Balancing Capital Needs and Economic Stability. An Examination of Challenges in the Governance of Increasing Short-Term International Private Capital Flows in Poor Countries: The Case of East Africa

By John Nimrod Bakilana, B.Sc. (Hons.)

A thesis submitted to the Faculty of Graduate Studies and Research in partial fulfillment of the requirements for the degree of

Master of Arts

Department of Law
Carleton University
Ottawa, Ontario

May 22, 2006

Abstract

Globalization of finance has impacted the various economies of the world in different ways. On the one hand, it has allowed for capital to flow freely across borders. This is beneficial to those areas that cannot create sufficient capital from within. On the other hand, globalization of finance has also increased international short-term private capital flows. With sudden, massive withdrawals, such flows can be very risky, not only to capital-importing countries but also regional economies and the global economy. Using East African countries as examples, and from a governance perspective, this thesis examines the challenges facing poor countries in the regulation of international short-term private capital flows and puts forward some general recommendations on how the governance of international short-term private capital can be improved, at the country, regional and global stages.

Acknowledgements

Writing about global finance is a challenging undertaking because of the ever-changing conditions in the industry. Nevertheless, the few findings of this thesis provide a foundation for future works in this important sector.

This thesis would not have been possible without the advice, support and encouragement extended to me by my supervisor, Professor Paul Davidson. I am also grateful to Professor Obijiofor Aginam (Law Department), Professor Dane Rowlands (Norman Patterson School of International Affairs) for their informed contributions that allowed for the completion of this thesis, and Andrew Squires of the Law Department.

I would also like to thank my family and friends for their support and encouragement throughout the period of my studies.

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INTRODUCTION

Global Finance has existed for centuries. In its earliest form, nations would facilitate international economic activities through bartering. In recent decades the meaning of global finance has expanded tremendously to include more than just the financing of international trade. Over the years, the surge in the number of countries globally has significantly contributed to the emergence of "new" activities under the umbrella of global finance.

Initially, currency trading was a vital activity.[1] Huge profits derived from arbitrage attracted governments and private participants into currency trading. In terms of volume, presently, currency trading still dominates financial activities that take place in the world markets. Recently, the increased economic interdependence among nations has led to a growth in cross-border investments and asset trading among them.[2] This interdependence has allowed for the availability of new forms of financial instruments in the world market, both in terms of debt and equity. In other words, the relative availability of capital globally has led to more international debt and equity financing.

This trend is in contrast to what was happening throughout the twentieth century, when global lending activities were, for the most part, an activity between sovereign states, or between sovereign states and international financial institutions. Countries

[1]IMF, Capital Flows to Emerging Markets-A Historical Perspective, IMF International Capital Markets, Annex VI, 1997. http://www.imf.org/external/pubs/ft/icm/97icm/pdf/file14.pdf [online-March 2006].
[2] *ibid*

obtained funds from each other and from institutions such as the International Monetary Fund (IMF), The World Bank and Regional Development Banks. Borrowing from international private sources was likely in wealthy countries, but was rare in poor countries.

The end of the Cold War combined with integration of world economies marked a new chapter in global financial activities.[3] Countries today have a wider field to explore in terms of business opportunities that, for most, were previously out of reach. The number of transactions taking place globally has thus increased exponentially, both as a result of the number of transactions and the invention of financial products. This increase has been accompanied by a surge in cross-border private lending activities. This is a relatively new area for poor countries of the world. As most of these countries did not run free market economies in the past, mechanisms that were previously in place hindered private enterprises within these countries from acquiring funds from abroad.

Official finance still constitutes a huge proportion of external financial capital inflows to poor countries, especially in Southern Africa.[4] In the recent years, however, there has been a tremendous embracing of foreign sources of capital in these countries,

[3] There was a lot of lending in the 1970s, with the debt crisis exposing the weakness of the international financial system. However, the end of the cold war brought about new levels of freedom in international capital movements, especially in relation to poor countries of Africa.
[4] Bhattacharya, A., Montiel, P. and Sharma, S., "How Can Sub Saharan Africa Attract More Private Capital Flows?", (June 1997) Finance and Development, p.1.

including those flowing in through foreign portfolio and equity investments.[5] According to the International Monetary Fund (IMF), since 1990, private capital flows exceeded official loans and grants to become the dominant source of external funding for poor countries.[6]

Both portfolio and equity instruments have become very popular financing mechanisms by entrepreneurs and foreign investors with business interests in emerging and poor markets. With some potential for risk, private equity investments are more stable than portfolio investments.[7] Most private equity investors aim for long-term positions but some aim for high capital gains when a firm becomes listed.[8]

Notwithstanding the importance of investments (capital) from abroad, this trend in investing is not without problems. As a result of the liquid nature of some, which increases the speed at which the funds can be withdrawn from the system, and fewer controls by host governments in most countries, capital originating from foreign sources can be risky to economic stability. Such was the case in South East Asia and Latin America, whereby rapid outflows of capital, especially as a result of speculation, led to financial and economic crises in the nineties.

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[5] In this thesis, portfolio investments are linked with publicly traded shares while equity investments are investments in companies not listed on an exchange. In most cases, private equity investments end up being long-term, while the opposite is true for portfolio investments.

[6] IMF, Volatility of Private Capital Flows to Emerging Markets, Global Financial Stability Report-Chapter 4, http://www.imf.org/External/Pubs/FT/GFSR/2003/01/pdf/chp4.pdf [online-March 2006].

[7] Most of the investments are undertaken by private equity funds and involve liquid capital injections accompanied by some form of controlling stake in the companies. Most of the funds are located in rich countries, where they buy significant minority equity stakes in unlisted companies. Their level of risk is not considered to be as high as that of portfolio investments. This is due to their usual duration in an economy. Apart from convertibility, transfer and exchange rate risks associated with such investments, other factors in their operations can destabilize money flows. This is especially true when private equity funds decide to exit investments.

[8] Carter, L. *Investment Funds in Emerging Markets*, (Washington, D.C. : World Bank Publications, 1996).

As they continue to adopt economic reforms aiming at attracting investors and their capital, the less developed countries (hereinafter referred to as poor countries) must make sure they also position themselves to defend their economies from within, against all factors that may pose risks, including speculative withdrawals and other types of withdrawal risks associated with foreign private capital investments. At the global level, wider reforms in international financial architecture, including better standards and regulatory measures, must be undertaken in order to minimize risk for the various participants of the system, including these poor countries that are more vulnerable to speculative attacks and are less equipped to withstand or even recover from them.[9] Some clarity is therefore needed in the regulation of short-term private capital investments which are increasingly becoming a choice of foreign investments in the poor countries.

On the ground, most poor countries lack effective regulatory frameworks. When they try to create them in order to ensure safety for the investors while promoting their own economic stability, they are faced with difficulties. It would seem that the design, size and aim of the regulatory frameworks of international finance lack the muscle to contain possible crises in these countries.

A sound regulatory environment, both at international and local levels, is vital for all parties in an economy: people, government and investors, as they seek stability in their plans. While examining the existing international regulatory framework upon

[9] Seeraj, M., "Why South Africa Still Needs Capital Controls", http://www.polity.org.za/pol/opinion/seeraj/?show=54676 [online- March 2006].

which these nations rely, this thesis will seek to investigate the challenges that (economically) poor countries in East Africa are facing in creating and sustaining conducive regulatory environments to manage their external finance sectors. The focus will be the East Africa Custom Union area, which constitutes of Kenya, Tanzania and Uganda.

Even though the area is not a fully-fledged recipient of short-term capital flows from abroad, the situation is changing and will continue to change in the near future. Foreign Direct Investments still constitute the bulk of investments heading to East Africa. However, with the rate of economic growth the area is experiencing and the continuous reforms taking place to attract foreign capital, portfolio investments are increasingly becoming a popular choice of investment for foreigners. This research, therefore, uses a forward-looking approach by capturing the possible areas of improvement in the fast-changing environment.

This thesis is structured as follows. Chapter One will discuss the notion of global capital flows in detail. I will look at capital flows and financial crises *vis-à-vis* liberalization of global finance, as advocated by the international financial community. In this section, I hope to draw the link between neo-liberal economic policies as adopted by most developing countries and their contribution to the opening up of economies, and show how this adoption exposes the countries to more risks. With legal powers, such policies naturally become obligations to the countries.

After a look at capital flows, particularly with interest in capital flight from poor countries, Chapter Two will address the question of regulation. I will start by discussing its meaning in the global economic discourse. After looking at its meaning, I will outline the regulatory frameworks of East African countries, particularly those which are meant to manage the external component of the financial sector and offer protection from crises.

Apart from the "traditional" measures advocated internationally, I will look into new strategies that these countries are creating in their efforts to manage the external finance sector. Areas of interest include legislation and other provisions for banking and investments, short-term borrowing, funds repatriation, portfolio and equity investments, including those from abroad.

Chapter Three will illustrate the challenges facing the poor countries of East Africa in regulating private international capital flows. The challenges exist in both the international and domestic regulatory frameworks. Internationally, the challenges relate mostly to the power of international laws and regulations, particularly their ability to open a sovereign state's economy, and limit the power of local governments to devise effective rules and regulations to reduce the loopholes in the regulation of capital flows. Domestically, challenges exist in setting-up and maintaining sound regulatory environments for the International Finance sector. In East Africa, challenges also exist within the laws, in law-making and law enforcement.

Chapter Four of this thesis will put forward recommendations on what can be done by East African countries to improve the regulation of financial sectors, particularly the external component, which is growing fast. The section will emphasize effective risk management through legal measures.

All in all, my goal is to look at the challenges facing the poor countries of East Africa in managing "externally-induced" crises through regulation. This includes managing the entry, use and exit of funds. By exposing the problems that the three countries have in this area, I hope to be able to establish the basis for improvement so that the threat of future crises is reduced.

KEY WORDS: *Poor Countries, East Africa, Portfolio Investments, Financial and Economic Crises, Governance, Regulation, Prudential Regulation.*

CHAPTER ONE

CAPITAL FLOWS AND CRISES: ECONOMIC AND LEGAL PERSPECTIVES

International capital flows have existed for many years. They form a major constituent of the international business sphere, and in their earlier occurrences, they were meant to facilitate trade and other economic activities.[10] In recent years, however, capital flows have established themselves as a separate business activity, as the growth of the world economy has led to an increase in demand for capital globally. The need for capital is especially extensive in poor and emerging economies, something that has resulted in an increase in capital exports to these parts of the world. Most of the capital originates from highly industrialized and advanced economies to the poor and emerging economies.

In most cases, this export of capital to poor countries is also associated with times of economic prosperity and the concomitant capital surplus.[11]

This Chapter will discuss the question of capital flows and financial crises. These related subjects are in their own ways extensive. However, it is important to explore them to the extent necessary to gather a picture of how and why both incidents happen, and their implications for poor and emerging economies, such as those in the East Africa Custom Union.

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[10] Krugman and Obstfeld, *International Economics: Theory and Policy*, (Reading, Mass, Addison-Wesley, 1997), Chapter13.

[11] Hilferding, R., "Extracts from Finance Capital: A study of the Latest Phase of Capitalist Development", in Cain, P. J. and Harrison, M. (Editors), *Imperialism: Critical Concepts in Historical Studies*, (U.K.: Routledge, 2001), p.230

In this chapter, I will focus on three areas:

Firstly, I will look at Capital flows and financial crises from an economic perspective. This part will discuss the economic rationale for capital flows and financial crises from points of view of both investors and capital-recipient countries.

Further, I will look at capital flows and financial crises from a legal perspective. This part will examine international legal parameters which, both directly and indirectly facilitate or encourage the flow of capital across borders. As known, capital flights are part of capital flows and financial crises are a major outcome of capital flights.

Finally, this chapter will point to the effects of capital flights on least developed countries. Examples from countries previously hit by financial crises will help to give a snapshot of what actually transpired on the ground. It is intended that this account will illustrate the dangers of flight-led crises, the regulation of which I consider to be a priority, especially for poor and emerging economies such as those in East Africa.

I. ECONOMIC PERSPECTIVE

I a. Capital Flows

Before one can discuss capital flight, one first needs to look at the overall picture of international private capital flows. International borrowing/lending and investment (Foreign Direct, Portfolio and Equity) are the major functions of private international capital flows.[12]

[12] Bryant, R. *Turbulent Waters: Cross-Border Finance and International Governance,* (Washington, D.C. : Brookings Institution Press, 2003) pp.166-170.

Private capital flows to poor countries, including those in Africa, have been increasing since the 1990s.[13] Most of the flows have been through Foreign Direct Investment (FDI), which, relative to other sources, remain the largest single source of private capital in poor economies.[14] However, the discussion in this thesis will focus on borrowing/lending and portfolio investments, whose flows to poor countries are expected to rise as a result of new provisions allowing for such flows, especially in African countries (including East Africa). These flows are usually short-term in nature and can therefore result in crises.

In most cases, international borrowing and lending of capital involves seeking debt financing from abroad by capital seekers and investment opportunities for capital lenders. From a business point of view, the exercise depends primarily on interest rates. Such activities occur in situations where huge disparities exist for interest rates in different parts of the world.

According to a World Bank report, two primary forces that are driving investor interest in developing countries are the search for higher returns and opportunities for risk diversification.[15] In situations where funds move from industrialized economies to poor economies of the world, such movements are mostly due to low interest rates in the rich economies. Cycles of lending in the 1990s, for example, are claimed to have been caused by the transitory international conditions, particularly low real

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[13] IMF, Developments in Aggregate Net Private Capital Flows to Emerging Markets, Chapter 3-Emerging Market Financing, IMF International Capital Markets (Washington D.C., 2001).
[14] *ibid*
[15] World Bank, *Private Capital Flows to Developing Countries, The Road to Financial Integration*, (New York : Oxford University Press for the World Bank, 1997) pp 1-2

interest rates in industrialized countries.[16] During that particular time, interest rates in the industrialized economies were at historically low levels. [17] The opposite is also true. As Calvo *et al* indicate in the case of Latin America:

> [I]f interest rates explained a large share of the capital flows to developing economies, then a shift toward tighter monetary policies in the industrialized economies could sharply reduce the scale of capital outflows to emerging markets.[18]

The borrowing and lending analysis suggests that low interest rates in foreign money markets are attractive for borrowers in poor countries, especially banks, which can capitalize on arbitrage resulting from interest rate differentials. Conversely, higher interest rates offered by capital-seeking money and capital markets in poor countries are attractive to foreign lenders, who want to maximize their profits. By offering high interest rates, the banking systems in poor countries may become ports of entry for short-term capital inflows.[19] This behavior is also true of other capital seekers who issue debt instruments such as bonds to overseas investors. There has thus been a general rise in the issuance of international bonds and syndicated loans by poor countries since the 1990s to early 2000s.[20]

Generally, for poor recipient countries, foreign funds provide an important source of capital, as most of them are in desperate need of foreign currency to finance various economic activities. For the actual borrowers, such as banks and bond issuers, the

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[16] Kahler, M., "Introduction: Capital Flows and Financial Crises in the 1990s", in Kahler, M., (Editor): *Capital Flows and Financial Crises*, (Ithaca, N.Y. : Cornell University Press, 1998), p.1
[17] *ibid* at p.4
[18] Calvo, G., Leiderman, L. and Reinhart, C., "Capital Flows to Latin America: The 1970s and the 1990s: Unpublished Manuscript", (Washington D.C., International Monetary Fund, 1992), as quoted in *ibid.*
[19] Eichengreen, B., *Capital Flows and Crises*, (Cambridge, MA : MIT Press, 2002). pp.34-35.
[20] IMF, supra, note 13.

funds are more readily available and are obtained at lower interest rates. It therefore follows that when interest rates in creditor countries are low, debtors in recipient countries can afford to borrow.[21]

Apart from borrowing, poor countries have recently been major recipients of capital from international private investors, either directly or through private investment funds.[22] The investors have increasingly been buying stocks of companies listed on poor countries' stock exchanges. By investing in these countries, private international investors play a big role in meeting the demand for badly needed capital by the companies. This situation is due to the fact that the majority of the local population cannot afford to participate in stock market activities through acquiring positions in the various publicly-traded companies. Even though portfolio flows are small in most of Africa, that situation is likely to change soon as a result of relaxation of rules and the continuing growth of confidence in emerging Africa markets.

