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The SADC Protocol on finance and investment: background, implications and prospects for deepening regional financial integration in SADC

Yvonne Ruf

1. Introduction

During the August 2006 Summit in Lesotho, SADC Heads of States signed a Protocol on Finance and Investment (FIP). This incidence is a milestone in a process which has now been ongoing for more than ten years, commencing in 1995 when South Africa as a new SADC Member State was assigned to host the Finance and Investment Sector Coordinating Unit, which was mandated to draft a Finance and Investment Protocol.

Together with the SADC Trade Protocol, the FIP constitutes a cornerstone of regional economic integration aiming for the SADC targets of establishing a Free Trade Area by 2008, a Customs Union by 2010, a Common Market by 2015, and a Monetary Union by 2016. It features provisions for increasing cooperation and policy harmonisation in areas such as investment, taxation, financial and capital markets development and macroeconomic policies. The overall goal is to create an environment conducive to attracting intra- and extra-SADC investment flows and to achieve and maintain macroeconomic stability and convergence among SADC countries.

This chapter looks into the evolution, the content and the envisaged goals of the FIP against the backdrop of persisting structural problems of the financial sector in SADC. Section 2 briefly outlines the situation of SADC financial and capital markets and policy frameworks. Section 3 presents the background to the FIP process and the current state of implementation that began a few years ago when respective Memoranda of Understanding, now constituting Annexes to the FIP, were adopted and their provisions put into action. Furthermore, the FIP's contributions to addressing the aforementioned structural problems and regulatory obstacles are discussed. The political economy analysis of the development and implementation

process sheds light on the driving actors and categories of pressure on the FIP process and suggests explanations for the current state of implementation in Section 4. In the light of these insights, the prospects for addressing the regional economic and financial problems with the provisions in the FIP, as well as open questions, are discussed in the conclusion.

2. SADC financial and capital markets /policy frameworks

With independence, most African countries embarked upon a financial reform process to overcome the legacy of financial systems mostly tailored to the needs of their former colonial authorities. This process entailed the appliance of *dirigiste* methods such as directed credit, exchange controls and the nationalisation of banks or even the entire financial system, as was done in Tanzania, Mozambique and Angola (Brownbridge and Harvey, 1998). From the late 1980s, liberalisation and reform in most southern African economies were, and still are, guided by Structural Adjustment Programmes (SAP) under the auspices of multilateral donors -- with the exception of Botswana which never had to borrow from the International Monetary Fund (IMF) due to its mineral wealth and prudent governance stance. Today, the financial systems in SADC countries are fairly liberalised with market-determined interest rates, no prohibitions of foreign bank ownership and virtually full current account liberalisation in most countries.

Despite the reforms, which have been conducted in the region some problems persist: Firstly, the macroeconomic position of many SADC countries is unbalanced. To conduct financial liberalisation and integration reforms in such an environment involves a certain degree of risk as high levels of inflation and large budget and current account deficits undermine the confidence of markets and precipitate currency speculation, especially in undiversified and distorted real economies. As a consequence, strong exchange rate fluctuations increase external government debt. Table 1 provides an overview of the macroeconomic situation of SADC countries and illustrates that high levels of inflation, large budget deficits and a high rate of external debt are prominent characteristics.

Table 1

| | Inflation (CPI), % change 2005 | Government Budget Balance / GDP, % 2005 | Public Debt /GDP, % 2005 | Current Account / GDP, % 2005 | Growth Rate / GDP, % 2005 | Lending Rate, % 2004/5 (Source: EIU) | Net ODA, Total, Mio. US\$, 2004 (Source: EIU) |
|--------------|--------------------------------|---|--------------------------|-------------------------------|---------------------------|--------------------------------------|---|
| Angola | 17.6 | -2.7 | 73.5 (EIU) | 7.8 | 20.6 | 82.0 | 498.7 |
| Botswana | 11.4 | 1.2 | 8.9 | 13.3 | 8.4 | 15.7 | 39.0 |
| DRC | 21.3 | -1.2 | 3.3 | -3.5 | 6.5 | n.a. | 5,381.0 |
| Lesotho | 3.4 | 1.5 | 50.5 | 1.4 | 1.2 | 11.7 | 102.1 |
| Madagascar | 18.4 | -10.1 | 87.0 | -12.1 | 4.6 | 27.0 | 1,236.0 |
| Malawi | 15.4 | -2.9 | 189.0 (EIU) | -26.8 | 2.1 | 36.8 | 1,236.0 |
| Mauritius | 4.9 | -5.0 | 66.2 | -5.0 | 2.5 | 21.0 | 37.9 |
| Mozambique | 6.4 | -2.3 | 70.0 | -1.1 | 6.2 | 21.9 | 1,228.4 |
| Namibia | 2.3 | -1.1 | 33.6 | 8.4 | 3.2 | 10.6 | 179.1 |
| South Africa | 3.4 | -0.4 | 13.3 (EIU) | -4.2 | 4.9 | 10.6 | 617.3 |
| Swaziland | 4.8 | -4.3 | 16.8 | 0.6 (EIU) | 1.8 | 10.6 | 116.6 |
| Tanzania | 4.4 | -5.0 | 79.1 | -7.9 | 6.8 | 15.1 | 1,669.0 |
| Zambia | 15.9 | -2.6 | 137.3 (EIU) | -9.6 | 5.0 | 28.2 | 1,081.0 |
| Zimbabwe | 585.8 | -5.8 | 165.0 | -19.0 | -4.3 | n.a. | n.a. |

Sources: Bank of Namibia: Integrated Paper on Recent Economic Developments in SADC (Oct. 2006) with data sourced from SADC members Central Banks and, where not available, from the IMF; Economist Intelligence Unit Country Reports and Profiles (EIU)

Secondly, the costs of and access to capital remains an obstacle. Interest rates in southern Africa are fairly high and the region suffers from structurally low domestic savings squeezing local investment incentives. Furthermore, borrowers in the international capital markets pay a considerable exchange rate and default risk premia when issuing debt.

