Free Movement of Capital and East African Monetary Union

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13.1 Introduction

The free movement of capital and the monetary union are closely correlated. Indeed, a successful monetary union is dependent on the effectiveness of capital movement liberalization.¹ At the same time, it is argued that fully liberalized movement of capital and integrated financial markets within a regulatory framework featuring economic policies create tensions in exchange rates, which in turn puts undesirable pressure on monetary policy-makers.² Therefore, the East African Monetary Union (EAMU) is a necessary step towards a more stable economic community in the East African Community (EAC).

The free movement of capital is provided by Article 76 on the Establishment of the Common Market, and the monetary union by Articles 82 to 88 of the Treaty for the Establishment of the East African Community. The interrelation between the free movement of capital and the monetary union has been acknowledged in the Treaty under Article 86 entitled 'Movement of Capital' under Chapter Fourteen on monetary and financial cooperation between EAC Partner States. This highlights how the free movement of capital—more than other common market freedoms—is crucial for an effective monetary union. This Chapter, however, is not intended to analyze the correlation between free movement of capital and the monetary union, but considering their close connection, it discusses both fields after one another, shedding light on the provisions governing these two areas in the EAC integration arrangement.

1 Catherine Barnard, *The Substantive Law of the EU: The Four Freedoms* (4th edn, OUP, 2013) 614.

2 *Ibid.*, p. 613.

13.2 Free Movement of Capital

13.2.1 *Principle*

The free movement of capital is provided in Article 76(1) of the Treaty and further detailed in Articles 24 to 28 of the Protocol on the Establishment of the East African Community Common Market. However, neither the Treaty nor the Common Market Protocol provide a definition for “capital”. Article 28 of the Common Market Protocol simply enumerates a non-exhaustive list of operations that should be considered as meaning “capital and related payments and transfers”. These are direct investment; equity and portfolio investments; bank and credit transactions; payment of interest on loans and amortization; dividends and other income on investments; repatriation of proceeds from the sale of assets; and other transfers and payments relating to investment flows.³ This list should be read in conjunction with Annex VI to the Common Market Protocol which enumerates specific operations that the Partner States agreed to liberalize in order to free the flow of capital.⁴

These operations may be categorized into four groups. The first group is related to securities operations which includes securities transactions that are controlled by regulations, the prices of which are regularly published, either by official stock exchanges (quoted securities) or by any other facilities (unquoted securities); some collective investments schemes; money market instruments; and derivatives.⁵

The second group is composed of credit operations meaning, “financing of every kind granted by financial institutions, including financing related to commercial transactions or to the provision of services in which non-residents participate”.⁶ This group also includes, mortgage loans, consumer credit and financial leasing, as well as back-up facilities and other note issuance facilities.

The third group consists of direct investments. Direct investments are investments of all kinds, by natural or legal persons, that serve to establish or maintain lasting and direct links between the person providing the capital and the entrepreneur or undertaking to which the capital is made available in order to carry on an economic activity.⁷ Generally, direct investment involves

3 Article 28 of the Protocol on the Establishment of the East African Community Common Market, signed on the 20 November 2009.

4 Compare in this regard also the role of secondary law in the definition of capital, as discussed in EU Chapter 13 par. 2.

5 Explanatory notes of Annex VI to the Common Market Protocol.

6 *Ibid.*

7 *Ibid.*

participation in new or existing undertakings, the establishment and extension of branches or new undertakings belonging solely to the person providing the capital as well as the acquisition in full of existing undertakings, and finally the reinvestment of profits.⁸ All these three alternatives should feature an intention of the performer to establish or maintain lasting economic links with the undertaking.⁹ This is also the case under European Union law, where these types of capital movements are also considered to be direct investments.¹⁰

The final group concerns personal capital operations, which include, among others, loans, gifts and endowments, inheritances and legacies, death dues, damages, authors' royalties, etc.¹¹

According to Article 24 of the Common Market Protocol, Partner States commit to progressively remove all restrictions and discrimination which could impede the above-mentioned operations, including current payment.¹²

It is noteworthy that, unlike other common market freedoms, which are an exclusive entitlement of the Partner States' nationals, Article 24(1)(e) of the Common Market Protocol opens the free movement of capital to any person who *resides* in the territory of a Partner State. This includes of course nationals, and any other legal or natural person legally living in the territory of a Partner State.

Article 24(1)(b) of the Common Market Protocol prohibits any form of discrimination based on nationality, place of residence or place where the capital is invested. Discrimination based on nationality and place of residence mean that any person of any nationality residing in the territory of the EAC is allowed to move capital within the Community. The question of what "the place where

8 *Ibid.*

9 The guidance provided by IMF and OECD should be taken into consideration to understand the scope of "lasting" and "direct" links referred to by this explanatory note. See IMF, *Balance of Payments Manual* (6th ed., IMF, 2008, updated version of 2011) 100; and OECD, *OECD Benchmark Definition of Foreign Direct Investment* (4th edn, OECD, 2008) 48.

