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MASTERS OF ARTS IN INTERNATIONAL STUDIES

LEVI SAMUEL HERI

LECTURER: DR. OCHIENG

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DECLARATION

This dissertation is my original work and has not been submitted for award of a degree to any other University.

LEVI SAMUEL HERI

R50/ 63 782/ 2010

Signature.. Date..15th November, 2012..........

This dissertation has been submitted for examination with my approval at a University supervisor.

DR. OCHIENG KAMUDHAYI

Signature.. Date.........15.11.12.........................

DEDICATION

To my family, friends, and colleagues for their selfless support and patience that helped me through the program at the Institute of Diplomacy and International Studies (IDIS), University of Nairobi.

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ABSTRACT

Integration' refers to a much more formal arrangement that involves some political and economic sacrifices as well as commitments, concessions, processes and political will to redefine participation in the international economy. In this regard regional cooperation may be a phase in the process of regional integration. Integration can be said to exist when units join together in order to satisfy objectives which they cannot meet autonomously. In this way, integration can be a process which hastens up the achievement of certain objectives in the interest of a larger body.

The main goal for the East African Community stems from the desire by the governments of the EAC countries to improve the standard of living of the population through increased competitiveness, value-added production, trade and investment. Regional integration is seen as a rational response to the difficulties faced by a continent with many small national markets and landlocked countries Kenya like most countries in Africa has been part of regional integration both in Africa and in the world. Kenya is a member of The East African Community (EAC). The East African Community is the regional intergovernmental organization of the Republics of Burundi, Kenya, Rwanda, Uganda and the United Republic of Tanzania with its Headquarters in Arusha, Tanzania. The Treaty for Establishment of the East African Community was signed on 30th November 1999 and entered into force on 7th July 2000 following its ratification by the Original 3 Partner States – Kenya, Uganda and Tanzania.

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LIST OF ABBREVIATION AND ACRONYMS

ADR	Alternative Dispute Resolution
AU	African Union
DRC	Democratic Republic of Congo
EU	European Union
OAU	Organization of African Unity
USA	United States of America
EAC	East African Community
RIAs	Regional Integration Arrangements
WTM	World Travel Market
COMESA	Common Markets for East and South Africa
IGAD	Inter-Governmental Authority on Development
ICT	Information and Communication Technology
EALA	East Africa Legislative Assembly
EU	European Union
WTO	World Trade Organization
ECB	European Central Bank

CHAPTER ONE

INTRODUCTION TO THE STUDY

1.0 Introduction

This chapter presents the introduction to the study. The chapter entails background of the study, the statement of the research problem, objectives of the study, literature review, justification of the research, theoretical framework, methodology and outline of chapters in the study.

1.1 Background of the Study

Regional integration is seen as a rational response to the difficulties faced by a continent with many small national markets and landlocked countries. As a result, African governments have concluded a very large number of regional integration arrangements, several of which have significant membership overlap. While characterized by ambitious targets, they have a dismally poor implementation record. Part of the problem may lie in the paradigm of linear market integration, marked by stepwise integration of goods, labor and capital markets, and eventually monetary and fiscal integration. This tends to focus on border measures such as the import tariff. However, supply-side constraints may be more important[1]. A deeper integration agenda that includes services, investment, competition policy and other behind-the-border issues can address the national-level supply-side constraints far more effectively than an agenda which focuses almost exclusively on border measures.

Successful regional integration can be realized if countries must start small; build on successes; think globally, linking Africa to more external markets; and compensate the

[1] EAC (2007) Secretariat, Protocol on the Establishment of the EAC Custom Union, Arusha, EAC secretariat.

least fortunate, recognizing that benefits are not always evenly distributed. Regional approaches propel economic growth and overcome the region's economic barriers. Regional integration increases the scale of infrastructure construction, operation, and maintenance. It reduces costs, pools scarce technical and managerial capacity, and creates a larger market. The goal of all regional integration is to facilitate the spatial organization of economic activity as a catalyst for faster growth. The shift in trade that allowed East Asia's rapid growth can also benefit Africa.

The benefits of concentration mean that economic growth in Africa is in a small number of existing cities that have location advantages and an existing economic base, such as coastal cities with a good investment climate. Favoring these areas in planning regional infrastructure investments makes economic sense. With the proper complementary policies, other areas in the region will also benefit. Labor mobility leads to remittances from migrants who find jobs in dynamic growth centers. Specialization means that even small players can find a niche in the integrated regions in Africa.

Kenya like most countries in Africa has been part of regional integration both in Africa and in the world. Kenya is a member of The East African Community (EAC). The East African Community is the regional intergovernmental organization of the Republics of Burundi, Kenya, Rwanda, Uganda and the United Republic of Tanzania with its Headquarters in Arusha, Tanzania. The Treaty for Establishment of the East African Community was signed on 30th November 1999 and entered into force on 7th July 2000 following its ratification by the Original 3 Partner States – Kenya, Uganda and Tanzania. The Republic of Rwanda and the Republic of Burundi acceded to the EAC Treaty on

18th June 2007 and became full Members of the Community with effect from 1st July 2007[2].

This study investigates how Kenya has benefited financially as a result of integrating with its neighbors in the East African Community. The study examines the financial gains or losses that Kenya has made as a member of the EAC. The study then recommends measures that can be taken to ensure that Kenya maximizes financial benefits of regional integration.

1.2 Statement of the Research Problem

Integration can be looked at as voluntary pooling of resources together for a common purpose by two or more sets of partners belonging to different states. Economically, this study will focus on the aspect of creating an economic community in order to promote free trade and coordinate economic policies so as to attain economic advantage. The other aspect of integration will be regional, which is linked to geographic factors and physical space.

There is much support from African governments for regional integration. Indeed since independence they have embraced regional integration as an important component of their development strategies and concluded a very large number of regional integration arrangements (RIAs), several of which have significant membership overlap. There are however few success stories. African RIAs are generally ambitious schemes with unrealistic time frames towards deeper integration and in some cases even political union African RIAs are usually neighborhood arrangements.

[2] EAC (2007) Secretariat, Protocol on the Establishment of the EAC Custom Union, Arusha, EAC secretariat.

The African paradigm is that of linear market integration, following stepwise integration of goods, labor and capital markets, and eventually monetary and fiscal integration. The starting point is usually a free trade area, followed by a customs union, a common market, and then the integration of monetary and fiscal matters to establish an economic union. The achievement of a political union features as the ultimate objective in many African RIAs.

The main goal for the East African Community stems from the desire by the governments of the EAC countries to improve the standard of living of the population through increased competitiveness, value-added production, trade and investment. This is aimed at promoting the sustainable development of the region with a view to creating a prosperous, internationally competitive, secure, stable and politically united region.[3]

The East African Community aims at having a people centered and market driven community pegged on pillars of a Customs Union, Common Market, Monetary Union and a political federation. It is the view of this study that as long as the citizens of the members of community are not educated on how they stand to benefit from the Integration then the push for the fulfillment of the dream may not be achieved and it may take a long period of time. The study targets the Kenyan populace by seeking to answer the question, 'what are the financial benefits to Kenyan and its citizens in the East African Community?'

This study interrogates Kenya's benefits or losses arising from integrating with its neighbors. If there are benefits, the study will establish such benefits by showing how

[3] Magazine Centre (T) Ltd, East African Handbook, pg 4

Kenya position itself in order to maximize from the East African Community for the benefit of the community and itself.

The study will attempt to answer the above question by focusing on three objectives.

1.2.1 Objectives of the Study

a) General Objective

To find out how Kenyan benefits financially from the East African Integration

b) Specific Objectives

i) To determine the effect of regional integration on economic integration in east Africa

ii) To examine challenges encountered in regional integration in the East African Community

1.3 Literature Review

1.3.0 Introduction

The study looks at the literature review for the subject from different angles. The angles used are on what is the composition of the East African Integration, the financial benefits of the Partner States coming together and lastly the financial benefits to Kenya as a member of the East African Community. The review will also look into the challenges faced by the integration.

1.3.1 Financial Benefits of Regional Integration

There are a number of financial benefits arising from regional integration. Regional integration had led to reduction in the cost of Information communication technology (ICT) in Africa. The most immediate direct benefits of enhanced connectivity in African countries are reduced prices and better service for international voice and Internet connectivity. Prices for most services in countries with underwater cable access are half those in countries without access.[4] Such large price reductions could boost demand for these services and, ultimately, economic productivity.

Regional trade also puts Africa on a cleaner development path in terms of carbon emissions. Regional power trade would increase the share of hydropower in the continent's generation portfolio from 36 percent to 48 percent, displacing 20,000 megawatts of thermal power in the process and saving 70 million tons a year of carbon emissions (8 percent of Sub-Saharan Africa's anticipated emissions through 2015). Applying the Clean Development Mechanism at $15 per ton of carbon would reduce the region's carbon emissions another 4 percent. Closely integrating power grids will also help balance loads when other renewable energy resources, such as concentrated solar and geothermal energy, are deployed on a large scale.[5]

Regional integration has been proposed in the literature as a solution to stock market development in smaller emerging countries.[6,7] Proponents of this approach have argued that regional integration can bring greater efficiency, synergies, and economies of scale; attract the foreign flow of funds; foster risk sharing and portfolio diversification; act as an impetus to financial sector reforms, thereby broadening the competitiveness of

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[4] Leamer, E. E., and Storper, M. (2001). The Economic Geography of the Internet Age. Journal of International Business Studies 32 (4): 641–65.

[5] Orvika, R and Vennemo, H. (2008). Powering Up: Costing Power Infrastructure Investment Needs in Sub-Saharan Africa. Background Paper 5, Africa Infrastructure Country Diagnostic, World Bank, Washington, DC.

[6] Demirguc-Kunt, A., T. Beck, and P. Honohan, (2008). Finance for All? Policies and Pitfalls in Expanding Access, A World Bank Policy Research Report, (Washington: The World Bank).

[7] Tahari, A., P. Brenner, E.D Vrijer, M. Moretti, A.S. Senhadji, G. Sensenbrenner, and J. Sole, (2007). Financial Sector Reforms, Prospects for Financial Integration in Maghreb Countries," IMF Working Paper 07/125 (Washington: International Monetary Fund).

regional financial systems and minimizing the risks of financial instability; facilitate capital market development; and lead to economic growth.[8]

The African continent's economic geography makes transport connections with the world something of a public good. Major corridors to the sea connect the continent's landlocked countries to the major seaports, through a combination of road and rail infrastructure. The main ports include Douala (Cameroon) for central Africa; Durban (South Africa) and Maputo (Mozambique), for southern Africa; Dar es Salaam (Tanzania) and Mombasa (Kenya) for eastern Africa; and Abidjan (Côte d'Ivoire), Cotonou (Benin), and Dakar (Senegal) for western Africa. About $200 billion a year in imports and exports moves along these corridors, barely 10,000 kilometers long. About 70 percent is in good or fair condition, with donors channeling more resources to improve infrastructure along the routes.[9] However, regulatory and administrative hurdles continue to inflate costs and prolong delays for freight movements along these strategic arteries. Tariffs for road freight are several times higher than in other parts of the developing world, which is attributed not to higher road transport costs in Africa, but to exceptionally high profit margins in the trucking industry.[10] These margins in turn reflect cartelization and restrictive regulatory frameworks, such as market entry barriers; technical regulations; and the tour de role system that allocates freight business based on queuing, particularly in central and western Africa. This system favors large fleets with mostly older trucks in poor condition.

[8] Ibid
[9] Teravaninthorn, S. and Raballand, G. (2008). Transport Prices and Costs in Africa: A Review of the Main International Corridors. Directions in Development Series. Washington, DC: World Bank.
[10] Ibid (2008).

The community stands to gain from different avenues which include: Increased Investment, both domestic and foreign, because of its position as a competitive and attractive market area with vast investment opportunities in the, "agro-processing, mining, tourism and fishing industries, manufacturing and services as well as investments in regional infrastructure, including roads, railways, telecommunications, energy and the Lake Victoria Development Programme."[11]

Improved standards of living resulting from; lower product and service prices, increased competition between firms and the employment of economies of scale which means increased productivity levels and elimination of internal efficiencies from the firms in the market.[12] Employment opportunities resulting from increased production leading to reduced levels of unemployment and reduced brain drain.[13] Institutions such as Kenya Commercial Bank have been employing more in the last decade due to having access to the other partner states in the community. These employment opportunities have been of benefit to the nationals of the countries the bank has entered into.

Global Trade: A commitment was made by the EAC Partner States in 2002 to act collectively in global trade issues in articulating their interests and when negotiating. This is because the Partner States share common interests. An example would be in the tourism and wildlife sector with the launch of joint marketing of East Africa as a single tourist destination. The partner States hold join promotion under one common exhibition

[11] Magazine Centre (T) Ltd, East African Handbook, pg 5
[12] World Bank Report, 1999, pg 1
[13] East African Community Secretariat, East African Customs Union: Information and Implications, 2001, pg 5

area in different markets around the world such as the World Travel Market (WTM) in London.[14]

Infrastructure Development: The community is keen on networking the infrastructure in the region. Infrastructure development will be focusing on rail, road, water and energy. A good infrastructure across the region will help tap into external markets that surround the community such as Ethiopia, Sudan, Somali, Central Republic of Africa and Democratic Republic of Congo.

Consumers will benefit from higher food security in the region.[15] This is because of free movement of agricultural produce from areas of plenty to areas with shortages. Several times like in Kenya there has been a shortage of maize which has resulted in the government importing maize from South Africa. The East African Community will help to stop such occurrences giving local governments and businesses the option to purchase products from other partner states and thus save on import duty.

Benefits of the EAC to ordinary citizens will include optimal utilization of the existing training and education facilities resulting in reduced costs of human resource development for citizens, greater mobility and enjoyment of accruing benefits, improved health facilities and availability of drugs, improved power supply through the establishment of a common grid, and enhanced quality management through establishment of common standards.[16]

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[14] East Africa Handbook, pg 9

[15] East African Community Secretariat, East African Customs Union: Information and Implications, 2001, pg 4

[16] EAC Strategy Workshop, Nairobi, 2000

1.3.2 Challenges

The EAC faces a variety of challenges which can be classified into tariff barriers and non-tariff barriers. Examples of non-tariff barriers include deficient road infrastructure and telecommunications networks that lead to high transport and communication costs, lack of information on trade opportunities.[17] The road network has led to the high cost of transport making it difficult to encourage trade in the region. This is coupled with regular down-time of vehicles used to transport products due to the bad infrastructure. Information on trade opportunities would encourage the business sector to be more pro-active thus leading to the achievement of the East African goals way sooner.

Other barriers to trade in the region include duty and tax administration problems, corruption, customs procedures, licensing procedures, police checks and roadblocks, immigration procedures and transit difficulties.[18]

Membership to different regional blocs: This imposes undue administrative and financial cost on Partner States.[19] Kenya for example is a member of COMESA (Common Markets for East and South Africa), IGAD (Inter-Governmental Authority on Development) and the East African Community. It has different obligations in these different organizations which reduce its level of commitment to the EAC making the achievement of its goals in the EAC to be achieved more slowly than would be anticipated.

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[17] Heinz-Michael Stahl, East African Community Customs Union Tariff Liberalisation Impacts in Perspective, East African Community, 2005, pg 49

[18] Heinz-Michael Stahl, East African Community Customs Union Tariff Liberalisation Impacts in Perspective, East African Community, 2005, pg 51

[19] M.A. Consulting Group, Study on the Establishment of an East African Community Common Market: Final Report, August 2007, pg 17& 18

1.3.3 Financial Opportunities for Kenya in the East African Community

The largest of the five EAC economies is Kenya having a GDP of US$ 21.2 billion in 2006, a population of 35.1 million with a per capita income of US$580.[20]

Kenya has led in the intra-EAC trade. Figures of 2008 show that the balance of trade between Kenya and Uganda was in the favor of Kenya with $535.8million. Trade between Kenya and Tanzania went in favor of Kenya with the net balance being $317.4million. Trade between Kenya and Rwanda went in favor of Kenya with the net balance being $129.1million. Lastly trade between Kenya and Burundi went in favor of Kenya with the net balance being $49.2million. The trade balance between Kenya and the rest of the East African Community went in favour of Kenya with $1031.4 million.[21] The main reason behind the dominance of Kenya in the EAC trade is because Uganda, Rwanda and Burundi are landlocked and thus rely on Kenya (Mombasa). In addition, Kenya is the leading country in the region when it comes to the manufacturing industry.

Uganda and Tanzania are among the leading export destinations for Kenyan exports, the main re-export products have been petroleum products, chemicals, machinery, transport equipment's and manufactured goods.[22]

Kenya also proves to be a leader in the community based on the fact that by volume of cargo passed by air transport it lead with 320 340 tonnes. Kenya was also the

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[20] Evarist Mugisa, Chris Onyango, Patrick Mugoya , An Evaluation of the Implementation and Impact of the East African Community Customs Union: Final Report, March 2009, pg 27

[21] East African Community Facts and Figures 2009, January 2010, pg 37

[22] Dr. Evarist Mugisa, Mr. Chris Onyango, Dr. Patrick Mugoya , An Evaluation of the Implementation and Impact of the East African Community Customs Union: Final Report, March 2009, pg 29

lead destination or transit point for international passengers with 1.87 million international passengers passing through the country in 2008.[23]

In the line of production, Kenya leads in the production of tea in East Africa with figures in 2008 showing production of 346 tonnes. Kenya is also the lead producer of Sugar cane by producing 5 100 tonnes in 2008.[24]

In the energy sector, in spite of its abundant resources, Eastern Africa faces an energy deficit which limits productive capacity. This is despite having a diversity of energy resources which include hydro, oil, gas and coal. On the other hand, there is a huge energy market including the demand from households, commercial, industrial and mining sectors.[25] Despite this, Kenya is the lead producer of energy in the region. It leads in hydro-electric power according to figures provided by the States of EAC, Kenya generated 3 272 GWH. In terms of thermal energy Kenya lead with produced 2 145 GWH in 2008. Kenya is the only country in the region that has taken advantage of geothermal energy producing 1 039 GWH in 2008.[26]

In the construction industry, Kenya features highly with focused attention on cement production, consumption and exports. In terms of production, Kenya's figures in 2008 show that Kenya was the lead producer with 2 830 tonnes of cement. Of the cement produced Kenya exported 693 tonnes.[27]

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[23] East African Community Facts and Figures 2009, January 2010, pg 62
[24] East African Community Facts and Figures 2009, January 2010, pg 74
[25] African Development Bank, African Development Fund, Eastern Africa Regional Integration Strategy Paper 2011 – 2015, Revised Draft, Regional Departments – East (OREA/ OREB) October 2010. –pg 12
[26] East African Community Facts and Figures 2009, January 2010, pg 80
[27] East African Community Facts and Figures 2009, January 2010, pg 89

Total tax revenues have been increasing in Kenya despite the initial fears that implementation of the CET would affect government revenues. This may be attributed to improved economic performance and reforms in revenue administration, including the introduction of electronic tax registers as well as the increased trading activities with the rest of the world, following the tariff reductions initially averaging 35% for Kenya. In addition, recent reforms have seen greater reliance by Kenya on income, VAT and excise duties for revenue generation.[28]

The level of cross-border investment in the EAC is still low, standing at 5 – 10% of total FDI (EAC, 2006). It has been primarily from Kenya to the other Partner States (mainly Uganda and Tanzania) and is concentrated in the manufacturing, tourism and transport sectors. Kenyan companies have increased investments across the region. They include banks such as Kenya Commercial Bank, retailers (Nakumatt, Uchumi), beverage manufacturers (Kenya Breweries), telecommunication companies, media companies (Nation Media Group) which have extended their operations to as far as Burundi, Rwanda, and even Southern Sudan.[29]

Kenya has a strong and more educated labour/ workforce.[30] This is an advantage as it would mean that Kenya could take advantage of its position by taking advantage of the benefits the community brings. In terms of leading companies, Kenyan citizens will be advantaged.