One important thing to note is that international private capital flows in both directions, namely into and out of capital exporting and importing countries. Apart from relatively significant levels of long-term investments in poor countries, some of the private capital flows end up being short-term. In this manner, the aim on the part of private investors who invest in poor/emerging economies is not to assist the economies with their (foreign) capital needs. Short-term investors' decisions are driven by profit. When such investors decide to leave a market, they do so at their

[21] *ibid,* p. 31.
[22] These are firms that pool funds from investors and place them in specific investments (portfolio and equity) in line with the objectives of the investors. (www.nvestorwords.com)

own discretion, even if such an action is not in the interest of the recipient country. On the part of recipient countries, such ease with which capital may leave could be risky, as the (capital) flight deprives the economies of the much-needed instrument for investment. More importantly, capital flight leaves a vacuum in economies, leading to potential crises and stalling of economic activities in general. As will be clarified in the following sections, this ease of capital flight, caused by several factors-including those related to governance, constitutes a potential problem to most poor countries.

I b. Capital Flight

Capital flight is a large-scale removal of individual and corporate investment capital and income from a country.[23] It is the movement of money from one investment to another in search of greater stability (by avoiding country-specific risks such as high inflation or political turmoil), or increased returns.[24] The risks in question could be economic, social or political. The risks lead to fear of failure of investments on the part of investors, something which triggers the flight of capital. As will be detailed later in the chapter, the sudden and massive withdrawals of capital, apart from derailing to the economic efforts of a country, can lead to social breakdowns.

When exploring the notion of financial/economic crises *vis-à-vis* capital flights in least developed/emerging economies, one can look at the causes from two major

[23] www.dictionary.com http://dictionary.reference.com/search?q=capital%20flight [online-November 2005]
[24] www.investorwords.com http://www.investorwords.com/c1.htm#capitalflight [online-November 2005]

points of view. Firstly, crises can be discussed from a legal perspective. Before there can be capital investments abroad, the activity has to be sanctioned by the regulatory authorities. In other words, there must exist freedom to invest.[25] The same applies for the withdrawal of funds. There must be freedom to withdraw capital. Before an investor can make a decision on investment withdrawals, the activity has to be legal. The legality is facilitated by both international and domestic regulations. In other words, one needs to look at the legal provisions through which capital can flow across borders and therefore allow for investments into and withdrawals from capital markets and other forms of investment.

Secondly, reasons for (foreign investors') decisions to withdraw funds from any capital market, especially those in poor markets like East Africa, have to be understood. This calls into scrutiny the whole issue of market decisions. Investors make decisions based on the conditions of the market. Such conditions include economic policies (including interest rate policies) and political stability. More importantly, their decisions are based on information about a particular market or investment. For example, investors need to have a very candid and detailed business position of the company in which they intend to invest. The same applies to countries in which they are interested in investing. Such information is needed in order to determine the rationality and worthiness of the decisions they intend to make from a risk-based perspective.[26] Without such details, investments tend to become

[25] Edwards, S. *Capital Controls, Exchange Rates, and Monetary Policy in the World Economy* (Cambridge [England] ; New York, NY : Cambridge University Press, 1997) p. 77.
[26] Griffith-Jones, S. *Global Capital Flows- Should they Be Regulated?*, (Houndmills, Basingstoke, Hampshire, U.K. : Macmillan Press ; New York : St. Martin's Press, 1998), p.181-184.

intentionally speculative. When investors are uncertain of their decisions, it may lead to abandonment (exiting) of investments and in some cases herding.[27]

Once the law provides for movement of capital, investors can make decisions to lend or invest abroad. The following section discusses legal provisions that allow for access to global financial markets. The accessibility allows for capital flows, giving room for the possibility of financial crises.

II. LEGAL PERSPECTIVE

II a. Free Markets and Liberalization

The dominance of private international capital stems from ideas that shape current international economics, most of which are new to poor countries, especially those that previously had centrally-planned economies. Globally, there is a strong leaning towards an international economic arrangement based on the principles of free market economics and liberalization of world economies. This arrangement has been in existence for a long time, especially in rich Western countries.[28] However, the end of the cold war and the disintegration of security alliances, especially within the Soviet bloc, allowed for poor countries that had centrally-planned economic systems to more freely engage in economic activities with other countries of the world, on the basis of free market principles. Essentially, the end of the cold war provided the necessary political environment for the creation of a truly global economy. Developments in

[27] Herding is a group behavior on the part of investors. In this case, it has been used to indicate the tendency of investors to panic and exit investments, mostly as a result of information asymmetries.
[28] Among the East African countries, only Kenya's economy was based on the market system; economies of Tanzania and Uganda were centrally planned until the mid-1980s – 1990s, when they began implementing reforms towards the market system.

trade and technology further facilitated the globalization of the new economic arrangement.[29]

The general acceptance of free markets as the solution to economic ills of modern societies is especially seen through international economic and legal provisions that are formulated and supervised by international organizations such as the World Trade Organization (WTO) and the International Monetary Fund (IMF). These institutions, both directly and indirectly, lay down rules and procedures that have to be followed by the various countries of the world in order to be accepted as participants in the international economic system. Generally, the rules reflect agreed-upon conduct in economic activities by the members of the said organizations.

Even though international economic law exists in the form of specific rules and regulations governing the conduct of business and trade activities globally, its current strength is particularly visible in its fundamental principles, which are liberalization and free-market economics. It is the globalization of these two principles that has been at the center of discussion in recent decades. As will be seen later, law has, both directly and indirectly, been used to provide a framework for implementation of the two principles globally. Some may argue that the said principles themselves are products of activities by the members. This relates to the customary law doctrine, whereby international law is derived from the practice of different nations.[30]

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[29] Gilpin, R. and Gilpin, J. *Global Political Economy: Understanding the International Economic Order*, (Princeton, N.J. : Princeton University Press, 2001). p.8.
[30] Kindred, H. et al, *International Law-Chiefly as Interpreted and Applied in Canada*, 6th Edition, (Toronto: Emond Montgomery, 2000), pp.165-168.

However, one can also strongly suggest that it was the presently rich countries that established the principles in modern economics, thus giving those countries an edge.[31] Evidence ranges from the adoption of English (economic) values when Great Britain controlled the world[32] to the embrace of market economics (a Western trend) by almost all poor countries of the world by the end of the twentieth century. The new participants to the system, most of which are poor countries, have little knowledge and experience of the said principles. This situation puts them at a competitive disadvantage. Most of the rules and regulations of the various institutions tend to favor the opening up of economies, increasing financial and economic risk for poor countries. This trend is very true with regard to activities that lead to capital flows. Notwithstanding the primary roles of the institutions, as will be shown later, various provisions by the WTO and the IMF allow for easier movement of capital into and out of economies. According to the World Bank, as a result of financial integration, a phenomenon that is being pushed by these institutions, there has been an increase in (global) financial market activities in areas such as: multinational financial institutions in foreign markets, transactions between financial intermediaries in different countries and the cross-border delivery of financial services.[33] As will be shown in the next section, these international economic institutions indirectly provide the means for opening up economies, facilitating capital flows, flights and paving the way for financial crises.

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[31] Mackintosh, M., "Playing by the rules? Developing Countries in the World Trade Regime", in Bromley, S. et al (Editors), *Making the International: Economic Interdependence and Political Order*, (Pluto Press, 2004) pp.34-35
[32] Kindred et al, supra, note 30.
[33] World Bank, supra, note 15, p. 347

II a i. The World Trade Organization (WTO)

With the mandate of administering trade (in goods and services) agreements globally, the WTO provisions advocate for market access by all members through the most-favored nation and national treatment principles.[34] Under these provisions, liberalization has been made mandatory for all members, with steady movement towards a liberalized global economy based on principles of free market economics.

Over the past two decades, services have become the fastest growing sector of the global economy. At the WTO, the development and boom of trade in services has resulted in the establishment of the General Agreement on Trade in Services (GATS). The GATS identifies a total of 155 service sectors in which international trade may occur. The agreement covers all measures taken by the members affecting trade in services and all service sectors.[35] Through four modes, the agreement defines trade in services and modes of supply.[36] The services include, among others, financial.

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[34] About the WTO http://www.wto.org/english/thewto_e/thewto_e.htm#intro[online]

[35] Mattoo, A., "Financial Services and the WTO: Liberalization in the Developing and Transition Economy", (Geneva: WTO Staff Working Paper, 1998).

[36] GATS, Art. 1, Para 2: Basic Purpose and Concepts: Definition of Services Trade and Modes of Supply.

- Mode 1 deals with cross-border supply of services. This refers to services supplied from one country to another.
- Mode 2 involves consumption abroad, whereby consumers or firms make use of a service in another country.
- Mode 3 addresses commercial presence, whereby a foreign company sets up subsidiaries to provide services in other countries.
- Mode 4 covers the presence of natural persons, that is individuals traveling from their own country to supply services in another. GATS annexes form another important element of its framework. They deal with rules for specific sectors. The service sectors include among others, finance, telecommunications and air transport.

The GATS and the Financial Sector

Financial sector liberalization under the GATS is a major contributor to the opening up of least developed economies such as those of East Africa. The multilateral agreement reflects an attempt to consolidate this market-opening trend and to advance the process of progressive liberalization.[37] On the other hand, it was the realization that efficient supply of financial services is a precondition for stable development that led to increased deregulation and liberalization of the sector.[38] After failure to agree at the end of the Uruguay Round, and an interim agreement in July 1995, the negotiations on financial services in the context of the General Agreement on Trade in Services (GATS) were finally concluded in December 1997, to establish the Financial Services Agreement (FSA). The largest service sector, encompassing all banking and other financial services, and all insurance and insurance-related services, was now fully subject to multilateral trade rules.[39]

Through the Financial Services Agreement (FSA), national treatment and most favored nation treatment for international service providers in the financial industry are emphasized. These two areas are significant, especially at the early stages, when firms are attempting to establish themselves in a new market. According to Mattoo,[40] if we apply the GATS mode definition to the financial industry, an example of Mode 1 would include taking of a loan or the purchase of insurance cover by a domestic consumer from a financial institution abroad. An example of Mode 3 would be where

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[37] *ibid*
[38] Mattoo, A., supra, note 35.
[39] *ibid.*
[40] *Ibid.*

a foreign bank or other financial institution establishes a branch or subsidiary in the territory of a country and supplies financial services. These two provisions provide the basis to facilitate the movement of funds between countries, thus creating the opportunity for eventual capital flights.

Most foreign investors in the financial service industry have been calling for more freedom when it comes to capital movements between countries.[41] Some have related the issue to market access, insisting that government regulation in this area constitutes a form of denial of total market access. Footnote 8 of Article XVI, Para 1 of the GATS (Market Access) provides that:

> "[I]f a Member undertakes a market-access commitment in relation to the supply of a service through the mode of supply referred to in subparagraph 2 (a) of Article I (Cross-border supply) and if the cross-border movement of capital is an essential part of the service itself, that Member is thereby committed to allow such movement of capital. If a Member undertakes a market-access commitment in relation to the supply of a service through the mode of supply referred to in subparagraph 2(c) of Article I (commercial presence), it is thereby committed to allow related transfers of capital into its territory".

This would seem to obligate members to allow capital flows related to consumption abroad, and with respect to capital outflows related to commercial presence. The provision further emphasizes that even though the provisions of the GATS apply to all services, they can be particularly relevant in the context of capital flows, since a commitment to liberalize market access could be undermined by the absence of a corresponding obligation to liberalize associated capital flows. This gives room for capital flows even for reasons not intended.

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[41] *ibid*

Poor countries therefore end up with a risk-management task associated with those investors who have commercial presence in their countries, as capital flows are allowed within the domain of their businesses. The actions of such investors, especially in relation to capital withdrawal, may prove to be detrimental, especially in such countries.

The previous section has demonstrated that GATS, through the FSA, has allowed for the opening up of the financial industry by providing a framework for improved market access for foreign services and service suppliers.[42] Significantly, market access is what guarantees the ability to engage in direct fund transfers (deposits and withdrawals) internationally. This creates room for massive withdrawals during panics or even speculation. The GATS, through the FSA may not directly push for the flows. It is the leeway provided by the two agreements that facilitates the rapid flows of funds. The openness created to allow for the smoothness of private capital flows also creates gaps that can lead to crises, particularly in least developed economies, such as East Africa. As will be seen in Chapter Three, even though GATS might provide some mechanisms to manage risk caused by the openness that it creates in general, the mere goal of the agreement, that is, market access, overrides the said provisions.[43]

[42] Kono, M., Low, P., Luanga, M., Mattoo, A., Oshikawa, M. and Schuknecht, L., "Opening Markets in Financial Services and the Role of GATS", (Geneva: World Trade Organization, 1997).
[43] Refer to The GATS Annex on Financial Services, Sections 1 (Scope and Definition) and Section 2 (Domestic Regulation).

II a ii. The International Monetary Fund (IMF) and the World Bank

Since their formation after the Second World War, the International Monetary Fund (IMF) and the World Bank have had a commanding presence, especially in poor countries. Charged with an overall duty of ensuring financial stability and fighting poverty globally, these two Bretton Woods institutions have developed a strong presence in Sub-Sahara Africa, and have over the past three decades influenced tremendously the economic policies of this region. This presence and influence is due to the need for economic and technical assistance on the part of the countries as a result of the high levels of poverty that exist. With poor countries' desperation, international financial institutions usually provide the much-needed finance and assistance, invariably along with conditions. Since the two institutions' principles are premised on free market economics, particularly privatization, most of their conditions for assistance have a liberal foundation, thus pushing poor countries towards privatization and opening up of economies.

Structural Adjustment Programs (SAPs) by the two institutions provide good examples of the stated policies. This eclectic collection of various economic policies made the bitter pill that developing countries had to swallow (particularly during the 1980's and 1990's) in order to qualify for new World Bank and International Monetary Fund loans and to help them make debt repayments on the older debts owed to commercial banks, governments and the World Bank.[44] Even though SAPs are meant to be tailor-made for individual countries, they contain a concoction of

[44] Mohammed, A., "Future Role of the IMF: A Developing Country Point of View", in Griffith-Jones, S., [Editor], *Developing Countries and the Global Financial System*, (London: Commonwealth Secretariat, 2001) p. 125

common principles, all of which advocate for the efficiency of the free market. Further, although these programs were/are administered largely by the World Bank and the IMF, some donor countries also insist on them, and monitor their implementation before disbursing much needed funds to recipient poor countries.

Apart from privatization (for which they are mostly known), the Bretton Woods institutions, particularly the IMF, have been advocates for, among other policies, the liberalization of exchange controls and capital account liberalization.[45] These two areas provide the foundation for capital movements globally. With their liberalization, capital (in the form of investments) can move from one country to another without hurdles. In other words, the liberalization of the two areas allows for flows of capital both into and out of poor countries.

The IMF has been the biggest supporter of capital account liberalization, an exercise that has directly facilitated and encouraged the whole wave of capital flows into emerging markets of poor countries. In fact, one of the most common recommendations to poor countries under SAPs, connected also to conditionality, has been capital account liberalization.[46] The capital account of an economy tracks the movement of funds for investments and loans into and out of the country. It makes up part of the balance of payments.[47] Its liberalization is simply the reduction or removal of policy barriers to the purchase and sale of financial assets across national borders.

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[45] Athukorala, P. C., *Crisis and Recovery in Malaysia: The Role of Capital Controls*, (Cheltenham, U.K., Northampton, MA, U.S.: Edward Elgar Publishing, 2003), p.1

[46] IMF, Volatility of Private Capital Flows to Emerging Markets, Global Financial Stability Report-Chapter 4, September 2003, p. 97 (Data).