10 Annex I to Council Directive 88/361/EEC for the implementation of Article 67 of the Treaty [1988] OJ L178. Furthermore, for the purpose of implementing Article 63 of the Treaty on the Functioning of the European Union [Ex Article 67 EC, repealed by the Treaty of Amsterdam], the list includes long-term loans with a view to establishing or maintaining lasting economic links.

11 The guidance provided by IMF and OECD should be taken into consideration to understand the scope of "lasting" and "direct" links referred to by this explanatory note. See IMF, *Balance of Payments Manual* (6th edn, IMF, 2008, updated version of 2011) 100; and OECD, *OECD Benchmark Definition of Foreign Direct Investment* (4th edn, OECD, 2008) 48.

12 Article 24(1)(d) of the Common Market Protocol. This paragraph also highlights the interpenetration between capital movement and other common market freedoms.

the capital is invested” entails is not as clear-cut. It seems clear that this provision advocates for the free movement of capital from the territory of a Partner State to the territory of any other Partner State without discrimination. However, it is not clear whether this provision could be construed as compelling Partner States not to hinder the movement of capital when their residents want to invest in a third country. *Prima facie*, the response would appear negative, as there is no immediate apparent benefit for the EAC to facilitate such an activity, which appears contrary to the common market’s aim of creating wealth within the community.

However, a reading of paragraphs (f) and (g) of Article 28 of the Common Market Protocol may suggest otherwise. Article 28 (f) and (g) define “capital and related payments and transfers” to include, the “repatriation of proceeds from the sale of assets” and “other transfers and payments relating to investment flows.” Therefore, since it allows, among others, foreign residents in the Community to repatriate the proceeds from the sale of assets or to do other transfers and payments related to investment flows, it can be inferred that the free movement of capital—in terms of the Common Market Protocol—entails that capital is also free to leave the Community. The confinement of the free movement of capital only to intra-EAC operations would affect both inward and outward investment flows in the region. Obviously, such a provision would be contrary to the general expectation of EAC Partner States, who all rely on the attraction of foreign direct investment (FDI) to sustain their national economic development agendas. The free movement of capital between EAC Partner States and third countries would be beneficial, as among other things, it strengthens the control of capital towards third countries, as investors would not attempt to enter or exit the Community market via the most liberal jurisdiction to access their target Partner State.¹³

Therefore, it seems logical to interpret that the EAC lawmakers decided to open the EAC capital market to third countries.¹⁴ Furthermore, Article 25(1)(d), in providing that “[t]he free movement of capital may be restricted upon

13 J. Snell, ‘Free Movement of Capital: Evolution as a Non-linear Process’ in Paul Craig and Grainne de Burca (eds), *The Evolution of the EU* (OUP 2011) cited by C. Barnard, cited *supra*, p. 584.

14 Note that the free movement of capital is also open in the EU to third countries but its implementation is closely regulated with strong available safeguard measures. C. Hjalmsroth and S. Westerberg, ‘The Contribution of trade to a new EU growth strategy: Ideas for a more open European Economy’ (Part 1 A Common investment policy for the EU), Report, National Board of Trade, p. 11(29) online at <http://www.kommers.se/upload/Analysarkiv/Arbetsomr.pdf> (accessed on 24 April 2016).

justified reasons related to ... (d) financial sanctions agreed to by the Partner States”, confirms the view that free movement of capital is applicable also to third countries.¹⁵ It follows that since free movement of capital is allowed between EAC Partner States and third countries, the former would restrict this free movement in case they decide to take financial sanctions against such third countries. Essentially, the free movement of capital between EAC Partner States and third countries would foster the possibility of business expansion for EAC companies or firms to non-EAC countries. In other words, it could be asserted that this freedom encourages FDI outflows from the EAC. When EAC companies and firms invest abroad, it increases the bloc’s competitiveness.¹⁶

In any event, Article 24(2) compels the Partner States to progressively remove all restrictions to the free movement of capital that existed at the entry into force of the Common Market Protocol and not to introduce new ones. According to the Schedule on the Removal of Restrictions on the Free Movement of Capital, Partner States committed to fully liberalize the movement of capital in the EAC by 31 December 2015. However, the reality on the ground suggests otherwise. In fact, a World Bank Report published in 2014, highlighted that, not only had the Partner States not removed barriers to the free movement of capital existing prior to the entry into force of the Common Market Protocol, new restrictions had actually been introduced.

This Report revealed that out of 20 operations pinpointed by the Common Market Protocol to be liberalized according to the free movement of capital, no EAC Partner State has succeeded to fully liberalize them all. Kenya, the best performer in this domain, has liberalized 17 operations out of 20. All the EAC Partner States restrict the movement of the three remaining operations. Those restrictions are related to the free movement of inward investments, consisting of, for example, the requirement of minimum capital for investors from other Partner States; or the shareholding of nationals in some businesses before they start operating in their territories; as well as the lack of legal framework for the sale or issue of derivative products locally by non-residents and abroad by residents. For instance, Tanzania and Burundi are the countries where restrictions are still preponderant on the free movement of capital, as only four operations have been liberalized.¹⁷ This can be attributed to Burundi and Tanzania’s strong reluctance toward the liberalization of capital movement, as displayed

15 Article 25(1)(d) the Common Market Protocol reads “The free movement of capital may be restricted upon justified reasons related to ... (d) financial sanctions agreed to by the Partner States”.