Liberalisation policies for the financial sector have enabled the entry of foreign banks into domestic markets, thus increasing competition for local and state-owned banks. South African banks have widely expanded into the region from the early 1990s onwards triggering growth of the financial sector and helping to increase the quality of financial services provided to their corporate clients. Their competitiveness derives from sheer size, international supervisory and capital adequacy standards, regional affinity and from operational support from Johannesburg back-offices with high-standard technological underpinnings. Standard Bank (Stanbic Africa) and ABSA 'most aggressively' expanded to the North through acquisitions of local and foreign banks in the entire SADC region and beyond (Genesis, 2004:78).¹ South African banking services are strongly focused on the wholesale and, increasingly, the retail sector, which reflects the original motivation for their expansion, i.e. to provide

¹ From 1990-2004, South African banks have purchased shareholdings in 33 cases. They are present in every SADC country and now dominate the markets in three SADC countries (Genesis, 2004:97/98).

reliable services to their investing clients in urban areas (Genesis, 2004:67). In contrast, local banks lack efficient technological infrastructure, adequate supervisory and legal frameworks, and offer only poor financial services to the general public. Therefore strengthening the local banking sector by improving legal frameworks, price competition and operational technologies is imperative.

Stock exchanges in the region are generally small and list only few companies with the outstanding exception of the Johannesburg Stock Exchange (JSE). Consequently, the debt markets are still the main (and inadequate) financiers for the long-term financing requirements of corporations. Many stock exchanges face operational inefficiencies precipitated by a lack of technological infrastructure and skills. However, recent privatisation policies have boosted capitalisation of younger stock exchanges in Namibia, Mauritius, and Zambia and it is hoped that foreign investors will contribute to increasing liquidity in the future.

The lion's share of investment flows into the SADC region as well as intra-regional investment flows goes to South Africa. In 2005, total FDI inflows into SADC amounted to US\$ 10,480.1 million of which South Africa attracted US\$ 6,379 million, mainly due to a large foreign investment in the banking sector. The total figure for SADC represents an increase of about 76.8% in relation to inflows from 2004.² Albeit much less in aggregate terms, recent contenders in attracting FDI are Angola, Mozambique, DRC and Tanzania (UNCTAD 2005).³ European firms still provide most of the shares of FDI into the SADC region, followed by South Africa. However, South-South investment from countries outside the region, India and China, is increasing, too. (For an overview of investment trends in the region, see the chapter by Jude Amos in this volume). Investment is considered to be vital for increasing regional economic growth in SADC, and governments in the region have committed to reforming investment policies towards pursuing this objective. However, apart from political factors such as the 'Zimbabwe effect', double taxation, poor and arbitrary administration, exchange and licensing controls, the insufficiency of domestic savings and inadequacy of capital markets present investment hurdles. The absence of

² Data sourced from Bank of Namibia: Integrated Paper on Recent Economic Developments in SADC

³ Inward FDI Stocks as % of GDP in 2004: Angola: 88.8, Botswana: 15.5, DRC: 28.7, Lesotho: 31.6, Madagascar: 11.8, Malawi: 20.4, Mauritius: 15.0, Mozambique: 39.9, Namibia: 32.6, South Africa: 21.7, Swaziland: 39.2, Tanzania: 48.0, Zambia: 55.5, Zimbabwe: 20.7.

strong cross-border investment linkages among SADC countries and the difficulties in developing those due to restrictions on capital flows into other countries of the region pose a disincentive (cf. Jude Amos). In order to foster these linkages, the current legal basis consisting of overlapping bilateral and multilateral investment treaties in SADC must be addressed with the goal of achieving some sort of standardisation and harmonisation for transparency.

Despite the generalised overview, the financial sectors in SADC are heterogeneous. South Africa is the major exception to the problems outlined above with deep and strong capital markets in terms of size, scope and technical sophistication. Other SADC countries feature fairly developed financial markets (Botswana, Namibia, Mauritius) or are currently undergoing rigorous reform (Mozambique), whereas some still require reform, strengthening and deepening if they are to become supporters and drivers of growth and development (Lesotho, Malawi, Zambia, Angola, DRC). Achieving macroeconomic stability as well as increasing investment incentives is imperative for poorer members to reap the benefits of increasing regional financial integration. On a regional level, much remains to be done in the area of standardisation and harmonisation of the legal and regulatory circumstances to attract increasing investment flows.

3. The SADC Protocol on Finance and Investment: Provisions, status of implementation and discussion

Formal cooperation in the SADC finance and investment sector has been ongoing since 1995 when SADC Heads of States allocated the responsibility of coordinating the finance and investment sector to South Africa and mandated the SADC Finance and Investment Sector Coordinating Unit based in the South African National Treasury to coordinate the process of developing a Finance and Investment Protocol to provide strategic guidance for cooperation in this area. With the rationale of ensuring comprehensiveness of a SADC specific approach, but also adequate responsiveness to international trends and developments in this sector, a wide amount of research has been undertaken from the beginning of the 1990s onwards

to inform the process.⁴ The first draft of a Finance and Investment Protocol from 1994 was considered to be too sophisticated and was rejected by Member States as it required a more advanced stage of economic integration with strong and effective institutional mechanisms for the benefits to materialise; preconditions which did not exist in SADC then. Hence, contrary to the 'top-down' development process embarked upon with the SADC Protocol on Trade, Member States agreed to opt for a 'bottom-up' approach entailing consensus building, drafting and endorsing of various non-binding Memoranda of Understanding (MoU) in respective finance and investment sectors and commencing with their implementation. The involvement of stakeholders from official and private sectors of the financial realm ensured that the process would be 'industry-owned' and responsive to the needs of the region⁵. Following subsequent steps, the general framework of a protocol was developed and the MoU have now become integral parts of the protocol as Annexes of which the legally binding FIP boasts eleven.⁶

The overall goal of the FIP is to 'foster harmonisation of the financial and investment policies of the State Parties in order to make them consistent with objectives of SADC and ensure that any changes to financial and investment policies in one State Party do not necessitate undesirable adjustments in other State Parties' (FIP Article 2). In order to achieve this goal the FIP shall facilitate regional integration, cooperation and coordination within the finance and investment sectors.

