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Is There A SADC Business Cycle: Evidence from Dynamic Factor Model

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Countries that are successfully executing trade and economic liberalization are experiencing high levels of economic growth and improved living standards. Therefore, in striving to eradicate poverty and promote economic growth the African Union (AU) made its goal to form a monetary union followed by a single currency for the whole continent of Africa (Tipoy, 2015), thereby fostering trade and economic liberalization in the African continent. Building from the AU's goal, the Southern Africa Development Community[1] (SADC) decided to establish a monetary union by 2016 to be followed by the launch of a single currency in 2018. The plan to form a monetary union and establish a single currency in the SADC area not only aims to reduce poverty but it also aims to reduce heterogeneity among SADC economies. Simply put, it aims to achieve convergence in economic growth among SADC member states (Tipoy, 2015).

It is generally accepted that regional unification through the elimination of barriers to trade, the coordination of policies that would otherwise segment the market, and allowing free labour and capital movement, not only leads to equalization of factor prices but also leads to convergence of economic structures and growth (Krugman, 1990). Contrary to what the SADC region seeks to achieve, Romer (1986) argues that the unification of countries may lead to regional and geographical heterogeneity because factors of production will be shifted and concentrated to developed countries due to returns scale and scope (Backus et al., 1992). However, Solow (1956) holds a different view, which lends support to the aims of the SADC area: that integration will automatically lead to convergence because of the free movement of factors of production and the international diffusion of technical know-how (see, Frankel and Rose, 1998).

Following the seminal work of Mundell (1961) and the issues experienced in the Eurozone an enormous amount of literature has been devoted to the assessment of the readiness of countries to form monetary unions and forgo their monetary policy sovereignty. To highlight some contributions, both international and in the SADC area, Tipoy (2015), Kumo (2011) and Zerihun et al. (2014) all find that SADC as a whole is not yet ready to form a monetary union.

The formation of a single currency should not be based only on political advantages for a single country but it should be based on economic costs and benefits as well. Put differently, the costs of forming a monetary union should be outweighed by the benefits of forming a monetary union (Mundell, 1961). Therefore, in order to avoid the formation of a monetary union based only on political considerations, the theory of optimal currency areas (OCA) formulated by Mundell (1961) and developed by Kenen (1969) amongst others, proposed some conditions that countries need to adhere to in order to form a successful monetary union. The theory of OCA emphasizes business cycle synchronization as a necessary and primary condition for forming a monetary union (Faia, 2007). Therefore, this study employs real GDP to assess the aptness of SADC member states to form a monetary union. If business cycles are synchronized it means that member states do not necessarily require country-specific exchange and monetary policies (Masson and Pattillo, 2004). However, if they are not synchronized it means that countries need country-specific

[1] SADC consists of Angola, Botswana, Democratic Republic of Congo, Lesotho, Madagascar, Mozambique, Mauritius, Malawi, Namibia, Seychelles, Swaziland, Tanzania, South Africa, Zambia, and Zimbabwe

policies in order to deal with economic disturbances and, hence, they are not ready to adopt a single monetary policy or to form a monetary union.

1. **Key findings of the study**
    - Our findings show business cycles in the SADC region are primarily explained by country-specific factors. Simply put, there is no or little comovement in business cycles for SADC member countries.
    - However, our findings also reveal that although SADC business cycles are not synchronized, but they are to some extent synchronized in the Common Monetary Area (CMA) which comprises of South Africa, Namibia, Lesotho and Swaziland.

2. **Policy Implications**
    - The proposed timeframe is ambitious given that business cycles are not synchronized. Hence, countries will require country-specific monetary and exchange rate policies to tackle economic disturbances.
    - Instead of rushing into establishing a monetary union for the SADC as a whole energies should be invested into factors that will drive SADC toward an optimal currency area.
    - Lastly, CMA countries could be used as a pilot project and SADC monetary union could come through as an extension of the CMA.

References

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