UNIVERSITY OF PRETORIA

COLLATERALISATION OF PUBLIC DEBT INSTRUMENTS:PROSPECTS FOR FINANCIAL DEEPENING THROUGH REGULATION OF THE KENYAN REPO MARKET

LL.M INTERNATIONAL TRADE AND INVESTMENT LAW IN AFRICA

Dissertation submitted in partial fulfilment of the requirements for the Degree LL.M (International Trade and Investment Law in Africa)
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November, 2017

Declaration

I declare that this Mini-Dissertation which is hereby submitted for the award of Legum Magister (LL.M) in International Trade and Investment Law in Africa at International Development Law Unit, Centre for Human Rights, Faculty of Law, University of Pretoria, is my original work and it has not been previously submitted for the award of a degree at this or any other tertiary institution.

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Acknowledgement

First, I am grateful to God for His guidance and wisdom throughout the duration of my studies.

Secondly, I wish to express my sincere gratitude to the Centre for Human Rights, University of Pretoria for the financial support that enabled me pursue this course.

Thirdly, I am grateful to Dr. Enga Kameni who inspired my interest in trade finance and challenged me to engage in this financial markets discourse. I also appreciate everyone who assisted me in one way or the other in the course of writing this mini dissertation.

Fourthly, I am forever indebted to my dear friend Sarah Swart whose friendship and support made my stay in Pretoria very comfortable and the pressures associated with the preparation of this work bearable.

Lastly, I am humbled by the support of my husband Dr. Japheth Biegon who has constantly taken pride in my success and encouraged me to pursue my dreams and achieve greater heights.

Dedication

To my husband Dr. Japheth Biegon and my sons Jeffrey Kimutai and Ryan Kiprotich, whose unconditional love, support and confidence in me made this pursuit possible.

List of acronyms

BMA	Bond Market Association
CBK	Central Bank of Kenya
EU	European Union
Fed	Federal Reserve System
GMRA	Global Master Repurchase Agreement
GMSLA	Global Master Securities Lending Agreement
GoK	Government of Kenya
ICMA	International Capital Markets Association
IMF	International Monetary Fund
IPMA	International Primary Market Association
ISDA	International Swaps and Derivatives Association, Inc.
ISMA	International Securities Market Association
Kes	Kenya Shilling
KRA	Kenya Revenue Authority
NBFIs	Non-Bank Financial Institutions
NSSF	National Social Security Fund
SFTs	Securities Financing Transactions
SIA	Securities Industry Association
SIFMA	Securities Industry and Financial Management Association
SSA	Sub Saharan Africa
USA	United States of America
USD	United States Dollar
WW1	1st World War
WW2	2nd World War

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CHAPTER ONE

INTRODUCTION

1.1. Background to the study

The advent of international trade was perhaps one of the greatest innovations of all time. This is especially true for developing countries which continue to rely heavily on international cooperation for their self-actualisation and development. A natural concomitant to international trade is international trade finance. A healthy trading environment is defined by the availability of adequate finance without which opportunities for growth and development are greatly fettered.[1] The inadequacy of finance has over the years been considered by enterprises and even countries as a major barrier to their capacity to participate in trading activities.[2] Financial innovation is therefore necessary to provide alternative financing options where there is a financing gap and, as aptly put by Roberto Azevêdo,[3] to ensure that "trade finance provision is no longer a barrier to trade but a springboard to growth and development".[4]

The financial markets provide tremendous opportunity for financial innovation. They are, however, inherently unstable. In fact, historically, major economic challenges experienced the world over have resulted from instability within the financial markets with severe adverse effects on developing economies. As a starting point, the Great Depression, which was attributed to disorderly financial markets,[5] resulted in the collapse of many domestic economies and the world economy at large.[6]

The 1980s debt crisis was another financial crisis that effectively crippled developing countries' economies[7] and exposed:

> …the vulnerability of developing countries to changes in the world economy over which they have little direct control; their sensitivity to monetary changes in the

[1] World Trade Organisation, *Trade finance and SMEs: Bridging the gaps in provision* (2016) 4.
[2] As above.
[3] The World Trade Organisation's Director-General.
[4] World Trade Organisation (n 1 above) 5.
[5] H James *The end of globalisation: Lessons from the great depression* (2001) 29.
[6] M J Trebilcock & R Howse *The regulation of international trade* (1999) 20.
[7] Mexico's announcement of its inability to pay its debts in 1982 marked the beginning of the crisis.

advanced industrialized countries, and their dependence on primary commodities as sources of their export earnings.[8]

Other notable financial crises were the Latin American *Tequila effect* of 1994-1995 caused by the devaluation of the Mexican *peso;* the *Asian flu* of 1997-1998 also caused by the devaluation of Thailand's *baht;*[9] and most recently the 2008 global financial crisis that manifested in the collapse of the USA credit market.[10]

The 1980s debt crisis was perhaps one of the major turning points for developing countries in international trade finance. The massive defaults in loan repayments forced many international banks to cut their credit lines to developing countries with devastating consequences on development finance. It is on this backdrop that financial innovation becomes imperative to avert the effects of overreliance on foreign debt and to devise more sustainable financial streams for both private and public investment.

Financial markets in SSA are largely underdeveloped and therefore present a massive potential for innovative exploitation to meet the ever increasing financing needs. However, as with the global financial markets, the potential for instability within this market cannot be ignored. Thus in pursuing financial independence through innovation, African economies should be alive to the potential volatility within this market and put in place the necessary checks in the form of regulation to ensure market discipline.

1.2 Problem statement

Kenya, like many other developing countries, relies heavily on public debt to meet her development objectives and annual budgetary obligations.[11] Public debt comprises both external and domestic debt. Although Kenya's capacity to borrow and repay its debts is considered sustainable, the unpredictable nature of external financing has resulted in a shift

[8] V Ferraro & M Rosser 'Global debt and third world development' in M Klare & D Thomas (eds) *World security: Challenges for a new century* (1994) 332-355.
[9] R Glick & AK Rose 'Contagion and trade: why are currency crises regional?' (1998) Working paper No. PB98-03 Pacific Basin Working Paper Series 3.
[10] D Sikorski 'The global financial crisis: Explanation and implications' in JA Batten & PG Szylagyl (eds) *The impact of the global financial crisis on emerging financial markets* (2011) 18.
[11] Central Bank of Kenya *The Kenya financial sector stability report, 2015* (2016) issue 7 22 available at: https://www.centralbank.go.ke/uploads/financial_sector_stability/2057936782_Financial%20Stability%20Rpt%202015.pdf accessed on 23/06/2017.

from over-reliance on external debt towards a greater reliance on domestic debt.[12] Indeed, by the end of June 2015, the ratio of external debt to internal debt stood at 50:50.[13]

Domestic debt mainly consists of government securities in the form of treasury bills and treasury bonds.[14] In Kenya, the volume of domestic debt held by the banking sector as at June 2015 was 55.9% with commercial banks holding the largest volume among all investor categories at 51.4%.[15] This bias towards government securities, largely considered low risk, by commercial banks has contributed to a slack in the growth of private sector credit.[16]

Also, government securities have recently become more attractive for commercial banks with the introduction of interest rate caps on lending and deposits in 2016 effectively curtailing the exorbitant rate of returns on lending activities previously enjoyed by commercial banks.[17] Other factors crowding out private sector credit include a segmented interbank market with great disparities in liquidity levels; low levels of deposits affecting the banks' capacity to lend; and underutilisation of overdraft facilities by corporate borrowers.[18] There is, therefore, need to bridge the financing gap in private sector credit through alternative liquidity sources for commercial banks.

