



**EAST AFRICAN COMMUNITY
SECRETARIAT**

Discussion paper with regard to a Study on the establishment of a monetary union among the Partner States of the East African Community in preparation of visits to the EAC Partner States from 7 to 25 September 2009 by the Project Teams of the East African Community and the European Central Bank



EUROPEAN CENTRAL BANK

EUROSYSTEM

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Acronyms

EAC	East African Community
EACB	East African Central Bank
EAMI	East African Monetary Institute
EAMU	East African Monetary Union
EC	European Community
ECB	European Central Bank
EMI	European Monetary Institute
EMU	European Economic and Monetary Union
ESCB	European System of Central Banks
EU	European Union (Belgium, Bulgaria, Czech Republic, Denmark, Germany, Estonia, Greece, Spain, France, Ireland, Italy, Cyprus, Latvia, Lithuania, Luxemburg, Hungary, Malta, Netherlands, Austria, Poland, Portugal, Romania, Slovenia, Slovakia, Finland, Sweden, United Kingdom)
MAC	Monetary Affairs Committee
MUP	Monetary Union Protocol
NCB	National Central Bank

1. Introduction

1.1. Visits to the EAC Partner States by the EAC and ECB Project Teams

On 2 June 2009, the East African Community (EAC) and the European Central Bank (ECB) entered into a consultancy agreement (the Consultancy Agreement) with regard to the preparation of a Study (the Study) on the establishment of a monetary union (EAMU) among the Partner States of the East African Community (EAC). This Consultancy Agreement provides among other matters that the Project Teams of the EAC and ECB visit the EAC Partner States. These visits have been scheduled as follows:

- 7 and 8 September, Dar es Salaam, Tanzania
- 10 and 11 September, Nairobi, Kenya
- 14 and 15 September, Kampala, Uganda
- 17 and 18 September, Kigali, Rwanda
- 21 and 22 September, Bujumbura, Burundi
- 24 and 25 September, Arusha, Tanzania

The purpose of the above visits is to meet with the various stakeholders in the process towards monetary union and to make them acquainted with those matters which are likely to arise in this process. These stakeholders are generally composed of the following parties: (a) the National Central Banks (NCBs) of the EAC Partner States; (b) Ministries of: Finance, EAC Affairs, Planning, Trade, Industry; Capital Markets; Bureaus of Statistics; and (c) Bankers Associations, Academia, Parliaments, the Private Sector, Civil Society; and other stakeholders. The purpose of this Discussion Paper is twofold. Firstly, it explains the scope of the Study, which will in a final version be submitted by the ECB Project Team to the EAC Project Team in January 2010, as agreed in the above Consultancy Agreement. Secondly, this Discussion Paper is intended to stimulate reflection and discussion between the various stakeholders and the EAC and ECB Project Teams during the visits. It goes beyond saying that the observations in this Discussion Paper are of a tentative nature and that they do not prejudge the final content of the Study.

1.2. The agreed content of the Study

In the Consultancy Agreement, and in line with the EAC's Terms of Reference for the Study, it was agreed that the Study will outline the different actions and steps in the move to EAMU and set them in context. The intention is to show what needs to be done in the move towards EAMU, and how it could be done. The Study (of which a tentative Table of Contents is attached to this Discussion Paper as Annex) will address four main topics:

- the prerequisites for EAMU (Part I) ;
- the establishment of the legal and institutional framework necessary for the implementation of EAMU (Part II);
- preparatory work for the move to EAMU inclusive of the measures to be taken in replacing the national currencies with the future single currency (Part III); and

- the operational regulatory framework for EAMU (Part IV).

As far as the structuring of the different sections of the above parts of the Study is concerned, where possible and appropriate, each section will first provide for a general introduction of the topic at stake, then turn to experiences gained in the European Union (EU), subsequently address the situation in the EAC and its Partner States, and conclude with recommendations to the EAC and its Partner States with regard to the way forward. Below, each of the above topics will be elaborated separately and the main issues at this juncture at stake will be highlighted for further reflection and discussion, noting that the process towards EAMU is at present obviously in its early stages.