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[28] Dr. Evarist Mugisa, Mr. Chris Onyango, Dr. Patrick Mugoya , An Evaluation of the Implementation and Impact of the East African Community Customs Union: Final Report, March 2009, pg 35

[29] Evarist Mugisa, Chris Onyango, Patrick Mugoya , An Evaluation of the Implementation and Impact of the East African Community Customs Union: Final Report, March 2009, pg 39

[30] East Africa Handbook, pg 13

Kenya was the hub of Information and Communication Technology (ICT) in the region and it was aiming to become the hub of ICT in Africa. The country has got the highest number of Internet service providers at over 100, highest number of Internet exchange points. There are also over 4,000 cyber cafes in the various cities and towns and over 1 million personal computers in the country. ICT hubs were established in villages and ICT bureaus established across the country. In 20007, an ICT master plan was also launched. Mobile telephones have grown from zero in early 2000 to over 12 million at the moment.[31]

1.4 Justification of the Research

This study will help in providing literature for integration especially in the African context. Examples of successful integration can be seen with the formation of the United States of America and the European Union. However, in Africa we do not have any successful example. This study will attempt to show how Africa, being unique, can be able to put aside their differences and push forward for such a union.

The study will look at providing literature on the power of the people when it comes to co-operation and the achievement of unity. Integration in Africa has centred on the political elite who are hungry for power and this has more often than not resulted in the achievement of goals in the short term only. An example would be Uganda president Yoweri Museveni who changed the constitution that had put a limit on the number terms a president can be in office, in order to remain in power. The other reason behind why this study will attempt to provide literature that will be a drive for the population, is because the researcher believes it is important for the integration to be based on the

[31] East Africa Handbook, pg 100, by Joshua Kato

concept 'of a Community of the people and by the people.' This is because when African leaders get power, they tend to surround themselves with their own close friends and relatives, a phenomenon that has come to be known as 'the kitchen cabinet' in Kenya, in order to reap maximum benefits and consolidate power.

Nationalism could be seen as the biggest hindrance to integration. This study will look at both the short and long term benefits of the integration from the Kenyan perspective and will hope to inspire the other partners in the region to do the same for their own countries. For many countries, with emphasis to those in East Africa, their interest is of prime importance in contrast to the interest of the community. Tanzanians, as an example, have been slow to accept the East African Community because of the fear that Kenyan's will benefit the most from the integration by investing in Tanzania and thus locking out their own nationals. The study will aim at showing that even though events could appear to favour another country in the community, if approached at in the right way one's country will benefit in the long-run

This study has the intention of showing ways that will be of benefit to the people of Kenya and of East Africa.

a) Businessmen and women

An expanded region which allows for free movement of labour and capital will increase the market size which is an attractive offer for any businessman or woman. These individuals will be able to either invest in the other countries of the community or increase their production in Kenya and sell to those markets. An example of companies that have moved to take advantage of this are Kenyan banks such as Kenya Commercial Bank. An expanded region will provide avenues for increased profits to businesses.

b) Kenyan Government

Enlarged territories are attractive to foreign investors. Many companies will be willing to establish businesses in the region with the aim of making money. Kenya being strategically located has always been an attractive destination for businesses and integrating with its neighbours will make it even more attractive. Such investment will provide more revenue to the government in terms of taxes and the growth of the country's Gross Domestic Product. The government will also benefit from the growth of its Gross National Product with its citizens making money across the region and even returning some of that money to the country.

c) Unemployment

Increased investment made in the region from both local and foreign investors will need skilled and non-skilled labourers. This means that the rate of unemployment will reduce, standards of living will increase and therefore social ills that result from unemployment such as crime and prostitution will reduce.

1.5 Theoretical Framework

Literature observed points towards the international relations theory of idealism. This is because the literature that has been reviewed has shown that the East African Community collapsed in 1977 because of conflicts that originated from the interests of the different member states, competition for power and distrust. These interests were in line with realism which advocates for putting national interests first.

This study aims at finding out how to ensure that the East African Community does not fail again. The researcher believes that idealism will be the right guide towards the fulfilment of a successful integrated East Africa. This success could be looked at through the lens of co-operation. The researcher believes idealism is the right theory because it assumes that most people value and want individual freedom, the right to self-governance and a modicum of prosperity.

The first step would be having the people of East Africa to believe in its progress especially in the light of a peaceful and just community. This is because the school of thought of idealism focuses on the people. The people will only believe in the community if they see signs of the rule of law being observed through the courts and through democracy. The people will need to overcome ignorance, prejudice, ill-will and sinister interest that realism boosts of when advocating for the interest of the state.

The second attribute advocated by idealism is the instruments of international law. In the context of the East African Community, the East Africa Legislative Assembly (EALA) becomes an organization of grave importance becomes it will be responsible for coming up with legislation that will bind the different states and their people. It can therefore be seen that an inefficient EALA could lead to the collapse of the community.

Idealism also deems non-state actors as important actors in the realization of the East African Community. Non-state actors such as international organizations will be critical when it comes to formulating policies especially of an economic nature. These would include companies such as the East African Breweries that have a presence in the region.

According to idealism there are some cardinal features that have to be in place in order to be successful. These features include liberal democracy which will be key at the point of political integration.[32] However in the mean time, individual countries can individually push for democracy. Equal rights among the populace will also be key in ensuring integration where citizens from the different countries do not feel that there are some that are more favoured than others. Equal rights will also include equality in areas of gender, age, race, tribe, religion and nationality. independently, equal rights, a constitutionEffort will also be needed towards pushing towards reason and moral principles, the view of the idealists. These efforts will need to come from both the state and non-state actors, a concept that lies at the heart of idealism, including individual leaders and citizens.

According to Jean Jacques Rousseau's work (1712 – 1778), 'humans had joined together in civil societies because they reached a point in which obstacles to bettering their existence were greater than the resources at the disposal of each individual.' This is evident in the East African Community, as large proportions of the region's populace suffer from unemployment, poverty, lack of access to education and health. Idealism therefore shows that East Africans would be willing to go beyond the constraints of their nations if it would lead to the betterment of their lives.

The State will have its role to play in achieving the East African Integration which will include promoting dialogue between each other in order to ensure harmony in policy making and implementation. The different states will also need to refrain from aggression with issues such as Migingo island being avoided or having an alternative way of coming up with solutions and quick solutions to that effect in order to ensure peaceful co-

[32] Schell, The Unconquerable World: Power, Nonviolence, and the Will of the People, 2003, pg266

existence. Individually, states will need to focus on pushing political and national power to the periphery.

1.6 Hypothesis

i) Regional integration has a positive impact on economic integration in in east Africa

ii) There are more challenges encountered in regional integration in the East African Community

1.7 Methodology

This section is devoted towards means that the researcher will come up with, in determining the target population, the method of choosing who will be involved, and the research design that will look into data collection instruments, the presentation of the data collected and how it will be interpreted.

1.7.1 Research Design

The researcher adopted a descriptive research design as the aim is to try and get facts of different kinds. The researcher aims at only reporting what is happening. For this reason, the research will rely on primary and secondary data. Primary data will be used to understand the views of Kenyans when it comes to the East African Community and whether they have ways that they think will be of benefit to them as Kenyan citizens. Secondary data will be used to look into what different scholars have written concerning the area of study, the different views that they have presented and whether there are criticisms of any kind. The researcher will use books, journals, newspapers and the internet.

The survey will be carried out at Kenya commercial Bank and the general public through the collection and analyzing of data from a small sample, which will enable the researcher to get the overall population response desired.

1.7.2 Target Population

The target population of this study will be based at Kenya Commercial Bank and will consist of employees from different departments, with different levels of education, of different age groupings, at different positions and of different gender. The researcher is targeting 200 people. The main criteria used will be the level of education in order to obtain the divergent views of integration in East Africa.

Table 1.1: Target Population

Population Category	**Population Frequency**	**Percentage (%)**
Haven't obtained O level	20	10
Only Attained O level	20	10
Only Attained Certificate or diploma	40	20
Have a degree	80	40
Have a post graduate degree	40	20
Total	**200**	**100**

17.3 Sample Design

A stratified sampling method will be used to draw up the sample size of 50 employees which represents 25% of the target population. The researcher plans to use questionnaires to obtain information from the sample population. The sample was divided according to education levels that have been presented on the table below.

Table 1.2: Sample Composition

Category	Target population	Sample Size
Haven't obtained O level	40	5
Only Attained O level	40	5
Only Attained Certificate or diploma	40	10
Have a degree	40	20
Have a post graduate degree	40	10
Total	**200**	**50**

1.7.4 Data Collection

The main way for collecting primary data was the questionnaire which had open and close – ended questions. The questionnaire is structured in three parts as follows: Part A: General information, Part B: To determine what resources Kenyans have that can be used in order to benefit from the East African Community and Part C: To determine steps that need to be taken by Kenyans and their government in order to benefit from the East African Community. Drop and pick later method was used to administer the questionnaire because it was the most convenient and cost-effective way.

1.7.5 Data Analysis and Presentation

After information is received, the researcher will verify and check on the reliability of the questionnaires. The data will be analysed using descriptive statistics using tables and percentages.

1.8 Chapter Outline

Chapter One:

Chapter one will look into the introduction of the research problem, the statement of the research problem, the literature review, the justification of the study, the theoretical framework to be used and the methodology of study.

Chapter Two

Chapter two looks at the East African Community. Under the East African Community, the researcher will try and show the history behind the formation of the community. This will include how it started, those advocating for the integration of the different countries, how it has grown to its present membership. The chapter will also try to show the benefits and challenges experienced by the community since its conception. The chapter will also look at how Kenya has benefited over the years as a result of being a member of the community, the financial position it has held over the years.

Chapter Three

Chapter three will look focus on getting primary data on whether the community has been of benefit to the people of East Africa, ways that can be used to make the attainment of the Communities goals faster, the challenges faced by the citizenry, governments and other institutions operating in the region. The researcher will also try to express the views of Kenyans on how educated they are on the community and whether they stand to benefit from the integration and steps they are willing to take to ensure that they benefit from the Integration.

Chapter Four

Chapter four will analyze the data that has been collected in the previous chapters in light of the objectives of the study. The chapter will also look into the differences and similarity between the data collected from secondary sources vis a vis those collected from primary sources. The chapter will also look into whether the data collected meets the objectives of the research and if not where does it not meet the objectives.

Chapter Five

This chapter will provide conclusions that will be made by the researcher. These conclusions will be made from the data collected and will rely heavily on the analysis of the previous chapter. The chapter will also provide recommendations on futher areas of research to be done.

CHAPTER TWO

REGIONAL INTEGRATION AND FINANCIAL OPPORTUNITIES

2.1 Introduction

This chapter discusses the financial benefits of regional integration in the global perspective. The chapter explores Africa's Economic Integration and how the continent has gained financial benefits inform of the cost of Information Communication Technology (ICT) in Africa, energy costs, cross-listing of stocks on firm value, transport cost, creation of internal and external trade.

2.2 European Union Integration

The European Union (EU) progresses at an uneven rate. On one hand, the great expansion worked wonderfully in May 2004 when 10 new members joined the group. On the other hand, the dream of a "United States of Europe" hit a roadblock in the summer of 2005 when France and the Netherlands voted down the proposed constitution for the European Union. Of course, it doesn't end there. To successfully grow and develop, the expanded European Union faces abundant challenges both major and minor[33]. Three areas illustrate the complexity and significance of the decisions that must be made in the near future. First, there are a number of membership issues. The full integration of the 10 new members still needs to be accomplished. In addition, Bulgaria and Romania are on the threshold of membership, and Turkey and Croatia are at the beginning of the accession process with much to be accomplished before they join. Equally important will be confronting a European Union with member states vastly different in economic and

[33] World Bank (2004), *Global Economic Prospects*, Washington D.C.

social development and trying to integrate each one at the same level. Already there has been talk of a "two-tier membership[34]."

The rigidity of the economic and welfare systems in many of the member states, and continuing high levels of unemployment, are only two of many areas needing continuing attention. While there is widespread agreement on protection of the environment, case after case continues to emerge pitting environmental concerns against economic development[35]. On the international level, continuing EU objections to removal of agricultural subsidies have thwarted the World Trade Organization (WTO) free-trade agreement at the Doha Round and no comprehensive compromise has developed either within the EU or between the EU and the WTO nations, despite recent budget compromises. Within the EU, ongoing disregard of stringent deficit requirements by some of the main powers threatens the continued financial stability of the whole organization[36].

Despite these obstacles, the European Union's development into a new kind of supranational organization continues to be a path-breaking adventure of ongoing interest to researchers and politicians alike. The goal of Europeanization is now considered widely in the literature, but has proven harder to achieve in fact[37]. The addition of 10 new members in 2004 has added an even greater variety of people and ideas to the mix. This second edition of *The European Union and the Member States* assesses the new, enlarged

[34] Vamvakidid, A. (1998), *"International Trade and Economic Growth"*, The World Bank Economic Review, Vol.12, No.2.
[35] Fragmented Power: Europe and the global economy, Bruegel think tank, Sapir A. ed. 2007.
[36] Regional Innovation Strategies in Europe (EFMN), Hafner-Zimmermann S. 2008.
[37] Proposal for a Regulation of the European Parliament and of the Council: establishing a European

Europe of 25 countries (soon to include 27 member states), in order to shed some light on the direction of its policies and the progress it has made toward Europeanization[38].

Greece was living beyond its means even before it joined the euro. After it adopted the single currency, public spending soared. Public sector wages, for example, rose 50% between 1999 and 2007 - far faster than in other eurozone countries. And while money flowed out of the government's coffers, its income was hit by widespread tax evasion. So, after years of overspending, its budget deficit - the difference between spending and income - spiralled out of control. When the global financial downturn hit, therefore, Greece was ill-prepared to cope.

Debt levels reached the point where the country was no longer able to repay its loans, and was forced to ask for help from its European partners and the International Monetary Fund (IMF) in the form of massive loans. In the short term, however, the conditions attached to these loans have compounded Greece's woes. In May 2010, the European Union and IMF provided 110bn euros ($140bn: £88bn) of bailout loans to Greece to help the government pay its creditors. It soon became apparent that this would not be enough, so a second, 130bn-euro bailout was agreed earlier this year. As well as these two loans, which are made in stages, the vast majority of Greece's private creditors agreed to write off more than half of the debts owed to them by Athens. They also agreed to replace existing loans with new loans at a lower rate of interest.

However, in return for all these loans, the EU and IMF insisted that Greece embark on a major austerity drive involving drastic spending cuts, tax rises, and labour market and pension reforms. These have had a devastating effect on Greece's already

[38] Report of the High-Level Group on Financial Supervision in the EU, Jacques de Larosière 2009.

weak economic recovery. The European Commission expects the Greek economy to shrink by another 4.7% this year. Greece has already been in recession for four years.

Without economic growth, Greece cannot boost its own income and so has to rely on aid to pay its loans. European Union believe even the combined 240bn euros of loans and the debt write-off will not be enough to combat this risk, European leaders agreed a 700bn-euro firewall to protect the rest of the eurozone from a full-blown Greek default. For example, Greece owes French banks $38bn, German banks $5.5bn, UK banks $8.2bn and US banks $3.5bn. This problem would be exacerbated by savers and investors taking money out of banks in vulnerable economies, such as Greece, Portugal and Spain, and moving it to banks in safer economies such as Germany or the Netherlands. This could lead to more banks defaulting on their loans. These potential scenarios would be made immeasurably worse if Greece were to leave the euro. The country would almost certainly reintroduce the drachma, which would devalue dramatically and quickly, making it even harder for Greece to repay its debts.

2.2.1 Financial Benefit of European Union Integration

European financial integration is leading to profound changes in the structure and operation of the financial services sector throughout the continent. Through a more open and effective European financial market a number of benefits are expected for both investors and the corporate sector. Investors will benefit from higher risk-adjusted returns on savings, through enhanced opportunities for portfolio diversification and more liquid and competitive capital markets[39]. The corporate sector will benefit from generally easier

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[39] Cooper, R.N. (1968) *The Economics of Interdependence: Economic Policy in the Atlantic Community* (New York: McGraw-Hill for the Council on Foreign Relations).

access to financing capital. Competition in the financial intermediation sector will offer corporations a wider range of financial products at attractive prices.

The economy-wide improved allocation of financial resources to investment projects should impact positively on the equilibrium level of GDP and potentially also on GDP growth. Economic and Monetary Union takes the EU one step further in its process of economic integration, which started in 1957 when it was founded. Economic integration brings the benefits of greater size, internal efficiency and robustness to the EU economy as a whole and to the economies of the individual Member States. This, in turn, offers opportunities for economic stability, higher growth and more employment – outcomes of direct benefit to EU citizens. In practical terms, EMU means: Coordination of economic policy-making between Member States, coordination of fiscal policies, notably through limits on government debt and deficit, an independent monetary policy run by the European Central Bank (ECB) and the single currency and the euro area[40].

2.3 Latin America Integration

The presence of strong macroeconomic synchronization is regarded as a rationale for creation of Regional Trade Agreements (RTAs). The concept of RTAs in Latin American context dates back to 1960 when the Latin American Free Trade Association (LAFTA)[41] was created. The goal of LAFTA was to create a common market in Latin America and it was perceived as a first step to economic integration in Latin America.

[40] Commission of the European Communities (1985) 'Completing the internal market'. *COM*(85) 310 final, 14 June.

[41] The keyword of the structuralist school of thought was industrialization. The structuralist vision was to transform the structure of comparative advantages towards a higher level of productivity and competitiveness. Cyro Banega - Björn Hettne - Fredrik Söderbaum, "The New Regionalism in South America" in Michael Schulz- Fredrik Söderbaum- Joakin Öjendal (eds), *Regionalization in a Globalizing World*, London/New York: Zed Books, 2001. p. 235.

Many Latin American economists took it as a promising vehicle for enhancing economic and social development in their respective countries. But, the initial enthusiasm gradually faded away and a general air of pessimism regarding integration spread. Over the course of the past three and half decades, the process of economic integration has suffered numerous setbacks. Frequent abrupt political changes have been a deterrent to economic cooperation. During the 1960s, LAFTA was disrupted by military coups in Argentina and Brazil. Integration movement could not make any progress and obviously could not reap the benefits of greater extension in the region. In addition to that the Latin American countries were left out of this line of research mainly for lack of stability and lack of data.