16 C. Hjalmroth and S. Westerberg, cited *supra*, p. 8(29).

17 World Bank, *The EAC Common Market Scorecard* [2014], pp. 8–15.

by the fact that these two Partner States took the longest period of time to fully comply with the Common Market Protocol provisions. Burundi's compliance period ran till the end of 2014, while Tanzania's went up to 31 December 2015. In principle, the movement of capital should be now fully liberalized in the EAC and any existing restrictions should be treated as a violation of the Treaty to be addressed by the East African Court of Justice (EACJ).

13.2.2 *Safeguard Measures and Exceptions*

As much as EAC Treaty-makers provided for the free movement of capital, they were also aware of the volatility of this sector and the dramatic impact that a very slight disfunctioning could have on the Partner States' national macro-economy. This is why Article 26(1) and (3) of the Common Market Protocol allow any Partner State to take the necessary steps when the free movement of capital disturbs the functioning of its financial markets or when its balance of payments is "is in difficulties or is seriously threatened with difficulties".¹⁸

In addition, when the intervention made by a Partner State in the foreign exchange market seriously distorts the condition of competition among Partner States, Article 26(2) of the Common Market Protocol entitles other Partner States to take any necessary measures to counter the consequences of such an intervention. However, according to Article 27(1) of the Common Market Protocol, a safeguard measure taken pursuant to Article 26 should be temporary, proportional, reasonable, and should not discriminate among Partner States or be in favour of third parties. This provision does not however provide for a specific timeframe for what might be considered 'temporary'.¹⁹ Moreover, Article 27(3) prohibits Partner States to adopt or maintain safeguard measures for the purpose of protecting a particular sector, in violation of other provisions of the Common Market Protocol. However, the lack of specification of these provisions may cause Partner States to adopt broad interpretations. For example Article 26(2) which specifies a 'strictly limited period' could be understood as meaning as long as the consequences of such intervention might last.²⁰

18 Article 26(1) and (3) the Common Market Protocol.

19 Here it may be argued that the measure is temporary until the reasons it is taken to rectify are no longer present. This interpretation would be similar to the application of WTO law.

20 Nevertheless, paragraphs 5 and 6 of Article 27 seem to suggest that the temporariness of safeguard measures have been discussed during the drafting phase of the CMP but that in the end, Partner States decided to entrust the Council with the task of monitoring the necessity of their enforcement. By analogy, in the EU, free movement of capital received

There is no clear indication on the nature of the safeguard measures that a Partner State may take pursuant to Article 26 of the Common Market Protocol, except the restrictions provided for in Article 27(2) and (3). However, once a Partner State decides to take a measure to safeguard its economy from any disturbance or distortion in balance of payments that the free movement of capital may cause, Article 27(4) obliges it to send a notification to both the EAC Secretariat and other Partner States.

In addition to safeguard measures that could interfere with the free movement of capital, according to Article 25(1) of the Common Market Protocol, Partner States are also permitted to restrict this freedom for justified reasons: on the ground of prudential supervision, public policy considerations, money laundering, and financial sanctions agreed among them, provided that the Secretariat and other Partner States are informed. However, the Common Market Protocol raised the bar in allowing the use of restrictions based on any such exception as the concerned Partner State has to “furnish proof that the action taken was appropriate, reasonable and justified”.²¹ As indicated above, a Partner State that takes such a measure pursuant to Article 25(1) of the Common Market Protocol has an obligation to inform.²²

Then some questions may arise as to the relevance of the requirement of appropriateness and reasonableness of any measures taken. Two questions remain: firstly, who is entitled to assess whether or not a Partner State's measure impeding the free movement of capital was really justified, appropriate and reasonable, and secondly, what would the sanction be should such a measure be found not to fulfill these requirements. There is no clear regulation on this at the current state of affairs under the EAC law. Unless a case is filed before the EACJ, the full implementation of the free movement of capital will depend, like other community freedoms, on the good will of Partner States.

a distinct treatment by the ECJ and the Commission—the latter sometimes opposing to full liberalization—than the other market freedoms (C. Barnard, cited *supra*, p. 581).

21 Article 25(2) the Common Market Protocol.

22 It appears however that except Burundi, all other Partner States have taken in the past measures restricting the free movement of capital either on the ground of prudential supervision, public policy or anti-money laundering without taking care of informing neither the Secretariat nor the other Partner States (EAC Common Market Scorecard 2014, pp. 44–54). It is worth noting that no Partner State has taken a restrictive measure against the free movement of capital on the ground of financial sanctions.