This study posits that the much needed liquidity for private sector credit can be obtained in the repurchase (repo) market. Public debt instruments such as treasury bills and bonds, which comprise a large portion of commercial banks' asset portfolio, can be used as collateral in the repo market for short term borrowing to facilitate further lending activities. The repo market is a flexible and relatively safe investment opportunity for short term investors.[19]Also, the cost of a repo market transaction is relatively low and the transaction offers an attractive yield on a short term secured transaction hence beneficial to both the borrower and the lender respectively.

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[12] T Ryan & I Maana 'An assessment of Kenya's public debt dynamics and sustainability' (2014) 3 Paper presented during the Central Bank of Kenya Monetary Policy Committee technical retreat held on 13th and 14th June 2013 in Naivasha, Kenya.

[13] The National Treasury Republic of Kenya *Annual public debt management report 2014/2015* (2016) 3 available at: http://www.treasury.go.ke/economy1/debt-reports/category/157-annual-debt-management.html accessed on 23/06/2017.

[14] The National Treasury (n 13 above) 8.

[15] The National Treasury (n 13 above) 10.

[16] Central Bank of Kenya *Seventeenth bi-annual report of the monetary policy committee* (October 2016) 13 available at: http://www.centralbank.go.ke accessed on 23/06/2017.

[17] Introduced by the Banking (Amendment) Act, 2016 which came into force on 14 September 2016.

[18] Central Bank of Kenya (n 16 above) 13.

[19] FJ Fabozzi *The handbook of financial instruments* (2002) 173.

The repo market in Kenya is, however, very rudimentary. It is characterised by horizontal repos among domestic commercial banks for overnight lending activities and the central bank monetary policy function. It is based on pledges and not outright transfer of securities hence does not offer the same comfort with regard to mitigating credit risk and also does not ensure the wider benefits of a liquid repo market.[20]

Like any other lending arrangements, repo transactions are susceptible to credit risks even where the underlying collateral is considered high quality.[21] Therefore, to guard against such risks, repo markets should operate within a robust legal and regulatory framework. Regrettably, the existing legal and regulatory framework in Kenya does not extend to repo market transactions.

This study therefore seeks to explore the prospects of achieving financial deepening in the Kenyan repo market through collateralisation of public debt instruments and the adoption of a suitable regulatory framework.

1.3 Research question(s)

The main research question that this study seeks to answer is: whether financial deepening can be achieved through collateralisation of public debt instruments and the adoption of a suitable regulatory framework within the Kenyan repo market.

In answering the main question, the following sub-questions will also be addressed:

1. Why is financial deepening necessary within the Kenyan financial markets?
2. What are the mechanics of a ‘real’ repo as distinguished from Kenya’s existing horizontal repo in relation to collateralisation of public debt instruments?
3. Being a secondary market operation, how would the potential volatility in the repo market be addressed?
4. What form of regulation should be adopted to ensure stability and optimise the utility of the Kenyan repo market as an alternative source of finance for investment?

1.4 Thesis statement

This dissertation seeks to demonstrate that financial deepening can be achieved in Kenya through the repo market by collateralisation of public debt instruments and the adoption of a

[20] D Nicol ‘CBA and SBSA kick-start Kenya’s repo market’ Securities lending times 4 April 2016 available at: http://www.securitieslendingtimes.com/securitieslendingnews/article.php?article_id=220501accessed on 21/06/2017.

[21] Fabozzi (n 19 above) 176.

suitable legal and regulatory framework. This will encourage both public and private sector investment activities in Kenya.

1.5 Literature review

The subjects of public debt management and financial markets development have attracted considerable attention from various authors particularly in the wake of numerous debt crises the world over, culminating in the global financial crisis of 2007-2008. Developing countries are most vulnerable in the face of a global failure of financial markets due to their overreliance on external debt and there have been increasing conversations around alternative financing options.

Ugo Panizza observes that from the early to mid - 2000s, developing countries are increasingly expanding their net borrowing from domestic sources and effectively substituting external debt with domestic debt.[22] He argues that being denominated in the domestic currency, domestic debt results in a more stable investor base and may reduce currency mismatches thus effectively reduce the risks attendant to foreign finance.[23] Ugo nevertheless, acknowledges that since banks are the major holders of government bonds in emerging economies; this is an indication that domestic debt has a crowding out effect on private sector credit.[24] Ugo, however, fails to address the need to protect private sector credit and does not propose measures on how to mitigate the crowding out effect of domestic debt.

Zeits Botha posits that in order to address this crowding out effect, government bonds can be applied by banks in repo transactions as underlying instruments or collateral assets.[25] This is essentially a secondary market dealing where idle debt instruments in the form of government bonds are utilised to obtain short term funds from entities with surplus funds.[26] He refers to the repo market as the lifeblood of modern finance[27] and proceeds to identify the main benefit of a repo as providing a double security to the lender. As the lender takes ownership of the collateral (bond), in the event of default of the borrower, the lender still has recourse against the bond issuer.[28]

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[22] U Panizza 'Is domestic debt the answer to debt crises?' in B Herman, et al (eds) *Overcoming developing country debt crises* (2010) 91.
[23] U Panizza 'Is domestic debt the answer to debt crises?' in Herman, et al (eds) (n 22 above) 98.
[24] U Panizza 'Is domestic debt the answer to debt crises?' in Herman, et al (eds) (n 22 above) 103.
[25] Z Botha 'The money market' in C V Zyl, et al (eds) *Understanding South African financial markets* (2009) 251.
[26] Z Botha 'The money market' in Zyl, et al (eds) (n 25 above) 209.
[27] Z Botha 'The money market' in Zyl, et al (eds) (n 25 above) 251.
[28] Z Botha 'The money market' in Zyl, et al (eds) (n 25 above) 258.

Zeits, however, appears to perceive repo transactions only in theory. He does not identify the possible risks of such transactions especially in the context of developing countries and how they can be mitigated. In particular, the double security in a repo with recourse also against the bond issuer does not consider the fact that government bonds in developing countries, particularly in Africa, are issued by highly indebted sovereigns thus effectively increasing the risk factor.

Fabozzi, Mann and Choudhry also consider the repo market as one of the largest segments of the money markets in the world.[29] They underscore its efficiency and flexibility as a source of finance and note that it is a "relatively safe investment opportunity for short-term investors."[30] They, however, acknowledge that even where the quality of the underlying collateral is high for example where government bonds are used, repo transactions like any other financing arrangements are also exposed to credit risks.[31] In this regard, they argue that in repo transactions, these risks are mitigated through a built in mechanism known as a '*margin*' or '*haircut*'. This is the difference between the market value of the underlying collateral and the actual value of the loan advanced.[32] The loan must therefore be less than the market value of the collateral.

Indeed it is agreeable that the built in mechanism is a useful tool in dealing with the risk associated with the repo market transactions. However, the question that arises from the above proposition is whether the built in mechanism is sufficient to support a sound and efficient repo market in Africa particularly in Kenya. Fabozzi, Mann and Choudhry's proposition was made at a time when even the idea of repo market transactions was merely a pipe dream for African countries. Africa is only now developing this market and requires more than just the '*margin'* or '*haircut'* mechanism to build investor confidence in this largely untapped market.

According to the Bank for International Settlements (BIS) report, "shortcomings in the structural underpinnings of repo markets represent obstacles to the development of sound and efficient repo markets".[33] The report identifies lack of an adequate legal framework as one of

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[29] FJ Fabozzi, et al 'Money markets instruments' in FJ Fabozzi (ed) *The handbook of financial instruments* (2002) 173.
[30] As above.
[31] FJ Fabozzi, et al 'Money markets instruments' in Fabozzi (n 29 above) 176.
[32] FJ Fabozzi, et al 'Money markets instruments' in Fabozzi (n 29 above) 177.
[33] Bank for International Settlements 'Implications of repo markets for central banks'(1999) 28 Report of a working group established by the Committee on the Global Financial System of the central banks of the G10 countries.

the major shortcomings of the repo market operations. It notes that "the relatively complex tasks repo markets have to perform…requires a fairly comprehensive legal framework". While I largely agree with the BIS report, it fails to suggest guidelines and principles upon which such framework should be developed. Repo markets the world over are largely unregulated and the most significant attempts at regulation have only been seen in the EU repo market. Even so, the need for regulation has not been fully appreciated and the jury is still out on whether regulation should even be pursued at all.