⁴ In 1993 the African Development Bank produced a report on general Economic Integration in southern Africa; in 1996 CIDA financed various studies on Private Investment and Development in the SADC Region. A macroeconomic policy report looking into the state of convergence was completed by C. Jenkins and L. Thomas in 1996. In 1998, an EU funded study encompassing three separate reports was adopted by Ministers. This Report touched on (1) Macroeconomic Convergence; (2) Investment; and (3) Development Finance. Finally, and to support the process of developing the FIP, USAID funded a consultancy lead by Professor Joseph Norton, to provide guidance on an appropriate approach to negotiating such a protocol. The report, entitled "Strategic Issues Report on a New SADC Protocol on Finance and Investment" recommended a bottom-up approach to negotiating the FIP through consensus building MOUs (Ros Thomas).

⁵ Information obtained during an interview with Dr Rosalind Thomas in Gaborone, October 2006.

⁶ Cooperation on Investment; Macroeconomic Convergence; Cooperation in Taxation and Related Matters; Cooperation and Coordination of Exchange Control Policies; Harmonisation of Legal and operational Frameworks; Cooperation on Payment, Clearing and Settlement Systems; Cooperation in the Area of Information and Communications Technology amongst Central Banks; Cooperation in Respect of Development Finance Institutions; Cooperation and Coordination in the Area of Banking Regulatory and Supervisory Matters; Cooperation on Non-Banking Financial Institutions and Services; Cooperation in SADC Stock Exchanges.

Taking a closer look, the eleven Annexes can be categorised as four general FIP components. Since these have been individually developed over time, the status of implementation of the areas of FIP varies considerably.

3.1 Investment

With regard to investment, the FIP stipulates that Member States shall coordinate and 'pursue harmonization' of their investment regimes to create favourable and predictable national and regional conditions to attract extra- and intra-SADC capital inflows and market the region as a 'SADC investment zone' (Annex 1, Art. 19). Provisions are made to eventually harmonise Member States' domestic policies to allow most favoured nation treatment to granted investors of the third state, with general exceptions for preferential treatment included. Local as well as regional entrepreneurs shall be promoted. Commitments to investment protection provisions are made, with nationalisation or expropriation allowed for public purposes only provided legal remedies on national, regional and international level are sought in the process. Disputes (also investor-to-state) shall be addressed before national, regional (SADC Tribunal) and international (ICSID, UNICTRAL) courts. The FIP recognises the role of investment promotion agencies and envisages cooperation with regard to exchange of information on updates of the investment regimes, including incentives. Furthermore, a competition policy in the region shall be advanced.

Are these commitments strong enough to increase investment in the region? They feature characteristics of the 'new generation' investment agreements (UNCTAD 2006) including provisions on health, environmental and safety measures.⁷ Although investment protection is granted and dispute resolution provided for in the FIP, it remains to be seen how many exemptions 'for public purposes' there will be and how effective the national and regional courts and tribunals will be to ensure timely resolution of cases, especially in face of a rising incidence of disputes due to more complex and unspecified agreements. The SADC tribunal is not functional as yet and terminology referring to exemptions, standards and 'fair and equitable treatment'

⁷ They specify that a relaxation of existing national measures for the purpose of encouraging investment is 'inappropriate' (Annex 1, Art. 13).

remain undefined in the FIP. Contrary to the majority of International Investment Agreements, SADC Member States have not gone so far as to ensure national treatment of investors. To date, the treatment of investors is first and foremost based on national laws of the SADC Host State, which are non-transparent and cumbersome to access for potential investors. The overlapping bilateral investment treaties among SADC Member States and of Member States with third States remain a challenge to investors.⁸ In this light, the proposed creation of a SADC investment database⁹ and the envisaged harmonisation of investment policies are good progress. Compared to international standards the FIP investment commitments are weak, but taking into account the great heterogeneity of national investment regimes existing in SADC countries, the attempt to cooperation and harmonisation in selected areas is commendable. If the commitments are being implemented they will promote a more predictable and transparent investment climate and thus represent a great step towards increasing the ease of investing in the region.

However, implementation in this area has not taken off as yet. Meetings of the Investment Sub-Committee responsible for implementation and guidance in this area have taken place very irregularly, the last one in August 2005 when the then Investment MoU was adopted. To date, these commitments of the FIP are still an intention on paper.

3.2 Tax

The SADC regional approach in the areas of taxation and related matters firstly addresses matters of transparency and predictability by establishing a publicly accessible SADC Tax Database.¹⁰ Capacity-building programmes for tax officials shall smoothen administrative hurdles and modernise structures in the region.

⁸ According to the UNCTAD Investment Database there existed 58 bilateral investment treaties in southern Africa in 2004.

⁹ Including information on: the existence of investment laws and policies, competition policies, intellectual property rights, application of various types of taxation in relation to investment, different types of incentives offered by the State, legal procedures and framework in relation to the investor, issues of land rights and ownership, trade issues in relation to investment, requirements for starting a business, dealing with licenses, employing workers, registering property, getting credit, laws to protect investors, enforcing contracts, closing a business. Unfortunately, the Investment Database is not captured in the FIP but is currently being discussed by the respective Sub-Committees.

¹⁰ It includes details for each Member State on: all direct taxes, all indirect taxes and levies, all tax incentives, all Tax Agreements as well as statistics on revenue collection.

Furthermore, Member States agree to achieve a common approach to tax incentives, to avoid harmful tax competition and to harmonise their indirect tax regimes and administrations for excise duties, VAT and sales taxes. Increasing the network of bilateral Tax Agreements according to a SADC Model Tax Agreement shall provide for a more comprehensive and consistent legal framework for investors in the region.¹¹ An upcoming special meeting of SADC Ministers of Finance will, for the first time, address in a regional forum issues of direct and indirect taxation. Considering the political sensitivities remaining in an area related to the fiscal sovereignty of Member States the commitments made represent progress as they first and foremost increase the required transparency and predictability for investors.

Implementation of this area is progressing, albeit fairly slowly. The Tax Database is accessible via the official SADC website but it urgently requires updating. There has been considerable progress in the area of capacity building with events taking place throughout the year, and research as well as policy dialogue events have been ongoing for cooperation in the area of tax incentives. However, commitments have been put in place on the national level and countries have seemed to withhold buy-in. A significant step has recently been taken with the decision to convene a two-day Finance Ministers' Meeting (Lekgotla) to discuss issues revolving around implementation. It is the first time in SADC's history that the issue of taxation will be discussed exclusively on Ministerial level during a meeting. The Tax Sub-Committee and its technical working groups meet regularly twice a year and drive the process with support from a technical advisor in the SADC Secretariat.