However, the movement toward Latin American economic integration is gaining momentum. The formulation of the Common Market of the south or MERCOSUR a largest regional trade area signed in 1991 between Argentina, Brazil, Paraguay, Uruguay (and more recently Venezuela), with Bolivia, Chili, Peru, Colombia, and Ecuador as associates is taken as momentum gain. As a matter of fact, more than 14 agreement free trade areas or custom unions since 1990 have been made in the region. Hence, with this renewed interest this is of extraordinary relevance to investigate macroeconomic interdependence for Latin American countries[42].

The decade of the 1990s was characterized by an intense parley of regional trade agreement in Latin America. More than 14 agreements of free trade areas or custom unions creating Trading association, MERCOSUR and the Andean Community signed in 2004 a free trade agreement which, together with Chile, Guyana and Suriname shall lead

[42] Myriam Martins Gistelinck, *The Influence of Brazil's Developmental Projects on its Positioning in the Negotiation of Regional and Bi-regional Trade Agreements*, IIEB Working Paper 19, October 2005.

to the formation of a South-American Union of Nations, Bolivarian Alternative to Latin America and the Caribbean (known by its Spanish acronym ALBA) / People's Trade Agreement the Bolivarian Alternative is an initiative led by Venezuela and Cuba as an alternative to the negotiations for a Free Trade Area of the Americas (FTAA)[43]. In December 2004 these two countries signed a bilateral agreement. In April 2006 Bolivia joined in the People's Trade Agreement, and in January 2007 Nicaragua joined in. Observer members are: Antigua & Barbuda, Dominica, Ecuador, Haiti, Honduras, St Kitt & Nevis, St Vincent & Grenadines and Uruguay. The People's Trade Agreement comprises trade facilities and complementarities in the energy sector. In January 2008 the ALBA Bank was created, adding a new dimension to the initiative However, Latin America seems to be far behind in its endeavor to formulate regional integration and enjoy the benefits of greater integration. What are the main hurdles that have suppressed all the initiatives that have emerged so far? Or how feasible it is to imitate the European style integration model in Latin America. The Latin American Integration Association (LAIA) was created in August 1980, Latin American Free Trade Association), created in 1960(LAFTA), created in 1960. It is formed by Argentina, Bolivia, Brazil, Chile, Colombia, Cuba, Ecuador, Mexico, Paraguay, Peru, Uruguay and Venezuela[44]. Its objectives are to create a Latin American common market in the long run and in a gradual

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[43] Chagas, L. and R. Baumann. 2007. "Integração Monetária no Mercosul: Ganhos com Menores Custos de Transação?", *Economia Aplicada*, 11 (1): 95-112.

[44] Devlin, R. and P.Giordano. 2004. "The Old and New Regionalism: Benefits, Costs and Implications for the FTAA". In Estevadeordal, A., D. Rodrik, A.M.Taylor and A. Velasco (orgs), *Integrating the Americas – FTAA and Beyond.* Cambridge, Massachusetts: Harvard University Press

manner, by means of tariff preferences, as well as the signing of regional agreements. According to Mundell[45] the overall degree of economic integration can be judged by looking at the integration of product markets, that is the extent of trade between the joining country and the currency area, and at the integration of factor markets, that is, the ease with which labor and capital can migrate between the joining country and the currency area. The real GDP and intra-regional trade captures the integration of product markets and private investment represents the factor market (i.e. capital). Additionally, we further investigate the short-run and long run behavior of consumption in these countries. Hence, selection of our variables for this study is relevant and justifiable[46].

One of the most important, but also unsuccessful, regional integration movements of the 60s was the Latin America Free Trade Agreement (LAFTA), which was established with the ratification of the Treaty of Montevideo in 1960, and tried to comprise the South American countries and Mexico, and the five-member Central American Common Market (CACM).7 This treaty was signed by seven Latin American countries. The main pattern was the creation of a free trade area between those states within a period of twelve years. Nevertheless, and despite the fact that in the beginning the agreement seemed to flourish, as intra-regional trade increased from 8% in 1960 to 13.6% in 1975, the future of LAFTA was not so auspicious. many useful and essential approaches concerning the reasons for LAFTA's failure. These reasons were:

[45] *Mundell, R. (1961). "A theory of optimum currency areas". The American Economic Review, 51, p657-665.*

[46] Batra, Amita. 2004. India's global trade potential: The gravity model approach, Indian Council for Research on International Economic Relations, Working Paper No. 151.

The democratic gap that pre-existed and was increased by the establishment of military dictatorships throughout the continent during the 1970s was, in fact, a poor partner in promoting regional integration, considering at the same time the overlapping interests of Latin American countries[47]. The outcome was that the objective of a free trade area never materialized. It was partly defeated by extremely awkward and unfruitful tariff reduction negotiations. Economic stagnation due to demands of exceptions in combination with continued protectionism against third countries was the main characteristic of LatinAmerica.

Between 1998 and 2009, Latin American countries have made noted progress in trade liberalization, reducing tariffs significantly and entering into their own regional agreements. These include the South American Free Trade Agreement (NAFTA), the Dominican Republic-Central America-United States Free Trade Agreement (CAFTA-DR), and bilateral FTAs with Chile and Peru. FTAs with Panama and Colombia have been signed but not implemented, pending congressional action.

2.3.1 Financial Benefit of Integration Schemes in the LatinAmerica.

In recent years there have been steps toward further economic and political integration in South America. Since 2003, intra-regional trade has increased from 15 percent to 23 percent of total exports, and Venezuela has been invited to join as a full member of Mercosur. This led to the negotiation of a new Treaty of Montevideo in 1980. The outcome was the creation of the Latin American Integration Agreement (LAIA). The

[47] Veiga, P.M. and S.P.Rios. 2007. "O Regionalismo pós-liberal na América do Sul: Origens, Iniciativas e Dilemas", CEPAL, *Serie Comercio Internacional* no 82. Comisión Económica para América Latina y el Caribe: Santiago, Chile.

new agreement was believed to be more flexible and pragmatic in terms of regional integration instruments.

Latin American countries account for more than 90 percent of the continent's GDP and about 93 Percent of its population in 2008. More importantly, these seven countries' real GDP always maintain more than 89% of their five year averages in the region from 1980-2008 . Similarly, their trade share in the region is also significant and growing[48]. Argentina has a higher trade share in the region during 1980-2008. On five years average its exports plus imports for the region almost doubled the last decade from its eighties share. Mexico, being the second largest economy after Brazil, has the smallest regional trade share. Obviously, Mexico trades more with its northern partners USA and Canada. The rest of the countries in this study have an average of about one fourth of the trade share in the region[49]. Therefore, these countries are leading economies in the region and we believe that the possible integration of these leading seven countries would bring the other countries in. Our rationale for this choice is that if macro variables in the leading economies are synchronized then the smaller economies will catch up with them, which will result in a complete integration in the entire continent.

Unlike the case of European integration, sufficient amount of empirical studies have not been devoted for the case of Latin America, only marginal attention has been paid to in this regard. Hence, this study will have great policy implication in context of

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[48] Behrman, J., N. Birdsall and M. Székely. Economic reform and wage differentials in Latin America. Working Paper of the Research Department, No. 435. Inter-American Development Bank, Washington, D. C. 2000.

[49] Robert Devlin - Antoni Estevadeordal, *What's New in the New Regionalism in the Americas?*, Institute for the Integration of Latin America - Integration, Trade and Hemispheric Issues Division - Statistics and Quantitative Analysis Unit / Inter-American Development Bank, Working Paper 6, May 2001.

economic integration in Latin America. Past studies have examined economic integration based on the observed similarities of the economies and the correlation analysis of the business cycles. The problem with these methodologies is that the degree of correlation between shocks does not accurately follow short-run output co-movements. Hence, we complement our analysis by both testing cointegration (to assess the existence of long-run movements in real output among countries) and for the existence of common short-run cycles as suggested by Vahid and Engle. Sharing similar short and long run macro trends necessitates few or no country-specific policies that may hinder the stability of the union

Association formed by Argentina, Brazil, Paraguay and Uruguay, by the Treaty of Asunción, signed in March, 1991. Associate members are Bolivia, Chile, Colombia, Ecuador and Peru. Venezuela signed a membership agreement in June, 2006, but before becoming a full member its entry has to be ratified by the national parliaments of the four original members. Its objectives are to create a common market with free movement of goods, services and productive factors; adopt a common external policy; coordinate common positions in international forums; coordinate sector and macroeconomic policies.

Its Common External Tariff (CET) covers some 85% of intra-regional trade. Great exceptions remain the sugar and automobile sectors. The CET is effective and equal to national tariffs for 35% of total trade by Mercosur countries. From those, products stemming for 20 percentage points have zero tariffs. That is, only 15% of

Mercosur adopt CET (Veiga/Rios (2007). A number of non-tariff barriers remain in regional trade[50].

Preferential trade agreements have gained momentum in the region in recent years. Until 1991 trade preference agreements accounted for some 8% of total regional exports. By 2005 there were 68 agreements, being 51 of intra-regional preferences and 17 with countries in other regions, and affected about two-thirds of the region's total exports The percentage of intra-regional exports on total exports has changed in the last sixteen years as follows:

Table 2.1 intra-regional exports on total exports

	1990	1995	1998	2000	2002	2006
LAIA	12.1	17.4	17.2	13.1	11.3	14.6
Andean Community	4.1	12.3	14.2	8.5	10.0	10.2
Mercosur	8.9	20.2	25.3	20.7	11.4	13.5
CACM	13.9	16.6	18.4	15.7	16.9	17.8
Total Latin America & the Caribbean	13.9	19.8	20.2	17.4	15.4	17.4

Source: ECLAC (2006) and ECLAC (2007)

Intra-regional trade in Latin America is still relatively low when compared to European standards, and show varied trajectories and different intensities among different integration exercises. The most pronounced increase in the share of regional exports was experienced by Mercosur until the late 1990s whereas the most significant fall in that share is also found in Mercosur thereafter[51].

The sub regional initiatives that comprise integration schemes in the Americas are varied. Some have ambitious purposes, such as the creation of common markets, whereas

[50] Robert Devlin - Antoni Estevadeordal, *What's New in the New Regionalism in the Americas?*, Institute for the Integration of Latin America - Integration, Trade and Hemispheric Issues Division - Statistics and Quantitative Analysis Unit / Inter-American Development Bank, Working Paper 6, May 2001.

[51] Glick, Reuven, and Andrew K. Rose. 2001. Does a Currency Union Affect Trade? The Time Series Evidence. NBER Working Paper No. 8396.

others are essentially free trade agreements. They can be presented in a geographical sequencing. Moving from the Southern Cone towards the Artic Sea we find the following initiatives[52].

Brasil em Folhas a Brazil newspaper reports that Promoting the development of an integrated regional energy system, which will be "an example for the world," is a policy focus in Brazil, Ventura Filho said at the second Latin American hydropower summit, organised May 9-10 in the southern city of São Paulo by Business News Americas, an online business information service based in Santiago, Chile.

The process has already begun among the Mercosur (Southern Common Market) countries Argentina, Brazil, Paraguay and Uruguay with binational projects and interconnections that "avert conflicts," promote energy security, and bring down costs because they more than compensate for investment in power lines and plants, Ventura Filho said. And integration with Argentina will be given an enormous boost with the construction of two binational hydroelectric plants, Garabí and Panambí, on the Uruguay River, which forms part of the border between Brazil and Argentina and between Argentina and Uruguay. The plants will have a combined capacity of 2,200 MW by the end of the decade. Mercosur em Folhas (Newspaper), reports that, like the European Union (EU) on which it was modelled, ran into difficulties. Brazil's devaluation in 1999 caused Argentina to seek, and obtain, emergency restraints on imports from there. Politically negotiated exceptions to the block's rules became the norm. Nevertheless, a dispute-settlement body and a small secretariat were eventually set up. In 2010 the presidents finally agreed on a common customs code, to avoid outside goods having to

[52] ECLAC. 2007. *Latin America and the Caribbean in the World Economy – Trends 2007*. Economic Commission for Latin America and the Caribbean: Santiago, Chile.

pay tariffs more than once. This lead to an economic intergration of South America countries.

2.4 Integration in Asia

In the 1980s the region began to undergo fundamental change. First Sri Lanka (in the 1970s) and then the other countries began to open their economies to international trade and dismantle industry regulations. International trade volumes began to increase, particularly following the Indian financial crisis of 1991 and the set of reforms that followed. Trade as a share of GDP generally rose in the 1990s and into the 21st century especially for the larger economies. The bulk of these exports were bound for industrial countries. With the exception of Bhutan and India, South Asia did not share in the growth of trade in the region. Of Bangladesh's exports in 2004, only 1% went to India, 4% to Sri Lanka, and 0.5% to Pakistan. On the import side, things were a bit brighter. 19 % of Bangladeshi imports came from India 19%, and 14 % from Sri Lanka[53]. A simple gravity model suggests that trade should be much greater. Contiguous countries in the rest of the world have considerable trade with each other. Canada and Mexico, for instance, are the biggest trading partners of the United States. All countries in Europe trade with each other, and 65% of European Union trade is intraregional.

First, ASEAN economic cooperation features as the most prominent of regional accords, representing by far the most important initiatives prior to the Asian Crisis. Still, East-Asia-wide initiatives, such as the "ASEAN plus Three" accords and "ASEAN+1" agreements (e.g., the ASEAN-China agreement and on-going negotiations between

[53] Frankel, Jeffrey A., and Andrew K. Rose. 2000. Estimating the Effects of Currency Unions on Trade and Output. NBER Working Paper No. 7857.

ASEAN and Japan, India, South Korea, and Australia/New Zealand), are taking on greater importance over time

Despite the many early agreements in ASEAN's history that were mainly political and token in nature, its first major initiative was AFTA (1992). The AFTA is already in effect in the original ASEAN countries but the transitional ASEAN countries (Vietnam, Laos, Myanmar, and Cambodia) have been granted more time, with Vietnam having finished by the end of year 2006 and others given a few more years[54]. ASEAN has also made significant strides in the area of investment cooperation, e.g., in the form of ASEAN "one-stop investment centers" and the ASEAN Investment Area (AIA). These efforts at investment cooperation have been designed with essentially the same goal in mind as AFTA: reduce transactions costs associated with intra- regional economic interaction[55].

The region has seen an explosion of bilateral FTAs, all of which being between an ASEAN member-country and another country in Asia. That is, there is currently no bilateral agreement between the main economies in East Asia independent of ASEAN member countries, that is, between China, Japan, South Korea, Taipei-China, and Hong Kong[56].

2.4.1 Financial benefits of ASIA Integration

There are several mechanisms and modalities for increasing intraregional trade and fostering regional cooperation. There are three general areas where there is scope for

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[54] Caprio, G., and D. Klingebiel (2003). Database of systemic and borderline financial crises. World Bank, Washington D. C.
[55] Rose, Andrew K., and Charles Engel, Currency Unions and International Integration. Journal of Money, Credit and Banking 34(4): 1067–1089. 2002
[56] World Bank. 2004. Trade Policies in South Asia: An Overview. Report No. 29929, Washington, DC.

greater economic integration. They are cross-border infrastructure, international trade and investment (including[57] services), and financial sector cooperation. Major cross-border initiatives are being undertaken through the South Asia Sub regional Economic Cooperation (SASEC) program. This program was initiated by four members of the South Asian Association for Regional Cooperation (SAARC) (Bangladesh, Bhutan, India, and Nepal) that formed the South Asian Growth Quadrangle (SAGQ) in 1996. The SASEC program was launched in 2001 with support from the Asian Development Bank and its aim was to accelerate economic cooperation within SAGQ. Six priority sectors were identified: transport; energy and power; tourism; environment; trade, investment, and private sector cooperation; and information and communications technology (ICT). Business facilitation has been promoted through the recently established South Asia Business Forum and commissioned studies on private sector cooperation to lower trade barriers, boost human resources, and increase connectivity in ICT.

SAARC, with its trade initiatives SAARC Preferential Trading Arrangement (SAPTA) and South Asia Free Trade Agreement (SAFTA), is the major institutional entity charged with promoting free trade in South Asia. SAARC is an association of seven countries of South Asia: Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka. SAARC encourages cooperation in agriculture, rural development, science and technology, culture, health, population control, narcotics control, and antiterrorism[58]. SAFTA set out a series of objectives in discussions that started in 1995 and continued into the next decade. The objectives were the following: eliminate all

[57] Batra, Amita. 2004. India's global trade potential: The gravity model approach, Indian Council for Research on International Economic Relations, Working Paper No. 151.
[58] Glick, Reuven, and Andrew K. Rose. 2001. Does a Currency Union Affect Trade? The Time Series Evidence. NBER Working Paper No. 8396.

tariffs and import restrictions; harmonize customs procedures; facilitate intraregional banking, and port and land transport facilities; develop a program to facilitate trade-related services; establish a review and monitoring mechanism; ensure equitable benefits to all member countries; and remove structural impediments to regional trade. Representatives from the members of SAARC meet yearly to discuss progress and ensure that the benefits from trade expansion resulting from the implementation of the agreement are distributed equitably.

Bandara and Yu use the Global Trade Analysis Project (GTAP) computable equilibrium model to analyze the impact of SAFTA on the countries in South Asia. They find that India gains more than the other countries but that the rest of the region also benefits. Increased intraregional trade possibilities will be created but will be small relative to gains from unilateral liberalization by all SAFTA countries, shows strong evidence of trade creation in the region under SAPTA and Srinivasan (1994) uses a gravity model to show that complete removal of tariffs would result in a 3% increase in India's gross national product (GNP). Using an expanded gravity model, Batra finds positive trade potential in SAARC[59], mainly from increased trade between India and Pakistan. The estimates of Frankel, Stein and Wei[60] indicate that trade between India and Pakistan is 70% lower than that between two other economies that are otherwise identical.

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[59] Batra, Amita. 2004. India's global trade potential: The gravity model approach, Indian Council for Research on International Economic Relations, Working Paper No. 151.
[60] Frankel, Jeffrey, Ernesto Stein, and Shang-Jin Wei, 1995, "Trading Blocs and the Americas: The Natural, the Unnatural, and the Super-Natural," *Journal of Development Economics*, Vol. 47 (June), pp.96.

Two bilateral free trade agreements (FTAs) involve South Asian countries: those between Sri Lanka and India and between Nepal and India. The Sri Lanka–India FTA took effect in March 2000. The agreement provides for duty-free status as well as duty-preference access for goods manufactured in the two countries. Both countries have prepared a list of products that will be duty-free and have agreed to phase out tariffs on a number of other items.

The Bay of Bengal Initiative for Multisectoral Technical and Economic Cooperation (BIMSTEC) started as BISTEC in June 1997 at a meeting of the trade ministers of Bangladesh, India, Sri Lanka, and Thailand. Several institutional developments in the past decade were designed to promote greater monetary and financial integration in South Asia. In 1998, SAARC heads of state agreed in principle to establish a network of central bank governors and finance secretaries of the SAARC region. Dubbed SAARCFINANCE, its basic objective of the network is to discuss macroeconomic policy issues and establish closer links among the members. This is achieved through semi-annual meetings of central bank governors and finance secretaries, staff visits and regular exchange of information, and harmonization of banking legislations and practices[61].