Karin Van Wyk attempts an explanation as to why regulation should be pursued. She states that the objectives of regulation are "to protect consumers and investors; ensure solvency and financial soundness of the country's financial institutions; promote fairness, efficiency and transparency in the securities markets; and to promote a stable financial system".[34] She further states that regulation should facilitate the creation of new businesses and expansion of existing businesses through availability of capital and consequently facilitate economic growth.[35] Certainty and predictability of the business environment continue to be the primary magnets for investors more so in the untapped markets of developing country economies. This can be achieved through regulation.

The conversations around the need for and the potential benefits of pursuing financial deepening in the repo market are not exhaustive. However, there is a general appreciation of the need to develop and promote a stable financial system; and the development of a fairly comprehensive legal framework in this largely unregulated market is a viable option in achieving such development and stability.

1.6 Research methodology

This study is predominantly library-based coupled with desktop or internet research. It relies on significant primary and secondary sources of information on the topic. The primary sources include the EU SFT Regulations, the GMRA and the Kenyan domestic legislation. The secondary sources of information include, but are not limited to, relevant text books, journal articles, study reports, and papers/articles written by academics and researchers on issues relevant to the study.

[34] KV Wyk 'Regulation of the financial markets' in CV Zyl, et al (eds) *Understanding South African financial markets* (2009) 122.
[35] As above.

1.7 Delineation and limitations of the study

This study focuses exclusively on the repo market as a component of the money market. It is also limited to one class of assets comprising commercial banks' asset portfolio, being public debt instruments.

The major limitation to the study is the lack of existing and well-functioning repo markets in Africa from which lessons can be drawn in developing the Kenyan repo market. Indeed there are no real repos in the entire East Africa and the larger markets in Africa like South Africa and Nigeria are still in the process of developing their repo markets.

Also, this research is purely library-based coupled with desktop or internet research. Interviews with industry experts and legal transaction advisors especially from Kenya would have enriched the study.

1.8 Chapter breakdown

Chapter one is an introductory chapter. It contains the introduction to the dissertation, problem statement, research question, thesis statement, literature review, research methodology and the delineation and limitations of the study.

Chapter two highlights the theoretical underpinnings of financial markets development and regulation, with a greater focus on the theories espoused by Adam Smith, John Maynard Keynes, Milton Friedman and Roscoe Pound.

Chapter three identifies the need for financial deepening in developing countries and traces developing countries' financial challenges to the period of the great depression. It explores the major financial crises that occurred subsequently and the resultant efforts at strengthening financial market operations.

Chapter four is the main chapter of the dissertation. First, it examines the extent of public debt in Kenya. Second it analyses the role of commercial banks in facilitating domestic borrowing and its impact on private sector credit. Third, it explores the potential for financial deepening within the already existing repo market through the use of public debt instruments. Fourth, it proposes the adoption of a legislative framework to provide the necessary checks and balances to ensure market discipline and avoid instability within the market.

Chapter five is the concluding chapter. It summarises the findings of the research and recommends a suitable approach to developing the Kenyan repo market with the necessary

backstops to stem possible excesses and optimise the benefits of a well-functioning repo market.

CHAPTER TWO

THEORETICAL UNDERPINNINGS OF FINANCIAL MARKET DEVELOPMENT AND REGULATION

2.1 Introduction

"…today we have involved ourselves in a colossal muddle, having blundered in the control of a delicate machine, the working of which we do not understand. The result is that our possibilities of wealth may run to waste for a time - perhaps for a long time."
JM Keynes[36]

The financial market has increasingly been a source of great wealth for many economies and even private entrepreneurs. However, it has also caused great misery due to its volatile nature. Therefore, in exploring the development of financial markets in developing countries, particularly in SSA, it is imperative that an understanding of the theoretical basis for such development is first gained. Simply defined, a theory is a set of principles that justify a particular course of action. Therefore, the theories propounded in this chapter set out the basis for financial markets development and provide certain guiding principles for achieving such development.

In a financial markets development and regulation discourse, the above quote by John Maynard Keynes (Keynes), lauded as one of the greatest economic thinkers of the twentieth century, is perhaps a plausible place to start. Keynes made this observation at a time when the world was experiencing the Great Depression[37], having recognised that the business environment had changed and the complex system of the modern economy was only comparable to a delicate machine that nobody knew how to operate. If mishandled, this machine could potentially destroy the social order and bring misery to many as was manifested in the period of the depression.[38]

At the risk of engaging in a purely economics discourse, it is worth noting that the study of financial markets in itself only gained real respect and recognition in the 1970s.[39] However, prior to that, the study of financial markets was largely subsumed under macroeconomics, also known as 'the big picture economics', and the ideologies presented were as many and as varied as the large number of economic thinkers at the time.

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[36] JM Keynes *The Great Slump of 1930* (1930).

[37] This was the longest lasting economic downturns in the twentieth century attributed to disorderly financial markets. It is discussed further in Chapter 3 of this mini-thesis.

[38] A Leijonhufvud 'Out of the corridor: Keynes and the crisis' (2009) 33 Cambridge Journal of Economics 741-757 available at: http://www.jstor.org/stable/23601997 accessed on 25/08/2017.

[39] P Krugman 'How did economists get it so wrong?' The New York Times 6 September 2009 available at: http://www.nytimes.com/2009/09/06/magazine/06Economic-t.html accessed on 25/09/2017.

This chapter focuses on the theories propounded by Adam Smith, John Maynard Keynes, Milton Friedman and Roscoe Pound as they relate to financial markets and the place of regulatory or policy intervention in the operation of these markets.

2.2 Adam Smith's free market theory

Adam Smith (Smith), popularly known as the father of economics, is credited for being "a premier philosopher of western civilization".[40] His most significant contribution to economic theory was expressed in his 1776 book *The Wealth of Nations*[41] which heralded the market system as "a mechanism for resolving basic economic problems and for producing order without elaborate central direction".[42]

Smith was a capitalist who advocated for a self-regulating free market. He conceived of an invisible hand that safeguarded "the public good through healthy competition"[43] and "compelled men to pursue self-interests in social rather than anti-social ways.[44] According to Smith, "an individual's search for the most advantageous employment for whatever capital he can command . . . naturally, or rather necessarily leads him to prefer that employment which is most advantageous to the society."[45]

Smith's general principle was embodied in the following statement:

> As every individual, therefore, endeavours as much as he can both to employ his capital in the support of domestic industry and so to direct that industry that its produce may be of the greatest value; every individual necessarily labours to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. By preferring the support of domestic to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is *in this, as in many other cases*, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own

[40] WJ Samuels 'The political economy of Adam Smith' (1977) 87 Ethics 189-207 available at: http://www.jstor.org/stable/2380208 accessed on 01/09/2017.
[41] A Smith *Wealth of Nations* (1776).
[42] Samuels (n 40 above) 192.
[43] AL Macfie, *The Individual in Society* (1967) 62.
[44] Samuels (n 40 above) 196.
[45] Smith (n 41 above) 421.

> interest he *frequently* promotes that of the society more effectually than when he really intends to promote it.[46] (Italics mine)

Therefore, where individuals are left alone to pursue their own interests through enterprise or otherwise, they unintentionally contribute to the promotion of the society's well-being. Smith's marketplace is thus a perfect market where rational beings interact.