3.3 Macroeconomic convergence

Although Member States have not made a binding commitment to establish a monetary union, it is mentioned as an explicit goal in the Regional Indicative Strategic Development Plan and the FIP. Arguably, the first step into this direction has been taken by the commitment of Member States to achieve convergence on stability-orientated macroeconomic policies. In practical terms, Member States have agreed to achieve four macroeconomic indicator targets within a set time frame:

¹¹ According to the UNCTAD Investment Database there existed 78 Double Taxation Treaties in Southern Africa in 2004.

| | 2008 | 2012 | 2018 |
|-----------------------|------|------|------|
| Inflation (CPI) | <9% | <5% | <3% |
| Budget Deficit / GDP | <5% | <3% | <1% |
| Current Account / GDP | <9% | <9% | <9% |
| Public Debt / GDP | <60% | <60% | <60% |

Member states are currently developing national macroeconomic convergence programmes to achieve these targets over the next years. A Peer Review Panel supported by a Macroeconomic Monitoring, Surveillance and Performance Unit at the Secretariat shall evaluate progress, make recommendations and report to the SADC Ministers of Finance. Preparations for the establishment of the operationally independent Unit are ongoing at the Secretariat.

These appear to be far reaching commitments in theory, but only preparatory steps have been undertaken as yet on a regional level. As regards the Panel, Ministers of Finance have endorsed the establishment of this institution and the process of appointment of members shall begin in the near future. The preparations are progressing, but at a very slow pace, which is mainly due to the fact that the Macroeconomic Subcommittee has not met regularly in the past.

While it is acknowledged that macroeconomic convergence supports the goals of a free trade area, which SADC plans to achieve by 2008, there remain critical issues to consider: The small, open and undiversified SADC economies are heavily exposed to asymmetrical shocks in demand. The fixation on inflexible macroeconomic targets may hinder governments from buffering the consequences of these shocks with more flexible policy instruments, and hence, may turn out to be impediments to achieving the growth rates required towards reaching the Millennium Development Goals (7% per annum). The strict adherence to macro convergence targets may entail political costs diminishing the prospects for further integration. However, rather than 'convergence on stability orientated policies' such strictness is only required if a monetary union is the immediate target, and since that is currently not the case a flexible approach to the programme will foster macroeconomic stability but still allow countries to adequately respond to short-term difficulties.

Some Member States have come forward in the recent past (Lesotho, Swaziland) signalling their discontent with the indicators targeted: The public debt/GDP indicator is insufficiently significant in terms of the kind of public debt (external or internal / commercial or concessionary) and its implications. A 60% rate of public debt is less problematic for countries eligible to concessionary loans or countries with a mostly domestic debt stock, as they are not as prone to exchange rate shocks which potentially increase the debt burden. Furthermore, measuring the burden of debt service to assess the sustainability of public debt is an indicator used by the Highly Indebted Poor Countries (HIPC) Initiative and presents a more significant alternative for the SADC convergence programme.¹² Besides refining the public debt/GDP indicator it is desirable to also review the budget balance/GDP indicator and specify with regard to issues such as whether it includes grants and what kind of spending is undertaken.

The majority of Member States are within range of the target indicator for the first phase (2008) and the macro convergence undertaking can provide a useful peer review mechanism. However, outliers such as Zimbabwe present challenges to the credibility of such an undertaking especially since it is not yet decided how to deal with non-performing countries – ‘sanctions’ are not envisaged.

3.4 Financial and capital markets

This component comprises commitments and activities aiming at developing, strengthening and deepening financial and capital markets through standardisation and harmonisation. Mandated with the implementation of these Annexes the below-mentioned institutions have been established between 1995 and 1998 and have greatly contributed to the modernisation and improvement of financial markets, services and regulators in the region.

The Committee of Central Bank Governors in SADC (CCBG) and its sub-committees work towards enhancing the cooperation, transparency and efficiency of Central Bank operations in the region. Among others, this entails the harmonisation of

¹² Net present value (NPV) of debt service / exports. The debt burden is considered sustainable if the ratio is below 150%.

national payments, clearing and settlement systems in order to ensure the smooth and timely settlement of banking operations according to Real Time Gross Settlement principles across SADC. The payments system is in operation in nine SADC countries.

The Sub-Committee on Exchange Controls supports the envisaged liberalisation of current and capital account transactions amongst SADC member states, as well as the achievement of full currency convertibility by monitoring and producing recommendations on the progress in SADC member states.

In preparation for the envisaged SADC Central Bank, the Legislative Sub-Committee produced a model Legislation, which enshrines principles and objectives such as price stability, operational independence as well as transparency and accountability. This is a very progressive step, since most of the SADC Central Banks are not fully independent.

In order to ensure banking regulatory and supervisory systems based on internationally accepted principles, the Sub-Committee of Banking Supervisors is mandated to enhance cooperation and coordination among SADC Central Banks to establish a framework for a regional approach to this matter.

The overall objective of the Committee of SADC Stock Exchanges (COSSE) is to establish an integrated real time network of national securities markets in SADC. It also undertakes initiatives to enhance capacity through training, to increase the exchange of information and to facilitate cross-border listings and trading to enhance the liquidity of stock exchanges. In 2000, COSSE achieved the harmonisation of listings requirements across SADC stock exchanges according to the internationally recognised standards of the JSE. The latter also provides technical assistance to other stock exchanges. Recently registered dual listings in Zambia, Tanzania, Namibia and South Africa are considered by the deputy Chairman as preliminary signs for the success of COSSE's strategy.

The Committee of Insurance, Securities and Non-Bank Financial Authorities (CISNA) supports the establishment of regionally harmonised regulatory regimes and

practices according to internationally acknowledged standards in SADC non-banking financial systems with the ultimate objective of increasing efficiency and investors confidence.