13.3 Problems Facing the Free Movement of Capital in the EAC Common Market

History has shown that, following trade liberalization between EAC Partner States, industrial agglomeration as a consequence of inequitable FDI inflow is more than hypothetical. Kenya's historical position as the favorite destination for European and Indian FDI during the colonial period is uncontested.²³ This preferential treatment permitted Kenya to become industrially more advanced than the other two founding Partner States, Tanzania and Uganda. While Kenya has been able to maintain its industrial development advantage *vis-à-vis* Tanzania and Uganda, the industrial gap between Partner States has been widened by the accession of Burundi and Rwanda in 2007, and later South Sudan on 15 April 2016. Consequently, the differences in Partner States' development levels remain significant.²⁴

Nevertheless, it would be shortsighted to attribute the current differences in Partner States' development levels exclusively to historical decisions. Apart from the colonial decisions that favored the industrial development of one Partner State to the detriment of others, deep structural discrepancies in terms of factor endowments exist between them. The combination of historical events and disproportionate factor endowment distribution between Partner States predisposes the EAC to be an unbalanced region, especially with the implementation of a fully-fledged common market where goods, persons (including workers), services and capital enjoy total free movement rights. In other words, the implementation of free movement of goods, persons, services and capital would foster an inequitable FDI inflow between Partner States.²⁵

This inequitable attraction of FDI would create polarization within the EAC, whereby one or two countries with the best combination of FDI determinants, i.e. market access,²⁶ economic growth, human capital stock, infrastructure,

23 Mbembe Binda, *Good Governance and Foreign Direct Investment: A Legal Contribution to a Balanced Economic Development in the East African Community* (EAC) (Uitgeverij BOXPress, 2015), 30.

24 *Ibid.*, pp. 213–240.

25 On more about the impact of regional integration on the location of industries, see P. Krugman, *Development, Geography and Economic Theory* (MIT Press, 1995).

26 It is generally agreed that regional integration affects FDI determinants. For instance, in a common market, a factor like market size becomes less significant as FDI determinant for a single country since companies would focus increasingly on regional rather than local market. See A. Mold, 'The Impact of the Single Market Programme on the Locational Determinants of US Manufacturing Affiliates: An Economic Analysis', [2003] 41 *Journal of Common Market Studies* 38.

regulatory framework, and agglomeration effects would logically attract more FDI than the others. In the new economic geography (NEG), the Partner States which present strong potentials to attract more FDI are considered as 'central' economies, while those with weak potential are called 'peripheral'. According to NEG, structural differences between central and peripheral economies affect their respective ability to attract industrial capacity.²⁷ Accordingly, *ceteris paribus*, the individual efforts of each Partner State to attract more FDI to foster its own industrial development could not change the balance of power between 'central' and 'peripheral' Partner States. On the contrary, such individual efforts would lead to a fierce intra-EAC competition for FDI inflow, which in the end would unfortunately increase the gap between the two groups. Following the agglomeration effect that underpins the NEG theory, 'central' Partner States would attract more and more FDI—which implies becoming more and more industrialized—while 'peripheral' ones would attract less and less FDI. With no doubt, such a situation would arouse old demons of inequitable sharing of the benefits of the Community between Partner States which compromised previous regional integration initiatives in the EAC.

The occurrence of such a 'central-peripheral' division in FDI inflow in EAC would lead to a Rambo situation.²⁸ According to an unfolding theory of regional integration between developing countries, "increasing of extra-regional FDI and export flows for one member state cause losses for other members" since FDI are "common pool resources".²⁹ Consequently, the most frustrated Partner State(s) would become a Rambo with the dominant strategy of defection. Depending on the importance or the number of defected Partner States, the frustration over unbalanced FDI inflow might lead to the collapse of the EAC.

27 See also A. Mold, cited *supra*, p. 38. For more details about NEG, see J.P. Neary, 'Of Hype and Hyperbolas: Introducing the New Economic Geography', [2001] 39 *Journal of Economic Literature* 536.

28 S. Krapohl and S. Fink, cited *supra*, 475. It should be recalled that the "term 'Rambo' does not refer to the Hollywood movie, but to a game-theoretical constellation of two actors. A Rambo situation is an asymmetrical game, where one player has a dominant strategy to co-operate, whereas the Rambo's dominant strategy is defection". S. Krapohl, K.I. Meissner and J. Muntchick, 'Regional Powers as Leaders or Rambos? The Ambivalent Behaviour of Brazil and South Africa in Regional Economic Integration' [2014] 52 *Journal of Common Market Studies* 880 referring to K. Holzinger, 'Common Goods, Matrix Games and Institutional Response' [2003] 9 *European Journal of International Relations* 173.

29 S. Krapohl and S. Fink, 'Different Paths of Regional Integration: Trade Networks and Regional Institution-Building in Europe, Southeast Asia and Southern Africa' [2013] 51 *Journal of Common Market* 474.