Curiously, however, from a reading of his general principle, it is notable that while Smith acknowledged the market as self-regulating, he singled it out as merely one institution of social control in a much broader spectrum of institutions of social control. These institutions had to work together seamlessly if the market was to achieve its greater social objectives.[47] In his statement above, Smith noted that the invisible hand would intervene only '*in this*' case and that there were '*many other cases*' that perhaps would require the intervention of other institutions.[48] He also noted that the pursuit of private interests did not always promote the interests of the larger society; it did so only '*frequently*'.[49]

Therefore, an interpretation of Smith's theory of the free market economy would justify a conclusion that such freedom was not absolute freedom of the markets, it was controlled freedom.[50] The market was not perfect in itself but derived its 'perfectness' entirely on the existence and success of other institutions of social control.

2.2.1 Smith's institutions

The institutions of social control envisioned by Smith include moral and legal rules; and a system of rulemaking.[51] According to Smith, the order experienced in markets at the time was not only as a result of free enterprise directed by an invisible hand for the common good, but was also a manifestation of a well-functioning legal and moral framework.[52]

While institutions may potentially harness man's selfish interests[53], Smith's desired institutional structure was one that balances out the individual's self-interests with those of the wider society. Such institutions would first, facilitate the distribution of social gains

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[46] Smith (n 41 above) 423.
[47] Samuels (n 40 above) 197.
[48] As above.
[49] As above.
[50] Samuels (n 40 above) 199.
[51] Samuels (n 40 above) 197.
[52] As above.
[53] N Rosenberg 'Some institutional aspects of the wealth of nations' (1960) 68 Journal of Political Economy, 557-570 available at: http://www.jstor.org/stable/1829944 accessed on 25/06/2017.

among the various classes of society.[54] Secondly, they would ensure predictability of human behaviour.[55]Thirdly, institutions would aid in safeguarding freedoms and liberties. The determination of what these freedoms and liberties entailed and the rightful beneficiaries of such freedoms and liberties were a function of moral and legal rules. Therefore, in Smith's world, the law, rules of morality and the market are all necessary bedfellows in the protection of the freedom of markets.[56]

Smith's position on banking regulations, which is of greater relevance to this study, was that "those exertions of the natural liberty of a few individuals, which might endanger the security of [others], are, and ought to be, restrained by the laws of all governments; of the most free, as well as of the most despotic".[57]

2.2.2 The invisible hand

Smith's theory rested on the doctrine of the invisible hand whose ultimate message was '*trust the market'*. His analysis of a market driven by free enterprise acknowledged the interconnectedness of the players in the market. Every individual at one point or the other would need the assistance of his neighbour but such assistance would not always result from the generosity of the other. As Smith put it, "man has almost constant occasion for the help of his brethren, and it is in vain for him to expect it from their benevolence only".[58] Smith proceeded to explain the relationship within the market as a 'give and take', a form of barter where individual needs are met while at the same time preserving individual interests.[59] Thus in a free market;

> ..it is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages....[60]

It is in this environment that the invisible hand operates; to direct private enterprise for the public good.[61] Therefore, while an investor in a free market economy intentionally seeks out

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[54] N Rosenberg, 'Adam Smith on the division of labour: Two views or one?' (1965) 32 Economica 136-138 available at: http://www.jstor.org/stable12552544 accessed on 25/06/2017.
[55] Rosenberg (n 53 above) 563.
[56] Samuels (n 40 above) 198.
[57] Smith (n 41 above) 308.
[58] Smith (n 41 above) 117.
[59] As above.
[60] As above.
[61] Smith (n 41 above) 423.

his own interests when making an investment, he 'accidentally' finds himself also promoting the public good.[62] These according to Smith are the workings of the invisible hand.

Smith, however, qualified the application of this doctrine. The invisible hand did not operate in the same free market environment as merchants and manufacturers, akin to present day businessmen, whose activities are primarily driven by profits.[63] Their interests, Smith noted, did not have a "…connection with the general interest of society".[64] Further, Smith stated that this group of businessmen are "men, whose interest is never exactly the same with that of the publick, who have generally an interest to deceive and even to oppress the publick, and who accordingly have, upon many occasions, both deceived and oppressed it".[65]

This group of investors, according to Smith, should not be allowed to pursue their own selfish interest as they could cause harm to the public.[66] Smith, however, does not state how such selfish interests that are at variance with the common good are to be dealt with. It has been argued that in his works, Smith did not provide any set of immediate policy solutions, rather, he set out a "framework within which, given that it postulates and legitimizes a market economy, there can be no unequivocal or conclusive a priori determination of practical policy issues."[67]

Ultimately, the greatness of Smith's free market economic theory rested on the fact that it was an open market theory.[68] Open enough to appreciate that "there is more to the operation of the economy than such theory incorporates; that the theory of the market does not itself explain the larger system of which the market is a part; and that the theory does not conclusively assert the superiority of market solutions within the existing systemic structure".[69] Nevertheless, the market can be trusted.

2.3 John Maynard Keynes' general theory

John Maynard Keynes is known for his formulation of *The General Theory* also known as the *Keynesian Theory*. His ideas are largely contained in his 1936 book, *The General Theory of*

[62] JD Bishop 'Adam Smith's invisible hand argument' (1995) 14 Journal of Business Ethics 165-180 available at: http://www.jstor.org/stable/25072635 accessed on 01/09/2017.
[63] Bishop (n 62 above) 170.
[64] As above.
[65] As above.
[66] Bishop (n 62 above) 171.
[67] Samuels (n 40 above) 205.
[68] Samuels (n 40 above) 207.
[69] Samuels (n 40 above) 205.

Employment, Interest and Money[70] in which he makes a case against the long upheld capitalist view that rational beings interact within perfect markets.[71] Himself an active trader in stocks and futures, Keynes understood the value of financial markets in creating wealth. He however learnt the hard way, after losing almost all his wealth in the 1929 economic crash, that the markets were not perfect after all and that the invisible hand had failed to direct individual conduct for the greater good.[72]

Drawing lessons from the massive economic slump, Keynes attempted to present his *General Theory* as a happy medium or an alternative to both capitalism, which had prevailed for the most part over a hundred years but had now failed as manifested in the Great Depression, and communism, which was frowned upon and associated with a totalitarian State. He argued that while the exercise of private initiative and individualism bears certain advantages among which include the exercise of personal liberties and personal choice; the introduction of controls through enlargement of government functions would be the only practical means of maximising the benefits of individual initiative.[73]

By enlargement of government functions, Keynes did not in any way suggest that the State should be responsible for the entire economic life of the society. Rather, the State should guide and direct private initiative through a system of taxation, fixing of interest rates or some other form of control that optimises investments.[74] Keynes observed that;

> If the State is able to determine the aggregate amount of resources devoted to augmenting the instruments and the basic rate of reward to those who own them, it will have accomplished all that is necessary.[75]

As regards the financial markets, Keynes argued that the preoccupation with liquidity should be geared towards furthering social goals such as creation of employment and long-term productive investment.[76] This was however not the case as the predominant discourse on market liquidity, which is still pursued today, was mostly associated with the element of

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[70] JM Keynes *The General Theory of Employment Interest and Money* (1936).
[71] Krugman (n 39 above) 2.
[72] Keynes (n 70 above) 140.
[73] Keynes (n 70 above) 380.
[74] Keynes (n 70 above) 378.
[75] As above.
[76] J Crotty and GA Epstein 'The last refuge of scoundrels: Keynes-Minsky perspectives on the uses and abuses of the "liquidity defense"' in GA Epstain, et al (eds) *Banking, monetary policy and the political economy of financial regulation* (2014) 322.

personal choice and the ability of investors to trade securities quickly at a minimum cost.[77] Therefore the more market liquidity the better. However for Keynes, this presented a genuine dilemma. He noted that:

> In the former times, when enterprises were mainly owned by those who undertook them or by their friends and associates, investments depended on a sufficient supply of individuals of sanguine temperament and constructive impulses who embarked on business as a way of life, not really relying on a precise calculation of prospective profit.[78]

At the time, investment was a game of chance and private initiative did not necessarily portend any overarching advantages over the community at large as the capital goods in which investments were made were all illiquid. Hence "decisions to invest in private business of the old fashioned type were…decisions largely irrevocable, not only for the community as a whole but also for the individual".[79]

However, the evolution of the business environment, Keynes noted, brought with it both desirable and undesirable changes.[80] He argued that market liquidity through the development of organised investment markets on the one hand facilitates investments through an increased interest in long-term capital accumulation, employment creation and productivity growth. The same liquidity on the other hand contributes greatly to the instability of the system through excessive speculation and the herd mentality of investors where the average expectation of investors determines the direction of investments rather than sound policy.[81]

Therefore, free market economies, particularly the financial markets, "dominated by short term speculation with little regard for fundamentals", cannot operate without a minder in the form of active government intervention.[82] So, what exactly is liquidity and why is it still preferred by free market economists and private investors?