In order to facilitate cooperation with regard to development projects in the SADC region, the Development Finance Institutions Network (DFI) has recently become active through its implementation structure, the Development Finance Resource Centre (DRFC) established in Gaborone. Work is ongoing in the area of resource mobilisation and capacity building for members of the DFI. Complementary to this initiative, SADC is currently looking into the possibility of establishing a Project Preparation Development Fund assisting in the identification and preparation of bankable regional projects as well as a SADC Development Fund.¹³

Although it is not yet formalised with a MoU and as an Annex to the FIP, the work of the SADC Banking Association (SADCBA) facilitates the involvement of commercial banks in regional matters. It conducts capacity building and skills development projects for good banking practice among banks in the SADC region. Also, an Annex on Money Laundering is under preparation.

The technical Committees, especially in the area of financial and capital markets development have progressed well with implementation of various Annexes. As regards investment, macroeconomic convergence and taxation, the picture looks rather different.

4. The political economy of the FIP Process

Why has implementation progressed fairly well in some areas of the FIP and less so in others? In answering this question, we consider the role of interests, ideas and institutions as suggested in political economy and regional integration theory. The process of financial integration in SADC is promoted by various actors with specific interests, by institutions, by underlying market forces and by ideational factors, deriving from the international and domestic level.

¹³ The development of an Annex for this area is ongoing.

4.1 External influence

Regional integration in Southern Africa is inspired by the success of the EU and, at the same time, it is an attempt to construct a new regional self in order to counteract the increasing marginalisation within the global economy. The global trend to economic and political projects of regionalism, which has gained even further momentum with the failure of the WTO Doha Round has not gone by southern Africa. SADC is deeply embedded within the Pan-African ideational consensus on striving for 'Africa-oriented' self-help and peer group coordination, manifest in initiatives such as the New Partnership for Africa's Development. With regard to the realm of the FIP, the goal is nothing less than moving away from external macroeconomic planning and policy reform through the Bretton Woods Institutions, to establishing home-grown programmes which enable self-appraisal through an internal peer review rather than relying on external surveillance.

This process, however, is not as straightforward. On the one hand, there is a tendency in SADC to resist any indication of outside pressure and of a 'copy and paste' model, as illustrated by the explicit 'bottom-up approach' to the FIP. On the other hand, SADC has not departed much from the policy recommendations of the WB/IMF and the model of the EU, as illustrated by the selection of the macro convergence indicators, which very much correspond to the so called 'Maastricht Criteria'.¹⁴ This is, at least partly, attributable to the fact that many SADC member states and SADC projects under the FIP depend on donor funding. Structural Adjustment Programmes (SAP) are, or recently have been, ongoing in Angola, DRC, Lesotho, Malawi, Mozambique, Tanzania and Zambia. Bilateral and multilateral donors currently fund and technically support a large part of the ongoing and envisaged projects directly under the FIP.¹⁵ Also, individual national macroeconomic convergence programmes introduced above will have to be streamlined with the

¹⁴ The macroeconomic convergence targets for countries within the European Monetary Union in order to maintaining price stability in the Euro Zone: Inflation rate (<2.5%), Government Deficit / GDP (<3%), Government Debt / GDP (<60%), Long-Term Interest Rates (<7.9%) (Article 121(1) Treaty of the European Community).

¹⁵ The European Commission has earmarked €16.0 million for a Support Programme to the FIP implementation. DFID is currently financing two technical advisors to support the FIP coordination and implementation. Germany provides technical assistance to the macroeconomic area under the FIP and has allocated €4.8 million to support the establishment of the Project Preparation Development Fund. The AfDB has pledged €54.1 million for institutional support for establishing the MSPU.

demands of the SAP where applicable. Although the SADC Secretariat and especially Least Developed Country Member States are dependent on donors, and will be in the near future, the macroeconomic stability undertaking is an attempt at self-help and self-responsibility. For obvious reasons, it will not marginalise institutions such as the WB and IMF but, ideally, complement and potentially improve the multilateral programmes while fostering ownership.

4.2 Interests of Member States

The interests of different member states are central to determining the shape, content and progress of regional integration initiatives. Theory suggests that a higher number of members (Olson, 1965) as well as heterogeneity (Haggard, 1997) complicates the formation of a regional integration undertaking since, arguably, their preferences and priorities diverge. Member States on a higher level of economic development (with deep capital markets, a sophisticated and competitive domestic banking system, a regulatory regime according to international standards and a balanced macroeconomic position) are likely to prefer broader and deeper liberalisation and integration, since they feature the necessary preconditions and competitiveness to reap the potential benefits. On the other hand, countries at a lower level of economic development are likely to be more critical towards such integration in order to shield their economies from competition, market pressure, volatile capital flows and external price shocks while supporting domestic development.

The great heterogeneity among SADC members suggests a divergence of interests. Such divergence, however, does not exist with regard to the FIP financial and capital markets reform component: benefiting from expertise, weaker countries hope to approach a higher level of technical sophistication. Many of the approved standards and techniques in South Africa serve as sources of orientation for reforms in other SADC countries. The activities in COSSE, CISNA and SADCBA illustrate that South Africa has a lot to share with the region and reliably commits to doing so with the ongoing capacity-building projects. The benefits accruing from technical cooperation to modernise financial and capital markets can be pinpointed and signify quick-wins.

Furthermore, they are achievable without having to surrender policy-making sovereignty.

As regards other FIP components, such as taxation, investment and MEC, the situation is more complex. Commitment to the objectives in these areas requires comprehensive, costly and protracted policy and administrative reforms if they are to materialise. A harmonised taxation and tax incentives regime is, arguably, not in the interest of countries which are currently attracting investment with comparatively low and concessionary taxation rates (Botswana, Mauritius), and it is extremely costly to implement for weaker taxation regimes (Angola, DRC, Tanzania and Zambia). Also, cooperation on taxation remains a contended issue as member states regard the retention of fiscal policy-making sovereignty essential to ensuring the revenue base of governments. Fiscal policy instruments such as VAT, excise duties sales, taxes, and so on have only been introduced fairly recently, since the mid-1990s, in SADC economies. In this light, the convening of a Ministers' meeting to exclusively discuss taxation issues is an illustration of commitment to the FIP per se. As regards the macroeconomic convergence component, the necessity for smaller SADC economies to retain fiscal and monetary policy flexibility to buffer economic shocks and promote economic growth, rather than achieving fixed targets, has been mentioned above. The benefits of macroeconomic convergence, of a harmonised investment and taxation system and other areas in the FIP may be a long way down the road, especially for small economies.

