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The effect of real gross domestic product (GDP) growth rate convergence on exchange rate volatility in search for the East African monetary union

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Abstract

So far, the formation of a monetary union in the East African Community (EAC) has remained elusive. The EAC partner states therefore established set targets for macroeconomic convergence, with an aim to eliminate exchange rate variability within the bloc. Where countries are able to eliminate or reduce exchange rate adjustments to maintain external balance, the costs of a monetary union reduces, thus the more suitable it is for such a region to form a monetary union. Major macroeconomic variables need to be harmonized before establishing a monetary union such as real GDP, budget deficit/GDP, national savings, and inflation rate. However, empirical studies undertaken indicate that the rate of convergence of the member states economies to the set targets has been very slow, resulting into high exchange rate variability within the region. It is against this background that this study was carried out to determine the effect of convergence in real GDP growth rate on exchange rate volatility, of five EAC countries: Kenya, Uganda, Tanzania, Burundi, and

Rwanda. The bloc was chosen for the study since it has scheduled to establish its common currency earlier than other African economic blocs, and thus its success will be a lesson to them. A panel data analysis was used over the period of 2000 to 2016. Sigma (standard deviation) was used in the study to establish convergence of variables. Levin et al. 2002) test for panel unit root was employed to test for data stationarity and it was found that real exchange rate and real GDP growth rate were stationary. Pedroni residual-based cointegration test was carried out to test for the long-run relationship between variables in the model and it was established that there exist a long-run relationship between exchange rate and explanatory variable. The study results showed that the entire explanatory variable had a significant and a negative effect on exchange rate volatility. This means that convergence in real GDP growth rate among the EAC countries reduces exchange rate variability within the region. Thus, the policy makers should ensure that the EAC countries harmonize their economies, which will help greatly to eliminate exchange rate adjustments within the region, in readiness for a stable and sustainable monetary union.

Keywords

Convergence exchange rate volatility GDP East African monetary union

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