[47] Investorwords.com www.investorwords.com/5438/capital_account.html [online-November 2005]

Barrier removals include allowing foreign participation in domestic portfolio and equity investments. Thus, capital account liberalization is probably the biggest direct facilitator of capital flows on the ground. Its implementation in poor countries has enhanced the importation of capital, especially from rich economies. Apart from capital imported via banks (banks borrowing from abroad and accepting deposits from abroad) discussed previously, the inflows happen through portfolio and equity investments, whose importance has increased both in absolute terms and relative importance.[48]

Even though aimed at easing the availability of capital for poor economies, the level of openness resulting from capital account liberalization also allows for ease in repatriation of funds from emerging poor countries.[49] What the policy does is open up the developing markets to inflows of capital, some of which may be of a short-term nature and sometimes speculative; further, as will be addressed in later chapters, the policy does not address the withdrawal of these funds from the investments (and possibly countries), thus giving room for even more investor speculation and eventually withdrawals that can trigger financial crises.[50] As already pointed out, when investors enter a market, they are driven by nothing else but profits. In this case, whenever they feel the need to withdraw their investments, they will do so in order to preserve their positions. Participation of foreigners in raising capital for local companies without restrictions on the duration of the investments, even though it increases the sources of funds for local enterprises, also gives freedom to the foreign

[48] Kahler, supra, note 16, p.3.
[49] IMF, supra, note 46.
[50] *ibid*

investors to withdraw their investments at will.[51] It is said that since 1999, poor countries (with the exception of Latin America) have become net capital exporters, meaning that more capital leaves the country than is received.[52] When such a trend continues on a massive scale, especially in poor economies such as those in East Africa, they can create horror in terms of crises. This is one threat that poor countries of the world that have adopted such policy positions face.

In general, countries (governments) have made efforts to adjust and open up their economies so as to be in line with the provisions of the WTO (GATS/FSA) and the Bretton Woods institutions. As stipulated above, most of the provisions have been put forward and subsequently implemented to open up the economies so as to allow for, among other things, cross-border fund transfers, which on the other hand provide easier means for capital outflows.

III. CAPITAL FLIGHT AND ITS EFFECTS

As discussed above, one of the most probable outcomes of excessive capital flight is a financial crisis. Within the limits of this thesis, capital flight is interpreted as the outcome of international investment choice, as private actors seek to maximize returns on assets and minimize risks.[53] A financial crisis, in contrast, is a loss of confidence in a country's currency or other financial assets causing international

[51] Molle, W., *Global Economic Institutions*, (UK: Routledge, 2001), p. 32.
[52] IMF, supra, note 46.
[53] Ndikumana, L., 'Capital Flows, Capital Account Regimes and Foreign Exchange Regimes in Africa', in *Management of Capital Flows: Comparative Experiences and Implications for Africa/United Nations Conference on Trade and Development.* (New York: United Nations Publications, 2003). p. 320

investors to withdraw their funds from the country.[54] These definitions, from different perspectives, show the character of the two, with one's existence resulting from or leading to the other.

According to Jeffrey Sachs, there exist three main types of international financial crises that affect emerging market economies: Fiscal Crises, Exchange Crises and Banking Crises.[55] Even though the types are logically distinct, they often 'arrive' in combination, because the underlying shocks or market expectations are likely to operate simultaneously in the market for government bonds, the foreign exchange market and the market for bank assets.[56]

Sachs goes further to point out that there are four distinct factors that trigger crises. These include:[57]

1. ***Exogenous shock*** to markets, causing market agents to reassess the ability of government, central bank, or the commercial banks to meet various intertemporal commitments.
2. ***Policy shock***, in which a policy reform in one market triggers an adverse market reaction in another part of the economy.
3. ***Exhaustion of borrowing limits***, whether by government, the central bank or the commercial banks.
4. ***Self-fulfilling panic***, which emerges when the markets "rationally" expect a default of an illiquid but solvent government borrower.

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[54] Deardorff's Glossary of International Economics, http://www-personal.umich.edu/~alandear/glossary/f.html [online- November 19, 2005].

[55] Sachs, J., "Alternative Approaches to Financial Crises in Emerging Markets", in Kahler, M., (Editor): *Capital Flows and Financial Crises*, (Ithaca, N.Y. : Cornell University Press, 1998), p.247.

Fiscal Crises: The government abruptly loses the ability to roll over foreign debts and attract new foreign loans, possibly forcing the government into rescheduling or default of its obligations.

Exchange Crises: Market participants abruptly shift their demands from domestic-currency assets to foreign currency assets, depleting the foreign exchange reserves of the Central Banks in the context of a pegged exchange rate system.

Banking Crises: commercial banks abruptly lose the ability to roll over market instruments (i.e. Certificates of deposit (CDs) or meet a sudden withdrawal of funds from sight deposits, thereby throwing the banks into illiquidity and possibly insolvency.

[56] *ibid,* p. 248.

[57] *ibid*, pp. 248-249

According to Barry Eichengreen, there are at least four explanations for crises, the most important of which for present purposes is institutional weaknesses.[58] Like the other factors that he identifies, institutional weaknesses are important, particularly when observing regulatory frameworks. However, there is a great deal of interconnectedness between the 'economic' and 'legal' factors as a result of government involvement with private capital markets, even though not as a direct participant.[59]

When capital flight happens, it is the economies of host countries that suffer. The withdrawals usually lead to collapse of development projects that relied on the external funding. With such failures, a series of events is likely to follow as a result of stoppage of the projects. One such probability is the loss of employment on the part of participants in the said projects. The effects of massive job losses can then easily be felt in other areas. When people lose their earnings, their health will most likely be in jeopardy as a result of inability to foot medical expenses; further, they will not be able to feed or educate themselves or their children. In poor countries, capital flight can also exacerbate a situation already overburdened by high levels of debt.[60]

The Asian Financial crisis provides a snapshot of the mentioned problems. For example, the GDP of Indonesia contracted by 13.7% in 1998, while that of Thailand

[58] Eichengreen, B. (Comments), in Lomborg, B., *Global Crises, Global Solutions*, (Cambridge, U.K.: Cambridge University Press, 2004).
[59] Sachs, supra, note 55.
[60] As quoted in Boyce and Ndikumana, (2001) & Ndikumana and Boyce, (2002), supra, note 53, p.315

fell by 10%.[61] Such massive output drops usually lead to job losses, bankruptcies and cutbacks in production. In Indonesia, huge losses caused widespread bank failures. The massive losses eliminated the capital bases of much of the banking sector.[62] Further,

> "[T]he financial crisis left widespread socioeconomic distress in its wake, with massive job losses and bankruptcies. The resultant sharp rise in inflation (in the context of a considerably weakened labor market) exacted a toll in terms of falling real wages and incomes".[63]

At the end of 1998, unemployment in Indonesia, Thailand and Korea had reached some 18 Million, compared to 5.3 Million in 1996.[64]

In general, Africa experiences high levels of capital flight as a result of capital movements. It is said that Africa as a region has the highest proportion of private assets held abroad (as a percentage of total assets or GDP) compared to other developing regions.[65] It is also a net exporter of capital.[66] Even though these flights have not been very volatile, there is a chance that further integration into the world economy may change this.[67] If the continent encounters sudden, massive capital outflows, the impacts in terms of economic stability and growth will be tremendous.

The few examples point to the truth about the social effects of financial crises, something which affirms the need for better risk management to mitigate the peril.

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[61] Sharma, S., *The Asian Financial Crisis: Crisis, Reform and Recovery* (Manchester U.K.: Manchester University Press 2003), p. 4: The Asian Financial Crisis: Changes in Real GDP (%), World Bank (2000).
[62] *ibid*, p.161
[63] *ibid*, p.347
[64] *ibid*, p.4
[65] Collier, Hoeffler and Pattillo (1999), as quoted in Ndikumana, L., supra, note 53, p.315
[66] IMF, supra, note 46.
[67] Hussain, M., Mlambo, K., and Oshikoya, T., "Global Financial Crisis: An African Perspective", (1999) Vol. 11 African Development Review, pp. 199–232.

This chapter has set out, albeit very briefly, a context for capital flows and financial crises, from both the legal perspective and also the economic point of view. The chapter has given a snapshot of what capital flows and financial crises actually are. It has also identified the reasoning behind their existence and more importantly, the prevalence of both. We have seen throughout most of this chapter that even though international legal provisions help to widen the capital market regime by granting rights of participation in the open economic system, there is a possibility that a balance *vis-à-vis* financial and economic stability is amiss. The legal reasoning behind capital flows (and therefore financial crises) has laid a foundation of what is to follow throughout the remaining sections of the thesis, which will focus primarily on legal issues.

The next chapter looks at the regulatory framework that exists internationally and domestically to manage capital flows in East Africa and therefore mitigate possible financial crises.

CHAPTER TWO
REGULATORY FRAMEWORK FOR INTERNATIONAL CAPITAL FLOWS IN EAST AFRICA

This chapter identifies the regulatory framework for the risk-management of external finance in East Africa. Focus will be on those areas that are concerned with the regulation of short-term private capital flows channeled into the area in the form of loans and investments (portfolio or equity). Through a brief examination of both international and domestic frameworks, this chapter will form the basis for a set of analyses on the challenges facing East African countries in the regulation of short-term private international capital, to be laid down in Chapter Three.

Observations in the previous chapter indicate that international legal discourse gives more attention to the use of regulation as a facilitator of international economic relations. Over the years, there has developed an alignment of regulation and competition, meaning that regulation has now expanded to include 'techniques' that facilitate the spread of free market economics.[68] The techniques, which are sometimes referred to under the notion of 'regulation for competition', in most cases end up emphasizing the opening up of economies rather than protecting them. The end result has been minimal provisions by regulators at the international level to limit the uncontrollable expansiveness in the level of capital flows. This by itself increases the risk associated with the flows.

[68] Jordana, J. and Levi-Faur, D., "Politics of Regulation in the Age of Governance", in Jordana, J. and Levi-Faur, D. [Editors], *Politics of Regulation: Institutions and Regulatory Reforms for the Age of Governance*, (Cheltenham, UK and Northampton, MA, USA: Edward Elgar Publishing, 2004), Ch. 1

In this thesis, the focus will be on prudential regulation. Prudential regulation refers to the set of laws and rules designed to minimize risks that banks (and other financial institutions) assume, and to ensure the safety and soundness of both individual institutions and systems as a whole.[69] The aim of such regulation is both systemic regulation and protecting the individual investors (both domestic and foreign) against the effects of economic instability. For example, regulators need to prioritize information availability to foreign investors so that they do not make wrong choices when making investment or disinvestment decisions. If such a condition is allowed to thrive, it may lead to poor decisions and untimely exits of capital from an economy. Further, direct and targeted rules are necessary to maintain adequate liquidity in the system and discourage capital exits. Both areas, if not properly managed, may lead to crises and affect economic stability.

David T. Llewellyn correctly insists that the objectives of regulation in finance are systemic stability, safety and soundness of financial stability, consumer protection against hazardous behavior of financial institutions and the maintenance of consumer confidence in the financial system and the integrity of the financial institutions.[70] He further observes that a "regulatory regime" is to be viewed more widely than externally-imposed regulation on financial institutions. The regime, he believes, consists of six key components: regulation, monitoring and supervision (private and

[69] Limam, I., *Challenges and Reforms of Economic Regulation in the MENA Countries*, (Cairo: American University in Cairo Press, 2003) p. 45

[70] Llewellyn, D., "Institutional Structure of Financial Regulation and Supervision: The Basic Issues" in Carmichael, J., Fleming, A., and Llewellyn, D. [Editors], *Aligning Financial Supervisory Structures with Country Needs*, (Washington DC: World Bank Institute, 2004).

official), incentive structures, intervention and sanctions, market discipline, and corporate governance.[71]

Implementation of the above objectives in an effective regulatory regime is an essential combination for the attainment of systemic stability in an economy. Further, it confirms the premise that a successful regulatory campaign requires efforts from the various sectors of the economy that are connected to finance.

Generally, regulation at local and international levels is implemented through both 'legal' and 'non-legal' mechanisms. Legislation at the local level and treaties at the international level provide the necessary legal means (hard law) to directly manage financial matters. At the international level, the 'legal' mechanisms are accepted by countries when they enter international conventions and other agreements. Locally, they include acts of parliament and other laws that regulate the conduct of participants in the financial sector. Legal provisions in both areas of the law provide the basic law for the regulation of the sector.

On the other hand, regulation is also done through non-legal rules laid down by regulatory bodies and industry associations. Such bodies are prevalent in the financial industry and undertake most of the regulatory work, especially at the international level, where hard prudential mechanisms are absent. The various bodies lay down specific 'soft' commitments, whose implementation depends on voluntary action by

[71] Llewellyn, D., "Some Lessons for regulation from recent bank crises", www.microfinancegateway.com, http://microfinancegateway.com/content/article/detail/1687/ [online-January 22, 2006]

member organizations. The rules are not conceived by law making bodies or state agreements and can thus not be enforced. Despite this soft nature, compliance with the various commitments is important to the members of the club, mainly in order to maintain membership and in some cases receive favors from the members.

Currently, most 'regulatory' authorities in international economics aim to facilitate free market activities in various sectors. A few, however, have provisions in place to tackle possible risks that are associated with the freedoms in market economics. With regard to capital flows, there is no specific international organization that is charged with directly monitoring and controlling the level and speed of flows globally through legal means. Apart from efforts on the part of individual countries to manage the risks associated with capital flows by legal means, the Bank of International Settlements (BIS) and the International Organization of Security Commissions (IOSCO) are some of the few international organizations whose soft provisions can closely assist in curbing the dangers associated with such flows.

Outlined in the next section are regulatory frameworks which provide risk-management tools for capital flows in East Africa. The first part focuses on the existing international framework and the later looks at the regulatory framework within East Africa.

I. INTERNATIONAL REGULATORY FRAMEWORK

As will be discussed in sections to come, there currently exists no body of law to specifically govern international capital flows. Even though international economic law is made up of various rules which are related to the financial industry, most of them exist to facilitate free trade in the sector.[72] However, some soft rules are in place to govern activities directly related to capital flows. These rules are usually conceived by organizations such as the BIS and IOSCO but are mostly adopted by domestic regulatory bodies.

Ia. Role of The Bank of International Settlements (BIS) in the Governance of the Financial Sector

Analyzing the works of the BIS is a very detailed and complicated undertaking, well beyond the scope of this thesis. However, because of its influence in the regulation of financial matters globally, I discuss its work in brief.

The BIS is an international organization which fosters cooperation among Central Banks and other agencies in pursuit of monetary and financial stability. Its banking services are provided exclusively to central banks and international organizations.[73] When needed, the BIS organizes and provides emergency financing to support the international monetary system.[74]

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[72] See discussion above on the GATS.
[73] Bank of International Settlements, Main Page, http://www.bis.org, [online- December 30, 2005].
[74] BIS History, http://www.bis.org/about/history.htm , [online-January 22, 2006].

Relating to prudential regulation, the Principles of International Banking administered by the (bank's) Basle Committee on Banking Supervision provide a very important foundation for the regulation of banking activities globally. The BIS sets up rules and regulations that are usually adopted in member countries and can also be adopted by non-members. Through the International Convergence of Capital Measurement and Capital Standards Framework (Basle II), issues concerned with reserve requirements by banks, particularly the New Capital Adequacy Framework, are emphasized.[75] This framework consists of three pillars: minimum capital requirements, supervisory review of an institution's internal assessment process and capital adequacy; and effective use of disclosure to strengthen market discipline as a complement to supervisory efforts.[76]

The Basle Committee on Banking Supervision believes that the framework will promote the adoption of stronger risk management practices by the banking industry.[77] This so called 'capital regulation' of banks has encouraged banks to accumulate additional reserves of capital, which can be used in times of difficulty.[78]

The reserve requirement of 8% proposed by the BIS can assist in maintaining liquidity and therefore stability on the part of banks and other financial institutions. Illiquidity in banks exacerbates financial crises, particularly when banks borrow or accept foreign deposits from outside and have to pay their creditors. With liquid

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[75] Basle II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework, http://www.bis.org/publ/bcbs118.htm , [online-January 7, 2006].
[76] *ibid*
[77] *ibid*
[78] Yokoi-Arai, M, Basle II in National Sphere, (October 2005) Law in Transition Journal Online. http://www.ebrd.com/pubs/legal/OL05d.pdf [online- January 2006]

banks, however, risks of bank failures are slim and crises caused by capital flight via banks can be eliminated. Further, the convergence of risk-management rules globally as advocated by the BIS can help to curb the spillover effects that may be caused by increasingly linked financial systems.

Even though East African Central Banks are not part of the 55-member BIS, the principles advocated by the organization, particularly the banking (capital adequacy) standards, have been embraced by all three countries. Such has been the result of the push by institutions such as the IMF, which through its financial sector assessment programs, uses Basle standards to determine members' compliance with 'acceptable international standards.[79] It can also be argued that such is a push by individual participants in the global banking industry, who prefer uniform, accepted standards.