2. Prerequisites for East African Monetary Union

Having regard to the EAC Treaty, the EAC Development Strategy 2006-10, and the Directive by the Summit of Heads of State to the EAC Secretariat to fast-track the establishment of an MU by 2012, the establishment of a monetary union can be seen as a fundamentally political issue, though with important economic implications. Currency unions are generally formed (and expected to be viable) as part of a larger strategic push to integrate the countries entering the currency union, in particular in combination with the free movement of goods, persons, and capital within the single currency area. Viewed in this way, the decision to embark on a currency union is a major policy decision. In explaining the prerequisites of a viable and sustainable monetary union, the Study aims at assisting the EAC and its Partner States in developing methods and tools which would enable them to test their preparedness for EAMU and to take the necessary steps in the move towards EAMU. The focus of the Study will thus be to give the EAC and its Partner States the benefit of the ECB's experience while at the same time creating a strong sense of 'owning' the project on the side of the EAC and its Partner States.

2.1. Convergence and compatibility of economic policies and performances

Monetary Union will necessitate the conduct of a single monetary and exchange rate policy which will have to be geared to the conditions prevailing in the single currency area as a whole and thus can no longer address national imbalances. The impossibility of conducting a national monetary or exchange rate policy after the formation of monetary union underline the importance of starting from a position in which such a reduction of national discretion in macroeconomic policy can easily be borne and will not (in terms of its costs on the national economies) exceed the benefits of introducing the single currency.

To function smoothly and to bring about economic benefits for all EAC Partner States, EAMU should therefore start with a high degree of sustainable monetary and economic convergence and compatibility among the Partner States, which should continue thereafter. Thus, the EAC Partner States should experience broadly synchronous economic cycles, similar external shocks (arising for example from fluctuations in world commodity prices), and similar inflation and growth rates. Income levels may also be important. Comparable interest rates are likely to be similar, and the EAC Partner States should experience a good degree of stability in nominal bilateral exchange rates. To reap benefits from a single currency, EAC Partner States should enjoy a good measure of economic

integration (trade and financial flows, and cross-border movements of people and enterprises). Integration of financial markets is indeed necessary for monetary policy to work across the whole area.

2.2. Fiscal discipline

Fiscal policy is the most important element of economic policy which, it may be assumed, would remain at least initially within the competence of EAC Partner States in a monetary union. But a sustainable monetary union will rely in the longer run on commonly agreed standards for sound fiscal policies. Thus, the Partner States' freedom of action is in practice likely to be constrained by fiscal rules designed to avoid a 'free rider' problem, the enforcement of which would require political acceptance.

2.3. A comprehensive strategy for the transition to East African Monetary Union

This part of the Study is planned to address the kind of strategy which would be appropriate for the EAC to achieve EAMU. Again taking the experience of the process in the EU, there are two options. One would consist of keeping the goal of EAMU as a distant aim and wait for a firm political commitment embodied in a Monetary Union Protocol until the time when the fulfilment of all prerequisites for EAMU is within reach, agreeing in the meantime on measures which would lead in the right direction. The other would consist of EAC Partner States committing themselves to fulfil the conditions necessary for entering into EAMU, relying on an institutional drive to EAMU which would act as a catalyst for implementing the necessary reforms and policy measures to be taken.

The first option has the advantage that the move to EAMU can be easily rescheduled without much reputational loss if the degree of convergence remains insufficient within the planned time span to enter into a monetary union. In contrast, it may lack enough political drive for taking the necessary policy measures towards EAMU. The second option would avoid giving no date for the final aim of EAMU but may carry the risk that EAC Partner States rush into a monetary union arrangement prematurely. To be credible, the second option would need to include the possibility of a differentiated monetary integration, i.e. (as provided for in the Maastricht Treaty) a monetary union only among those countries which fulfil the necessary convergence criteria. It would have to be seen whether such an option would be politically viable in the EAC's case with a limited number of participating Partner States. Given the current circumstances, and the progress made by the EAC countries, emphasis should be put on the second option.