With this in mind, financial integration within Asia can be studied from several points of view. Looking at the background conditions required for a monetary union similar to the European Union, there are good prima facie reasons for moving forward with plans to pursue a monetary union. The region has begun to exhibit greater

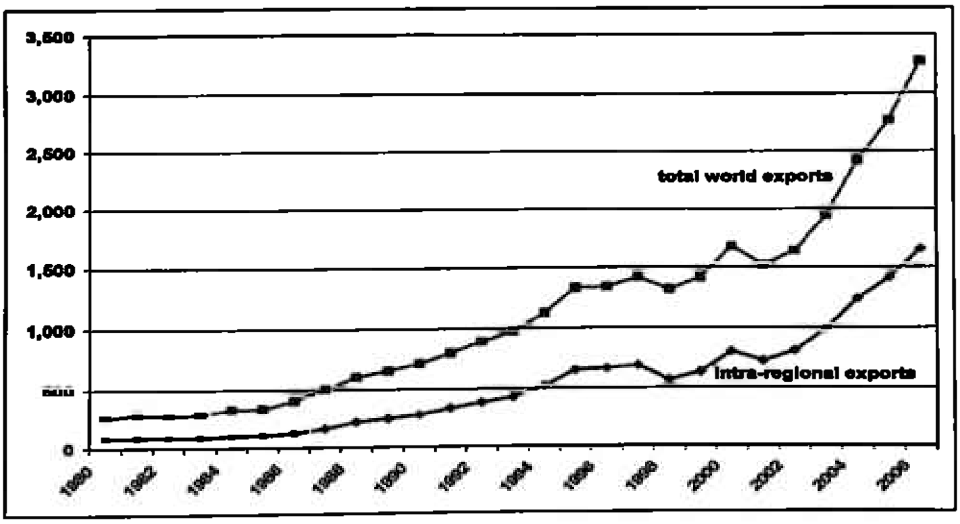
[61] Bandara, Jayatilleke S. and Wusheng Yu. 2003. How Desirable is the South Asian Free Trade Area? A Quantitative Economic Assessment. World Economy 26 (9): 1293–1323.

convergence for a number of macroeconomic indicators like the inflation rate, interest rates and exchange rates, public debt, and fiscal deficits[62]. The patterns of shocks experienced tend to be similar. Agricultural volatilities tend to be correlated since the monsoon patterns are similar across the region. The countries also have similar mixes of production, and a similar variety of agricultural products including sugar, wheat, and rice, and labor-intensive manufacturing including textiles, cotton fabrics, and garments. India is the exception. Its economy is more diverse and it produces a variety of manufactured goods[63]. Because of its small share of international trade, the region has not been subject to strong external shocks like Southeast Asia and East Asia. Exchange rates have tended to move together and the major currencies are closely aligned with the US dollar in a managed float while the small countries are tied to the Indian rupee. Pursuing a basis for a common currency could strengthen fiscal and monetary policy coordination and create more incentives for greater intraregional trade and the establishment of a single market. Labor mobility would be encouraged and fiscal transfers could provide insurance by diversifying risk among several countries.

Figure 2.1: Total World and Intraregional Exports of East Asia

62 Saxena, Sweta Chaman and Mirza Allim Baig. 2003. Monetary Cooperation in South Asia: Potential and Prospects, RIS (New Delhi)/SACEPS (Dhaka) Workshop on Monetary Cooperation in South Asia: Potential and Prospects, 23 December, 2003, RIS, New Delhi.

63 Frankel, J. A., E. Stein, and S. Wei. 1995. Trading Blocs and the Americas: The Natural, the Unnatural and the Super Natural. Journal of Development Economics 47(1): 61–95.



Source: IMF, Direction of Trade Statistics CD-ROM, June 2007.

Money and Finance, The recently established regular meetings of the South Asian finance ministers at the apex level could be supplemented by meetings of deputies comprising finance secretaries and central bank deputy governors to set the agenda for the ministerial meetings. Efforts could be made to develop consensus on topics of regional interest and to monitor short-term capital flows as part of an "early warning system" to detect potential currency and banking crises.

Infrastructure. The SASEC initiative in South Asia can benefit from interaction with the Greater Mekong Subregion Initiative begun in 1992 and involving Cambodia, Lao PDR, Myanmar, Thailand, Viet Nam, and two southern provinces in the PRC. This program is well established and has overcome many of the handicaps that SASEC may encounter as it begins its programs of regional cooperation in infrastructure. Land transit through Myanmar is not possible at present, but this situation will eventually change over time. Additional corridors between India and the PRC through Bhutan and Nepal will have to be developed. Logistic constraints will also have to be addressed to facilitate the movement of goods between the two regions[64].

International Financial Integration. One of the characteristics of the Asian financial crisis that most surprised economists and government officials was the power of capital movements to disrupt activity and cause large movements in exchange rates. There were many reasons for the large amount of speculation at that time, including the size of international liquidity and the large amounts of short-term external debt held by Thailand and other countries whose currencies were under attack. Capital account convertibility certainly played a critical role as well. Where capital accounts were closed in South Asia and in the PRC, speculators could not mount an attack. This does not mean that the countries of South Asia should eschew capital account convertibility. To fully integrate into the global economy and to attract foreign investors into local stock and bond markets, currency convertibility is a must[65].

2.5 Africa's Integration

With many small, isolated economies, Africa's economic geography is particularly challenging. Regional integration is likely the only way to overcome these handicaps and participate in the global economy. Integrating physical infrastructure is both a precursor to and an enabler for deeper economic integration, thereby allowing

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[64] Coulibaly, S., Roberts, A., Foster, V. and Deichmann, U. (2010). Africa's Infrastructure: A Time for Transformation, A report submitted to Infrastructure Consortium of Africa on Deepening Regional Integration.

[65] Deardorff, Alan, and Robert Stern, 1994, "Multilateral Trade Negotiations and Preferential Trading Arrangements," in *Analytical and Negotiating Issues in the Global Trading System*, ed. by Alan Deardorff and Robert Stern (Ann Arbor: University of Michigan Press).

countries to gain scale economies and harness regional public goods. For successful regional integration, countries must start small; build on successes; think globally, linking Africa to more external markets; and compensate the least fortunate, recognizing that benefits are not always evenly distributed.[66]

Regional approaches can address the infrastructure backlog in Africa and propel economic growth, overcoming the region's difficult geography.[67] Sub- Saharan Africa has 48 countries, most with small populations more than 20 countries have a population of less than 5 million. Economies are also very small 20 countries have a GDP of less than $5 billion.[68] The small scale means governments have difficulty funding the large fixed costs associated with infrastructure development. In addition, 15 African countries are landlocked, depending on their neighbors for access to global markets.

2.5.1 The financial benefits regional integration in Africa

Most infrastructure investments share characteristics of public goods, and all benefit to varying degrees from scale economies. Infrastructure sharing addresses the problems of small scale and adverse location. Regional integration increases the scale of infrastructure construction, operation, and maintenance. It reduces costs, pools scarce technical and managerial capacity, and creates a larger market. Economies of scale are particularly important in the ICT and power sectors. Big hydropower projects that would

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66 Coulibaly, S., Roberts, A., Foster, V. and Deichmann, U. (2010). Africa's Infrastructure: A Time for Transformation, A report submitted to Infrastructure Consortium of Africa on Deepening Regional Integration.

67 Nuno, L. and Venables, A. (1999). Infrastructure, Geographical Disadvantage, and Transportation Costs. Policy Research Working Paper 2257, World Bank, Washington, DC.

68 World Bank (2009). World Development Report 2009: Reshaping Economic Geography. Washington, DC: World Bank.

not be economically viable for a single country make sense when neighbors share their benefits.

The goal of all regional integration is to facilitate the spatial organization of economic activity as a catalyst for faster growth. Natural resource exports will remain important, but they provide few job opportunities and their benefits are seldom widely shared.[69] Greater macroeconomic volatility, and weak governance have slowed growth in some resource-rich African countries. Fast employment growth and sustained welfare improvements in developing countries require a move toward modern, mostly export-oriented manufacturing activity. The shift in trade that allowed East Asia's rapid growth can also benefit Africa. In the world's fastest-growing regions, the largest increase in trade has been within industries, for parts and components produced in one location and assembled in another. Manufacturing is more about specialized "tasks" than finished products. Splitting up manufacturing processes during regional integration in Africa allows much more specialization, which gives rise to scale economies and, thus, to cost advantages.[70] The result is the concentration of specialized production in new manufacturing centers around the world, linked across national boundaries in regional production networks. Launching such processes in Africa will not be easy, but some general points can be made.[71]

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[69] Collier, P. (2007). Poverty Reduction in Africa. *Proceedings of the National Academy of Sciences, 104* (43): 16763–68.

[70] World Bank (2008). Africa Regional Integration Assistance Strategy. World Bank, Washington, DC.

[71] The World Development Report 2009: Reshaping Economic Geography identifies three principles for regional infrastructure: start small, think global, and compensate the least fortunate (World Bank 2009)

The benefits of concentration mean that economic growth in Africa is in a small number of existing cities that have location advantages and an existing economic base, such as coastal cities with a good investment climate. Favoring these areas in planning regional infrastructure investments makes economic sense. With the proper complementary policies, other areas in the region will also benefit. Labor mobility leads to remittances from migrants who find jobs in dynamic growth centers. Specialization means that even small players can find a niche in the integrated regions in Africa. For instance, car assembly is possible only in some large African countries such as Nigeria and South Africa. However, smaller countries such as Cameroon or Zambia specialize in components.[72] For this approach, regional transport and communication costs have reduced.

The benefits of regional integration are visible across all aspects of infrastructure networks. For information and communication technology (ICT) and power, regional infrastructure provides scale economies that substantially reduce the costs of production. Thus, continental fiber-optic submarine cables could reduce Internet and international call charges by one-half. Similarly, regional power pools that allow countries to share the most cost effective energy resources can reduce electricity costs by $2 billion a year. For transport and water, regional collaboration allows optimal management and development of cross-border public goods. Road and rail corridors linking landlocked countries to the

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[72] Leigland, James Collier, P and Venables, A. (2007). Rethinking Trade Preferences: How Africa Can Diversify Its Exports. *World Economy* 30 (8): 1326–45., and Andrew Roberts. 2007. The African Project Preparation Gap: Africans Address a Critical Limiting Factor in InfrastructurInvestment." Gridlines, Note 18 (March), Public-Private Infrastructure Advisory Facility, World Bank, Washington, DC.

sea are an example of such a regional public good, as are regional airport and seaport hubs. The same can be said of Africa's 63 international river basins[73].

For private engagement in ICT or energy, the opportunity to serve a larger regional market makes the extensive up-front investments more attractive. Airports and seaports must be organized as regional hubs to reach the scale necessary to attract airline and shipping services from beyond the continent. Coordinated management and investment allow countries to reap the best from multicounty infrastructure systems. Some regional infrastructure investments, such as many types of transport investments, provide public goods, or they facilitate access to a common pool resource, as with water resource management for irrigation and other uses. Both public goods and common pool resources require strong coordination. Because the quality of a transport network depends on its weakest link, broad participation is crucial, even where benefits are unequally distributed.

Africa's regional infrastructure networks have major gaps that increase the costs of doing business and prevent the realization of scale economies. Supply of infrastructure as a public good and management of common pool resources have been deficient. More efficient regional integration of infrastructure is needed in all sectors: ICT, transport, power, and water.[74] As in other parts of the world, mobile telephones have greatly improved telecommunications in Africa. However, the benefits have been limited to local and domestic communications. The region's national telecommunication networks are

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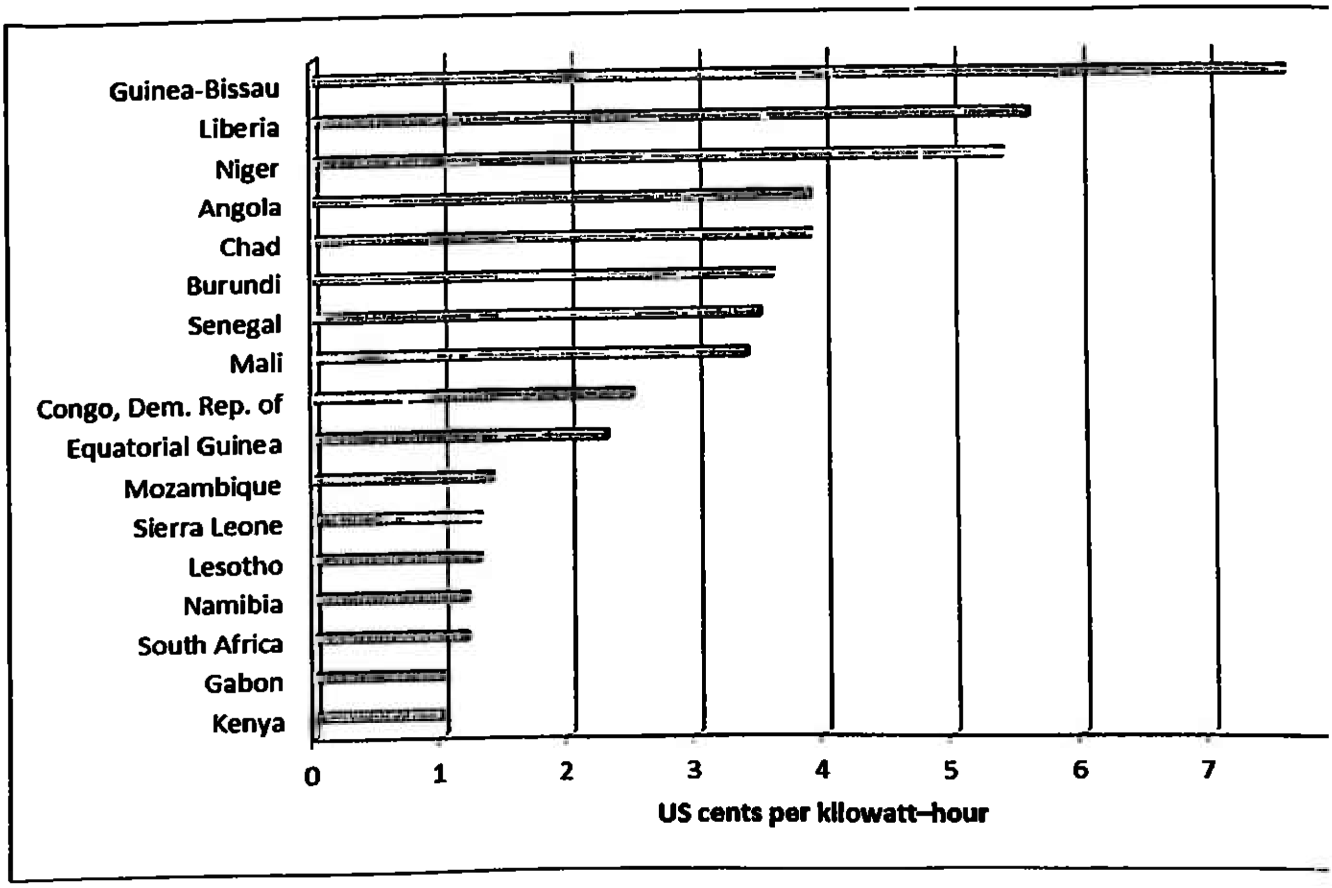
[73] Collier, P and Venables, A. (2007). Rethinking Trade Preferences: How Africa Can Diversify Its Exports. *World Economy* 30 (8): 1326–45.

[74] Coulibaly, S., Roberts, A., Foster, V. and Deichmann, U. (2010). Africa's Infrastructure: A Time for Transformation, A report submitted to Infrastructure Consortium of Africa on Deepening Regional Integration.

poorly integrated with each other and the rest of the world. Optical-fiber technology provides the least expensive and highest-capacity transmission of telephone, Internet, and other data traffic. Submarine and land-based communication cables combine high speed and large capacity. Although initial investments are high, marginal transmission costs are very low.

The desire to pool energy resources and leverage scale economies in power sector development led to formation of regional power pools in southern and western Africa during the mid- 1990s, and more recently in eastern and central Africa. However, trade has yet to take off.

Figure 2.2: Cost Savings from Power Trade for Major Potential Power-Importing Countries in Africa



Source: Derived from Orvika and Vennemo 2008.

African countries that stand to gain most from regional integration tend to be smaller countries or those heavily reliant on thermal power, such as Angola, Burundi, Chad, Guinea-Bissau, Liberia, Niger, and Senegal. However, reaping the full benefits of power trade would require a political willingness to depend heavily on power imports. As many as 16 African countries would be better-off (from a purely economic standpoint) importing more than 50 percent of their power needs. The future of power trade depends on the health of the power sector in a handful of key exporting countries endowed with exceptionally large and low-cost hydropower resources.

In descending order of export potential, these include the Democratic Republic of Congo, Ethiopia, Guinea, Sudan, Cameroon, and Mozambique. The first three accounts for 74 percent of potential investments needed to realize these export volumes is daunting. Each of the top three would invest more than $700 million a year for the next decade to develop the generation capacity for export, or more than 8 percent of their GDP. Thus, supporting such investments would be difficult without extensive cross-border financing arrangements that allow importing beneficiaries to make upfront capital contributions.

To make trade possible, countries need 22,000 megawatts of interconnectors to allow the free flow of power across national borders, at a cost of more than $500 million a year over the next decade. The returns to the interconnectors can be as high as 120 percent for the Southern African Power Pool, and more typically 20–30 percent for the other power pools. For countries with the most to gain from power imports, investments in cross-border transmission have exceptionally high rates of return, typically paying for them in less than a year.[75,76]

2.5.2 The financial benefits of regional integration in terms of reduced transport cost

The African continent's economic geography makes transport connections with the world something of a public good. Major corridors to the sea connect the continent's landlocked countries to the major seaports, through a combination of road and rail infrastructure. The main ports include Douala (Cameroon) for central Africa; Durban (South Africa) and Maputo (Mozambique), for southern Africa; Dar es Salaam (Tanzania) and Mombasa (Kenya) for eastern Africa; and Abidjan (Côte d'Ivoire), Cotonou (Benin), and Dakar (Senegal) for western Africa (table 6.4). About $200 billion a year in imports and exports moves along these corridors, barely 10,000 kilometers long. About 70 percent is in good or fair condition, with donors channeling more resources to improve infrastructure along the routes.[77] However, regulatory and administrative hurdles continue to inflate costs and prolong delays for freight movements along these strategic arteries. Tariffs for road freight are several times higher than in other parts of the developing world, which is attributed not to higher road transport costs in Africa, but to

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[75] Demirguc-Kunt, A., T. Beck, and P. Honohan, (2008). Finance for All? Policies and Pitfalls in Expanding Access, A World Bank Policy Research Report, (Washington: The World Bank).
[76] Tahari, A., P. Brenner, E.D Vrijer, M. Moretti, A.S. Senhadji, G. Sensenbrenner, and J. Sole, (2007). Financial Sector Reforms, Prospects for Financial Integration in Maghreb Countries," IMF Working Paper 07/125 (Washington: International Monetary Fund).
[77] Teravaninthorn, S. and Raballand, G. (2008). Transport Prices and Costs in Africa: A Review of the Main International Corridors. Directions in Development Series. Washington, DC: World Bank.

exceptionally high profit margins in the trucking industry.[78] These margins in turn reflect cartelization and restrictive regulatory frameworks, such as market entry barriers; technical regulations; and the tour de role system that allocates freight business based on queuing, particularly in central and western Africa. This system favors large fleets with mostly older trucks in poor condition.