The threat of an EAC collapse over Partner State's frustration based on inequitable FDI inflow could be accused of overstatement. However, whatever its magnitude, the threat is real and should be taken seriously, at least for two reasons. The first reason is history-based. In fact, previous crises in the EAC were closely related to the inequitable FDI inflow between Partner States,³⁰ though it must be acknowledged that in the colonial era the terminology FDI was not yet commonly used. The second reason lays with the importance that is accorded to FDI inflow by both the Partner States and the EAC Treaty. For Partner States, it is commonly believed that FDI is the most appropriate supplement, if not alternative, to conditionality-tied Official Development Aid (ODA).³¹ This belief motivates most countries, EAC Partner States included, to undergo various reforms to maximize the inflow of FDI in their territories. Consequently, it would not be surprising for a Partner State to vehemently oppose anything that could deter or divert the flow of FDI into its territory, even if it is a regional integration requirement.

As for the EAC Treaty, it mentions the attraction of investment as the means for the realization of a fast and balanced regional development.³² To understand to the fullest extent the expectations put by the EAC on the attraction of investment, one should remember that the treaty-makers deplored unbalanced regional development as a key factor that caused "continued disproportionate sharing of the benefits of the community among Partner States", which is identified as one of the "main reasons contributing to the collapse" of the EAC.³³ In contemplating the attraction of investment as a remedy against EAC's chronic unbalanced regional development, treaty-makers themselves

30 Reference is made to the collapse of the East African Common Services Organizations (EACSO) in 1964 following the Kampala Agreement and the collapse of the former EAC in 1977, as also rightly acknowledged by paragraph 4 of the Preamble to the Arusha Treaty.

31 Despite the controversial econometric results of the impact of FDI on the host country's economy, developing countries—including EAC Partner States—have massively embarked in the battle to secure more FDI inflows. This battle is fought on all grounds, including in particular the reform of national policies and regulations and the availability of various forms of incentives to attract FDI. The attraction of FDI is even considered by some authors as the rationale for regional integration in developing regions. See for instance S. Krapohl and S. Fink, cited *supra*, 474.

32 Paragraph 11 of the Arusha Treaty preamble which reads "And whereas the said countries, with a view to realizing a fast and balanced regional development are resolved to creating an enabling environment in all the Partner States in order to attract investment...". See also articles 79–80 of Arusha Treaty that stress the need for cooperation in investment and industrial development for a balanced industrial growth within the community.

33 Paragraph 4 of the Arusha Treaty Preamble.

had already decided to erect FDI attraction as one of the pillars of the regional integration success.

However, when one confronts these Treaty provisions (where a serious case is made for the attraction of investment) to the practice, the paradox becomes intriguing. As early as 2006, Partner States adopted a well-elaborated five-year Joint Export and Investment Promotion Strategies (JIPS) where most of the threatening issues related to FDI attraction were thoroughly identified and adequate solutions were recommended. At the end of the JIPS implementation period, most of its provisions never came into fruition. The same sad observation could be made regarding the fourth EAC Development Strategy (EAC-DS) which advocated for the enactment of an EAC common investment strategy in tandem with the development of a mechanism for equitable sharing of benefits and costs of EAC integration by 2016.³⁴ The drafting of the EAC Industrialization Policy (EAC-IP) is another interesting example. While the EAC Treaty mentions the “lack of adequate policies” to address the issue of unbalanced development in the EAC, EAC-IP astonishingly overlooks to mention the differences in Partner States’ economic levels as one of the key challenges for the industrialization of the region.³⁵ Furthermore, no reference is made to the key role that FDI location could play in the industrialization of the Community. Therefore, no single measure is suggested by the EAC-IP to tackle the issue of the uneven distribution of FDI, hence of industries, within the EAC common market.

The fact remains that, despite rhetoric recognition of the need to develop a mechanism related to investment attraction in the EAC in order to foster a balanced regional economic development, Partner States have paradoxically displayed an exasperating nonchalance for the adoption of an adequate framework and for its subsequent implementation.

This lack of regional regulation makes the common market a conducive area for a competition between EAC Partner States for FDI attraction. Unfortunately, as the EAC is characterized by striking economic discrepancies between Partner States, this intra-regional competition would be won

34 See EAC, *EAC Development Strategy (2011/2012–2015–2016): Deepening and Accelerating Integration* [August 2011], pp. 65 and 154. (Hereinafter 4th EAC-DS).