[77] J Crotty and GA Epstein 'The last refuge of scoundrels: Keynes-Minsky perspectives on the uses and abuses of the "liquidity defense"' in Epstain, et al (eds) (n 76 above) 320.
[78] Keynes (n 70 above) 150.
[79] As above.
[80] Keynes (n 70 above) 150-151.
[81] J Crotty and GA Epstein 'The last refuge of scoundrels: Keynes-Minsky perspectives on the uses and abuses of the "liquidity defense"' in Epstain, et al (eds) (n 76 above) 322.
[82] Krugman (n 39 above) 3.

2.3.1 Liquidity preference

"Everyone thinks he knows what liquidity means, yet no one has adequately defined and qualified it".[83] In attempting to define liquidity, mainstream economists tend to distinguish between *funding liquidity* and *market liquidity*. *Funding liquidity*, on the one hand, is "the ability of financial actors to fund their positions in financial assets".[84] It is predominantly manifested in the role of central banks in determining the monetary policy and as lender of last resort and also in the activities of private financial institutions.[85] It is the availability of money. *Market liquidity*, on the other hand, is the ability to trade securities quickly and cheaply at very low transaction costs.[86] Underlying both forms of liquidity is the importance of money[87] which "derives its usefulness from what it will buy and the flexibility it affords over the timing of payments".[88]

The main subject of this research hinges on the creation of funding liquidity or money, through market liquidity. While a high level of market liquidity is desirable for private enterprise, the Keynesian theory warns that it poses a liquidity dilemma and requires a careful balancing act between the social benefits of private liquidity *vis a vis* its social costs.[89]

The liquidity preference by free market economists and financial actors like investment banks is premised on the notion that "more liquidity leads to greater market efficiency".[90] Accordingly, any attempts at regulation would harm financial customers and the economy in general.[91] However, according to Keynes, this ideology is a fallacy. In fact, regulations in the financial sector would allow "financial institutions to provide investment finance in a more stable manner and firms to make sound investment decisions through stabilising the liquidity preference and controlling the liquidity pursuit appropriately".[92]

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[83] E Derman *Models behaving badly: Why conflating illusion with reality can lead to disaster, on Wall Street and in life* (2011) 48.

[84] J Crotty and GA Epstein 'The last refuge of scoundrels: Keynes-Minsky perspectives on the uses and abuses of the "liquidity defense"' in Epstain, et al (eds) (n 76 above) 324.

[85] As above.

[86] As above.

[87] J Crotty and GA Epstein 'The last refuge of scoundrels: Keynes-Minsky perspectives on the uses and abuses of the "liquidity defense"' in Epstain, et al (eds) (n 76 above) 325.

[88] V Chick *Macroeconomics after Keynes: A reconsideration of the General Theory* (1983) 194.

[89] J Crotty and GA Epstein 'The last refuge of scoundrels: Keynes-Minsky perspectives on the uses and abuses of the "liquidity defense"' in Epstain, et al (eds) (n 76 above) 335.

[90] J Crotty and GA Epstein 'The last refuge of scoundrels: Keynes-Minsky perspectives on the uses and abuses of the "liquidity defense"' in Epstain, et al (eds) (n 76 above) 321.

[91] J Crotty and GA Epstein 'The last refuge of scoundrels: Keynes-Minsky perspectives on the uses and abuses of the "liquidity defense"' in Epstain, et al (eds) (n 76 above) 320.

[92] B Cho 'Investment finance and financial sector development' in LR Wray & M Forstater (eds) *Keynes and macroeconomics after 70 years* (2008) 212.

Crotty and Epstein, in support of Keynes' position, also observe that "a market in which investors believe they can buy and sell cheaply and unload their risky securities instantaneously at the first hint of trouble will encourage excessive speculation and market volatility".[93] It is this kind of market volatility and instability that Keynes had sought to address in his *General Theory* in the first place.

Among the solutions offered by Keynes to mediate between the needs of private enterprise and the common good is government intervention in the control of capital expenditure. The State, according to Keynes, "is in a position to calculate the marginal efficiency of capital on long views and on the basis of general social advantage" and should therefore take "an ever greater responsibility for directly controlling investment".[94]

2.3.2 Government intervention

The role of government in the Keynesian school of thought is of great importance in reconciling the short term profit driven goals of private enterprise with those of long term societal goals. The arguments in support of liquidity, though plausible to a certain extent, disregard the fact that "there is no such thing as liquidity of investment for the community as a whole".[95] Keynes, in fact, considered liquidity as the most anti-social of the maxims of orthodox finance.[96] That notwithstanding, investment policies generally geared towards the social good are rarely known to be the most profitable[97] and are thus less attractive for investors. They should, however, be pursued for the common good.

Other than achieving societal objectives, government intervention is necessary to mitigate the instability resulting from speculation. Keynes noted that the average investor in the modern economy is not concerned with the actual value of an investment but rather the value ascribed to it by the market through mass psychology. His aim is "to beat the gun….to outwit the crowd, and to pass the bad, or depreciating, half-crown to the other fellow."[98] He engages, so to speak, in

> a game of Snap, of Old Maid, of Musical Chairs – a pastime in which he is victor who says *snap* neither too soon nor too late, who passes the Old Maid to his neighbour

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[93]J Crotty and GA Epstein 'The last refuge of scoundrels: Keynes-Minsky perspectives on the uses and abuses of the "liquidity defense"' in Epstain, et al (eds) (n 76 above) 321.
[94] Keynes (n 70 above) 164.
[95] Keynes (n 70 above) 155.
[96] As above.
[97] Keynes (n 70 above) 157.
[98] Keynes (n 70 above) 155.

> before the game is over, who secures a chair for himself when the music stops. These games can be played with zest and enjoyment, though all the players know that it is the Old Maid which is circulating, or that when the music stops some of the players will find themselves unseated.[99]

Keynes further likens professional investment to a beauty pageant in which "it is not a case of choosing those which…..are really the prettiest, but those which are likeliest to catch the fancy of the other…".[100] In essence, "anticipating what average opinion expects average opinion to be".[101] Ultimately, in both the Keynesian world and the real world, speculation is not necessarily an evil that should be purged out of the investment environment, unless it greatly alters the investment environment to the detriment of the larger society. As Keynes rightly noted, "speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation".