Ib. Role of the International Organization of Security Commissions (IOSCO) in the Governance of the Financial Sector

This is an organization that brings together security commissions of various countries around the world to promote high standards of regulation in order to maintain just, efficient, and sound markets.[80] Among other functions, IOSCO provides mutual assistance to promote integrity of the markets by a rigorous application of the standards, implemented through members.[81]

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[79] Mattoo, A. and Sauve, P. , *Domestic Regulation and Services Trade Liberalization*, (Washington, DC : World Bank ; [S.l.] : Oxford University Press, c2003) p. 36
[80] International Organizations of Security Commissions, About, http://www.iosco.org/about/ [online-January 1, 2006].
[81] *ibid.*

According to IOSCO, the objectives of securities regulation include, among others, the reduction of systemic risk.[82] For example, to reduce and/or prevent the occurrence of systemic risk, the organization advocates for capital, prudential and internal control requirements.[83] Further, the organization advocates for winding up operations of an intermediary if it is a threat to the financial stability of its customers and counterparties or even systemic damage.[84] IOSCO also advocates for appropriate risk taking and insists that there should be an effective regulation of the level and kind of risk that is allowed to be assumed by the various investors.[85] This is vital to consider, given the level of speculation involved in the various trans-national capital investments taking place.

All the provisions may be helpful to East Africa, as all three countries are members of IOSCO and stand to benefit from most of the provisions, which aim to protect member countries, and the increasingly integrating global securities industry, from crises.

Similar to the Basle Committee, IOSCO provisions are soft commitments whose implementation depends on voluntary action by member organizations. They are not conceived by law making bodies or state agreements and can thus not be enforced. Despite this soft nature, compliance with the various commitments is important to the members of the club, mainly in order to maintain membership and in some cases receive favors from the members.

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[82] Objectives and Principles of Securities Regulation, IOSCO (2003). http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf, [online-January 1, 2006], p. 5.
[83] *ibid,* p. 6.
[84] *ibid*, p. 7.
[85] *ibid*

With the creation of the Basle Provisions by the BIS and the Objectives and Principles of Securities Regulation by IOSCO, both organizations have set up some important principles which, if well implemented can create a safe environment in international finance. Good protection in banking and securities industries is vital, as the two sectors play the biggest role in the transnational movement of capital. Recommendations by the two organizations depend on local implementation in respective member countries. When the principles are accepted and implemented by the member countries, they stand a chance of being spread to other countries around the globe. Further, due to the level of connectedness that exists in global finance today, member countries may influence non-members to adopt the rules as a condition for continued partnership.

As will be detailed in chapter three, notwithstanding the possible benefits of such rules and regulations, the softness of the rules makes them optional rather than mandatory. However, as already pointed out, the rules are becoming prevalent as organizations from various countries see their benefits and use them domestically. Further, the increasing threat to financial security justifies their adoption in more countries.

II. DOMESTIC REGULATORY FRAMEWORK

Governance of international capital at the country level is also undertaken through legal and non-legal means. Governments of the three East African countries, through Acts of Parliament, have set up various overarching laws to regulate movements of

capital into and out of their economies. Regulation of economic activities is mostly done indirectly by the states through the Central Banks and official independent regulatory bodies, which set up and supervise mechanisms to regulate economic activity. The provisions by Central Banks and the other official regulators are legal. The rest of the 'regulatory' bodies are of a club character, mostly formed by individual participants within the system.

For the regulation of international finance, there exists an array of bodies that establish rules and regulations to directly or indirectly reduce, from within countries, risks associated with the frequency and speed of capital flows. Since the focus of this thesis is short-term capital flows, in observance will be banking and securities industries, which are the main conduits for private international capital flows.

At the top of the list of regulators are the rule-creators. In East Africa, these are the parliaments in the three countries and the newly-formed East Africa Parliament, which legislate Acts to regulate activities of financial institutions and other participants of the financial system.

Central Banks follow in importance. A central bank is universally accepted to have oversight of the financial stability of the system as a whole.[86] Central Banks set up mandatory rules and regulations which govern the operations of banking and in the case of East Africa, securities industries. Notwithstanding the importance of central banks in risk-management in the financial industry, they are not necessarily the

[86] Llewellyn, supra, note 70.

supervisory agency for individual banks or other financial institutions and markets.[87] Theoretically, Central Banks in East Africa are regarded as independent from government interference. However, their independence can be questioned because of their closeness to the governments.

Central Governments, especially through Ministries of Finance play a big role in the conception of various rules and regulations that may influence in some ways the movement of private capital flows in their respective areas. Basically, they are the originators of the various Acts for rules and regulations that go to parliament for approval. Furthermore, Ministers of Finance are extremely powerful; for example, they are very influential in the appointment of the Central Bank Governors and other important personnel in the financial sector.

Other important regulators include Security and Exchange Commissions and banking sector regulatory agencies in the three countries. These are regulatory arms of the governments which provide mandatory rules for participants in the area's capital markets.

Other bodies within the financial industry, such as banking and security dealers associations, and independent legal experts also play a role in the regulatory process, especially in advising on and actually designing the various rules and regulations. In the case of the associations, they set up certain rules, regulations and commitments that have to be followed by their respective members. In most cases, however, such

[87] *ibid*

rules are not mandatory for those participants that opt out or are not interested in becoming members. Also in the list are courts, whose interpretations in matters concerning consumer or investor protection and bankruptcy may be of great significance in determining the kind and level of investments and risk–taking on the part of both lenders and borrowers of (foreign) capital in poor countries.

When observing challenges facing regulation of capital flows in East Africa in Chapter Three, the focus will be on the design and expansiveness of the various rules, together with supervisory and enforcement capabilities of the existing regulators in the framework. This means looking at the institutional capabilities of the various organs trusted with regulating the external finance sector, particularly the knowledge of (modern) legal and financial issues on the part of employees. Also fundamental are technological abilities to conceive, supervise and enforce the various rules in the external finance sector.

The rules that are in place to regulate (both directly and indirectly) international private capital in East Africa also need to be examined. Of particular importance are the rules connected to banking and securities regulation, two leading conduits of short-term private capital to developing countries. Also important are foreign investment acts, which facilitate the entry of private capital into poor countries. These are important to observe due to their increasing role in the investment of international private capital.

The following is a brief survey of some relevant legislation in the three countries of East Africa. The various laws form the backbone for activities that facilitate private capital flows in the region. The list includes banking, securities and foreign investment acts, three areas that are directly associated with private international capital flows in the area.

Kenya

Kenya is the biggest economy in East Africa and one that has the most experience with the free market economic system.

The Banking Act, Chapter 488 of 1989 regulates banking business. It covers a wide range of issues including minimum capital requirements (Part II-7), limit on advances, credit and guarantees (Part III-10), reserves (Part IV) and inspections and control of institutions (Part VII), all of which play a part in the regulatory process aiming to maintain sufficient liquidity and eventually ensure stability. Also of significance is the Central Bank of Kenya Act, Chapter 491 of 1998, which establishes the legal status and identifies the principal objectives of the bank, which include maintaining systemic stability. The task of banking regulation also relies on Prudential Guidelines (2002 and 2005) and Risk Management Guidelines (2005), both of which apply to institutions established under the mentioned Banking Act.[88] Some of the prudential guidelines include those concerning corporate governance, capital adequacy, liquidity management, foreign exchange exposure limits and

[88] Central Bank of Kenya, http://www.centralbank.go.ke/publications/guides/pguides/index.html [online-January 4, 2006].

prevention of crime and money laundering. Risk management guidelines cover, among others, credit risk, liquidity risk and foreign exchange risk.

As for the regulation of securities, the Capital Markets Authority of Kenya relies on the legal and regulatory framework that includes, among others, the Takeovers/Mergers Act of 2002 and the Foreign Investors Regulations Act of 2002. All these provide guidelines for foreign portfolio investments (both debt and equity, short-term and long term).

Other General Business Regulations, especially those that apply to businesses that may seek capital from abroad are also very important. They are important in addressing issues such as disclosure, accounting standards and information symmetries. All these allow for better investment decisions on the part of foreign investors. Such is the case with the Securities, Public Offers and Disclosures Act of 2002.

Both Tanzania and Uganda have a set of laws similar to that of Kenya, despite their later adoption of free market economics.

Tanzania

Tanzania employs the Banking and Financial Institutions Act (1991) as a backbone to all banking operations in the country. This law allows for, *inter alia*, the establishment and operation of private and foreign banks in Tanzania. Further, the government instituted controls on all foreign exchange inflows and outflows. The

Bank of Tanzania Act of 1995 gives powers to the Central bank to regulate and supervise the banking sector. This Act ensures that commercial banks and other financial institutions conduct their business on a sound prudential basis and according to the various laws and regulations in force. It includes the supervision of banking conduct and the licensing of financial institutions.[89]

The two acts also give a summary of the main regulatory functions of the Bank of Tanzania, which include:[90]

> a) Implementation of prudential controls concerning capital adequacy, liquidity, concentration of credit and risk diversification, asset classification and provisioning, and prohibited activities;
>
> b) Licensing of banks and financial institutions;
>
> c) Facilitation and monitoring of a Deposit Insurance Fund, the purpose of which is the protection of small depositors; and
>
> d) Modification and monitoring of the Minimum Reserve Requirements and foreign exchange exposure.

Trading of securities in Tanzania is a recent but growing activity. The Capital Markets and Securities Act of 1994 established the Capital Markets and Securities Authority (CMSA), which is responsible for developing the necessary institutional and regulatory framework for capital markets.

Other important laws in operation include the Tanzania Investment Act of 1997 and the Foreign Exchange Act of 1992. It is through them that the 'vehicles' for international private capital operate.

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[89] Bank of Tanzania, http://www.bot-tz.org/AboutBOT/BOT_Function.htm [online- January 6, 2006].
[90] *ibid*

Uganda

In Uganda, banking activities are regulated by the Financial Institutes Statute of 1993. This statute is similar in nature to Tanzania's banking and financial institutions act of 1991, and it lays down a sound legal framework for regulation of banking business in a liberalized economy setting. The Act provides guidelines for the operation of financial institutions in the country. The Foreign Exchange Act of 2004 is also important, since it relates directly to the movement of foreign exchange into and out of Uganda.

The Bank of Uganda takes a leading role in the regulation of both the banking and securities industries. In recognition of the importance of private capital flows to the development of the economy and their inherent potential threat, the Bank of Uganda established a Private Sector Capital Flows monitoring and recording section in the Trade and External Debt Department (TEDD) for purposes of monitoring information on capital inflows.[91]

The Project's Objective is:

> [To] provide accurate and up to date data on Private Sector Capital inflows and outflows for compilation of Balance of Payments statistics, aggregation of all data on external liabilities and compilation of Uganda's International Investment Position (IIP). This will serve as an early warning system enabling policy makers to take pre-emptive actions to deter any financial crises.[92]

The expected output is improvement in the monitoring of private capital flows in order to enhance economic policy formulation.[93]

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[91] Bank of Uganda, Monitoring Private Sector Capital Flows by the Bank of Uganda, http://www.bou.or.ug/PriSec_CapFlows.pdf [online- January 6, 2006].
[92] *ibid*
[93] *ibid.*

Securities trading in Uganda is done through the Uganda Exchange Commission, run under the jurisdiction of the Capital Markets Authority (CMA), which reports to the Central Bank of Uganda. The Capital Markets Authority was established in 1996 following the enactment of the Capital Markets Authority Act (Cap 84)1996.[94] Section 102 of the CMA act gives the CMA powers to make regulations governing the establishment and operations of the stock exchange, procedures for companies going public and investors' guide to shares and public securities issues.[95]

It should be noted that all three Central Banks in East Africa, through banking supervision departments, still dominate the activities of banks (and security traders). Further, in all three countries, foreign investment laws and business laws are also of great significance, *vis*-à-*vis* private capital flows, their potential threats and mitigation strategies. This is especially true for those that focus on businesses seeking capital from abroad.

Also the re-introduction of the East African Cooperation (EAC), a custom union, has resulted in a tremendous push towards the harmonization of banking (and securities) laws in the region with a view to achieving convergence in bank regulation, supervision and cross-border transactions.[96] For example, in 1997 the three East Africa countries entered into a memorandum of understanding which set out

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[94] 'What is CMA?', Capital Markets Authority of Uganda, http://www.cmauganda.co.ug/about/about.htm [online- January 6, 2006].
[95] *ibid*
[96] Mukirya, N., "Changes in Banking Legislation in Response to Evolution of Banking Systems in East Africa: A Comparative View", Bank of Tanzania, http://www.bot-tz.org/TrainingInstitute/eacb/Course_Proceedings.htm [online- January 7, 2006].

cooperation goals for the three countries' security markets.[97] Under the memorandum, the East African Member States Regulatory Authorities (EASRA) was set up as a coordinating regulatory body for capital market integration and cooperation.[98] Further, Article 80 of the 1999 Treaty of East Africa Cooperation recognizes EASRA and provides for, among others, harmonization of capital market policies and regulatory frameworks; promotion of cooperation and crossborder listing and trading.[99]

All this is significant, as the area's economies grow, integrate and more private capital continues to flow into the area.

The adoption and integration of the various rules and regulations by East African countries show their realization of the importance of economic stability in the respective countries and region as a whole. However, the main challenge, as will be seen in the next chapter lies in the enforcement of the various rules of regulation. Apart from the complexity of the various existing rules to directly influence private capital flows, challenges still exist in their adequacy and the capabilities of the world community and individual governments to make them work.

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[97] IMF, Irving, J., Regional Integration of Stock Exchanges in Eastern and Southern Africa: Progress and Prospects, IMF Working Paper, 2005. http://www.imf.org/external/pubs/ft/wp/2005/wp05122.pdf [online- March 2006]

[98] *ibid*

[99] *ibid*

CHAPTER THREE

CHALLENGES OF REGULATING SHORT-TERM INTERNATIONAL PRIVATE CAPITAL IN EAST AFRICA

Chapter Two provided a brief examination of the frameworks that are in place to regulate private capital flows in East Africa. This chapter discusses the various challenges facing countries in the region for regulating international private capital.

There are various ways that one can discuss such challenges. In this chapter, I will address factors, both in the international and domestic environment that make the task of regulating capital flows difficult. It is important to look at both areas due to the (mostly) foreign origin of the private capital in discussion. Specifically in discussion is the short-term capital temporarily invested within the region that eventually exits. In this case, one needs to look at regulation as it relates to the whole path that the capital takes until its flight becomes detrimental to a poor region.

I look at challenges in regulation from three angles, all of which reduce the ability of the countries to control excessive capital exits. Firstly, international law and how it strengthens the current position of openness. Secondly, failure of the dominant prevailing notion of crisis response as opposed to crisis prevention in finance. Lastly, I will discuss the region-specific challenges which hinder the capabilities of the East African countries to establish a strong framework for regulation of the said flows, thereby making them prone to crises.

I. International Regulation

When discussing challenges in the regulation of capital flows internationally, two areas are important to note. These are the challenges existing within the international legal environment and the non-legal environment.

I a. Challenges within the International Legal Environment

Challenges of regulating private capital flows in poor countries such as those of East Africa stem from various factors in the international legal arena. These factors range from the goals of the existing international economic law, problems in its creation and the lack of international legal provisions to specifically address financial matters. All the mentioned factors contribute to the shortfalls that make the task of managing private capital flows, particularly capital exits, a challenging one to most poor countries.

When talking about the goals of international economic law, one needs to look at the objectives that are to be pursued by the regulations within this branch of law. In relation to risks that most countries face, international rules do not allow for a safe financial and economic environment for poor countries. The rules I am referring to include those governing international business relations and therefore link both directly and indirectly with capital flows.

The role of international economic law in establishing an international framework for capital flows and its failure to seriously consider the possible dangers that may face

poor countries stems from the fact that most rules derive from the Western economic model and therefore further support its objectives. This model, to many poor countries, is a relatively new experience, for many of them only came into being relatively recently. Further, most countries had closed economies for the larger part of their existence. Even in those areas where opening of economies is taking place, most of the reforms are still at their early stages. In international economic law, the priority towards the opening up of markets seems to have an upper hand relative to the safety of those nations that may be negatively affected by such openings. This branch of law, in the form of various rules and regulations which govern the capitalist conduct of international economics, has played a significant role in ensuring that free market economics and liberalization prevail. The various conventions, standards and bilateral agreements have been the introductory vehicles of liberalization and free market economic principles to the "new" followers of capitalism.