Implementation in these FIP areas requires significantly more political commitment. However, political commitment is difficult to raise when the benefits of integration are not clearly tangible. To date, little comprehensive (quantitative and qualitative) assessment of the envisaged impact of regional financial integration and macroeconomic convergence on economies of respective Member States has been finalised and the various ongoing studies have not been informing policy debates on the national and regional level -- yet.¹⁶ The signing of the FIP has come under the condition that a recently established SADC Task Force comprising of Ministers of

¹⁶ GFA/GTZ through TIFI has commissioned studies on the national macroeconomic convergence programmes of Member States of which the results fed into the development of these programmes on national level of SADC Member States. Friedrich Ebert Foundation is undertaking a comprehensive research project on the expected impacts of SADC macroeconomic convergence. The Norwegian Christian Michelsen Institute has

Finance and Ministers of Trade develop solutions and financial mechanisms to address specific needs of smaller SADC economies pertaining to the FIP implementation and also to the envisaged establishment of a Customs Union. The latter is not covered in the FIP, but as the Extraordinary SADC Summit in October 2006 has proclaimed to expedite regional economic integration towards a Customs Union it is increasingly becoming an issue of concern for SADC Member States, especially for those countries whose government budgets depend heavily on income from tariff collection (for Lesotho and Swaziland about 50%).

4.3 Institutions

The role of regional institutions was firstly examined by early functionalists (Ernst Haas and David Mitrany) looking at integration within the European Union. They argue that, once an integration process has been embarked upon, an automatism of spill-over effects demands ever-deeper integration, thereby promoting the establishment of regional institutions. More recent theory moving along functionalist lines emphasises the driving role of institutions in integration due to their independent internal dynamics and their ability to counteract market failures, to reduce collective action problems, to foster compliance, to monitor implementation and, thus, to enhance the equitability of the distribution of benefits (Mansfield/Milner, 1997).

The institutions involved in the development and implementation of the FIP are the Committee of Senior Treasury Officials and the Committee of the SADC Central Bank Governors, both reporting to the Ministers of Finance. Various technical Sub-Committees report to both of the abovementioned institutions and perform the actual work in terms of implementation. Taking a look at these institutions shows that assumptions made by scholars hold truth to a certain degree. The cases in point are institutions such as CCBG, COSSE, SADCBA, CISNA and DFRC which successfully foster integration and drive implementation in their respective fields of action with two major competitive advantages over other SADC institutions: firstly, they are relatively well equipped with resources and staff, and secondly, they are relatively independent

also commenced a research process on various sectors of SADC integration. A regional stakeholder (regional and national public sector, private sector actors, NGOs, academia) conference scheduled for the early 2007 will debate the preliminary results of the studies and look into the way forward for dissemination of results.

of regional and national government structures. Their secretariats are well resourced, located in and sponsored by their respective South African member institutions, the exception being DRFC. The DFRC has the strong support of the three biggest DFIs in the Network, who carry the bulk of its financing requirements because of the formula used to determine the respective contributions of members. Accordingly, these institutions develop their own implementation plans, their internal decision-making processes are short and their funding is adequate. These technical committees have developed an internal life of their own and become true, efficient and reliable drivers of the FIP process.

On the other hand the respective Sub-Committees for Investment, Taxation and Macroeconomic Convergence are constituted of stakeholders from government institutions within SADC member states and depend on impulse from the SADC Secretariat. Progress in these so-called 'Government Committees' (Bester, 2004) is very slow mainly due to, firstly, the lack of a functional and independent secretariat as well as adequate budgeting and, secondly, due to the abovementioned political sensitivities in these areas of cooperation.

SADC does not budget for their activities and a lack of funding is one of the main reasons why meetings have not taken place. The Tax Sub-Committee presents an exception as their meetings and activities are conducted with technical and financial support from donors. Lacking an independent secretariat, these 'Government-Committees' depend on input from the SADC Secretariat, which is currently still severely under-resourced. The prior SADC executive organ for the FIP process, which was hosted by the South African National Treasury, was moved to the SADC secretariat in 2001. Only one of 10 former staff members moved to Gaborone into the new structure, thereby diminishing the institutional memory. Aggravatingly, this loss has not been compensated with a reasonable topping-up of FIP related staff at the Secretariat, which reflects the focus on trade liberalisation within the Directorate for Trade, Industry, Finance and Investment: the three SADC posts related to the coordination of the FIP are vacant as of now and currently being bridged by staff with rather different professional backgrounds and expertise than the finance and investment sector. They are supported by two donor-funded advisors. Although the

vacant posts have been budgeted for, bureaucratic processes and a lack of suitable candidates are hampering the finalisation of the ongoing recruitment process.

The recent restructuring process in SADC has not cut down on costs of regional integration for Member States, as initially envisaged. This is mainly due to a growing regional agenda which the Secretariat is overburdened with, considering its current resources. With the exception of the technical committees, SADC is a case in point for the claim that regional integration initiatives in Africa are characterised by a high degree of institutionalisation, which does not necessarily positively correlate with their output (Mistry, 2003). The consequences resemble a vicious cycle: inefficient regional institutions depend on political commitment, but at the same time undermine it since Member States increasingly question the competences of the Secretariat to foster integration and question the effectiveness of the allocated resources. However, the recent SADC Extraordinary Summit has introduced a significant change: provision has been made to expedite the recruitment process in the SADC priority area economic integration and it is currently being made use of in the Directorate for Trade Industry Finance and Investment (TIF) where two new positions have been recruited in the last weeks. Further positions are being budgeted for the financial year 2007/8 as well as additional resources allocated to TIFI, which boosts its capacities to become a proactive driver of regional economic integration in the future.

Looking at domestic institutions to support the FIP: the respective national counterparts in the government committees driving the FIP are mostly full-time staff in national member states' institutions and burdened with the regional workload additional to their national responsibilities. Diverging national priorities, political sensitivities, cumbersome decision-making processes and communication gaps in their home-government institutions have so far hampered necessary impulse and support in the abovementioned areas. However, one also needs to take into account that institutions of some SADC Member States (especially LDC) mandated to work on regional integration issues are already burdened with their relationship to WB, IMF and other bilateral and multilateral agencies.