Extending the network to connect all Sub- Saharan African cities with more than 500,000 people added an estimated 50,000 kilometers of road. The costs of completing an intra-African road network of this kind were of a larger order of magnitude than those associated with the corridors to the sea. Some estimate a one-time cost of $20 billion and an ongoing maintenance cost of $1 billion a year.[79] Well-established relationships between trade volumes and transport costs mean that a fully operational Trans-African Highway network nearly tripled intra-African trade, from $10 billion a year to almost $30 billion.[80] However, even these higher projected volumes of regional trade look small alongside Africa's existing volumes of international trade, which stand close to $200 billion per year.

2.5.3 The financial benefits of regional integration in terms of trade creation and trade diversion

Africa has been experimenting with economic integration for quite a long time now (half a century). As a result Africa records around 11 economic blocs such as the

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[78] Teravaninthorn, S. and Raballand, G. (2008). Transport Prices and Costs in Africa: A Review of the Main International Corridors. Directions in Development Series. Washington, DC: World Bank.

[79] Buys, P. Deichmann, U. and Wheeler, D. (2006). Road Network Upgrading and Overland Trade Expansion in Sub-Saharan Africa. *Policy Research Working Paper 4097*, World Bank, Washington, DC.

[80] Ibid

Economic Community of Western African States (ECOWAS), the Common Market for Eastern and Southern African (COMESA) or the Southern African Development Community (SADC). Progress on Africa regional integration has nevertheless been slow due to several factors: overlapping membership, the lack of authority and bureaucratic sophistication to deal with bigger powers, political turmoil in some countries. All of these factors have contributed to slow down the process. Therefore, Africa's alliances have concentrated more on liberalizing trade within the region than with the rest of the world. Thus, protectionism has been easy to justify in so far as less developed, less diversified economies are also less able to weather the transition to Free Trade. For this reason, separate blocs exist within the larger ones and most countries are members of more than one block. When it comes to extra-African trade agreements, these multiple memberships cause problems. As a whole, the blocs are far from fulfilling their potential and far from giving its longed for voice in world trade.

The Southern African Development Community (SADC) is one of the richest regions in Africa. The participation of South Africa, the largest country of the continent, to SADC provides the basis for successful economic cooperation[81] In September 2000, SADC launched the SADC Free Trade Area. Under the accord, SADC countries would phase out tariffs on all non-sensitive products by 2008 and fully liberalized trade is expected by 2012. The SADC FTA is intended to act as a catalyst for increased regional integration and to facilitate trade and investment flows within the region.

Several financial gains were expected from the SADC FTA. The traditional analysis on preferential trade arrangements (Custom union or FTA) are related to the

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[81] Jenkins C. (2001). New Forms of Co-operation and Integration in Emerging Africa: Integration and Co-operation in Southern Africa, *OECD Development Centre Technical Papers* no 172.

overall (static) gains resulting from the net effect of trade creation versus trade diversion. Nevertheless, emphasis on dynamic benefits that the countries forming a FTA are likely to receive is increasing. These are due to increased competition, economies of scale, stimulus of investment and better utilization of economic resources. Static as well as dynamics gains vary from country to country.

The main benefits South Africa might reap from the FTA are twofold: Firstly, South Africa can increase its market share and develop new markets especially for manufactured goods in SADC. Indeed South African products might be more competitive in the SADC region than in other world markets such as in America and Asia.[82] Secondly, slower inward cross-border migration resulting from growth effects expected in the SADC countries customs revenue represents a significant source of government revenue for most of SADC members. Given the heavy reliance on imports duties by most of SADC countries as a source of revenue, and given the extent and pattern of trade among themselves, a move to a pure FTA within SADC involved significant short term fiscal costs for most of member countries. This meant that any trade reforms were accompanied by appropriate fiscal revenue policies to compensate for this loss of revenue. Moreover, the FTA led to changes in the sectorial and regional structure of individual economies that affected the overall level of tax revenues. Indeed the growth in cross-border trade and investment led to a contraction of some traditional, especially import-substituting industries that had been historically important sources of tax revenue. progress has been recorded among Southern African countries. Thus, Botswana is usually

[82] Tsikata Y.M. (1999). Southern Africa: Trade, Liberalization and Implication for a Free Trade Area, TIPS 1999 Annual Forum, at Glenburn Lodge, Muldersdrif, 19-22 September.

quoted as the 'success story' in Africa and over the last decade, three SADC countries achieved real GDP per capita growth in excess of 3%, with Mauritius.

The improved economic performance of Southern Africa since the mid-nineties results in part from better economic policies and structural reforms that led to an improvement of macro-economic indicators (reduced inflation rates and fiscal unbalances). Progressive trade liberalization was also an important component of the opening up of the economies and of the strengthening of export performance.[83]

The GDP per capita vary also largely across countries. In 1999 the real GDP per capita ranges from USD 156 in Malawi to more than USD 7000 in Seychelles. Even among the richer countries in the group (Mauritius, South Africa, Namibia and Botswana), the per capita income numbers are deceptive as marked inequality prevails within countries. Indeed analysis of income distribution in Africa shows a fairly degree of inequality. Compared with other regions in the world, Africa has the second most unequal income distribution next to Latin America. And while the Gini coefficient for Africa as a whole is 44.4%, the highest values for inequality are recorded for South Africa, Kenya and Zimbabwe with a Gini coefficient above 50%.[84]

Table 2.2: The real GDP per Capita growth rate

Country	1980-1990	1991-2000	2001-2010
Angola	1.69	1.53	2.57
Botswana	3.37	6.33	2.02

[83] Tsikata Y.M. (1999). Southern Africa: Trade, Liberalization and Implication for a Free Trade Area, TIPS 1999 Annual Forum, at Glenburn Lodge, Muldersdrif, 19-22 September

[84] UNECA, "Economic Report on Africa 1999: The Challenges of Poverty Reduction and Sustainability", www.un.org/depts/eca/divis/espd/ecrep99.htm

Congo	0.18	-2.33	3.75
Lesotho	1.4	2.04	3.81
Malawi	0.97	-1.18	2.4
Mauritius	0.29	4.95	4.1
Mozambique	1.37	-1.87	3.06
Namibia	n.a	-3.28	2.7
Seychelles	0.53	3.98	2.3
South Africa	1.73	-2.08	0.42
Swaziland	3.44	3.41	0.48
Tanzania	0.65	-0.4	-0.19
Zambia	0.48	-2.68	-0.86
Zimbabwe	1.46	0.06	0.28

The growth performances among countries of the region vary quite sharply, reflecting the diversity of the economies of SADC. Progress has been recorded among Southern African countries. Botswana is usually quoted as the success story in Africa and over the last decade, three SADC countries achieved real GDP per capita growth in excess of 3%, with Mauritius recording 4.1%, Lesotho 3.8% and Mozambique around 3%. Nevertheless a further acceleration of growth in most SADC countries is necessary to provide a dent into unemployment and poverty.

2.6 Conclusion

This chapter has discussed the financial benefits of regional integration globally. Economic and Monetary Union intergration takes the EU one step further in its process of economic integration, which started in 1957 when it was founded. Economic integration brings the benefits of greater size, internal efficiency and robustness to the EU economy as a whole and to the economies of the individual Member States European financial integration is leading to profound changes in the structure and operation of the financial services sector throughout the continent. Through a more open and effective European financial market a number of benefits are expected for both investors and the corporate sector.

There are several mechanisms and modalities for increasing intraregional trade and fostering regional cooperation. There are three general areas where there is scope for greater economic integration. They are cross-border infrastructure, international trade and investment (including services), and financial sector cooperation. Major cross-border initiatives are being undertaken through the South Asia Sub regional Economic Cooperation (SASEC) program. This program was initiated by four members of the South Asian Association for Regional Cooperation (SAARC) (Bangladesh, Bhutan, India, and Nepal) that formed the South Asian Growth Quadrangle (SAGQ) in 1996. The SASEC program was launched in 2001 with support from the Asian Development Bank and its aim was to accelerate economic cooperation within SAGQ.

Countries in Africa have gained economic benefits as a result of regional integration. The chapter explores Africa's Economic Integration and how the continent has gained financial benefits inform of the cost of Information Communication Technology (ICT) in Africa, energy costs, cross-listing of stocks on firm value, transport cost, creation of internal and external trade.

The regional integration of ICT infrastructure has benefited local and domestic communications by lowering marginal transmission costs. The most immediate direct benefits of enhanced connectivity in African countries are reduced prices and better service for international voice and Internet connectivity. Prices for most services in countries with underwater cable access are half those in countries without access. The benefits realized in the energy sectors are pooling together of energy resources and leveraging of scale economies in power sector development. The resulting overall potential savings of regional power trade amount to about $2 billion a year in the costs of power system development and operation. The largest potential power-importing countries have reduced their long-run marginal cost of power by $0.02–$0.07 per kilowatt-hour. However full exploitation of energy related benefits in the regional integration is hampered by the fact that the region's most cost-effective energy resources are far from major centers of demand in countries too poor raise the billions of dollars needed to develop them.

Regional integration is a solution to stock market development in smaller emerging countries. The benefits that result from regional cross-listing between stock markets include large economies of scale, increased foreign flow of funds, diversification of financial risk, impetus to financial sector reforms, minimization of the risks of financial instability; facilitation of capital market development and economic growth. Regional trade blocks have increased external trade among African countries. Regional integration also serves as an economic avenue for reduction of transport across African countries. However, regulatory and administrative hurdles continue to inflate costs and prolong delays for freight movements along these strategic arteries.

CHAPTER THREE

FINANCIAL BENEFITS OF REGIONAL INTEGRATION IN KENYA

3.1Introduction

This chapter discusses the benefits that Kenya has gained from regional integration. The chapter specifically explores the gains that Kenya has made as a member of East African Community. The chapter explores Bank Competition within the East African Community, effect of Economic Integration on Kenya's Exports and Imports, financial benefits of Capital Markets Integration in EAC, and Kenya's Foreign Direct Investments (FDIs).

3.2 East African Community (EAC)

The East African Community (EAC) is the regional intergovernmental organization of the Republics of Burundi, Kenya, Rwanda, Uganda and the United Republic of Tanzania with its Headquarters in Arusha, Tanzania. The Treaty for Establishment of the East African Community was signed on 30th November 1999 and entered into force on 7th July 2000 following its ratification by the Original 3 Partner States Kenya, Uganda and Tanzania. The Republic of Rwanda and the Republic of Burundi acceded to the EAC Treaty on 18th June 2007 and became full Members of the Community with effect from 1st July 2007[85].

East Africa is credited with one of the longest experiences in regional integration. As early as 1900, Kenya and Uganda operated a Customs Union, which was later joined by Tanzania, the then Tanganyika, in 1922. More elaborate regional integration

[85] EAC (2007) *Secretariat, Protocol on the Establishment of the EAC Custom Union*, Arusha, EAC secretariat.

arrangements in East Africa have included the East African High Commission (1948-1961), the East African Common Services Organization (1961-1967) and the former East African Community which lasted from 1967 to 1977. The collapse of the former East African Community in 1977 dealt a major blow to the East African region and was widely regretted, particularly so since the former Community had made great strides and was considered the world's model of successful regional integration and development. At its height, the East African Community was, in all but name, a federal government. The former Community operated the common services of over thirty institutions, including the four major corporations - East African Railways, East African Harbours, East African Posts and Telecommunications and the East African Airways besides a formidable array of joint research institutions. Many reasons have been cited for the collapse of the Community, among them structural problems which impinged on the management of the common services; inadequate involvement of the people in the decision-making processes; lack of compensatory mechanisms for addressing inequalities in the sharing of the costs and benefits of integration; ideological differences, vested interests and lack of vision on the part of some leaders.

Significant progress has been made in the implementation of regional integration. Most notably, the customs union was launched in 2004 and as of January 2010 all internal tariffs, surcharges, and excise taxes were removed for intra-regional trade, establishing a single market for goods and services.[86] However, practical implementation of these and other ambitious integration arrangements faces numerous practical and, most

[86] Dobronogov, A. and Farole, T. (2012) An Economic Integration Zone for the East African Community: Exploiting Regional Potential and Addressing Commitment Challenges. The World Bank Policy Research Working Paper 5967.

importantly, political challenges. For example, such issues as permanent residency and the right of access to and use of land remain subject to national policies (thus in effect restricting mobility of labor and capital) rather than being a part of the common market protocol. Moreover, the community's plans for monetary union by 2012 are unlikely to be implemented given the current state of preparations.

Thus the path to political federation remains a difficult one. On the other hand, economic integration through trade and investment is leading the way. Since the advent of the single customs territory, trade and investment in the region has grown strongly, both in terms of intra-regional flows and also with respect to global markets, exports from the region have grown rapidly; since 2005 total EAC exports have increased more than 15% per annum, with intra-regional trade growing 19% per year. Intra-regional trade rose from about 15% of total EAC exports in 2000 to more than 20% in 2008, reaching a value of nearly US$2 billion.[87]

According to research by World Bank (2010),[88] if the scale economies of the East African Common Market are fully realized, the exports of goods and services would grow from US$12 to US$20 billion over the next decade, contributing to a doubling of formal employment and GNI per capita. While intra-regional trade has significant growth potential, clearly the majority of this export growth will need to come from global markets. As suggested above, regional integration is complementary with the aims of promoting competitiveness and growth in global markets.

[87] Dobronogov, A. and Farole, T. (2012) An Economic Integration Zone for the East African Community: Exploiting Regional Potential and Addressing Commitment Challenges. The World Bank Policy Research Working Paper 5967.

[88] World Bank. (2010). Special Economic Zones in the EAC: Today's Situation, Tomorrow's Vision, Implications and Next Steps." Presentation to EAC Workshop, June 2010. Arusha, Tanzania.

However, while this combination of regional and global integration should contribute to faster growth EAC-wide, its effects will not be felt evenly across the region. As goods, capital, and labor markets open up in the EAC, economic activity is likely to concentrate increasingly in a few key areas where scale and access to global markets can be best exploited. Unlike in the ASEAN case, the unique geography of the EAC (3 of its 5 member states and 40% of its population is landlocked) is likely to restrict the spread effect of integration, resulting in higher concentration of economic activity. As discussed in the World Development Report 2009 (World Bank, 2008),[89] such processes of agglomeration and therefore geographically unbalanced growth is inevitable and for the most part growth supporting. The challenge in the EAC context is to use the regional integration process to facilitate broad access of workers, firms, and finance to the fast growing agglomerations, while at the same time opening up more peripheral regions to investment and expertise to enable them to take advantage of opportunities that may be available for producing goods and services within regional value chains. But when the perception of winners and losers from agglomeration extends across national borders, the political implications can threaten the project.

3.3 Regional Integration and Financial Benefits

Regional integration is not new in the East African context. The first attempt was initiated in the 19th century, culminating in the East African Customs Union in 1967. The Treaty of 1967 outlined the objectives of EAC as "to strengthen and regulate the industrial, commercial and other relations of the partner states to the end that there shall be accelerated, harmonious and balanced development and sustained expansion of

[89] World Bank. 2008. World Development Report 2009: Reshaping Economic Geography. Washington, D.C.: World Bank.

economic activities the benefits whereof shall be equitably shared". [90]However, due to perceived inequality in the distribution of benefits, ideological differences and differences in levels of development and lack of political will to solve real or imagined problems the Community collapsed in 1977.

Integration in the EAC offers significant opportunities not only to expand trade among member states, but more importantly to scale up regional production to take advantage of much larger global market opportunities. Experience of other parts of the world, most notably of East Asia, suggests that regional integration is more likely to succeed and to have larger economic benefits if it helps the economies of all participating countries to leverage global demand. For the EAC, where three out of five member countries are land-locked, this is more difficult to accomplish. Kenya is a key member state in EAC and stand gain in the areas discussed in the following subsections.

The Treaty sets the Customs Union as the first stage of the new co-operation. However, it provides a clear trajectory towards deeper co-operation as indicated by Article5 (2) which states that ".....the Partner States undertake to establish among themselves and in accordance with the provisions of this Treaty, a Customs Union, a Common Market, subsequently a Monetary Union and ultimately a Political Federation in order to strengthen and regulate the industrial, commercial, infrastructural, cultural, social, political and other relations of the Partner States to the end that there shall be accelerated, harmonious and balanced development and sustained expansion of economic activities, the benefit of which shall be equally shared". A protocol on the

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[90] EAC (2010), *Treaty Establishing the East African Community*, (Arusha: East African Community Secretariat).

East African Community Customs Union was concluded in March 2004 in accordance with Article 75 (7) of the Treaty, which stipulates that "...the Partner States shall within a period of four years conclude the Protocol on the Establishment of a Customs Union". The Customs Union came into force in January 2005 and has since made steady progress in the implementation of its programmes[91].

Following the attainment of the Customs Union, the Common Market is the next intended level of integration in East Africa. The Council of Ministers directed in April 2006 that negotiations for the EAC Common Market should be started by 1st July 2006; and that the negotiations should be concluded within three years so that the Common Market Protocol could become effective in January 2010.

East African integration intends to build a regional bloc, starting with a Customs Union (CU) as the entry point and eventually developing into a Political Federation. The Common Market (CM) negotiations were launched in January 2008.

The mission and vision of this second generation EAC are specified as a prosperous, competitive, stable and politically united East Africa. It aims at widening and deepening economic, social, and cultural integration in order to improve the quality of life of the people of East Africa through increased competitiveness, value added, production, trade and investments. The corresponding primary goals are to promote mutually beneficial co- operation among partner states in political, economic, social and cultural fields, research and technology, and defence and legal justice affairs.

[91] EAC (2010), *Treaty Establishing the East African Community*, (Arusha: East African Community Secretariat).

Since then, several policies and implementation machineries have been put in place to provide a platform of integration. In 2007 Burundi and Rwanda were incorporated into the EAC, thus covering most of the great lakes region. However, data are needed to establish to what extent these processes and programmes/projects have been realized by ordinary citizens. This study examines the experiences gained and benefits accrued by ordinary citizens through the integration process.