To cure investment instability occasioned by such uncertainty and excessive liquidity, Keynes proposed government intervention in the control of capital expenditure. He proposed actual participation by the government through public or semi-public bodies in long term investments to stabilise the markets. He noted that "if the bulk of investment is under public or semi-public control and we go in for a stable long term programme, serious fluctuations are enormously less likely to occur".[102]

By bulk of investment, Keynes actually proposed the control by public bodies of between two-thirds to three-quarters of total investments.[103] This was, however, not a case for socialism or State control as it was not necessary for the State to own the instruments of production.[104] Rather, it was "an arrangement under which the State would fill the vacant post of entrepreneur-in-chief, while not interfering with the ownership or management of particular businesses, or rather only doing so on the merits of the case and not at the behests of dogma".[105]

On investment instability, Keynes observed that:

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[99] Keynes (n 70 above) 156.
[100] As above.
[101] As above.
[102] J Crotty and GA Epstein 'The last refuge of scoundrels: Keynes-Minsky perspectives on the uses and abuses of the "liquidity defense"' in Epstain, et al (eds) (n 76 above) 343.
[103] AH Meltzer 'Keynes' general theory: A different perspective' (1981) 19 Journal of Economic Literature 34-64 available at: http://www.jstor.org/stable/2724234 accessed on 22/08/2017.
[104] Keynes (n 70 above) 378.
[105] Meltzer (n 103 above) 41.

> Perhaps the ultimate solution lies in the rate of capital development becoming more largely an affair of State, determined by collective wisdom and long views. If the task of accumulation comes to depend somewhat less on individual caprice, so as to be no longer at the mercy of calculations partly based on the expectation of life of the particular mortal men who are alive today, the dilemma between thrift and profit as the means of securing the most desirable rate of growth of the community's aggregate wealth will cease to present itself.[106]

2.3.3 Economic stimulus

Economic stimulus is a form of government intervention especially during periods of economic slumps. It revolves around the psychology of investment markets and the volume of investments at any given time.[107] During periods of economic booms and economic recessions, the monetary policies adopted by the government serve to regulate the volume of investments through manipulation of the interest rates as required.

During a recession, largely characterised by increased unemployment and a decrease in the demand for products,[108] the monetary policy would drive down the interest rates on short term government securities and make it unattractive for investors. Consequently, the investors will seek other investment avenues effectively bringing down general interest rates and encouraging consumption and economic recovery.[109] Sometimes, however, when the interest rates are too low, investors simply choose not to invest their money in non-profitable investments.[110] In such cases, where the psychology of the investment market is not expected to change, then, according to Keynes, the duty of ordering the volume of investments must fall squarely on the government.[111]

Therefore, when monetary policy fails to achieve its objectives and the private sector cannot be persuaded to spend, then government spending is the only viable option in cases of massive economic downturn to encourage consumption and thus kick-start the economy.[112] Even where some private investment may be experienced, this, according to Keynes, would

[106] JM Keynes *Treatise on money* (1930) 145.
[107] Keynes (n 70 above) 320.
[108] J Handa *Monetary economics* (2009) 648.
[109] Krugman (n 39 above) 11.
[110] As above.
[111] Keynes (n 70 above) 320.
[112] Krugman (n 39 above) 11.

not be as efficient as government spending since private investors are unlikely to spend on what they would consider unnecessary during economic slumps.[113]

Economic stimulus should however be approached with caution as too much stimulus may result in inflation in the long run thus undermining the economic efficiency it initially sought to restore.[114] This in fact happened in the period following the Great Depression due to the excessive and prolonged government spending. Coupled with the crowding out effect on private investment,[115] the inflation related distortions in the economy were a major platform for the Keynesian critics' revival of the neoclassical theory led by Milton Friedman.[116]

2.4 Milton Friedman's monetary theory

Milton Friedman (Friedman) was an American economist who gained popularity in the early 1950s when the Keynesian theory was no longer persuasive in light of the economic developments of the day.[117] Friedman challenged the very premise upon which the Keynesian theory was built and advocated for a monetary approach in understanding and responding to the financial and economic challenges of the day. While Keynes argued that the Great Depression was a result of the collapse of the free markets and the selfishness inherent in unchecked private enterprise, Friedman had a different explanation for the unfortunate economic contraction.

According to Friedman, it did not result from the failure of the markets or instability of private enterprise, but rather it was a manifestation of the failure of government.[118] The Fed, a government agency responsible for monetary policy had acted so recklessly in performing its role that what would have been a minor recession transformed into a major catastrophe.[119] Thus, the very idea of government intervention in private enterprise was in itself a threat to freedom, and on a larger scale, a threat to stability of the markets.[120]

In Friedman's world, there was no real need for an umpire or a minder to monitor the general direction of enterprise or investment. In any event, as was earlier pointed out, enterprise

[113] A Beattie 'Giants Of Finance: John Maynard Keynes' 22 April 2017 available at: http://www.investopedia.com/articles/economics/09/john-maynard-keynes-keynesian.asp accessed on 23/06/2017.
[114] Handa (n 108 above) 629.
[115] A Beattie (n 113 above).
[116] Krugman (n 39 above) 3.
[117] As above.
[118] M Friedman *Capitalism and Freedom* (1962) 39.
[119] As above.
[120] Friedman (n 118 above) 10.

simply "…depended on a sufficient supply of individuals of sanguine temperament and constructive impulses who embarked on business as a way of life….".[121] The market could still regulate itself as it did in the former times.

The role of government therefore is merely as "a means, an instrumentality, neither a grantor of favours and gifts, nor a master or god to be blindly worshipped and served".[122] It is a contraption that should be kept at bay lest it destroys the very freedom sought to be protected.[123] Friedman, in reiterating the need for the preservation of freedom and free enterprise noted that,

> Freedom is a rare and delicate plant. Our minds tell us, and history confirms that the great threat to freedom is the concentration of power. Government is necessary to preserve our freedom, it is an instrument through which we can exercise our freedom; yet by concentrating power in political hands, it is also a threat to freedom.[124]

It is therefore evident that though a critic of the Keynesian thinking, Friedman did not totally dispense with the role of government in ordering the society provided that the scope of government was limited and power was decentralised. The following statement by Friedman lends credence to this conclusion: "in one sense we are all Keynesians now; in another, no one is a Keynesian any longer. We all use the Keynesian language and apparatus; none of us any longer accepts the initial Keynesian conclusions".[125]

2.4.1 Monetarism

While Keynes found the solution to economic turmoil in increased government spending, Friedman was inclined to relying on the monetary policy. According to him, it was the irresponsible application of the monetary policy by the Fed that resulted in the Great Depression. Therefore a proper administration of the monetary policy would be a sure way of wading off economic and financial crises of such magnitude.

The Fed was a National Monetary Authority established by the American Congress under the Federal Reserve Act of 1913.[126] Its establishment was necessitated by a general dissatisfaction with the financial system at the time, aggravated by the banking crisis in 1907.

[121] Keynes (n 70 above) 150.
[122] Friedman (n 118 above) 10.
[123] As above.
[124] As above.
[125] M Friedman *Why economists disagree: dollars and deficits* (1968) 15.
[126] Friedman (n 118 above) 43.

Speculations on the potential decline in the value of the dollar resulting from a possible abandonment of the gold standard caused panic among depositors who sought to cash out their deposits. The banks, however, simply refused to honour the requests for withdrawal and the resulting backlash from the masses triggered reforms in the banking sector hence the establishment of the Fed.[127]

The Fed's primary responsibility was to achieve monetary stability. It was "designed to insure the convertibility of one form of money into others and to regulate and supervise banks".[128] Its powers were to be limited by the gold standard that still existed at the time and which stabilised the value of the dollar. However, post WW1, the gold standard was abandoned and the Fed became a very powerful institution capable of determining "the quantity of money in the United States and to affect international financial conditions throughout the world".[129]

According to Friedman, had the Fed been doing its job properly, the Great Depression probably would not have happened. In his view, the stock market crash of 1929, largely blamed for triggering the Depression, could not really have caused it. It

> …undoubtedly had some indirect effects on business confidence and on the willingness of individuals to spend which exerted a depressing influence on the course of business. But by themselves, these effects could not have produced a collapse in economic activity.[130]

The Fed focussed too much on a restrictive monetary policy to forestall speculation in the period leading up to the stock market crash and maintained such restrictive policies even after the market had crashed without consideration of the prevailing decline in the stock of money. Therefore, the series of bank failures that began in 1930 was actually the beginning of the massive economic decline that lasted almost a decade.[131] The shortage of money in circulation led to runs in the banking system with depositors seeking to cash out their deposits. As commonly known in the banking sector;

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[127] As above.
[128] As above.
[129] As above.
[130] Friedman (n 118 above) 45.
[131] As above.