2.4. Enhancing cooperation in the monetary and exchange rate field

There are strong reasons (as the EAC Treaty envisages) for implementing or continuing cooperation in the monetary and exchange rate field. As suggested by the history of monetary cooperation in the EU, such cooperation may help to foster internal and external stability within a regional area, recognising that such an institutional framework cannot replace (but can only support) Partner States' efforts to adjust domestic policies. The Study would in particular emphasise:

- A detailed statement of common objectives for monetary policy.

- A set of compatible monetary policy instruments which could achieve these objectives at each national level. The instruments need not be identical, because national banking/financial market structures differ, and they need not be applied simultaneously, but they should be capable of being applied nationally without creating difficulties for others, which may influence their features and require them to be used in a coordinated way and a cooperative spirit.
- A common exchange rate regime, perhaps in the form of narrow fluctuation margins for bilateral (nominal) EAC exchange rates and a wider margin against third currencies, which in turn might be specified against the dollar, the SDR, or a basket representing the pattern of the EAC's (joint) external transactions/relationships (perhaps composed of the dollar, euro, pound sterling, yen, Chinese renminbi, Indian rupee, South African rand).

The elaboration and implementation of such a scheme could signal a continuing endeavor to pursue the aim of monetary integration. A satisfactory outcome of such cooperation over a prolonged period would provide good evidence that EAC Partner States could live under the more constraining conditions of a monetary union. At the same time, it would be possible to pause or step back without undue difficulty, if this degree of monetary integration put the Partner States' economies, or some of them, under strain.

3. Establishment of the legal and institutional framework necessary for the implementation of East African Monetary Union

A monetary union needs to be prepared and subsequently be operated within the framework of a comprehensive set of pre-established rules (the legal framework) and an adequate institutional structure including the establishment of supra-national monetary institutions (the institutional framework). Throughout the Study, it will be assumed that EAMU is to be realised within the framework of the existing EAC institutional framework. However, the realisation of EAMU not only requires extending the present scope of the EAC, but also adapting its legal foundations and institutional set-up. The proposals contained in the Study will be based on EU experience and they will have to be critically reviewed by the EAC and its Partner States to confirm their feasibility and suitability for EAC purposes.

3.1. Legal framework

The Study will recommend embedding EAMU in an overarching framework through the adoption of a Monetary Union Protocol (the "Protocol"), laying down the foundations of EAMU. This Protocol, having regard to the EAC Development Strategy 2006-10, would specify in particular:

- the features and basic principles of EAMU, the timetable for its achievement, and the establishment of an interim East African Monetary Institute (EAMI) as the institutional framework for preparatory work;
- the institutional framework for running EAMU, including the establishment of the new monetary authority, the competences and the powers of the supra-national bodies;

- the name, definition, and status of the single currency and the measures to be taken for its introduction as unit of account and means of payment; and
- the Partner States' obligations arising from the establishment of EAMU and from the commitments undertaken to achieve and maintain economic convergence and fiscal discipline.

The Protocol would in terms of Article 151 of the EAC Treaty become an integral part of the Treaty. The mission, mandates, status and powers of the new monetary authorities would have to be defined by statutes consistent with the Protocol and thus the EAC Treaty.

3.2. Institutional framework

At the start of EAMU, the EAC Partner States would transfer their monetary sovereignty to the supra-national level. This would necessitate the establishment of the permanent institutional framework for centralised decision-making on all matters related to EAMU and the single currency. In particular, it would require setting up a supra-national monetary authority with the competence for conducting the single monetary policy (see 3.2.2 below) as well as the adaptation of existing Community bodies with a view to their new tasks in the context of operating EAMU (see 3.2.3 below).

In addition, it would be useful to envisage a specific institutional framework for ensuring an efficient organisation and implementation of preparatory work in view of the move to EAMU. While it would be possible to establish the new monetary authority well ahead of the start of EAMU and to entrust it with the task to take the lead in all necessary preparations, political and legal considerations may instead point to setting up a temporary institution (the East African Monetary Institute) as a precursor to the new monetary authority (see 3.2.1 below). It is understood that the EAC Heads of State have already decided that such an Institute shall be established and this will therefore be taken for granted throughout this discussion paper.

3.2.1. The proposed East African Monetary Institute

The EAMI would serve two main purposes.