3.3 Bank Competition within the East African Community

Banking sector reforms introduced at the beginning of the last decade have contributed to a sharp acceleration in credit to the private sector across the EAC in recent years[92]. Countries across the region have successfully implemented measures to liberalize state-controlled banking systems, restructure loss-making institutions, write off nonperforming loans, and improve governance and financial sector supervision.[93] In turn, banks that had previously largely held government securities and foreign assets have steadily shifted their asset allocation toward domestic lending. While this expansion in private sector credit has taken place from a very low initial volume, the rate of growth during this period has been impressive. The annual growth in credit to the private sector during 2002–2010 averaged 28 percent in Uganda, 32 percent in Tanzania, and 15 percent in Kenya. As a result, credit to the private sector as a share of GDP has increased over this period from 8 to 16 percent in Uganda, 6 to 16 percent in Tanzania, and 25 to 33 percent in Kenya (see Figure 2). There has also been acceleration in credit growth in both

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[92] EAC (2010), *Treaty Establishing the East African Community*, (Arusha: East African Community Secretariat).

[93] Sanya S. and Gaertner M. (2012). Assessing Bank Competition within the East African Community, IMF Working Paper WP/12/32

Rwanda and Burundi as stability has been restored, with credit to the private sector rising by an annual average of 20 percent since 2005. Table 2 below shows that Kenya leads othere EAC members in terms of aces to financial services in the formal banking sector.

Table 3.1: EAC: Access to Financial Services

Country	Formal	Informal	Excluded Entirely
Kenya	40%	27%	33%
Rwanda	21%	26%	52%
Tanzania	17%	27%	56%
Uganda	28%	42%	30%

Source: Sanya S. and Gaertner M. (2012).

Nevertheless, the level of financial intermediation in the region is low and access to financial services remains limited. As shown in figure 1, the mobilization of deposits by the banking system and the level of outstanding credit—especially outside the more developed Kenyan market are both well below the levels in some middle-income emerging market economies. Furthermore, less than a third of the population in Rwanda, Tanzania, and Uganda have access to the formal financial system, compared with nearly two-thirds of the population in South Africa, while more than half of the population in Rwanda and Tanzania has no access to financial services at all. Even in Kenya and Uganda, which compare more favorably to South Africa in terms of the level of financial inclusion, a large share of this reflects the segment of the population that utilize informal financial services.

The limited access to finance remains a key constraint on growth across the region, limiting the scope for smaller, less well-established firms to finance investment through the formal banking system.[94] How to improve access and increase the level of financial intermediation remains a key policy challenge. One possible explanation for the high level of financial exclusion lies in the lack of competition within the banking system; economic literature typically associates higher levels of bank competition with increased access to a wider range of financial services, at lower cost, with greater efficiency in production and delivery of these services.[95] The number of new entrants into the market in recent years show there are no regulatory barriers per se to competition in the banking system of the EAC countries. However, in most of the countries across the region, the former state-owned banks retain a very large market share despite steps to reduce regulatory barriers to entry and exit and attract increased participation from foreign banks.

Size and Structure of the EAC Financial Sector

The overall size of the financial sector in the three EAC economies can be gauged from their respective M2/GDP ratios which, as of 2004, stood at 38 percent in Kenya, 22 percent in Tanzania and 19 percent in Uganda (by comparison, the same ratio is 60 percent for South Africa). Credit to the private sector as a percentage of GDP was 23 percent for Kenya, 9 percent for Tanzania and 7 percent for Uganda in the same year (versus 83 percent for South Africa). Over 40 commercial banks are currently licensed to operate in Kenya. Of the four largest banks, two are subsidiaries

[94] Sanya S. and Gaertner M. (2012). Assessing Bank Competition within the East African Community, IMF Working Paper WP/12/32

[95] World Bank (2007), Financial integration in two regions of sub-Saharan Africa: How Creating Scale in Financial Markets can Support Growth and Development, Washington DC

of foreign banks and two are state-controlled. In Tanzania, over 20 commercial banks, including most of the major international banks with operations in Africa, are licensed to do business. The financial sector of Uganda is dominated by banks, the largest of which has recently been recently privatized, and is now controlled by a South African bank. Several banks from other countries have also been licensed to operate in the country. In each of the three countries, there are licensed non-bank financial institutions, but their weight in the financial sector is low.

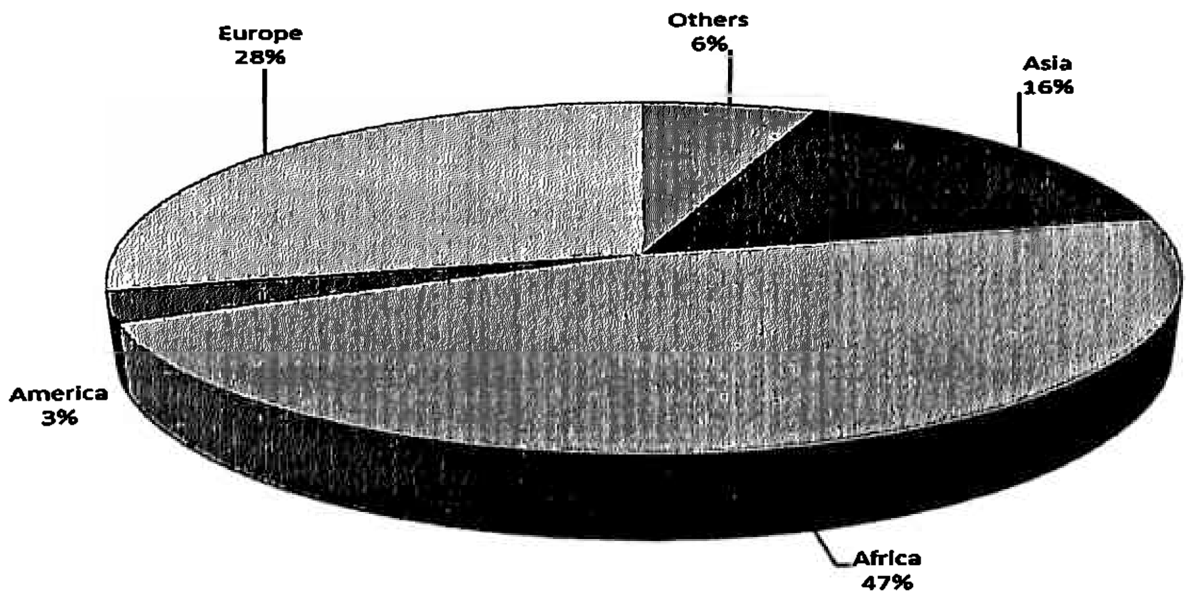
Table 3.2: Banking and Insurance in the EAC

		Total Assets	**No. of Insurance**	**Gross Premium**
Kenya	42	7,096	43	412
Tanzania	20	2,196	13	75
Uganda	14	1,738	12	27
Total	**76**	**11,031**	**68**	**514**
Sources: International Financial Statistics; IMF, EIU, AXCO country				
Note: Data is as of the latest available period.				

3.4 Effect of Economic Integration on Kenya's Exports and Imports

The leading market for Kenya's exports is Africa, taking a 47.5 percent share of all exports in 2010. Figure 2 below shows Share of Total Exports by Destination (2010).

Figure 3.1: Share of Total Exports by Destination (2010)



Source: Economic Survey 2010

Uganda and Tanzania are Kenya's top customers. Other major African importers of Kenyan goods are the Democratic Republic of Congo, Egypt, Rwanda and Sudan. By regional grouping, COMESA takes up more than 73 percent of the total exports within Africa while the EAC takes up 54 percent. Kenya's next largest market is Europe which absorbed 27.9 percent of its exports in 2004. The major customers were the United Kingdom, the Netherlands, Germany and France. In Asia, major importers of Kenyan goods in 2010 were Pakistan, India and the United Arab Emirates. The United States of America was the main customer from the American continent[96].

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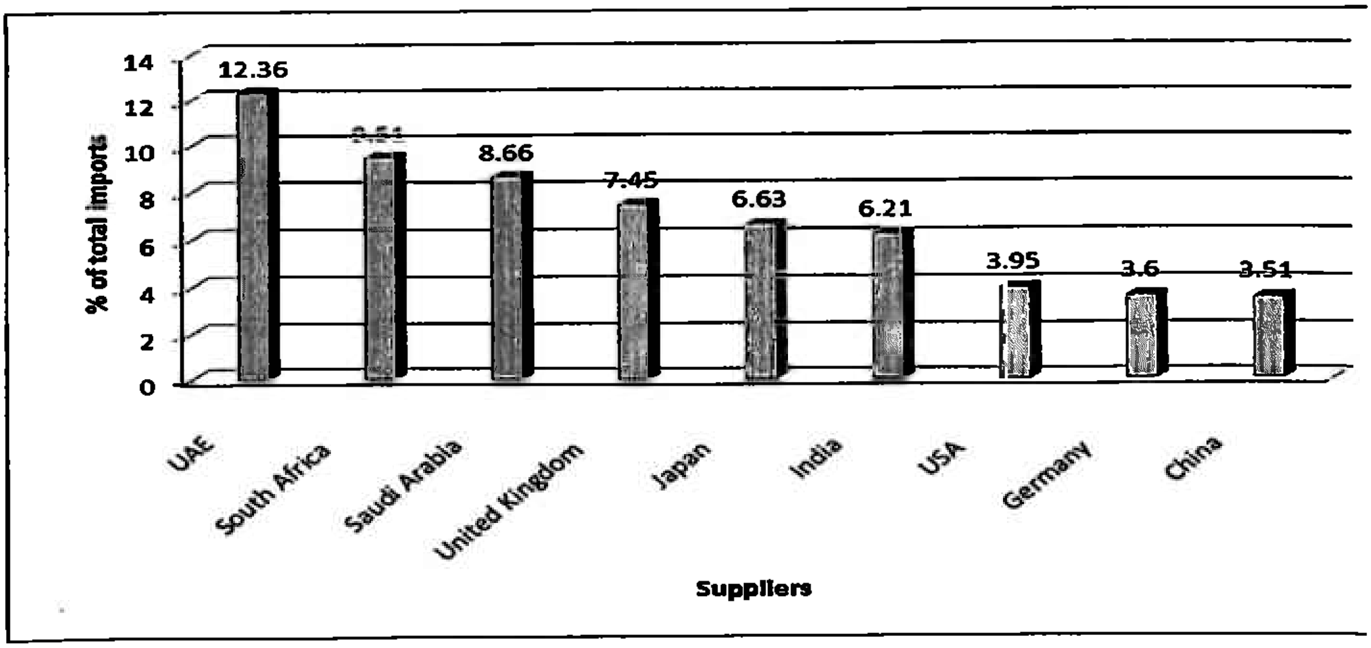
[96] Hangi, M.A.The Non-Tariff Barriers in Trading Within the East African Community. Research Paper. 2010

Agricultural productivity is central to Kenya's export industry. More than 75% of the population is engaged in agriculture and allied activities, which contribute almost 25% to the national production. Horticultural produce and tea are the major items of export for Kenya. In 2006, the combined share of these two products was 10 times higher than the share of the other export items. The country has subsistence petroleum production, which is consumed internally and exported to neighboring countries.

Kenya's imports include machinery, transport equipment's, motor vehicles, metals, plastics and electrical equipments. India and the UAE are the largest import partners for Kenya. In 2009, both countries accounted for more than 11% of the total import volume. Other major import partner countries are China, Saudi Arabia, South Africa, Japan and the US.

Kenya's top suppliers included the United Arab Emirates, South Africa, Saudi Arabia, the United Kingdom, Japan and India. The top 10 suppliers made up slightly more than 65 percent of Kenya's total imports in that year. Major imports by value are shown in figure 3. Kenya's main imports include crude petroleum and petroleum products, industrial machinery and motor vehicles.

Figure 1.2: Kenya's Suppliers



Source: Economic Survey 2010

3.5 Financial benefits of Capital Markets Integration in EAC

There has been great progress in integrating the EAC capital markets and the most apparent manifestation of this is the cross listing on the DSE, USE and Rwanda OTC of three Kenyan listed companies, five Kenyan listed companies and one Kenyan listed company respectively: East African Breweries Limited, Kenya Airways Limited, Kenya Commercial Bank, Equity Bank and Jubilee Holdings Limited.[97] However in each of these cases, the Tanzanian, Rwandese and Ugandan capital markets regulators still examined the prospectuses of the cross listed companies as if they were new applications. Moreover, the cross listings are treated as if they were separate listings on each exchange, with each company being required to meet the continuing obligations imposed by each

[97] Cadogan Financial (2008). East African Community (EAC) Regionalization: Models and Findings Report. The Private Enterprise Partnership for Africa Efficient Markets Institutional Development Initiative (ESMID), March 2008.

country's capital markets regulators. While the obligations are in practice similar, this in effect means that the three companies must provide separate reports to each capital markets regulator and make separate announcements on price sensitive information. On the other hand, Kenya, Tanzania and Uganda do appear to have achieved some synergies in the case of IPOs. Where IPOs have been marketed simultaneously in all the three countries, the capital markets regulators outside the home countries have been prepared to approve the IPO on the basis of the home country examination of the prospectus. However these IPOs have to be marketed through brokers who are licensed in the host market which may increase the cost of marketing the IPO in other EAC Partner States.

At an operational level the EAC exchanges under their umbrella body the East African Stock Exchanges Association (EASEA) have agreed to link their markets by an order-routing system which would enable remote access to all the EAC exchanges by all EAC brokers/dealers from the comfort of their national offices.[98] This would enable the EAC brokers/dealers to place their bids or offers for securities in other EAC markets in real-time. However they will still have to route these market orders through brokers/dealers licensed in the host markets until the legal framework in the EAC markets permits cross membership among the EAC. The EAC exchanges also have plans of demutualising which would then pave way for discussions of a merger. So far only Kenya has greatly progressed with demutualization. A demutualization committee which also includes the Capital Markets Authority-Kenya has already been instituted to spearhead the demutualization process. It is expected that by the end of 2009 the Nairobi

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[98] Cadogan Financial (2008). East African Community (EAC) Regionalization: Models and Findings Report. The Private Enterprise Partnership for Africa Efficient Markets Institutional Development Initiative (ESMID), March 2008.

Stock Exchange (NSE) will have been demutualized in Kenya, Tanzania and Uganda and the member state share their experience with a view of embarking on a similar process in their markets.

The EAC now boasts of three fully operational exchanges in Kenya, Tanzania and Uganda and an over the counter market in Rwanda.[99] A stock exchange is yet to be established in Burundi. There is also corporate and government bond market in all the four Partner States though not as prominent as the equity market. Table 4 shows the size and activity in the capital markets of the four EAC Partner States.

Table 3.2: size and activity in the capital markets of the four EAC Partner States

	Burundi	Kenya	Rwanda	Tanzania	Uga
Equity Markets					
No. of Listed Companies		55		13	11
Mkt. Cap (Incl. Cross Listed Companies)-US$ Million		10,939.30		3,800.14	3,08
Market Turnover-US$ Million		1,452		26.7	53.3
Turnover Ratio (%)		13.3		0.7	1.7
Bond Markets					
Value of Outstanding Gov't Bonds- US$ Million	10.31	1200.24	25.4	736.97	700
Value of Outstanding Corporate Bonds- US$ Million		80.65	1.79	39.13	41.2

Source: EAC Monetary & Financial Statistics Database (2012)

[99] Cadogan Financial (2008). East African Community (EAC) Regionalization: Models and Findings Report. The Private Enterprise Partnership for Africa Efficient Markets Institutional Development Initiative (ESMID), March 2008.

Table 3.2 clearly shows that the Kenyan capital markets dominate the EAC capital markets on all counts because capital markets have been operational in Kenya longer than in the other three EAC Partner States and Kenya is the biggest economy in the EAC.

3.6 Kenya's Foreign Direct Investments (FDIs)

For Kenya and other developing countries, attracting FDI has been a key aspect of its outwardoriented development strategy, as investment is considered a crucial element for output growth and employment generation.[100] The last decade of the 20th century has seen major shifts in the size and composition of cross-border capital flows into developing countries. Net debt flows have become less and less important. Portfolio flows have become firmly established. Foreign direct investment (FDI) has come to swamp all other financial flows.[101]

Studies on foreign investment in East Africa paint a gloomy picture for Kenya, compared to Tanzania and Uganda. A study by the Federation of Kenya Employers (FKE) (2002) indicates that Kenya began to lose out to its two neighbors from around 1991. The FKE study indicates that FDI investment to Kenya dropped from $79m in 1980 to $57m in 1990. Foreign direct investment in Kenya dropped further in 1991 to just $19m, then to $6m in 1992 and a further drop to $2m in the following year. The situation, according to FKE's figures, became worse as time went on. Kenya only received $4m FDI in 1994, similarly, while Kenya's foreign investment was worth only $42m in 1999, it was relatively low compared to other East African countries. In the last 8 years, Kenya has seen major shifts in the size and composition of cross border capital flows into the

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[100] Kayonga, G. W. (2008). A Comparative study of foreign direct investment policy in Eastern Africa: The case of Rwanda and Tanzania (2000-2006). Thesis (M.A.) - University of Nairobi

[101] World Bank. Global Development Finance (1994-2004). Washington, D.C.: World Bank.

economy. Net debt flows have become less and less important. Portfolio flows have not become firmly established. Foreign direct investment (FDI) has come to swamp all other financial flows and has faced a lot of shifts and instability. Table shows Kenya's foreign direct investment (FDI).

Table 3.3: Kenya's foreign direct investment (FDI).

YEAR	Amount in current prices (Millions of US Dollars)
2000	509
2001	466
2002	396
2003	522
2004	658
2005	752
2006	943
2007	1,323
2008	1,360
2009	1,400

Source: Central Bank of Kenya, Annual Report (2009)

Table 3.3 Shows that the amount of FDI to Kenya from all foreign investors in 2000 was $509 million, it reduced from $509 in 2000 to $396 in 2002. The flow of FDI increased in 2003 to $522 million, and continued through 2004, 2005, witnessing a steady increment till 2009. The highest amount of FDI received within the study period was in 2009, amounting to $1,400 million.

Both the flow of foreign aid and FDI do influence Kenya's GDP growth rate with a small margin. This indicates that most of the foreign aid financial support is not fully used in development projects and this raises issues of corruption or misappropriation of funds. It also justifies why donor governments are becoming more intransigent on the usage of their assistance. The low levels of FDI presence may be linked to declining levels of ODA, this is because FDI's are mostly from donor countries and wouldn't like to be viewed negatively if their governments are not contributing financial support and they may lose the risk of being awarded contracts.

New trends have reinforced the importance of private investment for many developing countries.[102] As a result of the move towards neo-liberal policies, the role of the Kenyan government has shifted from an active economic player with productive activities to a provider of an environment of doing business and the social risk insurance. Private investment, both domestic and foreign, is viewed as the driving force of the Kenyan economy.[103] However, he noted that recent work also points to the following potential risks: it can be reversed through financial transactions; it can be excessive owing to adverse selection and fire sales; its benefits can be limited by leverage; and a high share of FDI in a country's total capital inflows may reflect its institutions' weakness rather than their strength. It implies that policy recommendations for Kenya should focus on improving the investment climate for all kinds of capital, domestic as well as foreign. Issues affecting FDI are taxation, investment incentives, and laws on

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102 King'ang'i , Paul Kamau (2003). Private investment and Economic growth in Kenya. An empirical investigation: 1980 -2002. Thesis (M.A.) - University of Nairobi.