When explaining what international law really tries to achieve, Karl Marx is instructive when he points out that economic interests of the economically stronger group in society (rulers) influence the shaping of the various rules and regulations.[100] Further, drawing an analogy with the international society or community if you will, one can argue that the shaping of rules in international economic (and public) law is based on the interests of the "ruling class of the world". With all the states of the world considered subjects of international law, the ruling class of this group is the

[100] Marx/Engels, *The German Ideology*, MECW V, 90-92.

economically developed world.[101] The argument here is that economically developed countries are the ones with power and influence over the shaping of rules, invariably favoring their interests, and with power to impose the same on the less powerful countries for the same reason.

It is not very easy to specify the exact reasoning behind this unending trend of differences that exists between countries at different stages of development. However, the bottom line is that the globalization movement is attempting to bring together countries with different interests and priorities without a real common ground. The worst part is that there exists very little common ground between the extreme rich and extreme poor in this convergence. In such a case, priorities may differ, causing imposition of ideas by the economically powerful, as is the case today. For example, in the case of capital flows, rich countries may be interested in the lowering of hurdles to allow for the flows, which benefit money businesses in their countries. The opposite may be true for poor countries, whose priority may be economic stability through some control (limits) over such flows. For poor countries, getting a fair deal through international law can be a challenging undertaking because they would seek to achieve the kind of law that will look out for their interests. In the case of capital flights, they would be seeking the kind of international legal provisions that will tolerate restrictions of capital flows, so as to control the possibilities of capital flights and therefore crises in their economies. Even though these provisions are possible and in fact some countries use them, the reality is that with the current push towards the

[101] Okafor, O.C., "Newness, Imperialism, and International Legal Reform in Our Time: A TWAIL Perspective", (2005), 43 (1&2) Osgoode Hall Law Review, pp. 174-180.

opening up of economies, attempts to establish such hurdles are always met with resistance.

If that is the case, one may ask the simple question as to why poor countries do not challenge and seek change in the prevailing ideas in international economic law. There are a number of answers to the question. Principally, developing countries have challenged and sought changes in the international economic regime, but their need for capital undercuts or rather diminishes their power to bargain for change. They are desperate for capital. And as they struggle to expand economically, most of the poor countries need capital, a huge portion of which has to be imported. Until these countries can sufficiently cater for capital from domestic sources, capital imports will continue to be a part of their investment plans.

More importantly, their inability to force changes stems from the fact that the current international rule-making and rule-changing setup does not easily allow for changes. In simple terms, their abilities to make such changes cannot easily succeed, as that will go against the interests of the other section of the global population, which benefits from the existing set up. This is, for example, shown by the difficulty in withdrawal from WTO commitments, whereby a temporary withdrawal requires an appeal for a waiver to the organization per Article IX of the Marrakesh Agreement.[102]

[102] Woods, N. and Narlikar, A., "Governance and the Limits of Accountability: the WTO, the IMF and the World Bank", http://www.globaleconomicgovernance.org/governance%20and%20wto.PDF [Online-May 2006]

Law-creation is an important element in any legal system. In international law, the whole process of law creation therefore ought to reflect the characteristics that lend legitimacy to the rules and laws made; namely, professionalism, fairness and transparency. The goal should be to produce norms, standards and legal rules which deliver or have the capacity to deliver, given a fair chance, benefits and advancement to members of the global community. However, this very basic feature of rule creation is conspicuously absent in many international institutions wielding enormous influence on countries, which increasingly adopt many of the norms, standards and rules that govern a wide range of economic activities between states in the international plane. The fact that international institutions were created and charged with the task of assisting with the stabilization and advancement of economic conditions of all the nations of the world according to their needs and arguably without favoritism, one is at a loss to explain the reasoning behind these inequalities in both the conduct and the creation of these rules.

For example, some (wrongly) consider the WTO to be a representative international institution for the reason that its members vote and the votes are distributed equally among members.[103] In theory, each nation has one vote and major economic powers have no privileged positions.[104] Nonetheless, under WTO practice, decisions are reached through consensus. It is what goes on behind the scenes and in the "rounds" of negotiations that compels many to question the legitimacy of most of the decisions taken by the WTO. In these rounds which create the rules, decisions are reached

[103] Gilpin, R. and Gilpin, J., *Global Political Economy: Understanding the International Economic Order,* (Princeton: Princeton University Press, 2001), p. 383
[104] *ibid*, p. 382.

through a combination of consensus and arm-twisting by the big powers.[105] This trend has resulted in the creation of rules that benefit a smaller section of the global economic community, rather than the whole community. There have been specific cases whereby interests of poor countries have failed to receive the necessary concern of the rich countries. For example in the WTO's General Agreement on Trade in Services (GATS), markets were opened for financial services and information technology sectors, major exports from the developed world, but not for maritime and construction services, two areas in which some of the developing countries have some advantage and a chance of doing well.[106]

Furthermore, agendas that seek to address interests of the majority of the world population have a low probability of winning because of political capture. Most country representatives at such world bodies unfortunately go in with different agendas which in most cases are in conflict with the interests of the majority. According to Joseph Stiglitz, these representatives naturally see the world through the eyes of the financial community, especially given that some of them come from or end up in these communities once their public service ends.[107] In this case, they always push for provisions that tend to favor the various interest groups. Even though such a situation can largely be related to rich countries whereby groups such as corporations aggressively seek to have their interests represented, it may also be applicable in the case of poor countries, whose representatives to world bodies are

[105] Visit http://www.cafod.org.uk/policy_and_analysis/policy_papers/rough_guides/wto
[106] Stiglitz, J., *Globalization and its Discontents*, (New York: W.W. Norton and Company, 2003), p.61.
[107] *ibid*, p.19.

mostly presidential appointees and may not necessarily represent the interests of the masses.

Therefore rule creation faces a serious problem of political capture, whereby special interest groups influence policy, hence reducing the likelihood that the national governments will adequately represent the interests of their people.[108]

In the rule-making process of the World Bank and the IMF, balanced participation by all members is almost non-existent.[109] Indeed, these institutions operate as businesses and it can be argued that they were not meant to consider input by poor countries. However, since poor countries constitute a significant section of their 'clientele', it would make business sense to seriously consider their input for the benefit of the two sides. This is especially true in relation to such issue as conditionality, as has been demonstrated in the recent call for IMF reform.[110]

Another area that may be disadvantageous to poor countries is the lack of negotiation strength to match that of rich countries. With the strength of representation at international organizations possessed by the rich countries, made up of big numbers of highly trained negotiators, their counterparts from poor countries stand no chance to successfully reach rule-making decisions that may favor the majority of their populations.

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[108] Atik, J., "Global Trade Issues in the New Millennium: Democratizing the WTO", (2001) 33 George Washington International Law Review , 451.

[109] United Nations, Human Development Report 2002, (New York: Oxford University Press US, 2002), p.113. (In the two institutions, even the voting by the different countries of the world carries different weights, with the votes of Japan, the United States and some of the richer and powerful countries within the European Union carrying more weight).

[110] "IMF Faces New Pressure to Reform", BBC News Online, http://news.bbc.co.uk/2/hi/business/4929636.stm [Online - May 2006]

All these examples raise the question of fairness in the law that regulates economic activities globally. Even though it may be argued that the trade rules in question are put in place through consensus or voting, it is fair to say that such kind of consensus can end up being unjust. In that respect, the existing mechanisms and processes do not guarantee the creation of fair laws which cater for all the concerned parties in the global economic setting. This may carry some consequences. Once you have a situation whereby a law or body of rules does not benefit the subjects, its enforcement may become a problem. Well made laws, which consider the interests of all subjects concerned are easier to follow and therefore relatively easier to enforce. It has been argued that the current order is based upon systemic inequality whereby the advanced countries and their multinational corporations are the chief beneficiaries (financially) of the "interdependence" that seeks to preserve the status quo, hence preserving the privilege of a few at the expense of the many.[111] As previously mentioned, this is clearly seen in exploration contracts between poor countries and multinational corporations. "Realists" would probably argue that there is no free ride for any country in this world, however in need that country may be. It is easy to see, in looking at global economic, social and political relations, that countries cater for their own self-interests and that no country easily gives up opportunities so as to allow others to thrive and prosper. Whatever is given, there has to be a return, and often a higher return.

Such a situation whereby poor countries are the underdogs of the global economic system provides probably one of the biggest challenges internationally in the

[111] Letelier, O. and Moffitt, M., *The International Economic Order,* (Washington D.C: Transnational Institute,1977), p. 30

regulation of global financial activities, and dangerous capital flows in particular. As a result of the unbalanced abilities and opportunities that exist in the making of global rules and regulations (as discussed above), the world has ended up with rules which tend to favor rich countries. Worse is the situation which makes it hard for the poor countries to get out of such agreements, upon realization of problems. It is through such situations that the world has ended up with rules that may pose risks to poor countries but not rich ones, as has been seen in the case of provisions produced through the WTO and Bretton Woods institutions. The approval, for example, of rules that advocate for the opening up of economies is the result of such imbalances in the rule-making process. Such rules, which do not address problems of openness, increase the risk of capital flight and financial crises in poor countries.

Ib. Challenges within the Existing International Prudential Regulatory Framework

Aside from the above general challenges faced by poor countries within the international legal framework, there are other challenges specific to the prudential regulation environment.

The biggest one is probably the fact that there really does not exist international legal provisions to govern international private capital flows, and the development of universal rules and regulations seems to lag even further behind. Currently, there are no legal provisions that are mandatory to all participants in global finance for the mentioned goals. Apart from a few rules and regulations, especially on banking supervision, a broad-based universal set of laws that may be helpful in curbing risks-

inducing capital flows is absent. Such a situation allows for discrepancies in the way countries handle different kinds of capital flows.

To make matters worse, there is also a problem of access into the so-called "clubs" which take a leading role in the formation of the non-legal provisions for international finance regulation. Membership in the organizations is very hard to attain, especially for poor countries such as those in East Africa. For such groups, membership is limited to high-income, financially developed economies.[112] As Eatwell and Taylor note,

> "The virtues of club atmosphere have been seen as a barrier to the expansion of the BIS committee's membership beyond the G-10".[113]

Even though members in these club recognize the importance of external involvement and of coming up with international rules that are inclusive of other members of the international community, they seem to be more content with the quick decision making opportunity that the smaller groups provide.[114] This further strengthens the question of interests discussed previously, whereby in this case, interests of poor countries are not at stake in the formation of the regulations. It also makes the attainment of universal sets of rules a very hard goal to achieve. Furthermore, it makes the goal of regulating dangerous short-term capital flows from a global angle a hard one to achieve, thus increasing the potential risk for poor countries.

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[112] Eichengreen, B., *Towards a New International Financial Architecture*, (Washington D.C.: Institute for International Economics, 1999), p. 25
[113] Eatwell, J. and Taylor, L., *Global Finance at Risk*, (New York: The New Press, 2000).
[114] Eichengreen, supra, note 112, p. 202

As for non-legal mechanisms currently in place, including Basle Regulations on Banking Supervision embraced by countries in their quest to maintain stability in their financial systems, some challenges also exist. Even though these provisions provide a good foundation for prudential regulation in the banking sector, their effectiveness globally might be in question, mostly as a result of enforcement problems caused by the voluntary nature of their adoption, especially for non-compelled countries. With such softness, the level of difficulty in the regulation of capital flows internationally is increased. This further increases the risk of financial crises to countries.

II. Crisis Prevention versus Crisis Response

Prior to the 1997 Asian crisis, the world regulatory community placed more attention on responding to financial crises, rather than trying to prevent them. Such a trend, which can be problematic, is still prevalent in both international and domestic legal settings. Even though there have been discussions on surveillance and financial regulation through prudential measures, most of the (dominant) measures currently in place aim to tackle the problem of financial crises when they occur, rather than attempting to prevent them from occurring in the first place. The current regulatory emphasis is being placed on reliance on lenders of last resort, at both domestic and international levels. However, experience shows that lenders of last resort have not been able to meet their obligations when called upon to do so. Further, insurance and derivative instruments have become widespread within the financial-trading realm. All these have increased the level of moral hazard on the part of participants, making

them extreme risk-takers. Such risk-management strategies can be a challenge for poor countries in the quest for stability.

II a. Lenders of Last Resort and their Inherent Problems

A lender of last resort is a financial institution that lends money to other financial institutions which are facing unusually heavy withdrawals, in order to protect them from collapse. In a domestic setting, Central Banks act as lenders of last resort while internationally the function is done by a range of institutions ranging from regional banks to the IMF.

Protection of an economy against crises as a result of capital flight is a difficult task for Central Banks, especially in poor countries. The task requires a sufficient level of foreign exchange reserves to be held by central banks. One problem is that in most poor countries, there are not enough resources that are continuously available to anticipate and prevent financial crises; usually resources are put together after the crisis has taken place for purposes of economic rescue.[115] For most poor countries, foreign currency is crucial for economic survival but most of them do not earn enough from exports. Countries of East Africa are not excluded from this generalization. So far, they do not have a strong export base to guarantee a constant inflow of foreign currency.

Taking the example of Tanzania, the (traditional) agricultural sector is still the overall dominant sector of the economy, even though tourism and mining are the leading

[115] *ibid*, p. 38

earners of foreign exchange.[116] Notwithstanding that the two sectors have been doing well recently and are expected to continue with the trend, [117] the contribution of tourism and mining industries in the future does not in reality guarantee an increase in the level of foreign reserves as most of the revenue leaves the country because investors in the mining and tourism ventures are largely foreign.[118] When looking at the 2002/2003 financial year, for example, some 1.5 million troy ounces of gold were mined by five major companies; they were worth more than $350 million, but earned Tanzania a modest three per cent in royalties.[119] In the same country, over the past decade, the level of gross foreign exchange reserves held by the Central Bank has increased from US$ 775 Million in 1999 to US$ 2 Billion in 2003. During the period, the total external debt increased from US$ 7.5 Billion to US$ 8 Billion (official).[120] Further, the current account deficit also increased.[121] It is true that a mismatch between foreign debt and reserves may not be a big issue, as many countries have similar or even worse debt/reserves ratio. The threat for such a country like Tanzania is the existing level of risk (real and perceived) and even more importantly the

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[116] Tanzania Economy, http://www.tptanzania.co.tz/economy_body.html, [online- March 2005]

[117] Tourism earned the country some $735 million in 2003 and according to the Tanzania Chamber of Mines, the country exported minerals worth over $400 million in 2002, up from $302.23 million exported the previous year. According to government forecasts, in the next two years, gold worth $750 will be exported. This is 50 per cent of the country's current foreign-exchange earnings of $1.5 billion annually.

[118] Tanzania National Website, http://www.tanzania.go.tz/naturalresources.html or /mining, [online 2005/6]

[119] The East African, *Dar's Gold Exports to EU Yield Surplus of $68m,* http://www.nationaudio.com/News/EastAfrican/current/Business/Business100520040.html [online-March 2005]

[120] Bank of Tanzania, *Selected Economic and Financial Indicators,* http://www.bot-tz.org/Publications/EconomicIndicators/Economic_Indicators.htm [online-March 2005]

[121] IMF Press Release No. 03/127 July 28, 2003, http://www.imf.org/external/np/sec/pr/2003/pr03128.htm [online- March 2005]. Official (public) debt may not be of issue in this particular examination. However, during crises, it might disrupt private payments out of the country, especially in poor countries with insufficient reserves.

availability of the reserves in times of crises, since most of the reserves are deposited in foreign banks in the developed world. In case of a massive capital flight, therefore, the low level of reserves that the central bank holds can prove to be massively disastrous.

This cannot be compared to rich countries or emerging economies such as India and China, whose levels of reserves stood at US$ 659 Billion[122] and $141.45 billion[123] respectively in the 2003/2004 financial year. The latter countries are able to accumulate such huge reserves because of their strong export base. In such countries, a risk-management strategy that relies on lenders of last resort may be effective.