4.4 Market pressure

Regional integration in southern Africa is being pursued with the *raison d'être* that integration would counteract the threat of being left behind in an increasingly integrated world economy wherein many African countries are being marginalised. With regional liberalisation and reform processes at the forefront, SADC is an attempt to create a common economic area with more attractiveness in order to increase the integration of Member States economies into global markets. Trade and financial liberalisation on a regional level creates larger markets, increasing opportunities for economies of scale, cross-border value chain development and diversification of the production structure, thus leading to increasing intra-regional trade and investment opportunities as well as increasing extra-regional capital flows into these markets. With the endorsement of the FIP SADC Governments 'signal' to investors that they commit to liberalisation and macroeconomic reform processes by binding themselves to regionally agreed policies and approaches.¹⁷

States' interests are the result of a domestic bargain between different non-state interest groups and the government. The internationalisation of economic flows, precipitated by regional integration initiatives, entails distributive consequences for these domestic groups, and consequently changes their lobbying incentives. According to the degree of collective action and organisational problems, the envisaged beneficiaries of certain economic and integration policies will mobilise and lobby for their cause on a regional as well as national level if channels for influence are provided for. The most competitive actors will push for liberalisation by pressurising their home governments. Regionally competitive domestic business groups lobby for regional rather than global integration in order to reap the benefits of increasing returns to scale, while simultaneously being shielded from global competition (Chase, 2003).

¹⁷ This phenomenon has been introduced and examined in other cases by Haggard and Maxfield (1996) and is a distinct feature of the 'new regionalism', which encompasses the wave of regional integration agreements emerging from the mid-1980s onwards and goes substantially beyond covering issues of tariff liberalisation to including policy reform in various sectors (Mansfield and Milner, 1999).

On SADC level, domestic business expanding into the region is a major source of market pressure for the FIP process. This refers especially to the South African private sector that is a key market driver for regional integration, and also for the FIP. The South African retail sector has expanded considerably in search of new markets in the last years. South African financial institutions expand into SADC member countries, entering new markets and reaping benefits from their regional competitive advantage, since being relatively less competitive on a global scale (WTO, 2006).

As the private sector plays such a key role in regional economic integration issues coordinators responsible for the development and drafting of the MoU on investment have taken care to engage regionally organised private sector actors, such as the Association of SADC Chambers of Commerce and Industry (ASCCI), and their delegates have been actively involved in the drafting process. However, in the recent past, the private sector has not been sufficiently involved in the development and implementation of other FIP related areas. Despite the benefits the private sector stands to gain, it has not proactively engaged in concrete lobbying on a regional level for initialisation or support of the ongoing activities within the FIP framework, such as for the initiatives of the COSSE and the SADCBA. Both institutions are so-called 'private sector initiatives' (Bester, 2004a:80) but their establishment goes back to impulse from the CCBG, which recognised the necessity and the potential of involving their commercial counterparts. According to COSSE's Chairman, the institution 'sells' the undertaken capacity building activities to its stakeholders, the listed companies. There is neither proactive involvement nor are most JSE listed companies aware of the activities undertaken. The lack of proactive engagement through regional fora is due to a lack of viable regional channels for advocacy and communication. Although a SADC Business Forum has recently been established to strengthen the relationship of the private sector in the region and the SADC institutions, operational links and mechanisms for cooperation require establishment and consolidation and national level advocacy presents a more viable alternative for now.

The general interests of South African business are communicated and furthered through domestic channels such as the Business Unit South Africa. With financial services accounting for about 20% of the South African GDP and being the third export champion into the region after extraction industries and telecommunications,

the sector does play a significant role for the South African economy. Accordingly, the link between South Africa's corporate (financial) sector expanding into the region and government institutions, which actively promote this expansion, is strong. Whereas CCBG activities might be technically useful, government-level initiatives, such as promoting the removal of legislative, regulatory and infrastructural barriers among the partner countries in SADC are of primary importance to achieving the environment conducive to South African investment in the region. Accordingly, the National Treasury is identified as the main driver of the FIP process by most of the experts. With the abovementioned hosting of the FIP executive organ within the National Treasury, historically, South Africa enjoyed a disproportionate influence and the fact that the development of the entire process was, until 2001, coordinated by the South African Treasury, explains that it is, by nature, identified as being in the driver's seat.

Private sector actors in other SADC member states have also been only minimally involved recently. Considering the fact that many members of the SADCBA and the COSSE can substantially gain from projects in these institutions, it is striking to learn that their stakeholders, the banks, and listed companies play a rather passive role, too. The most prominent reasons for little involvement are firstly, the existence and utilisation of more efficient national channels considering the necessary resources to engage on a regional level, and secondly, the low levels of awareness of the costs and benefits of regional financial integration among the small and medium-sized private sector in many, especially poorer SADC countries. Whereas the benefits of the FIP might be more tangible to the regionally competitive South African and Mauritian business sector, they have not been quantitatively identified for all economies of SADC Member States.

Summing up the explanation of driving forces behind the FIP, the below matrix illustrates the current state of financial integration in SADC and reflects explanatory factors. Evidence of external influence and market pressure driving the FIP has been presented above.

Due to a favourable combination of factors, significant progress in the area of financial and capital markets reform has been achieved (Quadrant 1): the

implementing technical institutions are strong, interests in this area converge, gains are fairly quick and tangible and the national policy-making sovereignty remains unconstrained. In contrast, progress in the areas of investment and macroeconomic convergence is lagging (Quadrant 4). The government-supported institutions responsible for implementation of these areas lack political, technical and personnel support and are thus severely hampered in their important role as drivers. Furthermore, interests diverge, the gains materialise in the long-term and commitment requires the constraint of policy-making sovereignty. As illustrated in Quadrant 2, implementation in the area of taxation is lagging but progressing faster than in other 'Government Committees' due to strong leadership from the institution and donor funding supporting implementation and compensating for the unfavourable factors of the equation.

| | Quick and tangible gains | Long-term and/or intangible gains | |
|------------------------------------|--|---|--------------------|
| Strong institutions/ Leadership | 1 Advanced implementation <i>FIP financial and capital markets component</i> | 2 Implementation progressing slowly <i>FIP taxation component</i> | Interests converge |
| Weak institutions/ Leadership | | 4 Lagging implementation <i>FIP investment and MEC components</i> | Interests diverge |
| | Policy-making Sovereignty unconstrained | Policy-making Sovereignty constrained | |

Market pressure is the main driver for regional integration in SADC. South African business, long before the FIP, has pursued its economic 'Great Trek' (Söderbaum, 2004:85) into the region, and it will carry on doing so. Like SADC itself, the FIP is a political project driven by state actors, especially from South Africa, who envisage the facilitation of capital flows into and across the region as well as the locking-in of domestic policy reforms. However, the FIP and open questions relating to its implementation also constitute an effective instrument for SADC Member States to

design the approach to regional financial integration according to their special needs and to bind South Africa to commitment and support.