103 King'ang'i , Paul Kamau (2003). Private investment and Economic growth in Kenya. An empirical investigation: 1980 -2002. Thesis (M.A.) - University of Nairobi.

privatization, legal reforms, land law, the strength of the judiciary and the state of corruption, bureaucracy and cross border issues in the two countries.

3.7 Conclusion

This chapter has examined the benefits that Kenya has gained from regional integration. Kenya has gained economic benefits as a member of East African Community. The benefits include increased competitiveness of Kenyan banks increased exports to East African member states, increased financial performance of Kenya's capital markets and an increase in Kenya's Foreign Direct Investments in East Africa. Kenyan banks that had previously largely held government securities and foreign assets have steadily shifted their asset allocation toward domestic lending in East African Community members states. However the limited access to finance remains a key constraint on growth across the region, limiting the scope for smaller, less well-established firms to finance investment through the formal banking system.

Kenya has greatly progressed with demutualization of the capital market as a result of regional integration. Nevertheless, Kenya still has to route these market orders through brokers/dealers licensed in the host markets until the legal framework in the EAC markets permits cross membership among the EAC. The flow of Kenya's FDI has increased in the last decade. The flow of FDI influences Kenya's GDP growth rate with a small margin. Kenyan government has shifted from an active economic player with productive activities to a provider of an environment of doing business and the social risk insurance.

CHAPTER FOUR

DATA ANALYSIS AND PRESENTATION

4.1 Introduction

In this chapter, data is presented on the impact of regional integration on financial benefits in Kenya. Personal information was generated to establish various individual characteristics since this has a bearing on the nature of responses given and comprehension of research questions.

4.2 EAC Partner States

This section examines how ordinary citizens perceive the East African Community and whether they really understand which Partner States make up the East African Community Partner States. The signing of the treaty to establish the East African Community (EAC) on 30 November 1999, and its entry into force on 7 July 2000 marked a major milestone in rekindling the integration of the three East African countries: Kenya, Uganda and Tanzania. With the treaty, the three partners undertook to establish among themselves a customs union, a common market, subsequently a monetary union and ultimately a political federation. In March 2004, the countries signed the EAC customs union (CU) protocol, which came into force on 1 January 2005. In 2007, the EAC Heads of State agreed to form national committees to coordinate the exercise of gathering views on fast-tracking the formation of the East African political federation. The protocol for establishing the common market came into force in July 2010.The countries have also been slowly working towards a monetary union. Rwanda and Burundi have since joined the EAC, increasing the Member States to five. Clearly, the EAC has covered some ground in its integration path, although it is still very far from the levels it had reached with the defunct EAC treaty, which collapsed in 1977.

An important issue in the EAC integration process and indeed in any other regional integration agreement (RTA) is the manner in which the benefits and costs are distributed among the participating countries and its implications for the long-term sustainability of the agreement. This is because real or perceived imbalances in the distribution of benefits and costs often lead to disillusionment in advancing the RTA agenda, and in the extreme case may result in dissolution. Equitable distribution of benefits and costs is thus critical for successful integration, even if they do not accrue equally. The EAC as an RTA has often been cited as being unequal in as far as the distribution of benefits and costs is concerned. Indeed, the failure of the original EAC has been linked to the perception of skewed distribution of benefits associated with the integration process. As the EAC member countries forge ahead with integration efforts, an assessment of the benefits and losses that arise from the integration process is necessary in order to boost gains and to minimize losses.

Most of the respondents in all three countries (96% from both Kenya and Uganda and 99% from Tanzania) answered the question 'Are you familiar with the East African countries?' in the affirmative. Only about 3% stated they did not know the countries that comprise the EAC Partner States.

Table 4.1 EAC Partner States identified by ordinary citizens*

Country identified as EAC	Nationality of respondents			
	% Kenyan	% Ugandan	% Tanzanian	%
Uganda	93.7	89.3	95.7	**92.9**
Kenya	92.3	81.7	97	**90.3**
Tanzania	92	76	97.7	**88.6**
Rwanda	50.7	50.7	71	**57.4**
Burundi	47	44	68	**53**

Kenyan citizens were quite familiar with Kenya, Uganda and Tanzania as Partner States; 93.7%, 92.3% and 92.0% respectively of the respondents mentioned them as partner states. However, in total only 50.7% identified Rwanda and 47% Burundi as Partner States. In Uganda, 89.3% of the interviewees mentioned Uganda as a Partner State while 81.7% identified Kenya and 76% Tanzania as Partner States. However, only 50.7% of the Ugandan interviewees were able to identify Rwanda and 44% could name Burundi as Partner States. A slightly different pattern was demonstrated in Tanzania where 97% of the interviewees mentioned Kenya, 95.7% Uganda and 97.7 Tanzania as partner states. In Tanzania, the percentage of those naming Rwanda and Burundi as Partner states was higher; it amounted to 71% and 68%. The better knowledge of Rwanda and Burundi as Partner States has probably to do with the fact that the EAC headquarters is situated in Arusha (Tanzania), and many citizens probably captured news on the newly acceded states because of the meetings taking place in Arusha.

4.3 How Kenyans benefit from the East African Community

The EAC agreements represent an ambitious process of economic and political integration. Kenya, Uganda and Tanzania have since 2005 been implementing the customs union protocol, which in principle allowed the free movement of goods across their borders. Along with newcomers Rwanda and Burundi, the member countries in 2010 ratified the EAC common market. The ultimate objective of the EAC is to form a political federation. The EAC brings together nationals of five countries namely, Kenya, Tanzania, Uganda, Rwanda and Burundi. In 2008, the five countries had a combined population of 126.6 million people and a nominal GDP of USD 73 billion (based on EAC Facts and Figures Report, 2009). In the same year, Kenya's GDP stood at USD 26.9 billion, that is 37 percent of the EAC total. It is the dominant economy in the bloc. This enlarged market means potential for increased free trade among members. Free trade is expected to lead to rapid expansion of trade and output, which in turn is expected to lead to demand for further investment, employment and GDP growth. These gains result from the dynamic effects of a Common Market, which have been shown to overshadow the static effects, that is, trade creation, trade diversion and terms of trade effects. The dynamic effects, which are cumulative in nature lead to growth. Indeed, the dynamic effects of a Common Market are often described as the long-run consequences for the economic growth of member countries as a consequence of increased market size and exploitation of economies of scale, increased competition, learning by doing and increased investment. Also, the stronger the potential economies of scale are, and the more rapid the autonomous productivity advantages, the more likely the economic integration will lead to growth. Thus, the contribution of the EAC Common

Market to economic growth and employment will be greater if the economies of scale are possible by increased market size, takes place paripassu with learning by doing. Regional integration brings many advantages to the private sector, such as economies of scale, specialisation and easier access to products. In addition, regional integration means a harmonisation of policies, especially regarding trade facilitation[104]. For example, skills within the East Africa region can be transferred from one country to another if free movement is allowed, and institutions like the central banks can work together, all of which make it much easier for the private sector to take advantage of opportunities and make investment decisions.

Table 4.2: Total value of Kenya's exports to the EAC (Kshs '000)

State	2004	2005	2006	2007	2008	2009
Tanzania	17,920,984	19,953,695	18,288,422	22,325,810	29,223,947	30,086,582
Uganda	37,059,413	42,679,280	27,812,308	33,570,946	42,285,352	46,239,885
Rwanda	6,189,939	7,282,450	4,765,033	5,801,234	8,953,198	9,535,976
Burundi	2,971,904	3,714,366	2,184,269	2,423,978	3,479,476	4,597,172
Total EAC	64,142,240	73,629,791	53,050,032	64,121,968	83,941,973	90,459,615

Source: Kenya National Bureau of Statistics Economic Survey 2010

Regional integration increases the level of regional trade, which prepares partner states to be globally competitive. The statistics above illustrate Kenya's value of trade within the EAC region, between 2004 and 2009. From Table 4.2 above, we can observe that there has been an increase in the value of Kenya's exports to the EAC from the year 2007 which stood at approximately KShs.64 billion, while in 2009, it was approximately KShs.90.5 billion. In 2004, Kenya's total value of imports from other countries of the EAC was approximately KShs.3 billion, while in 2009, it increased to approximately

[104] Agatha Nderitu, Executive Director, East African Business Council

KShs.12.5 billion.

Table 4.3 Kenya imports

Country	2005	2006	2007	2008	2009
EAC	4,630,694	6,065,052	12,898,294	12,898,294	12,568,221
% EAC	7.4	9.6	17.9	14.6	12.1
% Africa	70.4	51.1	51.1	41.3	68.5

Source: Kenya National Bureau of Statistics Economic Survey 2010

From Table 4.3, we can observe that Kenya imports more goods from the rest of Africa than from the EAC or COMESA. In 2009, 68.5% of Kenya's imports from Africa came from the rest of Africa. An important element of the regional integration process involves the likely positive impact of increased trade opportunities on the welfare of Kenyan citizens (customers and traders). However, of concern is whether this will lead to poverty reduction and pro-poor growth. The common market is in the implementation stage and should eventually lead to the free movement of goods, services, people, labour and capital, leading to developmental benefits.

4.4 The EAC is one of the fastest growing economic communities in the world.

At its most basic regional integration is a process in which countries enter into a regional agreement in order to enhance regional cooperation. Whilst this is mostly a politically driven process the main objective of these agreements is usually the formation of closer economic linkages among countries that are geographically near each other. The main way in which a region is able to do this is thought the creation of regional regulation that is implemented nationally. This section will outline the main phases and important stages of regional integration, and what they mean in concrete terms for a business sector[105].

Regional integration, and the features of a customs union and a common market, it is possible to identify three specific and distinct aspects of regional integration, and their business implications. This framework cuts through the theory of regional integration, be it for a customs union or a common market, and helps to explain the three key facets of regional integration that impact on a business and on how business needs to engage with regional integration. Not only this but within the following framework the objective is explicitly on linking regional integration processes, and issues, to business needs and objectives, so that business can clearly identify the opportunities, challenges and risks inherent in each[106].

It has grown faster than all other economic communities in the last decade, except for ASEAN, which grew at 6.1 percent. The EAC grew at an average of 5.8 percent per year, between 2001-2009 and over the last decade, each EAC country more than doubled its own GDP. The EAC also experienced unprecedented population growth – the region grew by 25 percent from 110 million people in 2002, to 138 million people in 2010. The region's high population growth has been close to 3 percent per year over the last two decades, compared to the Sub-Saharan Africa's average of 2.6 percent. The population in Kenya alone doubled over the last twenty-five years, and rapid population growth is set to continue.

The leading motif of regional integration is that there will be increasing sales and

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[105] UNCTAD (2009) Economic Development in Africa 2009 – Strengthening Regional Economic Integration for Africa's Development , United Nations New York and Geneva 2009, 1.

[106] ECA Assessing Regional Integration in Africa: ECA Policy Research Report. Addis Ababa: ECA. (2004).

profits for the most cost-effective producers, as well as a reduction in consumer prices, an increase in Gross Domestic Product (GDP) and employment. All regional initiatives strive towards enabling policies for their own regional business sectors, policies that are conducive towards ensuring that opportunities and returns on investment increase, enabling regional firms to become regionally and globally competitive[107]. These are the standard driving factors behind a regional integration project, but these benefits will not be evenly distributed, nor will they appear very quickly and in a linear fashion. The process of regional integration is a long, complicated, inherently political, and at times unpredictable journey[108]. Business needs to understand the objectives, the processes and the likely outcomes and then follow attentively to protect its interests and realize the opportunities that are on offer. Regional integration might have political drive behind it but it needs strong regional business advocacy to move in the right directions at the right times. Integration also invariably produces winners and losers among a region's private sector stakeholders, which makes it all the more vital for business interests to organize and mobilize for their industry.

Tanzania, Uganda and Rwanda grew at an average of over 7 percent per year between 2002 and 2010, compared to Kenya and Burundi which grew at 3 and 4 percent respectively. Kenya is the largest economy with a GDP of approximately US$ 32 billion in 2010, followed by Tanzania, Uganda and Rwanda, and finally Burundi with a GDP of only US$ 1.6 billion in 2010. Between 2002 and 2010, GDP per capita increased at an average of 112 percent across the region, and now ranges from over US$

[107] ECA Assessing Regional Integration in Africa II: Rationalizing Regional Economic Communities. Addis Ababa: ECA. (2006a).
[108] ECA Assessing Regional Integration in Africa III: Towards Monetary and Financial Integration in Africa. Addis Ababa: ECA. (2008).

800 in Kenya, to under US$ 200 in Burundi. To reach middle-income status (GDP per capita of US$ 1,000) by 2020 – the ambition of most EAC countries the region would have to grow at an average of 8.5 percent per year, for the rest of the decade. Rwanda, Tanzania and Uganda, with per capita income somewhat behind the regional average, would have to grow at 10 percent per year, in order to meet that goal, individually

4.5 Regional integration can bring substantive benefits

Intra-EAC trade can lead to lower prices for consumers and create more jobs for EAC citizens. Gains are expected from both traditional sources (e.g. economies of scale, increased and more diversified trade and investment), and non-traditional sources (e.g. commitment for domestic reforms, benefits from access to regional public goods, and increased bargaining power in wider trade negotiations)[109].

The production of food staples for growing urban markets and food deficit rural areas, represents the largest growth opportunity for regional farmers. Given that there is population growth and increased urbanization, Africa's demand for food staples will grow dramatically in the coming decade. Indeed, demand in Africa is expected to double by 2020, primarily in cities. But agricultural resources are not allocated equally across EAC countries, or even within them, so borders often artificially demarcate food surplus areas, from food deficit ones. Regional trade integration can have a substantial impact by better linking farmers to consumers across borders, and in ameliorating the effects of periodic national food shortages, and increasing global food prices. At this stage, however, regional trade in food staples remains far from free, despite efforts for policy and regulatory harmonization. The arbitrary and erratic imposition of barriers undermines

[109] *This section is based on World Bank, Defragmenting Africa, 2012.*

private sector confidence to invest, and distorts incentives towards cash crop production away from food staples

4.6 Links between Integration and Economic benefit

Regional financial integration relates to deepening financial ties within regions. There exists a strong relationship between financial markets and economic growth and the presence of strong financial institutions in Africa could advance the important role of economic development in the region. Capital markets in the region seem quite fragmented with low capitalization and insufficient liquidity as well as a shortage of long- term finance for the private sector. The East African Community (EAC), which is dominated by commercial banks, might not be the most reliable in terms of providing long term capital to the private sector. East African Community (EAC) is at a higher level of financial integration, as it has set up various financial institutions, such as, central banks, development finance institutions, stock exchanges and insurance and non-banking institutions. A focus on integration could give rise to countries linking their financial markets with other markets in the region. This would involve in part the harmonization of regulatory and legislative polices as well as institutional frameworks within the region, including the harmonization of tax and trade policies. Merging markets has quite a number of advantages including the pooling together of savings (which are low in a number of African countries), establishing regional capital markets (to support the private sector) increasing the number of financial instruments in use, as well as increasing the number of financial institutions. An important point to note here would be that the success of financial integration to a great extent falls on national government commitment and political will towards these efforts.

The ultimate goal of regional integration is to create a common economic space among the participating countries. Monetary and economic integration may evolve from trade links, as well as, historical and cultural ties. The process entails the harmonization of macroeconomic policies, legal frameworks and institutional architectures, towards nominal and real convergence. Other objectives of monetary union include the enlargement and diversification of market size, the promotion of intra-regional trade and the strengthening of member countries' bargaining power in the global economy. Although the promotion of regional economic integration among African countries dates back to the colonial days, a conscious effort at the continental level was made only in 1991, when a single monetary zone for Africa was for the first time mainstreamed in the Organization of East African Unity's Treaty[110]

During the 1980s and early 1990s, most African countries adopted economic policies that entrenched the state in all aspects of economic activities, thus relegating the private sector as marginal player in the development effort. The thinking was that the infant industries should be nurtured by the state through a system of subsidies, and protected from global competition. This necessitated the imposition of high tariff walls to enable these industries grow and compete with foreign firms. Several reasons including, limited domestic markets which hampered the realisation of economies of scale; lack of technology/human capital, which gave rise to poor quality goods and paucity of

[110] O. J. Nnanna, PH.D is the Director General of the West African Monetary Institute in Accra, Ghana. The research assistance provided by Mr. E. Onwioduokit and comments from Dr. Buira and Ms. Reis of the G24 Secretariat are greatly appreciated. The views expressed in this paper are personal and do not represent those of the Institute or its management

resources, etc., were advanced as factors which militated against the achievement of a viable domestic industrial base in majority of African countries

Direction and patterns of trade flows in the EAC

The trade structure of the EAC countries, like those of many African countries, displays the following common characteristics: a commodity structure of exports dominated by primary products in Standard International Trade Classification (SITC) categories 0–4; a commodity composition of imports heavily weighted in manufactured goods in SITC product categories 5–8; and a heavy concentration of exports to markets in Europe, Asia and North America. The evolution of EAC trade (by Kenya, Uganda and Tanzania) since the 1980s. It is evident that the pattern has been dominated by trade with industrialized countries and in particular the EU and (lately) Asia (accounting for 14.9 percent of exports and 21.5 percent of imports in 2005). It is also important to note that trade – both intra- and inter-regional, has constituted a sizeable and growing proportion of the EAC's GDP, rising from 8.1 percent in the 1980s to 14.5 percent in 2005 for exports, and from 14.1 percent to 30.6 percent for imports over the same period.

Intra-regional trade between the EAC countries has also increased, with the latest estimates (2010) showing that it has grown by 49 percent since the commencement of the EAC CU in 2005. Even so, trade in the region remains largely uneven in direction and intensity. Kenya remains the dominant player in EAC trade, accounting for the bulk of the intra-EAC exports. For most of the period since the 1980s, except for around 1990–1994, Kenya's exports to the EAC were well above 80 percent of the total EAC trade. This has been declining in recent years, however, and more sharply since 2005 when the EAC CU protocol came into force. In 2008, Kenya accounted for about 61 percent of the total intra- EAC exports.

Benefits accrued from the EAC integration process

A number of achievements have been made in the process of integration. EAC citizens were asked whether they had experienced any of these benefits. Freedom of movement across EAC countries was most frequently mentioned. 54% of the respondents in Kenya, 56% of those in Uganda and 43% of those in Tanzania made this statement. Freedom of movement was further associated with ease of travel across borders in the three selected countries. The benefits accrued are examined separately for each category of East African citizens (business persons, workers, professionals, students and farmers). Discussions held with government officials from the three EAC Partner States revealed that there were already measures in place to facilitate free movement of persons, such as the use of abstracts, and that the time for processing documents had been greatly reduced. The immigration officials highlighted the use of harmonized forms for immigration, the use of special tills for EAC citizens with faster services, and the six month automatic permit for East African citizens.

Implementation of the customs union and the move to a common market

Trade policy is largely defined in the EAC's CU protocol. The main elements of the protocol are: removal of internal tariffs and all non-tariff barriers on intra- EAC trade; introduction of CET regime; and agreements on a list of goods classified as sensitive and therefore requiring additional protection. In the first phase, i.e., from 2005 –to 2010, exports from Kenya were categorized into two lists, A and B, in order to provide Uganda and Tanzania with an adjustment time. Category A goods enjoyed immediate duty free status in the other two countries. Category B listed some 880 and 443 importable goods from Kenya by Tanzania and Uganda, respectively that are subject to duties. The tariffs on these goods were to be phased out over a five-year period and were not to exceed the CET.