35 The challenges facing the industrialization in EAC are exhaustively listed in the EAC-IP. “Development disparities among Partner States is simply marginally listed in the table summarizing the threats to the industrial sector. For more details, see EAC, *East African Community Industrialization Policy 2012–2013* (2011) 9, available online at http://industrialization.eac.int/index.php?option=com_docman&task=cat_view&gid=38&Itemid=70 accessed on 10 February 2015 (hereinafter EAC-IP).

by one or two Partner States offering the best combination of FDI location determinants, including *inter alia* the economic productivity, the availability of qualified human capital, the existence of adequate infrastructure, and the overall observance of good governance principles. To these determinants, it is necessary to add the agglomeration effect professed by NEG. In confronting one Partner State against the other, a twofold observation is made. On the one hand, Kenya leads by far on five out of the six compared determinants, i.e. economic productivity, human capital, infrastructure, good governance and—of course—the agglomeration potential. On the other hand, Burundi seems to be worse off in this FDI attraction intra-EAC competition. As suggested by Krapohl and Fink, the likelihood of a “Rambo situation” (defection) is very high for an unbalanced regional integration like the EAC. Burundi and Tanzania have demonstrated in the past the applicability of this theory in the EAC by their reluctance to join some fast-tracked projects such as single-customs territory, single tourist visa, and the approval of national ID cards to be used as travel documents to cross their mutual borders. As no consensus could be found within the Community settings to fast-track these aspects of integration, Kenya, Rwanda and Uganda—now known as the Coalition of the Willing—decided to make a tripartite intergovernmental deal under the Northern Corridor integration projects. The defectors, Burundi and Tanzania, are allowed to join at their most convenient time. Although, at the beginning, it was perceived as sidelining Burundi and Tanzania, this kind of arrangement is nonetheless allowed by the Treaty under the principle of variable geometry enshrined in the Article 7(e), as one of the operational principles of the Community. Undisputedly, the three projects named above are not directly linked to the flow of inward FDI in the EAC. However, the behavior of some Partner States exemplifies the propensity of defection when regional integration does not, for one reason or another, match the national expectation.

The regional cohesion is even more vulnerable when the object of the competition is external, such as FDI attraction. In this case, if there is no common regional policy to streamline the behavior of member states *vis-à-vis* external actors, the likelihood of fragmentation is high. It is in line with this view that, in order to minimize the risks of defection based on Partner States frustration over the claim of inequitable FDI inflow, it is suggested that there is an urgent need for a regional common investment policy,³⁶ especially on inward FDI in the area of goods production and services distribution.

36 It should be noted, however, such a regional policy must be within a large framework of common commercial policy which, to some extent, may require the adoption of a common foreign policy that Partner States have failed to make so far.

The adoption of such regional policy is *sine qua non* for the harmonization of Partner States' laws and policies. It is therefore a necessary prerequisite for the establishment of any sustainable mechanism for equitable sharing of benefits and costs of the EAC integration. The regional investment policy would set common rules and principles for the admission and treatment of foreign investment in the EAC.

Since playing by the same rules does not necessarily guarantee the *bona fide* application of those rules by all the players—especially when they are diametrically unequal—it is imperative to have a central referee to monitor the game. For the EAC common regional investment policy to be effectively implemented, it is suggested that the competence on FDI in the production of goods and services distribution should be entrusted to a central regional authority, the Secretariat. This can be easily be based on the—so far unused—principle of subsidiarity contained in Article 7(d) of the EAC Treaty. Indeed, the EAC Treaty defines subsidiarity as a “principle which emphasizes multi-level participation of a wide range of participants in the process of economic integration”. Of course, this short definition does not do justice to the rich content encompassed by this principle. To grasp this principle to its fullest extent, a leaf needs to be borrowed from EU law where the principle has been debated, clarified and tested in various areas.³⁷

Indeed, in the EU, when it becomes obvious that an action can efficiently achieve its objectives only when it is taken at the supra-national level rather than when it is taken by EU Member States individually or collectively, this forms a compelling argument to transfer an authority to the EU, or for the EU to actually use any competences conferred on it. To assess this efficiency, consideration is given to the scale or the effects of the proposed action.³⁸

The principle of subsidiarity has not yet received any substantial attention in the EAC. However, as experienced by the EU, it can be anticipated that the effective development of the EAC's operational framework will much depend on the applicability of this principle in the future.

As the Partner States' individual promotional campaigns for the attraction of FDI would lead to toxic intra-EAC competition, the most efficient alternative way would be to apply the principle of subsidiarity in order to transfer the competence to promote and, to some extent, to protect FDI, to the EAC

37 See also EU Chapters 2 and 4. Although in the EU the principle is often used to limit the use of a competence, one can also argue that it may be used to justify why the EAC should be presumed to have a competence and is allowed to use it, namely in those cases where the objectives stated by the EAC Treaty can clearly not be achieved at the national level alone.

38 See Article 5 of the Treaty on the European Union.

Secretariat. Obviously, it is foreseeable that some Partner States would resist that competence transfer as, for many, competence of an area as vital as the attraction of FDI could mean loss of national sovereignty. For this, despite the fact that Partner States decided themselves to give up some national sovereignty by the mere fact of joining the EAC, it is important to indicate that there are channels available in the EAC system for such decision-making. As, due to its predominant political character, the Council might be tempted to block such a competence transfer, the EACJ on the other hand has a very strong potential to play a role in furthering the pro-integration agenda. However, instead of putting the EACJ's legitimacy at stake in trying to impose a position that the primary players of the regional integration would oppose, good governance as a principle may help in reconciling Partner States' diverging points of view about the decision to transfer the competence on FDI in goods and services production from the Partner States to the EAC. On this specific issue, it would be sufficient for all Partner States to think about this transfer not from their individualistic national interests standpoint, but rather as a step towards better governance in the EAC. Better governance would be materialized only through the adoption of better regulations and better institutional framework in order to pursue the objectives of the community.

