Development Economics* 93 (2): 287–98.

[R5] Adam, C S, D Kwimbere, W Mbowe and S O'Connell (2012) 'Food Prices and the Dynamics of Inflation in Tanzania. *IGC Working Paper 12/0459*. London: IGC.

A policy-focused version of this paper appears as *African Development Bank Working Paper 163* (2012) of the African Development Bank Group and is featured in the forthcoming African Development Bank Research Bulletin on *Inflation in East Africa*, edited by Christopher Adam and Anthony Simpasa for the African Development Bank.

[R6] Montiel, P, C S Adam, W Mbowe and S O'Connell (2012) 'Financial Architecture and the Monetary Transmission Mechanism in Tanzania'. *IGC Working Paper 12/0343*. London: IGC; and *CSAE Working Paper 2012-03*. Oxford: Centre for the Study of African Economies.

[R7] Adam, C S, P Kessy, C Kombe and S O'Connell (2012) 'Exchange Rate Arrangements in the Transition to East African Monetary Union'. *IGC-Working Paper 12/458*. London: IGC. Forthcoming in Oral Williams (ed) *The Quest for Regional Integration in East Africa* (IMF and OUP). This paper was written at the request of the MAC (see [C4] below).

Evidence of quality:

The *Journal of Development Economics* is widely regarded as the leading field journal in development economics; the *European Economic Review* is a top-10 general economics journal and *IMF Staff Papers* is the in-house (peer-reviewed) journal of the IMF and is widely read in relevant macroeconomic policy circles.

Research grants:

Managing Macroeconomic Risks in Developing Countries: Policies and Institutions; ESRC project award RES-156-25-001; October 2005–January 2009, £265,000.

The International Growth Centre, Department for International Development (DFID); 2008–12 (Phase 1), £37 million; 2013–17 (Phase 2), £51.6 million. The annual budget for the IGC-Tanzania

programme is approximately £400,000.

4. Details of the impact

Advising the Monetary Policy Committee on food prices and inflation dynamics

Rising inflation and the challenge of implementing an effective monetary policy in the face of increased volatility in world food and fuel prices have recently emerged as major concerns for policy-makers in Tanzania and for the Bank of Tanzania in particular.

The team's work on food price dynamics and the transmission of monetary policy [R5, R6], was initially discussed at internal and public seminars hosted by the Bank of Tanzania in 2011 [see Section 5: C1].

As a result of the exposure of his research, Christopher Adam was subsequently invited to present his research findings to a High-level Policy Dialogue meeting of East African central bank governors and advisors hosted by the African Development Bank in Nairobi in February 2012 and to edit a special issue of the African Development Bank's Research Bulletin on *Inflation in East Africa*.

Based on this research, Christopher Adam was then invited to make a presentation on inflation dynamics to the August 2011 meeting of the Bank of Tanzania Monetary Policy Committee (MPC), the first time an external speaker has been asked to address the committee. In response to specific follow-on requests from the governor of the bank, he made further presentations in February 2012 and May 2013 to assist the committee in analysing the inflationary consequences of, and the monetary policy response to, changes in domestic and international energy prices [C2].

Based on these presentations, Christopher Adam (for the IGC) has subsequently been working with Bank of Tanzania research department staff to produce the bi-monthly *Inflation Report* for the MPC [C3]. Reports of this kind were pioneered by the Bank of England and other leading central banks and are core components of the new framework for the conduct of monetary policy being developed by the Bank of Tanzania. It is anticipated that as the Bank of Tanzania's own capacity strengthens, it will take over full responsibility for the *Inflation Report* [C1].

Exchange rate policy and the transition to monetary union

At their summit in 2007, the heads of state of the EAC (Kenya, Uganda, Tanzania, Rwanda and Burundi) committed themselves to move with all deliberate speed towards monetary union. Charged with the role of advising the heads of state on the economic implications of monetary union in the region, the Monetary Affairs Committee of the EAC, comprising the central bank governors of the five partner states, invited the IGC-Tanzania led by Christopher Adam to act as one of their five lead advisers. The other invited advisers were the IMF, the African Development Bank, the Bank of England and the Riksbank of Sweden. IGC-Tanzania was asked to be the lead advisor on 'Exchange Rate Arrangements in the Transition to East African Monetary Union'. The research report outlining its recommendations is listed above [R7].

Five options for exchange rate policy during the transition towards monetary union were examined by the researchers. As recent developments in Europe have highlighted, the challenges of monetary union with incomplete fiscal union are significant and these are compounded in East Africa by the limited integration of goods and factor markets and by emerging structural tensions being exposed by large-scale oil and gas discoveries in some EAC countries. The researchers therefore advised (contrary to earlier advice from the European Central Bank) that EAC countries should maintain their current inflation-anchors (ie moderately managed floats) during the possibly attenuated convergence phase towards monetary union. Only when a viable level of (political and fiscal) convergence is achieved should the authorities move to an exchange rate grid as a prelude to establishing irrevocable conversion rates to the new currency. The researchers recommended that during this transition, partner states should develop strategies that exploit the benefits of

greater integration and coordination in the monetary sphere but should not prematurely commit the countries to difficult-to-reverse steps to full monetary union.

Drafts of the research paper and policy recommendations [R7, C4] were discussed by Partner State central bank governors at meetings of the MAC between December 2010 and April 2012. These recommendations were endorsed in full by governors and formally submitted to the High-level Task Force of the East African Community Secretariat in May 2012 [C5]. The task force is responsible for liaison with heads of state and for the eventual preparation of the protocol for negotiating monetary union in the region. The protocol is effectively East Africa's Maastricht Treaty. The recommendations were incorporated into the draft protocol in November 2012 and approved by EAC heads of state in Kigali on 23 February 2013 [C6]. The final protocol is expected to be published for ratification by partner states in late 2013 or early 2014. Thanks to his research and existing impact, Christopher Adam continues to advise Bank of Tanzania representatives on the High-level Task Force.

5. Sources to corroborate the impact

Advising the Monetary Policy Committee on food prices and inflation dynamics

[C1] Governor, Bank of Tanzania. In a letter to then-Secretary of State for International Development Andrew Mitchell dated July 2011 he notes the contribution of IGC to the Bank of Tanzania's work on monetary policy and inflation and its support to the MAC (held on file).

[C2] Minutes of the Bank of Tanzania's MPC Meetings illustrating discussion of the Oxford research on inflation forecasting (not circulated, but available on request).

[C3] Bank of Tanzania *Inflation Reports* produced for bi-monthly meetings of the MPC (July 2012, October 2012, January 2013, May 2013, July 2013 and September 2013) (available on request).

Exchange rate policy and the transition to monetary union

[C4] Adam, C S, P Kessy, C Kombe and S O'Connell (2012) 'Exchange Rate Arrangements in the Transition to East African Monetary Union'. Report submitted with Executive Summary of Recommendations to the EAC Monetary Affairs Committee and Economic Affairs Sub-committee, Nairobi, April 2012.

[C5] *Monetary Affairs Committee of the EAC, Report of Governors, Kampala, 11 May 2012* (Section 1.6.1). Governors endorse recommendations from the IGC report and recommend transmission to the High-Level Task Force negotiating the protocol (available on request).

[C6] Draft Protocol from the High-Level Task Force, approved at Kigali, Rwanda, 23 February 2013 (available on request).

[C7] An EAC press release on the negotiations, noting the involvement of the IGC, is available at http://www.eac.int/index.php?option=com_content&view=article&id=1053:eac-single-currency-talks-resume-monday-23-july&catid=146:press-releases&Itemid=194