The implementation of the CU protocol has been ongoing since 2005. By and large, tariff reductions have been effected as expected. Tanzania and Uganda began eliminating the internal tariffs in the 2006/07 fiscal year. Although there were initial hiccups in the removal of the tariff, the achievement has been remarkable. As will be discussed below, however, there remain numerous non-tariff barriers that still hinder the smooth movement of goods across the countries. The three EAC countries also successfully negotiated and agreed on the CET, which became operational in January 2005. A three-band tariff structure (0 percent, 10 percent and 25 percent) was codified under the EAC Customs Management Act of December 2004.

Trade gains

Regional trade agreements will cause the demand for third party goods to decrease, which will drive down prices. In addition, more acute competition in the trade zone may induce outside firms to cut prices to maintain exports to the region. This will create positive terms of trade effect for member countries. However, the move to free trade between partners who maintain significant tariffs vis-à-vis the rest of the world may well result in trade diversion and welfare loss (Viner, 1950). The risk of trade diversion could be mitigated if countries implement very low external tariffs ("open regionalism" arrangements). Business opportunities across the three east African countries were quoted widely as benefits being enjoyed. 45% of those interviewed in Uganda, 21% of those in Tanzania and 31% of those in Kenya mentioned increased business opportunities in the region. Ability to buy goods from other regions cheaply was mentioned by 53% of the Kenyan interviewees, followed by 26% of the Ugandan interviewees. However, only 4% of the Tanzanians interviewed agreed to this statement. Increased tourism was mentioned by 5% of the respondents from Uganda, while Kenyans and Tanzanians had only minimal expectations (2%) in this matter.

The ability to travel with minimal documentation, especially the "abstract" which enables persons to cross borders, was mentioned by 40% of the Ugandans, 20% Kenyans but only 7% of the Tanzanians. Especially business persons from small enterprises and the informal sector found the abstract very useful.

Increased returns and increased competition

Within a tiny market, there may be a trade-off between economies of scale and competition. Market enlargement removes this trade-off and makes possible the existence of (i) larger firms with greater productive efficiency for any industry with economies of scale and (ii) increased competition that induces firms to cut prices, expand sales and reduce internal inefficiencies. Given the high level of fragmentation in EAC, it is expected that market enlargement would allow firms in some sectors to exploit more fully economies of scale. Competition may lead to the rationalization of production and the removal of inefficient duplication of plants. However, pro-competitive effects will be larger if low external tariff allows for a significant degree of import competition from firms outside the zone. Otherwise, the more developed countries within the regional integration scheme would most probably dominate the market because they may have a head-start. On the other hand, current technology may be obsolete in these countries compared to current and future needs of the regional market. Firms may then decide to re-deploy new technology and relocate in other areas depending on factor costs. In this case, countries with the most cost effective infrastructure and human resources would be the beneficiaries.

Investment

Regional trade agreements may attract FDI both from within and outside the regional integration arrangement (RIA) as a result of (i) market enlargement (particularly for "lumpy" investment that might only be viable above a certain size), and (ii) production rationalization (reduced distortion and lower marginal cost in production). Enlarging a sub-regional market will also bring *direct foreign investment*, which will be beneficial, provided that the incentive for foreign investors is not to engage in "tariff-jumping". This advocates once again for the necessity to reduce protection and more specifically external tariffs.

Informal Sector Business

The respondents noted that the East African integration process had created a conducive environment for informal business at the borders of the three Partner States. The border posts at Malaba, Busia and Lwahaha between Kenya and Uganda have become extremely busy during market days, because people can move more easily. It was even observed that both legal and illegal routes were used, for instance in Malaba (Uganda), where on market days near the borders goods are bought during the day and sold across the border on alternative market days.

These products are mainly cereals, fruits, fuel, detergents and cooking oil.

Cereals are ferried on bicycles, and each bicycle can carry up to 30kg across the border three times a day. In Malaba (Kenya), most unrecorded trade involved products like maize, beans, millet, rice, sorghum and clothes. Cross-border trade was not just experienced during the market days. The "jua kali" sector in the town also manufactures items for internal markets and markets across the border.

The effect of the integration process was felt even in smaller border towns such as Lwahaha between Uganda and Kenya in the Mount Elgon region. This trade goes on unrecorded and some of it could find its way into either Kenya or Uganda. Most products traded were cereals, maize, beans, millet, rice, and sorghum ferried on foot or by bicycle. The Lwahaha border post is not as well developed as other borders.

Benefits accrued by farmers

Farmers stated that they were now able to buy items to improve farming from across the border. This was mostly mentioned by Kenyan farmers (13%) at the border and Tanzanians (4%) while only (2%) Ugandans mentioned this. Reduced taxes made it easier to import such products. Another benefit was the abolishment of double taxation, mentioned by 12% of Kenyans, and 9% of both Tanzanians and Ugandans. 6% of the Kenyan and Ugandan and 4% of the Tanzanian farmers mentioned that immigration procedures had become less restrictive. Respondents in the three countries mentioned that documents are now processed faster than in the past. 7% in Uganda, 4% in Tanzania and 2% in Kenya mentioned this aspect. 48% of the Tanzanian and 16% of the Ugandan farmers interviewed mentioned that they had not realised any benefits resulting from the process of integration so far. However, none of the Kenyan farmers supported this statement.

4.7 Challenges experienced when doing business across borders in the EAC

The study also sought to establish what challenges are currently being experienced by East African citizens doing business across the borders. The sample of these business persons was 20% of the total sample size. Since most of those interviewed did business largely in Kenya, Uganda and Tanzania, the answers were directed to these countries. However, a few respondents also mentioned problems encountered in Rwanda and Burundi.

It is important to note that 15.8% of this sample mentioned they had no difficulties, 8.4% said the verification of documents was slow at all points, and 22.2% mentioned high taxes. High taxes were mentioned by 43.8% of the respondents in Kenya, 25.8% in Uganda and 27.5% in Tanzania. Harassment by custom officials was mentioned in all the three selected countries. Corruption and requests for bribes was highlighted as an experience by 45% of the Kenyan, 16% of the Ugandan and 34% of the Tanzanian respondents. A small percentage of business owners stated that they had to use illegal routes to move across borders in order to carry out their business. Although the figures here were not large, the EACBC (2008) reported that such unrecorded trade in the region is worth US $31.6 million. Most unrecorded trade was noted in Namanga (Kenya) followed by Malaba (Kenya). It was also noted in Namanga and Mutukula in Tanzania.

This study also established that there are no mechanism in place where truck drivers, cross border traders and clearing agents could report the non-tariff barriers they encounter. The respondents were strongly in support of establishing a formal mechanism through which they could relay their problems.

In spite of these difficulties the study by the EAC found that there was an overwhelming support for the principle of asymmetry among the business community in the region. In Kenya, 73% of businesses agreed with the principle. In Tanzania and Uganda 67% and 75%, respectively supported the principle. They also cautioned the need to improve awareness of this principle as views from about 31% of Kenyan companies termed it as unfair, while 40% in Tanzania and 14% in Uganda felt that the principle had not been implemented.

Further discussions with government officials from the East Africa Community in Tanzania revealed that the currency issue is a major problem because of the differences in the value. They also noted that their clients sometimes complain about it. Further they acknowledged that there are issues related to tariff differentiation that need to be addressed, because this means for instance that the tax paid by Tanzanians when importing goods to Kenya is not the same in value as that paid when importing goods to Tanzania.

CHAPTER FIVE

SUMMARY OF FINDINGS CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter present summary of data findings, conclusions based on the findings and recommendations there-to. The chapter also presents recommendations on further studies.

5.2 Summary of findings

From the data findings, there are indeed efforts by the concerned East Africa countries towards economic integration in east Africa. The study found that there is co-operation in the priority areas of trade and industry and in the priority areas of security and in the priority immigration and the promotion of investment in the region. Abolishing all tariffs, sharing electrical power, and freely exchangeable currencies were found to be important in integration in East Africa.

The study further found that ethnicity, economic crisis and political violence pose major threats to regional security in East Africa. Mutual accountability and strengthening African security capacity are the most important factors in ensuring regional security in East Africa. Regional cooperation was found by the study to be the key element in avenue in the process of integration.

The study found that commitment level of member-states, and the distribution of costs and benefits of integration, leads to adoption of security measures is most vital element in economic integration and regional security in East Africa. In a simple sense it means bringing parts or units together to form a whole or creating interdependence. It could also represent a situation in which states becomes interdependent in whatever aspects of their relations they desire. The priorities of the EAC Integration on economical grounds have been identified as an increased dialogue on common challenges, the full operationalization of the EAC Peace and Security Architecture (APSA) and predictable funding for enabling the AU and regional mechanisms to plan and conduct peace support operations. Today it is very rare to find one Africa country that has not shown overt interest in at least one of the several existing regional cooperation schemes on the continent. It is significant to note that Africa alone, within the past four decades, has experimented with about 200 inter-governmental organizations; most of them claim to have responsibility for promoting regional cooperation. The practical results, however, have been very disappointing. But African governments have continued to promote the ideals of regional cooperation which they justified on the claim that regional cooperation is a strategy for self-reliance and development. The Joint EAC Strategy adopted at their Summit of December 1999 represents a new phase in cooperative relations between these regions. These member states have committed themselves to forge strong links based on a consensus built around values, interests and strategic objectives.

This paper has outlined the theory and practise of regional integration through a framework for understanding the business implications, and applied this framework to the current situation of the African textiles industry[111]. The objective of this research was to analyse the current and potential future role of regional integration in contributing to the reform and success of the African and to help business understand the issues and advocacy requirements. The report has found that regional integration has a key role to play in the future of the African textile industry, but that this role is far from being

[111] ECA Assessing Regional Integration in Africa: ECA Policy Research Report. Addis Ababa: ECA. (2004).

maximised at the moment. The three aspects of the framework; regional business to business, advocacy for trade within the region and advocacy for trade outside the region, are all being lobbied in various ways to advance specific issues at the regional level, but this is mixed with a number of short-term goals and national measures. The conclusions come back to the main issues that have been highlighted in this report.

Despite the potential benefits and the apparent comparative advantage, few African countries have managed to assert themselves in the world market. The regional measures that have been embarked on to combat the competitiveness problems of the industry have been seen to be soft integration measures. Whilst these are the logical first steps in any integration process they mask the challenges of the next stages of integration. Regional integration is not always going to be about win-win measures that do not threaten any member of the group. These early measures, if implemented in a timely and efficient manner, will deliver an additional boost to the industry, but they will not fundamentally alter the long-term issues that need addressing for sustainable competitiveness. Business needs to be prepared and ready for this next stage.

The current process of moving ahead with win-win low hanging fruit, such as business directories and tariff openings in the EU and US markets will be sufficient to give momentum to an integration movement. At the same time there needs to be considerable regional vigilance that national measures, such as upgrade schemes and preferential loans are coordinated to make sure duplication and wastage are avoided. This can be achieved through subsidy agreements, and despite the political sensitivities it should be possible to ensure some coordination that moves towards enhancing the regional value chain.

Regional integration is a cross-cutting issue that goes beyond the scope, or influence, of one single industry[112]. A second key aspect that was highlighted in this report was that many of the main driving forces of genuine regional integration go beyond the remit, influence and interest of one single industry, or indeed one single country. Infrastructure projects that improve regional linkages, energy supply, or export facilities offer advantages to all businesses in the region, as well as to importers wanting to export to the region. The major benefits of regional integration will accrue to the region as a whole, but they are major investment projects that will cost significant amounts of money to implement. Beyond the low-hanging fruit regional integration is all about creating a regional market based on intra-regional competition and the ability to create a regional value chain that can compete globally, and that can insert itself into global supply chains.

5.3 Conclusion

Nonetheless, integration can be said to exist when units join together in order to satisfy objectives which they cannot meet autonomously. In this way, integration can be a process which hastens up the achievement of certain objectives in the interest of a larger body. Such a process would involve the shifting of loyalties, expectations and political activities towards a new and larger centre whose institutions and processes demand some justification over those of the national states. The extent of such a transfer of loyalties and

[112] ECA Assessing Regional Integration in Africa II: Rationalizing Regional Economic Communities. Addis Ababa: ECA. (2006a).

jurisdiction enjoyed by the new centre would depend on the level and goals of integration schemes as well as the socio-economic and political ramifications, which the implementations of integrative policies generate within and between the integrating units.

Another level of classification is possible; the one, which considers the specific meanings of 'integration' from the perspectives of different, disciplines. Thus, there can be political integration, social integration, and economic integration. Although, the concept of economic integration has dominated the discourse on African regional integration yet it is often wrongly conceptualized. For instance, economic integration has often been defined in terms of liberalization or absence of economic discrimination among economic units.

This can be misleading especially for the less developed regions. The conception of economic integration as the progressive elimination of trade and tariff discrimination between national borders shows it as a state of affairs and a process. And upon this restrictive notion of regional integration, many self-styled common markets, federations, unions and communities have emerged without promoting regional integration among members or even showing the potentials to do so. In all these, there is unanimity among scholars of economic integration on one question: that integration can be regarded as processes or as a state of affairs reached by that process[113].

Integration' refers to a much more formal arrangement that involves some political and economic sacrifices as well as commitments, concessions, processes and political will to redefine participation in the international economy. In this regard

[113] ECA Assessing Regional Integration in Africa II: Rationalizing Regional Economic Communities. Addis Ababa: ECA. (2006a).

regional cooperation may be a phase in the process of regional integration. In the context of less developed areas, regional integration is an extremely complicated and varied phenomenon which is conditioned by socio-economic and political dynamics different from what is obtained in the North. It is to be noted however that each of these forms of integration arrangements has its own regularities, class content, and mechanism of operation.

The wide concepts of 'self-reliance' and 'south-south cooperation', with the obvious policy Corollary of regional integration and cooperation have featured prominently in the analyses of less developed societies, including the African continent. A common assumption especially among dependency theorists is that the potentials of the less developed countries for autonomous development are limited, more by externally infused dependency profiles, rather than internal processes. It thus follows logically that, auto centric development can be realized through disengagement from the global system. This prescription would result in some dislocation of the national economy since trade, aid and investment relations with the metropolis are expected to be reviewed. The impact of these dislocations is assumed to be too much for individual economies to bear, hence the need for a collective action to "ameliorate the effects of the national disengagement process by replacing North-South vertical relations with South-South horizontal relations among UDCs". In this way collective self-reliance represents a strategy against dependence on external resources aimed at promoting the principles of autonomous development. This is the context in which CSR and regional integration among less developed countries is seen in some circles as one and the same. However, the argument about regional economic cooperation as a form of collective-reliance cannot be carried too far. "When the integration process is itself shaped and conditioned by relations of dependence and underdevelopment, what ensures might in fact create a gap between economic integration and CSR. The problem with the prescription of the apologists of CSR is its failure to give serious systemic attention to the relationship between CSR and integration schemes in the less developed regions. The focus of analysis is on relations between systems while its neglects the internal processes of class formation that shape historical developments. For instance, when adopted as framework for analyzing crisis of development in Africa, it becomes more difficult to understand the causes of underdevelopment beyond the effects of Europe's predatory needs. In terms of policy prescription, self-reliance is to be pursued through the policies of import-substitution, export-substitution, export promotion, favorable balance of payment-strategies that do not in any way address the structural problems of underdevelopment and dependency. In this way what apologists of CSR have suggested, through its advocacy of mere reforms within the global capitalist system expressed in some forms of 'dependent' regional integration, amounts to nothing but autarky, and definitely not 'delinking' in the form of subordinating external relations to the logic of internal development.

While building together the institutions of the new African Union, the best contribution each country can make to the African development and integration process is national reconstruction through poverty eradication and democratic governance. Poverty eradication is not going to take place through slogans and target dates adopted by multilateral agencies or international conferences. It will come about only through concrete policies and programmes designed to transform the economic, political and social structures that reproduce poverty in Africa, which are local, national and international in nature. Such a transformation is not possible in situations of violent conflicts and/or those in which the institutions and processes of governance are unresponsive, unaccountable, or simply ineffective. There is widespread consensus that peace is inexorably tied to both security and development. The provision of security in its broadest sense implies meeting the basic human needs of the population as a condition for sustainable development. In this regard, the African state has been extremely deficient in meeting this condition. When the state itself is under the control of self-serving leaders, who have privatized public resources and are impervious to popular suffering, there is nothing that the African Union as an inter-state organization can do to improve the situation. Peer review, as provided for in the NEPAD programme, is not enforceable as long as gross violations of human rights remain common currency in the majority of states.

5.4 Recommendations

Equally threatening to the African project is the persistence of poverty, which creates insecurity with respect to decent livelihood and human survival. It not only reduces the ability of people to lead productive lives, it also exacerbates identity conflicts along communal, ethnic, religious and regional lines. How can we talk with sincerity of a common African identity when we are still incapable of dealing effectively with the issues of identity and citizenship in our respective countries?

Solidarity with one's identity is best mobilized when the group faces a threat, real or imagined, to its interests, security or its very existence as a group. This is why there is an increase in identity-based conflicts during periods of economic and political crisis. The ease with which warlords can recruit young men and boys to their armed bands in

Africa today is undoubtedly a function of the large number of school leavers and unemployed youth with nothing to do and no hope for the future. Likewise, the high incidence of intercommunal violence is due to growing competition over scarce resources and the persistence of poverty. Thus leads to insecurity and poverty intertwined, and their persistence can only frustrate the African integration and development process.

In a brilliant article published in the magazine West Africa seventeen years ago, the late Claude Ake posed the key question concerning the predicament of our continent: "Why Africa is not developing." My own answer to this melancholic question is twofold. On the one hand, the lack of development has to do with an internal environment in which the state itself was more likely to function as an obstacle to development than as an agency of economic and social transformation. This was due to the fact that rather than being a set of impartial institutions serving the general interest, the state and the resources under its control were for the most part privatized by the ruler and his entourage. On the other hand, the lack of development is a function of external development strategies whose main achievement has been to further integrate African rulers into the international networks of wealth and privilege rather than to promote development and democracy.

The persistence of poverty remains the major threat to the pan-African project of unity, peace and development in Africa. For it creates insecurity with respect to people's expectations of a decent livelihood and, indeed, of human survival, and thus undermines respect for diversity, tolerance and solidarity in favour of the politics of identity, intolerance and social exclusion. By reducing people's ability to lead productive and rewarding lives for themselves and their children, poverty exacerbates identity conflicts along communal, ethnic, religious and regional lines. It therefore becomes insincere to talk of a common African identity, when citizenship rights are daily being denied to fellow nationals on the basis of ethnic or regional origin, and the legendary African hospitality is replaced by violence against immigrants. All this goes to say that regional security mechanisms and the overall African security infrastructure cannot function effectively in the absence of developmental states capable of maintaining state authority throughout their national territory and of ensuring the promotion, respect and fulfillment of the fundamental rights of all citizens, particularly the right to human security.

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