Even though it is not possible to predict the level of foreign reserves that Central Banks in East Africa will have in the future, or if they will be able to effect a financial rescue of relative magnitudes, the current trends in the export sector are not very promising. For example, in the case of Tanzania, while statistics point to an increase in the level of exports, real revenues that return to and remain in the country are small due to the fact that most of the revenue is repatriated by the investors (mostly foreign). The apparent lack of reserves can be of concern to East Africa countries because of past experiences. For example, in the 1990s, the area was hit with a series of bank failures caused by, among other reasons, money laundering. A few banks such as Meridian Biao (Tanzania) and Greenland Bank (Uganda and Tanzania)

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[122] China Forex Reserves Swell to 659bln. http://www.reuters.com/newsArticle.jhtml?storyID=8179212&type=businessNews [Online-March 2005]

[123] Forex reserves surge by $253 Million [Online-March 2005] http://www.ndtv.com/money/showbusinessstory.asp?slug=Forex+reserves+rise+%24253+mn&id=24724

collapsed.[124] Central Banks in the respective countries did not rescue the banks, leaving the depositors to bear the losses.[125]

With such a situation, the country will have to continue relying on foreign lenders, including regional banks and the International Monetary Fund (IMF) in cases of serious financial crises.

Internationally, the IMF has often been looked upon as the leading lender of last resort to provide liquidity to countries in crisis. Among others, the IMF is charged with the duty to promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.[126] This helps to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members. However, the speed with which the Fund responds to financial crises has been criticized.

For example, many have questioned the failure of the fund to tackle problems with the Thai Baht in a timely manner during the 1997 South East Asia crises. After using US$ 33 billion of its foreign exchange reserves, the Thai government could no longer support the Baht and ended up devaluing its currency.[127] After requests, the IMF package was a mere US $ 17.2 Billion, which was just 50 percent of the needed

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[124] Bagenda, P.M., "Combating Money Laundering in the SADC Sub-Region: The Case of Tanzania", http://www.iss.org.za/pubs/Monographs/No90/Chap3.html [online- May 2006].
[125] *ibid*
[126] IMF Finances, *Where the IMF Gets Its Money,* http://www.imf.org/external/np/exr/facts/finfac.htm [online- March 2005]
[127] Yergin, D. and Stanislaw, J. , *Commanding Heights, Battle for the World Economy,* (New York, NY: Simon and Schuster, 2002) p. 178

sum.[128] Many believe that the spread of the crisis could have been avoided had the IMF intervened and come to the rescue three months earlier, before the situation had deteriorated and spread to the rest of the region.[129] This makes one wonder whether the poorest countries should expect to be treated any differently when crises happen. The IMF is also blamed for the conditions imposed by its rescue packages, some of which go beyond its mandate, making them counterproductive.[130] It has been suggested by some, including prominent scholars like Jeffrey Sachs, that the institution's packages are in a sense the cause of the crises due to their contractionary nature.[131]

Apart from the 'politics' associated with the Fund, it is important also to recognize that the IMF does not have sufficient funds to fully rescue countries facing financial distress. This is largely the result of the modest reserves it holds. By the end of February 2005 the Fund held quotas amounting to SDR 213 billion (about $327 billion). Out of that amount, total usable resources amounted to US $ 176 Billion.[132] When one looks at the size of the world economy and compares it with the size of reserves that the Fund holds, it is fair to conclude that it will be a significant challenge for the Fund to support massive bailouts when extreme crises happen. Currently, the total world GDP stands at about US $ 41 trillion, out of which the industrial nations produce US$ 32 Trillion and Sub Sahara Africa about US$ 600

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[128] *ibid*
[129] *ibid*
[130] Fortin, C., "The UN System and Financial Regulation", in Bello, W. *et al* [Editors], *Global finance : new thinking on regulating speculative capital markets*, (New York : St. Martin's Press, 2000), p. 38
[131] A contraction is a period of general economic decline.
[132] IMF, supra, note 126.

Billion. Obviously, supporting a recession of such an economy will be a difficult task to undertake.

Further, with the worldwide volume of foreign exchange trading having increased from US$ 600 Billion per day in 1999 to 1.2 Trillion per day in 2001[133] and net private capital flows to emerging economies having shot up to US $279 billion range in the 2004/2005 period,[134] this suggests that the overall level of risk in international financial markets has tremendously increased due to the increased level of activity and inherent risks. Such conditions make it even harder for the IMF to promptly provide sufficient funds when needed. Because of this, and based on the past working relationships with The Fund, East Africa cannot expect to receive sufficient (as requested) funds on time from the IMF when it faces difficult financial problems.

The situations demonstrated above show how levels of foreign exchange reserves can affect the ability of lenders of last resort to sustain economies in times of danger. Such conditions therefore increase the imbalance between the possible level of moral hazard and the actual abilities that lenders of last resort have. This makes Lenders of last resort unreliable for the task of risk management of short-term capital flows. Furthermore, the fact that they are responsive measures makes them more unreliable in the regulatory process. It is more feasible for poor countries to attempt to identify and solve problems associated with capital flight and financial crises rather than trying to tame them once they have occurred and done some damage. Even though East Africa may not have had notable crises in the past, past performance of the

[133] Krugman and Obstfeld, supra, note 10, Chapter 13
[134] Net Capital Flows to Emerging Markets Rose Sharply in 2004, http://tokyo.usembassy.gov/e/p/tp-20050120-17.html[online]

area's Central Banks during bank crises and the slow and insufficient help by lenders of last resort makes the reliance on this approach unadvisable.

II b. Moral Hazard

The presence of lenders of last resort also leads to moral hazard. The notion of moral hazard comes from the economic theory of insurance.[135] The presence of insurance from the lenders of last resort reduces the incentive for prudence and encourages more risk taking. These lenders of last resort provide guarantees and inject liquidity into threatened institutions. Such behavior encourages excessive levels of risk-taking on the part of institutional investors who borrow from abroad, with the hope of being rescued. According to Carlos Fortin of the United Nations,

> "Rescuing means essentially that the public sector, national and international, is called upon to bail out private creditors and debtors who have entered voluntarily into commercial transactions without appropriate prudential safeguards and who subsequently have run into difficulties. Resources that could be used for development are thus diverted to support private failures of prudential judgment".[136]

Their reliance on assurances by lenders of last resort essentially gives them freedom to act recklessly during the intermediation process. However, the problem with excessive risk-taking on the part of individual investment firms (for example in intermediation) is that their actions may lead to systemic risk. One big factor in systemic risk is its externality factor.[137] This means that its sum is greater than the sum of private risks. The sum of the risk managed by private agents is less than the total risk to the community.[138] Therefore, even though lenders of last resort aim to

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[135] Eatwell and Taylor, supra, note 113, p.46.
[136] Fortin, supra, note 130, p.38.
[137] *ibid*
[138] *ibid*

control this social risk, moral hazard distorts social risk management by transferring risk from private entities to agents (insurance/lender of last resort) and eventually to the public.

Moral hazard has also been nourished by the presence of derivatives. Derivatives are products developed to allow firms to 'hedge' their financial exposure and protect themselves against adverse market moves.[139] Their use has tremendously increased recently, not only as a result of their risk-management purpose but also due to their potential for huge profits.[140] In this case, it has been argued that even though these instruments were aimed to offset or control risk, they end up increasing it due to their potential to cause losses to investors and countries.[141]

With globalization, whereby there is convergence of national policies towards free market economics, foreign exchange reserves still remain the ultimate tool for maintenance of exchange rate stability. In this case, countries still need to maintain substantial levels of foreign exchange reserves to assist currency stability. However, for most poor countries, it is difficult to maintain huge reserves of foreign exchange, making them easy victims of crises.

In this section, I have sought to analyze situations whereby countries may be at a disadvantage due to the unreliability of the lenders of last resort. My argument is that they do not provide sufficient security to economies in times of crises. Records have

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[139] Tickell, A., "Dangerous derivatives: controlling and creating risks in international money", (2000) 31Geoforum, pp. 87-99.
[140] *ibid*
[141] *ibid*

also attested to the inability of the lenders of last resort to respond to crises in a timely manner.

III. Challenges within the East African Legal Environment and Framework

The previous chapter indicated that many laws are available to the countries of East Africa to manage the financial sector in general. However, even though proper laws may be present, the legal environment in East Africa contains some features that may prove to be a challenge in the regulation of flow-driven financial crises. Analyses of recent financial crises (both in developed and less-developed countries) indicate that regulatory failures are not exclusively an indication that the rules were wrong.[142]

To determine what is 'wrong' with the current regulatory environment/structure in general, one needs to investigate not only deficiencies and problems that exist in the laws and rules of financial regulation themselves, but also in other institutional factors that make regulation of capital flows a very difficult task to implement. Problems of financial sector regulation within East Africa can be classified into two broad categories – those inherent in the various laws and those related to institutional capabilities. Such a classification has been used in order to make a distinction between problems inherent in the rules from other factors that surround the law, such as its formation, expansiveness and enforcement, all found within the organs and personnel associated with its workings.

[142] Eichengreen, supra, note 112, p. 31

III a. The Problems Inherent in the Laws

Chapter Two outlined a number of laws in East Africa that govern activities in the banking and securities industries. Through the respective Acts, provisions have been laid down in several key areas to assist in the maintenance of adequate levels of capital in banks, maintenance of good levels of foreign exchange reserves in Central Banks' coffers and more importantly in the control of levels of capital leaving the three countries' systems. The rules include, among others, capital adequacy requirement acts, foreign exchange control acts and private foreign borrowing rules.

The aim of this section is to identify whether the existing laws adequately address the issue of safety of capital flows (debt and equity). This means, determining whether there are sufficient domestic laws to manage capital flows and whether the laws are able to deter possibilities of excessive capital flight. This applies not only to laws that are directly related to capital flows and flights but also ones that can indirectly facilitate their exit.

The first major problem in this area is lack of sufficient laws in some key sectors of financial industry. Basically, there has been a rush to allow the operation of non-banking financial intermediaries without first establishing strong laws, strengthening them and allowing regulators to familiarize themselves with them. For example, by 2003 no regulatory framework for microfinance had been drawn up, finalized and

passed into law in Tanzania.[143] Notwithstanding the situation, several microfinance institutions were operational without proper supervision by the Directorate of Microfinance at the Bank of Tanzania. Non-governmental organizations (NGOs), Savings and Credit Cooperative Societies (SACCOs) were allowed to operate under supervision of other departments (Ministry of Cooperatives in the case of SACCOs), which had no expertise in regulating financial institutions.[144] Activities by SACCOS and other informal groups are thriving in Tanzania and other parts of the developing world, making them a very lucrative activity for illegal capital flight-related activities, including laundering. Such absence of basic law (and other supervisory problems) can allow the respective institutions or other insiders to engage in activities that encourage excessive capital outflows. This can be a major challenge in the regulation process.

Another problem relates to the immersion into and familiarity of existing laws on the part of local stakeholders of the financial industry, especially the regulators. As indicated in Chapter Two, East African countries have in place some fundamental laws that may assist in preventing or reducing capital exits when such a threat occurs. In all three countries, banking and securities Acts give precautionary measures in relation to capital from abroad and its potential risk. For example, throughout East Africa, regulations instruct banks on levels of additional capital that they can import from abroad. Further, securities regulation Acts clearly indicate to the local capital

[143] World Bank, Randhawa, B. and Gallardo, J., "Microfinance Regulation in Tanzania: Implications for Development and Performance of the Industry", Africa Region Working Paper Series No. 51, http://www.worldbank.org/afr/wps/wp51.pdf [online- February 1, 2006].
[144] *ibid*

seekers the portion of foreign investment capital that can be borrowed or invested from abroad. Such provisions act as precautionary measures to restrict excessive inflows of capital from abroad, which may eventually leave prematurely. The same is true in relation to capital accumulated domestically. The presence of basic (fundamental) law, however, is not a guarantee for safe economies in the area. There is a tendency for many poor countries to come up with laws without being in an economic position to use them and without supervisory capabilities to enforce them. In the case of Tanzania, for example, it is said that the country's legal and regulatory structure in the financial sector has been supply-driven, rather than demand-driven, and it has not developed in response to the needs of the marketplace nor the requirements of the Tanzanian society.[145] According to a World Bank report,

> [T]his approach to legal and regulatory development has provided Tanzania with a regulatory framework that is in accordance with international standards, but one that appears to be far more complex and expensive than what Tanzania needs at present or the immediate future.[146]

The World Bank's observation indicates the aggressive approach by countries towards adopting free market principles in the financial industry without the institutional and more importantly, psychological preparedness on the part of the directly involved parties. This is despite the appearance brought about by the presence (in books) of laws and structures. Such situations constitute risk in terms of the inability of the stakeholders to use the laws effectively for risk-management purposes.

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[145] *ibid*

[146] World Bank, Financial Sector Assessment Report, *ibid.*

The biggest problem within the existing laws is probably the lack of harmony among the various laws towards the clear goal of capital flight control. It is evident from what has been discussed that the three countries have done a laudable job of producing blueprints, the contents of which can help to ensure capital adequacy within and prevent massive exits out of the systems.[147] However, it can also be argued that comprehensive frameworks, whose laws holistically address regulatory gaps linked to all other sectors related to the financial industry, are still missing in the three countries. This lack of harmony can be related to what has been described above as the rush by countries to adopt some of these rules. The result has been missing links that ensure effectiveness of the rules or sets of rules which are not in harmony for the pursuit of safe and stable financial conditions. For example, it has been noted that policies and laws governing property ownership are not cohesive and transparent.[148] Further, rules that emphasize issues such as information symmetry *vis-à-vis* capital flights tend to be absent. Even though important in ensuring safe market practices, in most poor countries, including East Africa, the speed to integrate such essentials into the law and various sectors of the society has been slow. Furthermore, the non-existence of a credit bureau or loan default registry in a country like Tanzania, for example, may affect the ability of investors to make rational decisions, especially when directing flows there.[149] The same applies to the lack of deposit insurance arrangements. All the areas mentioned above are supposed to operate in harmony so as to ensure the smooth functioning of the overall investment process and avert the dangers of capital flight.

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[147] See discussion in Chapter 2.
[148] World Bank, supra, note 143.
[149] *ibid*

Even though there is a growing realization of the importance of harmonization of rules and regulations, as a result of poverty and other factors, poor countries still have a long way to go in their efforts to establish efficient and low-risk free market system. A total assimilation into the free market system by all stakeholders of financial systems in East Africa is one way that can produce an efficient financial system, with better rules that actually work.

Finally, there is a challenge in relation to the strength and sufficiency of the existing rules and regulations which govern external finance in the area. The challenges stem from the fact that most of the rules have been 'borrowed' from outside. It is no secret that most of the law governing capital adequacy borrow from the Basle Principles. However, it should be noted that Basle Principles are designed for its members, who happen to be rich countries. Albeit helpful, most of the rules may not be compatible with the level of risk that exists in poor countries such as those in East Africa.

The next section looks at challenges that exist in institutional and other support mechanisms set up to facilitate the regulatory process. These challenges exist despite the presence of multiple rules for governance of financial sectors in the area.

III b. Institutional Impediments

Institutional impediments are all those factors (other than the rules themselves) within the legal framework that hinder the facilitation of an efficient regulation process. As put forward by Barry Eichengreen, the threat of financial stability arises not from the

letter of the law but from how the law is (or is not) enforced.[150] Most of this is true in East Africa where institutional impediments stem from, among others, problems in supervision, enforcement and lack of resources. These factors are interrelated; however, they will be discussed separately, with a major focus on the banking sector regulation, which is still the main conduit for capital movements into and out of the region.