> Any widespread attempt on the part of depositors to "get their money" must therefore mean a decline in the total amount of money unless there is some way in which additional cash can be created and some way for banks to get it.[132]

It was for such instances that the Fed was created and the Fed should have intervened in the banking crisis that ensued by providing the much needed liquidity. It did not. As noted by Friedman, "the System's failure was a failure of will, not of power...the System had ample power to provide the banks with the cash their depositors were demanding. Had this been done, the bank closings would have been cut short and the monetary debacle averted".[133]

It is such failure of the Fed in its implementation of the monetary policy that led to Friedman's conclusion that;

> The Great Depression in the United States, far from being a sign of the inherent instability of the private enterprise system, is a testament to *how much harm can be done by mistakes on the part of a few men when they wield vast power over the monetary system of a country*…..Any system which gives so much power and so much discretion to a few men that mistakes, excusable or not, can have such far-reaching effects is a *bad system*.[134](Italics mine)

2.4.2 The balance wheel analogy

Keynes' proposal for increased government spending during economic slumps to stabilise the economy has been compared to a *balance wheel*. In the post-Depression period, government intervention was likened to a *balance wheel* that would promote stability and security where unregulated private enterprise had wreaked havoc hence the popularity of government expenditure.[135]

Ideally, according to Friedman on expenditure implications, "when private expenditures decline for any reason…..governmental expenditures should rise to keep total expenditures stable; conversely, when private expenditures rise, governmental expenditures should decline".[136] The reality, however, is that the practical application of this principle does not match the theoretical expectation. Government expenditure is usually pursued far more

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[132] Friedman (n 118 above) 46.
[133] Friedman (n 118 above) 49.
[134] As above.
[135] M Friedman & R Friedman *Free to Choose* (1980) 70.
[136] Friedman (n 118 above) 67.

aggressively than the stabilisation it is meant to achieve during a recession and even where some stability is achieved, cuts in such government expenditure are seldom applied.

If the *balance wheel* were to be effective, Friedman suggested the replacement of the expenditure element of the fiscal policy with the tax element.[137] In his analysis, "a decline in national income automatically reduces the tax revenue of the federal government in greater proportion and thus shifts the budget in the direction of a deficit, and conversely during a boom". Therefore, "taxes can be lowered during recessions and raised during expansions".[138] Friedman, however, qualified his proposal by noting that the effects of such policy are not immediate and would only manifest at some future time. Thus the accuracy of such policy would depend upon the ability "to forecast those fluctuations a long time in advance".[139]

Meanwhile, Keynes' *balance wheel* remains quite unbalanced.[140]

2.5 Roscoe Pound on the theory of law

Roscoe Pound (Pound) was a jurist and a professor of law who gained prominence during his first address in 1906 to an assembly of jurists at the annual American Bar Association meeting.[141] His legal philosophy was hinged on the law as a process of social engineering; "a process of adjusting and compromising conflicting claims so that the maximum of human interest may be satisfied with a minimum of friction and waste".[142] He adopted a functional approach to the definition of law and proposed that "the law should be designed to meet the reasonable expectations of the society of the time and place".[143] In this regard, the law is considered an instrument of social control and order within a given society and the government merely a custodian of the law.

Therefore, in the pursuit of development and the common good, the crucial role of law cannot be gainsaid. It not only allows for the establishment of sound and just systems but also creates a conducive environment for entrepreneurship with minimum friction and wastage of resources. While government intervention is necessary to steer private enterprise towards the

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[137] Friedman (n 118 above) 68.
[138] As above.
[139] Friedman (n 118 above) 69.
[140] As above.
[141] LJ McManaman 'Social engineering: The legal philosophy of Roscoe Pound' (2013) 33 *St. John's Law Review* 2-47 available at: http://scholarship.law.stjohns.edu/lawreview/vol33/iss1/1 accessed on 10/10/2017.
[142] McManaman (n 141 above) 45.
[143] As above.

common good, such intervention should be guided by the law, "for the legal order is the filter through which policy becomes practice".[144]

Moreover, the existence of a robust legal environment provides the necessary comfort to investors as "entrepreneurs will hazard their capital only when assured that the society is relatively free of threats to physical security and property".[145] Other threats to investments particularly within financial markets are defaults by borrowers and market failures and the law, therefore, plays the crucial role of ensuring certainty and predictability in the manner in which such threats are handled and conflicts resolved.

2.6 Conclusion

Throughout history, as evidenced above, a consensus has never been reached on the most effective way through which markets should operate. The discourse from free markets to controlled markets and back to free markets only serves to create uncertainty in the policy making space particularly with regard to financial markets. Despite the varied theories on the operations of the markets, it is worth noting that a common idea transcends these theories; government intervention. While Smith advocated for free markets which relied on an invisible hand to direct private enterprise for the common good, he acknowledged that there was a group of entrepreneurs who could not be steered towards the common good. Their interests were at variance with the society and thus had to be controlled by some form of government.

Keynes message was clear from the outset, that the markets were not perfect and that the players were not rational. Therefore there was need for a minder in the form of active government participation within the market to ensure that the selfish interests of irrational beings were put in check. Friedman also, though advocating for free markets, acknowledged the importance of government but in a limited and decentralised form. In all these, the government should be guided by a system of laws, as propounded by Pound, designed for the particular society based on its unique needs.

The challenges in the markets today, particularly in the financial markets, are far more complex than they were in the nineteenth and twentieth centuries. The rate of innovation of

[144] RB Seidman 'The communication of law and the process of development' (1972) 3 *Wisconsin Law Review* 686-719 available at: http://heinonline.org/HOL/Page?handle=hein.journals/wlr1972&collection=journals&id=706&startid=&endid=739 accessed on 09/10/2017.
[145] Siedman (n 144 above) 688.

financial products is quite impressive but with it also comes massive challenges that cannot and should not be subject to what Keynes referred to as the activities of a casino. The realities of present day financial challenges, as espoused in the next chapter, require an abandonment of the assumption that “everyone is rational and markets work perfectly.”[146]

[146] Krugman (n 39 above) 15.

CHAPTER THREE

RECCURRENT FINANCIAL CRISES AND OPTIONS FOR DEVELOPING COUNTRIES

3.1 Introduction

> "….People who want to get rich fall into temptation and a trap and into many foolish and harmful desires that plunge men into ruin and destruction. For the love of money is a root of all kinds of evil….."[147]

In order to understand the situation of our financial markets today, it is important to take a journey in history and ask ourselves the all-important question; *what went wrong*? As outlined in the previous chapter, economists have attempted several explanations to the disorderliness of markets with the predominant views being the failure of the markets themselves or the failure of government. Here, the focus is on the behaviour of global financial markets.

The global financial markets have had a somewhat checkered history characterised by one financial crisis after the other, and the systemic effects have "catastrophically undermined the stability of the institutions that make global interchange possible".[148] The main culprit in most financial crises has been the liberalisation of capital flows operating within free markets[149]; and the frequency of such crises has resulted in the call for a "reorientation of thought since free markets are inherently volatile institutions prone to speculative booms and busts".[150]

Therefore, in addressing ourselves to the problems of financial markets, this chapter seeks to highlight the causes of some of the major global financial crises and the lessons drawn from them; why these lessons failed to stem subsequent financial crises; and the effects of these crises on SSA economies. This chapter also explores options for financial independence in SSA through the development of SSA financial markets while at the same time avoiding the global mistakes of the past.