- Firstly, it would serve as the institutional forum for the analytical and technical preparation of the central bank function in the forthcoming EAMU. In this context, it would replace the institutional arrangements which already exist under the auspices of the EAC for cooperation between the NCBs of the Partner States and preparation of EAMU.
- Secondly, it would serve as the institutional nucleus from which the new monetary authority will evolve. It would thus foreshadow the future monetary authority in charge of the single monetary and exchange rate stability.

The Study will suggest establishing the EAMI at an early stage with a view to providing the necessary impetus to the move towards EAMU.

The EAMI is intended to be a transitory body. Its mission will be completed at the latest when EAMU starts. Given its status as a transitory body and in the absence of powers in the field of monetary and exchange rate policy (which will remain in the realm of the EAC Partner States until the start of EAMU), the EAMI could not serve as the central monetary institution in EAMU. Indeed, a monetary union with a single currency requires a single monetary policy and a single exchange rate policy. A

mere coordination of national monetary policies is insufficient to sustain a monetary union with a single currency.

3.2.2. The proposed East African Central Bank

A monetary union with a single currency will require a supra-national institution, which will be responsible for the single monetary and a single exchange rate policy. Monetary policy is indivisible because, with the free movement of capital and efficient markets, liquidity conditions within a single currency area will tend to equalise at any moment. Furthermore, since the exchange rate is an important variable of monetary and financial conditions, monetary policy and exchange rate policy are closely interrelated.

The Study will propose that the supra-national institution will take the form of a central bank, the East African Central Bank (EACB). It would primarily be established with a view to providing the framework for centralising decision-making on monetary and exchange rate policies. Its supra-national status ensures that its decisions are guided by the objectives of the single currency area as a whole.

As the EACB performs a public function, it needs to be provided with a clear and unambiguous mandate stating its primary objective. The Study will suggest that price stability is an objective which is clear and unambiguous and leaves relatively little room for interpretation. It is in line with the current state of art in central banking, not only in Europe but also in other parts of the world.

The EACB may be organised in various forms:

- as a single supra-national central bank which would be substituted for the existing national central banks (which could become regional administrative offices of the single central bank);
or
- as leader and core of a system of central banks: the latter would act under its guidance as points of access to the central bank facilities of the single currency area.

The first option presents many advantages from a functional and presentational point of view, but may meet some objection at a political level. The central bank system model would be more complex but would be politically more palatable and would imply lower transformation costs. By not discriminating between the financial centres in the single currency area, it would also ease the choice of the EAC Partner State to host the EACB.

Legal, institutional, and functional independence of the EACB would facilitate its task to achieve the primary objective of price stability. An independent central bank is not only in a better position to pursue the primary objective of price stability; it is also perceived by the financial markets and the general public to be more credible than a central bank which is dependent on a government. These considerations are especially important for a supra-national central bank which operates in a monetary union formed by otherwise sovereign states, whereby decisions and operations should be taken with a currency area perspective and without any national bias.

While independence is an essential prerequisite for the fulfilment of the EACB's objectives and tasks, the Study will also recognise the importance of transparency and accountability. Transparency enhances the effectiveness of monetary policy and it also facilitates the process of holding an independent central bank accountable. The EACB may discharge itself of this obligation in particular by issuing regular reports which allow the EAC, the Partner States, the financial markets, and the general public to assess whether and to what extent the EACB has achieved its objectives.

The EACB Statute would not prejudice the monetary and exchange rate policy approach which an EACB might wish to adopt following its establishment. It also does not predetermine the extent to which central bank operations will be centralised or decentralised in EAMU should the approach of a central bank system be chosen. In that case, it is assumed that the NCBs will be involved in the implementation of policies formulated by the EACB as points of access to the central bank facilities of the single currency area. As members of the EACB, the NCBs will in particular:

- assist the EACB in the performance of its operational and statistical functions; and
- carry out the tasks delegated to them in conformity with the regulations and decisions of the EACB.

3.2.3. Other components of the institutional framework

There are several further aspects which require adaptation of the institutional set-up of the EAC.