13.4 East African Monetary Union (EAMU)

13.4.1 *Journey to the Adoption of the EAC Monetary Union Protocol*

According to Article 5(2) of the Treaty, the EAC regional integration can be achieved through four milestones: the customs union, the common market, the monetary union and the political federation.³⁹ The first step has been achieved through the EAC Customs Union Protocol in 2005. The others remained in a state of dormancy until August 2007 when the EAC Heads of States decided during the 6th Extraordinary Summit that some extra steps should be taken to further the regional integration process. This Summit took a resolution that a common market and a monetary union were to be established by 2012.

Accordingly, the EAC Secretariat was directed to explore measures for the fast implementation of the Summit's resolutions. This led to the adoption and signature of the EAC Common Market Protocol by the Heads of State on 20 November 2009 before it entered into force exactly six months later on 20 May 2010 upon ratification by all the Partner States. Pursuant to this successful progress, in January 2011, the Council put in place the High Level Task Force (HLTF) with the special mandate to initiate negotiations on a protocol

39 See on these steps also Chapter 9 and EU Chapter 9.

establishing a monetary union. As time evolved, it became clear that having this protocol signed within the timeframe directed by the Summit would be very challenging. The negotiation progress was communicated to the Heads of States during their 11th Extraordinary Summit held on 20 April 2013.⁴⁰

This Summit urged the Council to accelerate the drafting process of the East African Monetary Union (EAMU) Protocol in order to have it ready for signature during its scheduled 15th meeting in November 2013. Following this instruction, the HLTF worked so hard that in July 2013 a consensus was reached on all the articles of the draft EAMU Protocol which was then submitted to the Sectoral Council for approval.

On 25 October 2013, a final legal touch was given by the Sectoral Council on Legal and Judicial Affairs in order to prepare the draft of an EAMU Protocol for the signature of EAC Heads of States, which was done as planned on 30 November 2013.

13.4.2 *Highlights of the EAMU Protocol*

The EAMU Protocol entered into force in February 2015, after ratification by all the Partner States in accordance with its Article 30.⁴¹ EAMU is assigned, pursuant to Article 3 of its Protocol, with the objective of promoting and maintaining monetary and financial stability with the aim of facilitating economic integration in order to attain sustainable growth and development of the EAC.

With the adoption of the EAMU Protocol, the Partner States commit to cooperate in monetary and financial matters, including: harmonization and coordination of their fiscal policies; formulation and implementation of a single monetary policy and a single exchange rate policy; development and integration of their financial, payment and settlement systems; adoption of common principles and rules for the regulation and prudential supervision of the financial system; integration of their financial management systems; harmonization of their financial accounting and reporting practices; adoption of common policies and standards on statistics; and adoption of a single currency.⁴²

40 See in this context also the much longer road to monetary union in the EU, as described in EU Chapter 13.

41 Uganda was the last Partner State to deposit its instruments of ratification with the EAC Secretariat in early February 2015. See C. Ligami, 'Uganda ratifies the monetary union', *The East African*, 7 February 2015, online at <http://www.theeastafrican.co.ke/news/Uganda-ratifies-the-monetary-union/-/2558/2616360/-/g05itfz/-/index.html> (accessed on 23 April 2016).

42 Art. 4 EAMU Protocol.

Article 5 indicates the necessary steps to be taken by the Partner States prior to the monetary union. These include the full implementation of the Customs Union and the Common Market Protocols in order to ensure close integration of their economies through trade, investments, and factor mobility; the harmonization and coordination of their fiscal policies, and monetary and exchange rate policies; adoption of common principles and rules for payments and settlements; harmonization of their payments and settlement systems, and that of their policies and laws relating to the production, analysis and dissemination of statistical information; introduction of bands and gradual fixation of their bilateral exchange rates to facilitate the conversion of the currencies of the Partner states to the East African Currency Unit (EACU); and the integration of their fiscal systems and adoption of common principles and rules for regulation and supervision of the financial system.⁴³

In order to realize an effective monetary union, the Partner States committed—in addition to the prior necessary steps mentioned above—to phase out any outstanding national central bank lending to its government and public entities and to attain and maintain at least for three consecutive years the following macroeconomic convergence criteria:⁴⁴

- A ceiling on headline inflation of 8%;
- A ceiling on fiscal deficit, including grants of 3% of Gross Domestic Product (GDP);
- A ceiling on gross public debt of 50% of GDP in Net Present Value Terms; and
- A reserve cover of 4.5 months of imports.