Regulation of banks is done both internally and externally. Banks in East Africa, particularly in Tanzania and Uganda, have a common past, shown in features such as weak internal risk analysis and management systems within them.[151] The recent entry of credible regional and international banks in the market may have strengthened internal supervisory capacities. Further, as a result of reforms in the sector in the 1990s, which included updating and modernization of banking law and the building up of banking supervision capacity, the situation may have improved.[152]

Despite the internal improvements, prudential regulation, particularly in the banking sector is still a major problem. This is fuelled by, among other factors, the ever-growing participants in monetary transfers (capital flows). These include microfinance institutions, foreign exchange bureaus, and private equity funds. Their number may be a problem for regulators, given the meager resources available for

[150] Eichengreen, supra, note 112, p. 31
[151] Brownbridge, M. and Harvey, C., *Banking in Africa: The Impact of Financial Sector Reform Since Independence*, (Oxford [U.K.] : J. Currey ; Trenton, NJ : Africa World Press, 1998). p. 213
[152] *ibid*

that purpose. The fact that these financial institutions operate under different laws makes the regulatory task even harder.[153]

Further, there is a shortage of professional skills needed for regulation work. This is in terms of both numbers and skills. First, governments of the area cannot afford to employ and train large numbers of regulators. Secondly, the free market is a new concept, the depth of which is not known to the myriad of professionals in the legal field. The same professionals who operated under the centrally planned economic systems still run banks and other financial institutions today. It is true that training is continuously done and a new breed of bankers, financial and legal experts continue to join the industry. However, the best professionals in the industry are mostly in the private sector, leaving the public regulatory sector underserved and at a disadvantage. Regulators need to be a force of people with the right skills to oversee the operations of banks and other financial institutions, within the new global realities. An economy needs a good set of legal and economic professionals who can literally outsmart (or avoid being outsmarted by) malicious bankers. Such people are still needed in East Africa, as proven by the numerous bank failures that have hit the area in the recent past.[154]

Supervisory problems in the financial industry also exist within the judiciary and legislature, two other sections of the government that are responsible for the creation

[153] World Bank, supra, note 143.
[154] Brownbridge and Harvey, supra, note 151, Chapters 5, 7 and 10: All the three countries experienced bank failures, especially in the 1990s. Kenya experienced the most. However, Tanzania and Uganda were also affected.

and interpretation of law. Legislatures have shown lack of supervision by their failure to realize the problem of capital flows and address it. Lack of expertise on legal-financial matters on the part of most legislators denies them the opportunity to assess the dangers of capital flows and address the issue vehemently.[155] This lack of awareness allows the formation of laws that mostly open up the markets of the region and, worse, allows for outflows, ignoring the possibility of inherent risks.

The problem in the judiciary can be related mostly to lack of experience in operating in a free-market economy, particularly in the handling of complex, business-related cases coming with the international financial environment. Such a concern, for example, led to the establishment in 1999 of a commercial court to handle such cases in Tanzania.[156]

Regulation of finance in East Africa is also affected by political interference, which affects the work of regulators by hindering the ability to do their work freely. In Kenya, for example, many recent bank failures involved the so-called 'political banks'.[157] The bank failures resulted from, among others, liquidity crises due to fraudulent or imprudent lending, including to companies connected to politicians. Other forms of large-scale fraud, including the famous Goldenberg scandal in the 1990s,[158] allowed political banks to obtain large sums of foreign currency, most of which was laundered out of the country illegally. According to Martin Brownbridge,

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[155] Reference-Parliament of Tanzania Website [www.parliament.go.tz] - Legislators with Economics, Legal and backgrounds is very low.

[156] World Bank, supra, note 143, p.22 (Tanzania Financial Sector Report 2001)

[157] Brownbridge and Harvey, supra, note 151, pp. 93-95

[158] The Goldenberg scandal involved the abuse of pre-shipment export finance and export compensation facilities provided to banks by the CBK. Huge sums of money through fraudulent claims for export compensation submitted through the Exchange Bank (K).

> The ability of the Bank Supervisory Department to examine politically connected financial institutions was obstructed, as were its efforts to enforce compliance with the banking laws when infractions were discovered. In some cases, inspection reports recommending remedial action were prepared but never sent to the inspected financial institutions. Most importantly, the Central Bank of Kenya (CBK) and Deposit Protection Fund (DPF) extended large overdrafts to several of the political banks, allowing them to continue trading despite the fact that they had become illiquid as a consequence of fraud and mismanagement.[159]

As is the case in most areas, politicians in the region are very powerful. On top of that there is a strong tendency towards political loyalty and corruption, whereby financial institutions with links to politicians become untouchable, thus allowing failures, most of which trickle down to affect the masses. This is aside from the powers given to the Ministers of Finance and other political appointees over the sector and its regulation. This is a political problem that affects other sectors in society too, and as such would seem to persist unless stern measures are taken.

Problems in information disclosure also affect work by regulatory agencies. Specifically, most regulators do not receive sufficient information from the institutions they regulate, hindering their work.[160] It is impossible to regulate activities or health of a financial institution if there is a lack of access to correct information. It is common for unhealthy institutions or those involved in illegal activities to hide their information. Such is a problem in poor countries, whereby regulators have to work with old or wrong data.[161]

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[159] Brownbridge and Harvey, supra, note 151, pp. 93-95

[160] Brownbridge, C. and Kilpatrick, C., "Financial Regulation and Supervision in Developing Countries: An Overview of the Issues", (2002) 20 (3) Development Policy Review, pp. 243-245.

[161] Maimbo, S., "The Diagnosis and Prediction of Bank Failures in Zambia, 1990-1998", 2000 20 (3) Development Policy Review, pp.261-278.

As for the securities industry, inexperience may be a major problem, particularly in Tanzania and Uganda where the industry is not as established.

In summary, this chapter has identified the various challenges, both international and local, that make regulation of international private capital flows a difficult task to implement in East Africa. Most of the challenges at the international level stem from the current international finance architecture, whereby the practiced model of free market economics prioritizes the opening up of economies, rather than more regulation for safety purposes.

Within East Africa, one can summarize the challenges as being due to lack of experience and poverty. Probably the central impediment to smooth regulation of finance in the region is the overall lack of experience in international finance issues. This problem is present throughout East Africa's financial environment, both in most participants and even more seriously the regulators. These countries have accepted the free market economic system at a time when informality is still a characteristic of economic activity, even for sizeable businesses.[162] With a general lack of understanding on international economic matters, it is very hard to produce good regulators. Further, there are limited financial resources among the three governments to effect better financial regulation. For instance, the three governments in question cannot afford to employ sizeable teams that are well informed and trained on the conditions of the financial world. Moreover, lack of sufficient funds also hinders the ability of governments to equip regulators with up-to- date technologies for their

[162] World Bank, supra, note 143.

work. All these problems make the task of financial regulation a very difficult one for the poor countries. It is with such difficulties that the countries face the risk of capital flight and eventual financial crises. When a country is not well-equipped with rules, and lacks personnel and technology to enforce the available rules, its financial system can easily become a target for short-term investors, thus increasing risk in the economy. This is different from regulatory teams in the developed world, which in most cases are very experienced in many areas and are well-equipped to regulate economies.

Overall, the above challenges are significant as they show the difficulties that developing countries face in their efforts to protect economies from financial crises. This is crucial in identifying areas of improvement both locally and internationally. Apart from improvements in the international financial architecture and its regulatory framework, local improvements, especially in terms of resources and experience provide a good starting point to alleviate some of the hindrances that have been discussed. In the next chapter, I put forward some specific recommendations that can be helpful in easing the problems of capital flow regulation in the poor countries, including those of East Africa.

CHAPTER FOUR
RECOMMENDATIONS TO PROBLEMS IN SHORT-TERM INTERNATIONAL CAPITAL FLOWS REGULATION

Having described in the previous chapter the various factors which may prove to be challenging to East African countries attempting to mitigate effects of international private capital flows through regulation, this chapter puts forward some recommendations on possible ways to ensure that the risk-management task facing these poor countries is achieved.

In making these recommendations, the question of priorities in relation to needs of poor countries surfaces; that is, whether poor countries need to embark on rapid economic advancement or need to protect their economies and ensure economic stability and safety. Both are laudable aims and it is no surprise given the economic underdevelopment of East Africa that respective countries are left to make choices that strive to strike a balance between the two targets. Economic advancement is important, but at the same time sufficient regulation, combined with efficient enforcement mechanisms is crucial to ensure that whatever has been or is to be achieved economically, is not dissipated.

This chapter discusses some of the measures that have been suggested through the global finance regulation discourse as possible remedies to problems of capital flow regulation. The measures target both international and domestic regulatory environments. This will include capital controls, a measure that has always been considered a possible means of preventing financial crises.

I. International Regulatory Environment

Generally, at the international level, regulation through legal means is very challenging to execute. The most efficient way to undertake regulation at this level is through what is referred to as 'new governance' in the European Union (EU) governance discourse.[163] These include an array of processes designed to carry out public objectives using methods that are different from classic forms of law.[164] These methods may be easier to apply because they create more effective forms of participation, they can easily be used to coordinate multiple governments, they allow for more diversity and decentralization, they allow for flexibility and can be used for experimentation (especially if the aim is to establish hard law in the future).[165] Further, new-governance methods lead to new law.

In making recommendations on how to improve regulation of capital flows at the international level, one needs to undertake the task from global and regional perspectives.

Global Regulatory Approaches

Currently, the strength of 'open-up' policies seems to maintain an upper hand in global finance. For that reason, recommendations that are being put forward ought to be calculated to operate within such a setting. Further, the regulatory setting also needs to be flexible and accommodating to the various participants of the system.

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[163] Trubek, D. and Trubek, L., "The Coexistence of New Governance and Legal Regulation: Complementarity or Rivalry?", EU New Modes of Governance Project, www.eu-newgov.org [online-March, 2006].
[164] *ibid*
[165] *ibid*

Establishment of an international organization to regulate the financial industry globally is probably the most significant recommendation, at least in terms of the intended level of involvement by the international community. According to Eatwell and Taylor, this could be in the form of a World Financial Authority, an organization similar to the WTO, which would be tasked with establishing worldwide best-practice in financial regulation and risk management.[166] Among other functions, they recommend that the organization supervise the flow of private capital in order to avoid the occurrence of financial crises.

> [T]he WFA's main objectives, if it were created, would be to ensure that the operations of global financial markets remain consistent with, and indeed promote, growth, redistribution and employment in the real economy. To enable this, its central tasks would be to minimize systemic risk arising from the operations of securities and futures markets, and to develop policies to manage such systemic risk and avoid the creation of moral hazard.[167]

Such an idea is healthy for the well being of the global finance environment because legal commitments ensure good-practice measures on the part of various members of the global community. Besides, financial crises do not only threaten poor countries but also the entire global economic stability, and as a result of this interdependence, stability is essential. As a fundamental global activity, global finance needs regulation at a global level to complement local efforts which may not be as effective, especially if overshadowed by other international provisions that mostly advocate for the opening up of economies. Since to a large extent there appears to be a consensus on

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[166] Eatwell and Taylor, supra, note 113.

[167] Malhotra, K., "Renewing the Governance of the Global Economy", in Bello, W., Bullard, N. and Malhotra, K. [Editors], *Global Finance: New Thinking on Regulating Speculative Capital Market,* (Dhaka, Bangladesh: University Press; London; New York: Zed Books; Bangkok: Focus on the Global South; New York: Distributed exclusively in the USA by St. Martin's Press, 2000). p. 39

the effectiveness and benefits of free markets, there should therefore be convergence on the kind of strict mechanisms that govern financial activities globally.

However, despite the importance of the proposed mandate, the idea of a World Financial Authority would be difficult to implement given the stronger diverging interests of different regions and countries around the globe. This is the result of, among other factors, the different levels of economic advancement and priorities among the countries of the world. After all, the present uniting forces brought about by globalization of economic activities (trade and finance) are being challenged by equally powerful (or even more powerful) forces of nationalism and self-interest on the part of individual countries and more broadly, regions of the world. These conflicting interests of poor countries and rich countries would seem to be the central reason hindering the establishment of universal rules and regulations to govern global finance.

Since the proposal for a global financial organization at present appears to be difficult to implement, and in fact the idea has drawn much criticism, several initiatives can assist in establishing and maintaining order in the global financial movements in the short-run. As previously stated, currently, soft law seems to be the appropriate solution to global governance problems.[168] Due to the conflicting priorities of the various countries, the measure is feasible, as it addresses the problem of differing interests.

[168] Trubek and Trubek, supra, note 163.

A global organization for maintenance of financial stability may in the future be attainable. However, a finance regulatory body of global magnitude needs to be based on soft law provisions or a hybrid of soft law and hard law. Such a body will have to consider equally the needs of rich and poor countries in addressing this problem of short-term capital flows. It is true that interests will continue to differ among nations and the establishment of universal rules under such differing conditions is complicated. As it is difficult to directly impose strict legal provisions on over one hundred and fifty countries at a go, the process can be achieved through soft law. A good precedent has been set by organizations such as the BIS and IOSCO. Both organizations have established helpful international provisions for regulation in their respective industries. It would only be better if similar rules, that consider interests of all countries of the world, were accessible and applicable to the participants in the global financial industry.

A hybrid form of regulation under a global regulatory body is another option which can produce great results in terms of compliance. This has been attained, for instance, through the European Union's stability and growth pact, whose regulatory design combines hard and soft law.[169] The design includes a "soft-governance' system of non-binding guidelines, periodic reporting indicators and multilateral surveillance system to put pressure on countries to avoid non-compliance with the pact.[170] The design also allows the European council to impose sanctions if a country exceeds

[169] *ibid*
[170] *ibid*

limits allowed by the pact.[171] Hybrid systems are very effective because of the seriousness brought about by the hard law. They are also effective in the sense that the soft law can be a convergence factor for the differing countries of the world.

Based on the current state of affairs, and while proposals for an ambitious global authority are still being floated, emphasis should also be put on improving and spreading the existing soft regulatory arrangements. It is true that soft law is not the only remedy to the problems that the industry currently faces. It is also true that more concrete measures to manage crises will not be established immediately. It is only prudent, therefore that global economies have to have in place some reliable means at their disposal to manage crises. In the short-run, this includes strengthening the influence of soft rules by international organizations such as the BIS in order to make the rules even more effective. Since most of the rules have been 'accepted' as effective and since it is almost impossible for poor countries to be accepted as members into some of the so-called clubs, there should be deliberate measures on the part of poor countries to ensure that they embrace the rules of the regulatory organizations, especially those that facilitate stability within economies. Such a move can be done at country or regional level; it will facilitate the spread of use of the rules and allow for the attainment of the stability goal in more, if not all countries of the world.

In the long run, however, with improved economic performance of poor countries, and with convergence of economic interests of world communities, legal provisions

[171] *ibid*

may be necessary for the maintenance of order on the global economic setting. The order being discussed will have to come in the form of hard law so as to extract maximum commitment from all participants of the global economic system. The commitments from all the participants will boost efforts towards a more stable world economy. Soft law can be a good starting point towards harder, stricter laws.

Furthermore, apart from the need for better global rules to manage risk of short term capital flows, there needs to develop a culture in the international governance arena whereby interests of poor countries are seriously given weight, especially when it comes to the conception of global rules. As was analyzed in the first part of Chapter Three, real participation by poor countries in bodies that conceive global rules and regulations is still minimal. Furthermore, in those bodies where poor countries are participants, issues of concern to the area are not seriously considered, either for the reason that the former countries are being overwhelmed and/or lack of interest and irrelevance of their plight to the more economically powerful regions. This needs efforts from both rich and poor countries. On one side, poor countries as a unit should ensure that legal provisions that do not consider their interests are discouraged from thriving. This can be done by putting their people's interests first in all decisions made internationally.

On the other hand, rich countries should engage poor countries as partners that are on an unequal footing, and, therefore, not take advantage of their weakened positions. Such initiatives would, to some extent, control the legislation of global rules that

continue to facilitate the opening up of economies, thus increasing the risks caused by capital flights. Specifically, more input by poor countries in such institutions as the IMF and WTO should be encouraged and respected. It is true that as important decision-making powers are transferred to international organizations in order to increase efficiency, ideal democracy is often rejected as unrealistic.[172] Realism ought perhaps to urge restraint on the scope of expectations; however, measures should be taken to improve the deliberative components of law making at the global level and move away from the current situation whereby the majority citizens of the world are not the direct beneficiaries of the global laws.[173]

Regional Regulatory Approaches

Cooperation at regional level is a more achievable goal. Using this approach, more can be done by poor countries regionally to come up with better joint initiatives to mitigate financial crises. East African countries, for example, can come up with measures to slow down effects of short-term capital flows through joint initiatives to manage economies. These include technical cooperation in regulatory tasks and harmonization of rules to reflect a fight against financial crises.

The first and probably easiest approach for East African countries is networking.[174] East Africa can capitalize on the body of knowledge possessed by their financial

[172] Griller, S. and Rumler-Korinek, E., "Democracy and New Modes of Governance in Europe: Some Basic Reflections", EU New Modes of Governance Project, www.eu-newgov.org [online-March, 2006].
[173] *ibid*
[174] Trubek, T., Cottrell, P., and Nance, M., "Soft Law, Hard Law and European Integration Toward a Theory of Hybridity", EU New Modes of Governance Project, www.eu-newgov.org [online-March, 2006].

experts through the sharing of information. This can be done through regulatory policy networks, which can foster knowledge through the exchange of various regulatory approaches and experiences. The less experienced countries in the region may benefit from the experience of countries like Kenya, which have had a more varied and extended involvement in matters concerning regulation and governance of markets, including the training of regulators.