Firstly, while the EACB would perform its functions and tasks independently and in conformity with its Statute, it cannot operate in a political vacuum. Thus, without prejudice to its independence, the EACB needs to be integrated in the institutional framework of the EAC. This framework needs to ensure that:

- the EACB may be held properly accountable;
- a forum is established where the EACB may conduct a dialogue with the authorities of the Partner States (which remain responsible for economic policies other than monetary and exchange rate policy in the single currency area); and
- the EACB is recognised as the initiator of and/or adviser on all legislation covering areas falling within its competence.

Secondly, the institutional framework needs to be adapted to establish procedures and mechanisms for regularly monitoring and assessing economic convergence and fostering fiscal discipline in the EAC Partner States.

Thirdly, in order to ensure that the supra-national bodies act in line with a predefined rule of law regime, their legal acts (imposing obligations on third persons) should be subject to judicial review by an independent body which would decide solely on the basis of the law of the EAC, without considering any underlying national interests. The existence of a mechanism for adjudication creates a counterweight to regulatory and sanctioning powers in the monetary and prudential supervisory field, and ensures uniform implementation of the relevant statutory provisions throughout the single currency area. The EAC may therefore wish to consider empowering the existing East African Court of Justice to adjudicate on such matters.

4. Preparatory work for the move to East African Monetary Union inclusive of the measures to be taken in replacing the national currencies with the future single currency

Preparatory work for monetary union is complex mainly because:

- it will cover a wide range of interrelated topics involving different groups; and
- it is time critical and has to take account of different, but often long, project lead times.

Against this background,

- it is preferable to pursue preparatory work as early as possible once there is the prospect of EAMU;
- it is necessary to conduct such work in a coordinated and synchronised fashion on the basis of a Masterplan within the framework of the EAMI; and
- progress needs to be closely monitored by the EAMI.

The EAMI is expected to carry out the bulk of preparatory work in cooperation with the NCBs of the EAC Partner States. In order to organise cooperation between the EAMI and the NCBs, the Study will recommend that a number of specialised committees composed of EAMI/EACB and NCB representatives be established (representing a development of the present sub-committee structure of the Monetary Affairs Committee). Such committees will contribute to the different stages of projects to establish MU, namely the setting of strategic goals, technical preparations, and implementation (including testing).

The Study will describe preparatory work by area and topic. The different actions and steps will be further elaborated in so-called fiches or detailed task lists, which among other things identify the responsible committee and the relationship with other projects, and list relevant reference materials mostly drawn from monetary union in Europe which may serve as an example and save time in the EAC context. This may provide the basis of a Masterplan for preparatory work for the EAMI as whole and for the different committees individually.

The changeover from the existing national currencies to the single currency gives rise to a number of legal, organisational, and communication issues. The single currency will serve as a unit of account, medium for transactions, and store of value. The changeover to the single currency will affect all aspects of economic life and involve all sectors of the economy. It will thus be a great challenge for all bodies, and in particular the EAMI and thereafter the EACB in view of their special responsibility for the smooth realisation of this undertaking. To ensure transparency and public acceptance, the changeover will need to be guided by the principles of legal security, simplicity and user-friendliness, cost-effectiveness, and avoidance of competitive distortions. How well the changeover is conducted will no doubt affect the reputation of the EACB and the public perception of EAMU for many years

It is noted that some preparatory work has already been carried out by the EAC and its Partner States, in particular in the framework of the Monetary Affairs Committee (MAC). Such preparatory work is in particular described in a Report of the MAC called “Achievements, challenges and way forward (1998 – 2008)” and dated January 2009. This will be reflected in the Study.

5. The operational regulatory framework for East African Monetary Union

As elaborated in Section 3 of Discussion Paper, the establishment of a monetary union requires the adoption of several basic legal instruments such as a Monetary Union Protocol. However, in the legal field more needs to be done. In addition to such basic legal instruments, the legal underpinnings of the operational framework for a monetary union need to be created. In the experience of the ECB, this requires the adoption of a variety of legal acts in a number of different areas by various actors. Below, some examples are mentioned for illustration.

Firstly, the introduction of a single currency requires the adoption at an EAC level of legal acts on issues such as the continuity of contracts in legacy currencies, rounding rules, and counterfeiting.