The Council has full authority to develop measures to ensure regular monitoring, assessment, and enforcement of adherence to the macroeconomic convergence criteria and fostering discipline in the Partner states.⁴⁵ In turn, each Partner State has the responsibility of developing a medium term

43 Art. 5(1) EAMU Protocol.

44 Art. 6(1) EAMU Protocol. For the purpose of meeting the Macroeconomic convergence criteria, Partner States agree to monitor the indicative convergence criteria provided by article 5(3) which are (a) a ceiling on core inflation of 5%; (b) a ceiling on fiscal deficit, excluding grants, of 6% of GDP; and (c) a tax to GDP ratio of 25%

45 Art. 6(2) EAMU Protocol. See however the difficulties caused in the EU by a reliance on political enforcement of budget norms by the Council of Ministers, as discussed in EU Chapter 13.

convergence programme to facilitate the attainment of the agreed macroeconomic convergence criteria.⁴⁶

The EAMU is a progressive process that is set to run for 10 years starting from the entry into force of the EAMU Protocol in 2014. This process will be completed by the adoption of the EAC single currency in 2024, provided everything goes according plan. The name of the EAC single currency will be determined by the Summit at a later stage.⁴⁷ The single currency would be adopted by at least three of the Partner States that meet the prerequisites and the macroeconomic convergence criteria discussed above. Consequently, the Partner States which adopt the EAC single currency will form a single currency area in which that single currency will be the legal tender from a date determined by the Summit upon recommendation of the Council. However, before the single currency becomes the legal tender of the single currency area, the Council will have to fix irrevocable conversion rates at which the single currency will replace the current currencies of the Partner States.⁴⁸

An institutional framework is provided by the EAMU Protocol to mainstream the establishment of the monetary union within the agreed timeframe. The first institution to be established for the purpose of EAMU is the East African Monetary Institute (EAMI) as a provisional institution in charge of the preparatory work for the monetary union.⁴⁹ The EAMI was supposed to be operational in 2015. The EAMI will be shortly followed by the setting-up of the institutions provided for in Article 21 of EAMU Protocol, such as the East African Surveillance, Compliance and Enforcement Commission (EASCEM), the East African Statistical Bureau (EASB), and the East African Financial Services Authority (EAFSA) in 2018. These institutions will carry out various activities and initiate relevant reforms leading to the harmonization of Partner States' monetary and financial policies, laws, and systems until the establishment of the East African Central Bank (EACB) in 2024.

The EACB will be established by the Summit upon the recommendation of the Council in order to perform the functions of a central bank in the single currency area.⁵⁰ It will form, together with the national central banks of the Partner States in the single currency area, a functionally integrated system of central banks, endowed with full independence *vis-à-vis* the Partner States.⁵¹

46 Art. 6(4) EAMU Protocol.

47 Art. 18(5) EAMU Protocol.

48 Art. 19 EAMU Protocol.

49 Art. 23 EAMU Protocol.

50 Art. 20(1) and (3) EAMU Protocol.

51 Art. 20(4) EAMU Protocol.

In this sense, the EACB will be mainly in charge of two things. Firstly, the EACB will deal with the formulation of the single monetary policy, binding on the Partner States in the single currency area, with the purpose to achieve and maintain price stability while contributing to the financial stability and economic growth and development of the community.⁵² Secondly, the EACB will formulate a single exchange rate policy in compliance with the free-floating exchange rate regime chosen for the single currency area.⁵³

It is worth noting that, as far as the financial rights and obligations of the Partner States in the single currency is concerned, Article 20(6) provides that they will be distributed among the Partner States in the single currency area in accordance with the financial key to be determined by the Council and which will be adjusted every three years.

Reiterating, the EAMU entails the formulation of a single monetary policy aimed at achieving and maintaining price stability. The Protocol paves the way for the introduction of a new single currency, which will be the culmination of the EAMU process. *Economic* policy-making competences as such will remain with the Partner States. In the EU, this model of the European Monetary Union featuring centralization of monetary competence while leaving economic policy with the national governments, and relying on mere coordination on their parts, has been criticized.⁵⁴ A single monetary policy for the EAC implies the loss of an important tool for individual Partner States to address country specific shocks: nonetheless, strict adherence to the above-mentioned macroeconomic convergence criteria has the potential to avoid these shocks altogether. Consequently, the introduction of a single currency in the EAC is one of the areas where the EAC should pay careful attention to the experiences in the EU, as it is imperative that it learns from the very costly mistakes that have been made there.

52 Art. 11 EAMU Protocol.

53 Art. 12(1) and (2) EAMU Protocol.

54 See for example Stefaan Van den Bogaert and Armin Cuyvers, "Of carrots and sticks: From sanctions to rewards in Economic and Monetary Union" in Bernard Steunenberg, Wim Voermans & Stefaan Van den Bogaert, *Fit for the Future: Insights on the EU from Leiden University* (Leiden University Press, 2016) (eds) 133.