5. Conclusion and outlook

The FIP is a milestone in SADC regional integration, constituting the second pillar to furthering economic integration in SADC, which is increasingly showing as a focus of regional undertakings by Member States, as the 2008 deadline for the establishment of the Free trade area is looming ahead. Its provisions do not only address the abovementioned structural problems persisting in financial and capital markets in some SADC member states but also provide a comprehensive approach to increasing the attractiveness of SADC as a target for international capital flows and investment with its element of cooperation towards harmonisation and standardisation of the legal and technical background. From a technical and a political point of view, a regional approach to financial sector reform in Member States is indeed viable, and can serve as a model for other regions. The assistance of a fellow SADC Member State may be more acceptable than multilateral (IMF/WB) support, since its approaches are more sensitive to regional specific circumstances. A regional stance towards investment and macroeconomic reforms fosters ownership and potentially increases efficiency. To date, however, many member states lack the political commitment as well as the capacity for the implementation of such steps. The analysis has also shown that considerable capacity constraints exist on a regional level within the various committees to drive implementation. The SADC Secretariat is currently not fit to perform the role of a proactive driver of the FIP implementation. Hence, strengthening of institutions on a regional and national level is critical and a primary step to ensuring implementation of the FIP. As mentioned above, important steps and improvements seem to be underway with regard to the strengthening of TIFI.

Besides the lack of capacity for implementation, there remain other important questions to be addressed. Firstly, there is an urgent need to identify and quantify as reliably as possible the costs and benefits of FIP and its implementation for all SADC Member States. This will enable SADC countries to take better informed decisions and thus foster the reliability of political commitment pledged to the implementation

process. It also serves to inform and engage the private sector better into the FIP process by identifying potential for growth and estimates for increasing competition in sectors of the economy. Besides the desirability of creating a 'think tank' for regional economic integration in SADC, mechanisms must be identified to feed in the research and policy recommendations to the policy-making levels of Member States. An institution could be created which serves as reference point and impetus/input provider for a broader policy discussion within Member States, on a regional level and within the SADC Secretariat in order to discuss regional integration goals on a strategic level.

Secondly, there exists need to create a mechanism for ensuring the ratification procedure and integration into the national legal system of the FIP. As this volume reflects, the status of ratification of SADC Protocols is problematic and reflects the low degree of readiness within Member States to follow through the commitments made with signature. Issues of FIP ratification and implementation will be addressed on a political level through the recently established task force comprising SADC Ministers of Finance and Trade. Accordingly, the Secretariat should be empowered to engage in a technical dialogue with Member States and to provide sophisticated backstopping to the political dialogue. Within the Member States, a focus institution needs to be identified which ensures FIP ratification, national legislative and regulatory change and communication with the SADC Secretariat. It shall also provide capacity building for implementation and conduct impact assessment studies of the FIP.

Furthermore, issues remaining with regard to the macro convergence undertaking require attention and clarification: the target indicators need to be revisited, ongoing implementation and reporting structures need to be established and principles for the Peer Review and the approach towards non-performers require concretisation. This element of the FIP as well as the envisaged creation of a SADC Customs Union requires a high degree of political support. Although the wording 'compensation' is not explicitly mentioned in SADC Protocols or records, the concerns of countries highly depending on tariff income need to be addressed, as it will foster political commitment to fast tracking the regional economic integration agenda and moving further towards the establishment of a Customs Union.

The SADC macro convergence undertaking supports regional integration and the attraction of capital flows. However, experts conclude that other issues, such as accelerating trade integration to achieving a free trade area within the next two years and the issue of overlapping membership remain a greater priority than achieving macro convergence¹⁸. Hence, broader SADC integration goals cannot be lost out of sight and linkages between the Trade Protocol and the FIP need to be monitored and strengthened.

The FIP remains silent on the issue of fluctuations of the exchange rates, which is problematic since, according to the 2006 SADC Regional Business Climate Survey, it is regarded as the top obstacle for trade and cross border investments by the private sector in the region, followed by crime, theft and corruption. Although increasing domestic and regional macroeconomic stability supports the stabilisation of exchange rates, external economic and currency trends will continue to impact on SADC currencies and necessitate adjustment, as the devaluation of the Botswana pula in May 2006 illustrates. Creating a regional forum to commonly address and discuss significant changes in value of SADC currencies towards each other and towards major external trading partners' currencies would send a political message to the private sector and to extra-SADC investors.¹⁹ In the survey, economic and regulatory policy uncertainty ranks third and access to and cost of finance fifth. As explained above, commitments within the FIP address these two obstacles to increasing intra-regional trade with the activities – provided they are implemented.

Despite some shortcomings, the FIP represents a great step forward for SADC. It marks the end of SADC's preoccupation with trade liberalisation and correspondingly emphasises the areas finance and investment to stimulate productivity in all sectors. It has been developed in a long but sustainable bottom-up process, informed by a fair amount of research and consultation across various levels of actors, emphasising regional ownership and specificity. The potential for it to become a valuable vehicle for fostering trade and financial integration, to increase investment, productivity and growth is good, but, presently, the vehicle requires jump-starting in various areas.

¹⁸ Information obtained during an interview with Dr Keith Jefferis in Gaborone, October 2006

¹⁹ The abovementioned AfDB study compiled in 1993 suggests the introduction of a regional mechanism for exchange rate stabilisation. However, the issue has never been followed through due to its political sensitivity.

The political commitment to do so has been signaled by Member States and it remains to be seen in the coming months whether commitment will be put into action.

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