Secondly, if the EAC decides to create a decentralised system of central banks such as the European System of Central Banks, the introduction of a single currency will require the harmonisation of the operational frameworks of the National Central Banks (NCBs) in order to ensure that the relevant parties are all treated equally (at least materially), for example as far as the access to liquidity in the single currency is concerned. This requires the adoption of a legal act by the future EACB addressed to the EAC NCBs. Also, the conduct of a single monetary policy needs to be supported by accurate statistics, and non-compliance by reporting agents with their obligations to deliver the necessary data will have to be sanctioned through uniform rules applicable across the single currency area. This requires the adoption of legislation at an EAC and/or EACB level.

Thirdly, the smooth operation of a single currency area wide payment system requires harmonised rules on issues such as the finality of payments and the implications of an insolvency of a participant in such a payment system. Such rules need to be adopted at an EAC and/or EACB level and, where necessary, be implemented at a national level. At an EAC level, such rules may already be adopted in the framework of legislative programmes to achieve a common, single market within the EAC thus facilitating the creation of a single currency area wide payment system.

Fourthly, in order to reap the benefits of a single currency, market conventions may need to be created or adjusted and this may require the adoption of legislation in order to ensure the enforceability of provisions in such conventions, for example in the field of netting.

The regulatory framework underpinning monetary union in Europe is composed of a large variety of different legal acts covering many different issues and adopted by a selection of competent authorities such as the EU Council, the ECB, national legislators and NCBs. In fact, the introduction of the euro has led to the creation of a new body of monetary law, but the variety of legal acts does not make it easy to fathom this new body in all its facets and details. This raises the question to what extent the regulatory framework of monetary union in Europe may serve as an example for the regulatory framework of EAMU. In this respect, two qualifications are warranted. Firstly, the EU's regulatory framework is considerably determined by the EU's specificities and in particular the EU's institutional framework. Secondly, each new regional monetary union will have to tailor the necessary arrangements to the requirements in its specific context. That said, on the substance the EU's regulatory framework is likely to provide for many examples which may at the minimum provoke further reflection and perhaps in certain circumstances even examples which may be partially or fully copied. The purpose of this part of the Study will be to identify to what extent the EU's regulatory framework for monetary union may provide useful examples for the EAC. This is likely to result in an

inventory of issues on which the EAC will have to reflect when preparing for monetary union, together with references to legal acts, or provisions thereof, which may serve as an example (noting that such legal acts are of course subject to regular change).

Annex:

Tentative Table of Contents of a Study on the establishment of a monetary union among the Partner States of the East African Community

Tentative Table of Contents of a Study on the establishment of a monetary union among the Partner States of the East African Community

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3 Changeover to the single currency

3.1 Changeover scenario

3.2 Choosing the name of the single currency unit and its sub-division

3.3. Determination of conversion rates

3.4. Legal changeover

3.4.1. Substitution of the single currency for the national currencies

3.4.2. Conversion and rounding rules

3.4.3. Continuity of contracts

3.4.4. Exchange and redemption of banknotes and coins

3.4.5. Special legal issues

3.5. Changeover in the financial sector

3.6. Cash changeover

3.7. Managing a smooth transition to East African Monetary Union

3.7.1. Convergence

3.7.2. Monitoring preparations for the changeover

3.7.3. Control of inflationary pressures

3.7.4. A communication strategy for the changeover

V THE OPERATIONAL REGULATORY FRAMEWORK FOR EAST AFRICAN MONETARY UNION

ANNEXES

I Prerequisites for East African Monetary Union

- Financial Market Integration
- Economic Convergence
- Legal Convergence

II Proposals for a:

- Monetary Union Protocol

- Statute of the East African Monetary Institute
- Statute of the East African Central Bank

III Proposals with regard to:

- the establishment of a Committee Structure for preparatory work for East African Monetary Union
- a Masterplan for preparatory work for East African Monetary Union

IV The institutional, operational, and regulatory framework of the European Central Bank, the Eurosystem, and the European System of Central Banks

V Bibliography, List of addresses, and Glossary

VI Members of the Project Teams of the East African Community and the European Central Bank