Harmonization of rules can come in different ways and in different areas. The banking sector presents one such area. The harmonization in this sector can be achieved relatively faster and with less difficulty in a monetary union setting as has been the case within the EU. As for East Africa, though a reachable goal, a monetary union remains a long-term endeavor as the respective countries are still in the very early stages of moving towards total economic integration. Therefore, once a monetary union is achieved, even more can be shared in terms of regulatory capacities by the three countries. In the interim, however, the three countries need to seriously harmonize their banking laws so as to have a common goal in mitigating the effects of short-term capital inflows, which are slowly becoming popular with foreign investors. For example, the Foreign Currency Acts in all three countries should prioritize the restriction of flows of short-term capital into the area, effects of which can be detrimental to the whole custom union area. After all, when the three countries fight against the same problem and succeed, the contagion element is reduced.

Cooperation is also necessary and more easily achievable in securities regulation. As mentioned previously, East African countries already cooperated in this area.[175] Cooperation in the supervision of the sector is necessary, especially in relation to foreign (out of the region) investors' participation in securities markets. As a result of interconnectedness, East African countries need to have identical policies *vis-à-vis* foreign participation in the securities exchanges. Harmonization along those lines will enable containment of possible contagion effects by avoiding the possibility of massive capital flights. Such a move may prove difficult to operate as a result of different stages of development that the various security markets are in, especially within bigger regional bodies such as the Southern Africa Development Community (SADC) and the Common Market for Eastern and Southern Africa (COMESA).[176] However, since the East Africa Custom Union area consists of fewer members and the level of advancement of their capital markets is not very different, such an integration of regulatory approaches can be feasible.

Peer review within regional groups is another important governance measure that has been put forward by many participants in the field. This is a very effective form of soft regulation whereby countries assess each other's regulations and regulatory practices. There is no question that regulators in poor countries, especially Africa, need each other's technical assistance and input in order to implement supervisory work more effectively. The guidelines and information provided by the peer regulators would allow policy makers and regulators in the respective countries

[175] Irving, supra, note 97.
[176] *ibid.*

opportunities to adopt models from successful markets.[177] Under the New Partnership for Africa's Development (NEPAD) project, for example, the African Peer Review Mechanism (APRM) has been introduced to enable countries to monitor each other's policies and state governance.[178] Under a similar mechanism, East Africa could receive reviews and help from such a regional giant as South Africa which has a well advanced financial sector and is also experienced in its regulation. It is increasingly being recognized within the financial sectors of East Africa and the respective policy makers, that the assistance of and cooperation with the more experienced regulators in advanced economies is vital.[179] Such assistance helps in building capacities of regulatory bodies by formulating better regulations and instilling better supervisory techniques on the local regulators. This is an approach that can be implemented with relative ease given that similar programs in other sectors are already in place, some with some notable achievements. The need for safer economies regionally is in the interest of all respective countries.

Conclusion

Generally, the attainment of rules and commitments to govern finance internationally is hard to achieve in the current geopolitical setting. Given the diverging interests of various regions and countries around the world, the use of soft rules, standards, and non-binding commitments at the global level may be the best way, at least in the

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[177] Trubek et al, supra, note 174.
[178] United Nations, *Economic Report On Africa 2003: Accelerating The Pace Of Development*, (New York: United Nations Publications, 2003)
[179] The Guardian (Tanzania), *Tanzania readies for assessment by fellow African governments*, http://www.ippmedia.com/ipp/guardian/2006/03/25/62837.html [online- March 26, 2006]

interim, to maintain global economic stability. Countries are far more likely to work together in maintaining global financial stability if their interests converge, or the threat is common, and they agree on what ought to be done and how. Since it is very difficult for countries to agree on the legal modalities to govern global finance, there should be deliberate efforts on the part of poor countries to establish and strengthen financial regulations at least on the regional levels. Such approaches are easier to implement because of the similar interests of the various countries in the particular regional setting.

II. Domestic Regulatory Environment

Domestic regulatory settings are equally important in efforts to ensure stability in financial sectors, not only within individual countries but also regionally and globally. In the domestic regulatory environment, much has been suggested as to the various ways to improve efficiency in regulating private capital flows. In making recommendations, it is important to look at the situation on the ground, whereby most of the countries have adopted market economic systems and are doing the same in relation to the current trends in global finance. It would be impractical and perhaps unrealistic to propose that poor countries undergo complete reforms which aim to equip them with the institutions and approaches that are currently employed by the more advanced market economies. However, it may be helpful to poor countries to begin designing regulatory policies for the future.[180]

[180] Some of the recommendations include sequencing and abandonment of major reforms.

Recommendations for improvement of the domestic regulatory environment will focus on three main areas. These are: Strengthening the Rules, Capital Controls and Capacity Building. When deficiencies in these internal areas are properly addressed, East African countries will be in better positions to manage capital flows and therefore mitigate potential crises that come with them.

Strengthening of Rules

The first area that needs some attention is related to all the rules, particularly making sure that they are in harmony to protect the economy. Good prudential regulations and other business rules are necessary, and as already stipulated, some have already been created in the three East African countries. The issue is whether the existing rules and regulations are in harmony with the bigger and important goal of protecting the economy. In this case, there is a need to make sure that the new rules governing the new market economies take a holistic consideration of risk management. This is vital and should be considered both when designing rules and/or the regulatory policy. With deficiencies in such essential areas, markets tend to operate without essential components such as information, allowing excessive gambling and risk taking on the part of investors to thrive. These risky investment adventures are the source of eventual capital flights.

The countries also need to take deliberate measures to design core rules and regulations that fit the risk level of their respective countries or the custom union area. Core requirements for banks, for example, should be based on the level of risk

that may face poor countries (like themselves) and not rely on risks and rules that have been 'standardized' for international application. Since the risks in these areas are higher, standards of supervision and capital requirements should be set up to reflect reality.

Coming to specific areas of law, Company laws are very important as companies form an important part of the intermediation process (in the case of bank loans). Furthermore, major corporations can be major borrowers of capital from abroad. To ensure success in combating capital flights and financial crises, there should be deliberate efforts to ensure that if company laws give room for fund raising from abroad, that they also regulate companies on the issue of information/disclosure so that foreign investors who decide to invest in them do so in agreeable motives and not as speculators. Information is the basis for investor decisions and countries should be in the forefront to ensure that accurate information facilitates sound decisions. Such treatment of information is necessary in order to allow for rational investment decisions on the part of foreign investors. With such decisions, funds from abroad are more likely to stay in poor countries for longer periods of time. In other words, such decisions discourage speculative ventures that can lead to capital flight. That way, countries are protected from dangers of financial and economic crises.

Issues of corporate governance, which entail contract enforcement, shareholders' rights, private property rights and mechanisms for fair resolution of conflicts among shareholders, are also important in making sure that investors are confident in a

country's economic and legal system.[181] With such assurances in an economy, fear on the part of foreign investors is controlled as the rules guarantee protection, just in case things go wrong. With the confidence, short term investments are likely to be replaced by long-term ones, thus controlling the problem of capital exits.

All these governance issues are very important when building or operating a free market economy. Poor countries should therefore strive to make sure that such areas are well addressed so as to build confidence in investors and therefore attract more legitimate, long-term investments from abroad.

The examples above indicate the importance of having proactive means to reduce short-term capital imports and therefore effects caused by eventual flights. Probably the most efficient way to achieve such a goal is to have rules that discourage short-term investments but at the same time encourage, or even more importantly protect long-term investments. Most of the rules discussed above aim to facilitate that goal indirectly by encouraging stable investment from abroad. As will be detailed in the next section, measures such as Capital controls may act as a more direct remedy to woes of capital flight regulation.

Capital Controls

Essentially, capital controls are measures put in place by governments to control foreign exchange transactions in order to manage capital flows. Such restrictions

[181] Eichengreen, supra, note 112.

enable countries to maintain monetary autonomy while enjoying stable exchange rates.[182]

Most controls adopted by poor countries involve restraints on capital account transactions. Such controls involve restrictions placed on capital inflows or outflows[183]. Controls of capital inflows are intended to encourage long-term inflows of capital and discourage short-term ones. Among others, measures taken to encourage long-term investment include:[184]

- Interest free deposit requirements for all portfolio flows, foreign loans and bond issues.
- Reserve requirements on (foreign) credit lines for trade finance.
- Long maturity periods for bonds issued abroad by local companies;

All of these measures provide mechanisms to ensure that capital flows from abroad stay in the country for longer periods of time. In the first measure, for example, when an investor chooses to withdraw funds before an agreed time-frame, the country gains from keeping the deposit for the whole duration agreed at the time of contracting. In poor countries like those in East Africa, such benefits can allow for the reinvestment of the funds in different ventures which may provide overall benefits to the economy.

Capital controls as a tool of exchange rate policy has been implemented in other developing economies like Chile and Malaysia, providing a reasonable level of stability in their economies. Poor prudential regulations, poor corporate governance standards and inexperienced technocrats make the financial architecture in East

[182] Krugman and Obstfeld, supra, note 10.
[183] Buckley, R. "The Role of Capital Controls in Financial Crises", (1999) 11Bond Law Review , 231
[184] *ibid*

Africa risky to the region's economy and therefore in need of such measures as capital controls for protection, at least in the short-run. Other things being equal, such controls would be suitable for East Africa as they will establish financial stability (exchange rates), while allowing countries to strengthen regulatory capacities.[185]

Despite the fact that controls are contrary to what the IMF has proposed for the past two decades or so,[186] they are necessary tools to enable economies to maintain feasible levels of foreign exchange reserves. Even though it has been argued that capital controls may hinder economic expansion by denying an economy requisite foreign exchange, history shows that global economic growth has been lower since the general abandonment of capital controls by the developed countries than it was during the Bretton Woods period.[187] This observation shows that capital controls do not necessarily hinder economic growth. It is, however, true that capital controls may lead to some problems, especially in trade, by hindering the accessibility to foreign capital by local traders.[188]

Capital controls therefore, presents a feasible tool for stability-seeking countries like those of East Africa, notwithstanding the threat to the level of capital inflows that they receive. It is also a tool that can allow the countries to maintain monetary policy autonomy while also maintaining stable exchange rates.[189] However, despite their ability to contain crises by preserving levels of reserves, capital controls alone cannot

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[185] Krugman and Obstfeld, supra, note 10.
[186] Soederberg, S., "Unraveling Washington's Judgment Calls: The Cases of the Malaysian and Chilean Capital Controls", Antipode: (2004) Vol. 36 (1) Radical Journal of Geography, pp. 43-65.
[187] Buckley, supra, note 183.
[188] Schuknecht, L., "Trade Policy Perspective on Capital Controls", (1999) Vol. 36, #1, Finance and Development.
[189] Krugman and Obstfeld, supra, note 10.

guarantee a crisis-free economic environment. In this case, their existence, in line with measures to improve corporate governance and export earnings, provides a better mechanism to hedge against the danger of capital flights and eventual crises.

Capacity Building

One important tool necessary to improve regulation of capital flows in East Africa relates to capacity building. This includes improving those areas which support the functioning of the actual rules and regulations. In other words, capacity building involves strengthening the regulatory institutions through provision of attributes that will facilitate their functions. One important factor to consider in poor countries is the concept of 'regulation after delegation', whereby governments take deliberate and strong measures to monitor independent regulatory agencies.[190] Such monitoring of the agencies by principal bodies such as the government is important in poor countries, whereby both sides (the principal and agent) may not have the capabilities to fully implement their duties.

Even more important is the question of knowledge to all the stakeholders of safe and stable economies. Since most poor countries (in their totality) are not well informed on the new economic and financial setting and since most of their economic and legal reforms have not been sequenced to allow for familiarization, there is no other option but to learn the tricks of the trade.

[190] Thatcher, M., "Analysis: Regulation After Delegation", EU New Modes of Governance Project, www.eu-newgov.org [online-March, 2006]

Apart from making sure that the regulators are highly competent in the respective fields, initiatives should be taken to educate the business community and the citizenry in general on the mechanics of free market economics. In particular, the business community should be totally aware of foreign financing options and their risks, both to individual businesses and entire economies. In general, regulators should be highly experienced given the global environment that is filled with savvy investors and other facilitators of risky trades.

The subject of building capacities brings up the question whether most poor countries have and still are rushing towards economic reforms, putting themselves at risk vis-à-vis short term capital flows. As a result of economic reforms that have already been put in place, there have been recommendations to sequence reforms in the domestic financial environment in order to first gain enough experience in the new economic systems. Such gradual reforms would allow regulators within poor countries to familiarize with the new instruments and culture that exists in global finance. This is particularly true in relation to the adoption of measures that encourage flows of risky capital flows. The argument here is that poor countries such as those in East Africa have not yet reached the level of other developed countries so far as new financial instruments are concerned. In this case they cannot thrive in the same environment as those regions of the world from which these products and trades emanate.

The sequencing of reforms idea, notwithstanding the truth it may carry, is difficult to implement. The reality remains that it is not easy to hold back poor countries from

such a powerful wave of reforms that has swept many parts of the world. These countries appear desirous of being part of the global economic relationship, which happens to run on the western economic model. In this case, they are faced with the task of adopting and growing from within that system. It thus remains true that adopting whatever the rich and the seeming successful do, without experimentation, is risky. Therefore, prior to embracing any economic or financial reforms prudence necessitates that proper scrutiny be made. After all, the rich and successful economies the world over do the same.

The taming of financial crises in poor countries cannot succeed from direct prudential regulation only. Apart from strong laws that will restrict the massive and abrupt outflows of capital from such areas, other factors are also necessary as part of risk management strategies by countries. These include measures that will encourage foreign investors to make sound investment decisions from the start and steer them away from speculative ventures which lead to withdrawals.

On the other hand, efforts should be done especially by poor countries to ensure that investment by locals is given priority. It is true that even the richest countries in the world depend on foreign investments for their growth. However, the dependency on foreign investors must not be permitted to threaten economic stability of economies.

CONCLUSION

This thesis has examined the manner in which short-term capital flows present a problem to financial stability, the extent to which poor countries are equipped to regulate these flows in their markets, the challenges of this regulatory task and possible solutions to the difficulties they face. More importantly, the thesis has shown the difficulties facing poor countries in regulating private capital flows in the midst of conflicting laws and insufficient regulatory frameworks. It is here argued that we cannot even begin to redesign and fashion national financial regulatory processes for the presently globalizing financial market, unless a better understanding is achieved of the difficulties and concerns facing poorer countries, and appropriate solutions sought.

All in all, unmanaged capital flows still present a threat to the stability of global economies. As long as there is an incentive to make profit through the flows, the trend of movements to poor countries will continue. Poor countries, on the other hand are desperate for capital, and in most instances end up accepting short-term investments and their accompanying risk.

It would be easy to recommend that poor countries stick to local capital for developmental investment. Such funds are safer as they are most likely to remain within the said economies. Some poor countries may have realized this and may be working to ensure more local investments. However, poverty levels, snapshots of which were illustrated in some sections of this thesis, demonstrate that poor countries

still have a long way to go until they can comfortably have some reliance on local capital for investment. With a multitude of challenges facing them, poor countries, such as those in East Africa, are left with no choice but dealing with reality. In this particular case, slowing down reforms and relying on local capital is, for the obvious reasons, not a serious option, at least in the short-run. The bottom line is that countries have to strike a balance between their needs and safety- that is, continue accepting safer capital in a safer regulatory environment, while considering the pace of the reforms and the local capacities to withstand them. This may mean making considerable efforts to make sure that capital does not leave economies fast. This can be facilitated through a better regulatory environment that will encourage investors to undertake long-term commitments. This may also mean refusing entry into countries of some capital, whose mobility may be dangerous to economies. All in all, the goal should be to maintain the overall well-being of the economy.

Even though other important elements of private capital flows into developing countries and the risks associated with them have not been dealt with, this thesis provides a foundation for more work in the area of regulation of finance and private capital in poor countries, particularly those of Africa South of Sahara. More extended work, perhaps in various forms of private capital flows, is thus needed so as shed more light on the nature of threats facing poor economies of East Africa (and elsewhere) and the most effective measures that may be employed to mitigate the accompanying risks. Such exposure will be most useful to countries designing new regulatory mechanisms for the present and future interconnected global economies,

and generally in ensuring safety and soundness of the global financial and economic environment.

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