3.2 Understanding financial crises

The two major global financial crises experienced in the twentieth and the twenty-first centuries were the Great Depression of the 1930s and the global financial crisis of 2007-

[147] Holy Bible '1st Timothy chapter 6 verses 9-10' New international version.
[148] J Harold *The end of globalisation: Lessons from the great depression* (2001) 3.
[149] Harold (n 148 above) 3.
[150] Harold (n 148 above) 4.

2008. Both have been characterised as marking the end of the British and American centuries of dominance, respectively, in the world markets.[151] Other notable crises due to the magnitude of their effects were the 1980s petrodollar debt crisis, the Latin American tequila effect of 1994-1995, and the Asian flu of 1997-1998. While the Great Depression and the global financial crisis occurred in developed economies and had secondary effects on the developing economies, the petrodollar debt crisis, the Latin American tequila effect and the Asian flu all had direct effects on developing economies.

3.2.1 The great depression (1929-1939)

The Great Depression also widely known as the great contraction has often been attributed to the stock market crash of October 1929. A possible explanation for the crash, was the uncertainty in the USA trade policy at the time.[152] A new piece of legislation known as Hawley and Smoot was to be implemented in 1929.[153] It was a tariff bill intended to improve the agriculture sector which had suffered a great decline due to low prices.[154] However, the numerous amendments to the bill during congressional debate heightened the level of uncertainty among American investors resulting in massive speculation hence the crash.[155] The Fed's response to the speculation by imposing a relatively restrictive monetary policy also contributed to the crash.[156]

Other writers and economic thinkers have attributed the depression to the banking crisis that ensued after the stock market crash and the failure of the Fed to intervene appropriately. The restrictive monetary policy adopted by the Fed coupled with a decline in investments due to the erosion of investor confidence after the crash resulted in a decline in the stock of money.[157] The decline in the stock of money subsequently caused a liquidity crisis that began to manifest in November 1930, and which triggered a series of bank failures throughout the 1930s as there was a general loss of confidence in the banking system and depositors sought to withdraw their funds.[158]

Therefore, while the stock market crash of 1929 may have triggered the depression, it was just one of the many events, including the banking crisis, which contributed to the decade

[151] P Temin & D Vines *The leaderless economy* (2013) 21.
[152] Harold (n 148 above) 29.
[153] As above.
[154] As above.
[155] As above.
[156] Friedman (n 118 above) 45.
[157] As above.
[158] Friedman (n 118 above) 46.

long economic contraction. The banking crisis was however, according to Friedman, completely avoidable.[159] Had the Fed provided the banking system with the much needed liquidity at the time, "the bank closings would have been cut short and the monetary debacle averted".[160]

Keynes suggestion for ending the depression was an increase in government spending. Accordingly, "when monetary policy is ineffective and the private sector can't be persuaded to spend more, the public sector must take its place in supporting the economy".[161] Indeed there was increased government spending during WW2 on the military. There is however no consensus on what actually ended the depression; the increased spending during the war or the sharp decline in government spending at the end of the war.

3.2.2 The petrodollar debt crisis (1980s)

As the name suggests, the 1980s debt crisis was precipitated by the surplus of petrodollars in the vaults of western commercial banks. The increase in global oil prices in 1973-1974 had mixed effects for developing countries. On the one hand, the oil producing countries experienced a boom with excess cash being sent by investors to overseas banks and held in dollars. The non-oil producing countries, on the other hand, were reeling from the effects of the high oil prices and even had to deal with very high inflation rates.[162] Both groups of countries sought external financing, the former to capitalise on their much improved financial status and the latter to ease the trauma occasioned by the high prices.[163]

Coincidentally, the major American, European and Japanese commercial banks that experienced a surplus of the petrodollar were also eager to put the funds to productive use. They therefore lent huge amounts of money, even exceeding their capital, on the world market particularly to the governments of developing countries. The loans were meant to aid industrialisation in developing countries and the security for the loans was in the assumption that a sovereign or government could not go bankrupt.[164] In most countries, the loans were not used as intended but were embezzled through corruption.

[159] Friedman (n 118 above) 47.
[160] As above.
[161] Krugman (n 39 above) 11.
[162] V Ferraro & M Rosser 'Global debt and third world development' in Klare & Thomas (eds) (n 8 above) 332-355.
[163] As above.
[164] Trebilcock & Howse (n 6 above) 384.

However, with the fall in the oil prices in the late 1970s, the highly leveraged position of the oil producing countries quickly diminished. Moreover, the adoption of a restrictive monetary policy in America to deal with its own internal debt situation resulted in a very deep global recession in the period 1981-1982.[165] When interest rates rose significantly as a result of the recession, the demand for exports from developing countries also declined[166] and developing countries could no longer generate enough income to service their loans. In 1982, Mexico was the first to declare its inability to pay back its debts marking the beginning of the debt crisis. Many other developing countries followed in Mexico's footsteps.

With the threat of massive defaults, a banking crisis was also in the offing and in a bid to mitigate their losses many international banks cut their credit lines to developing countries and had to create fresh reserves against potential loss.[167] It took the intervention of the USA government to avert a near collapse of the international financial system. The consequences to developing countries were devastating, more so to SSA economies which now had fewer options for external financial assistance.[168]

The debt crisis of the 1980s is considered by many as one of the major turning points for developing countries in international trade finance.[169] It is credited for exposing:

> …the vulnerability of the developing countries to changes in the world economy over which they have little direct control; their sensitivity to monetary changes in the advanced industrialized countries, and their dependence on primary commodities as sources of their export earnings.[170]

3.2.3 The Latin American tequila effect (1994-1995)

Latin American countries have for generations been at the centre of such monetary ills as currency crises, banking failures and hyper-inflation among others.[171] Periods of economic booms and busts in almost equal measure were common place until later in the twentieth century when the worst financial crisis ever experienced in the Latin American countries hit

[165] V Ferraro & M Rosser 'Global debt and third world development' in Klare & Thomas (eds) (n 8 above) 332-355.
[166] As above.
[167] BO Oramah *Foundations of structured trade finance* (2015) 38.
[168] V Ferraro & M Rosser 'Global debt and third world development' in Klare & Thomas (eds) (n 8 above) 332-355.
[169] Trebilcock & Howse (n 6 above) 384.
[170] V Ferraro & M Rosser 'Global debt and third world development' in Klare & Thomas (eds) (n 8 above) 332-355.
[171] P Krugman *The Return of Depression Economics* (1999) 38.

Mexico.[172] The "tequila crisis caused one of the worst recessions to hit an individual country since the 1930s; its repercussions spread across Latin America, coming perilously close to bringing down Argentina's banking system".[173]

Following the debilitating debt crisis of the 1980s, most of Latin America adopted radical policy reforms to get the region back on track and restore investor confidence. Latin American economists, by mid 1980s, had embraced the principle of the so called Washington Consensus that "growth could best be achieved via sound budgets, low inflation, deregulated markets, and free trade".[174] Indeed, Mexico aggressively pursued this liberalisation policy. "State owned companies were privatised, restrictions on imports lifted, budget deficits trimmed" and the high inflation was put in check.[175] It, however, also accumulated a lot of short term public debt in the form of *tesobonos*[176]to support the expansionary policy. This would eventually lead to major liquidity problems.[177] A similar liberalisation policy was also experienced in Argentina.[178] Argentina, however, in permanently dealing with its inflation problem, went further and introduced the *currency board*[179] pegging the *peso* to the American *dollar*.[180]

Both Mexico and Argentina had done well in achieving currency stabilisation and policy reforms. However, there was very little economic growth to show for it. "The huge capital inflows were producing so little measurable result".[181] The value of the *peso* was therefore put in question. It was argued that the "excessively strong currency was pricing Mexican goods out of world markets, preventing the economy from taking advantage of its growing capacity".[182]Also, the Mexican foreign exchange reserves were quickly drying up. The solution: a reduction in the *dollar* value of the *peso* – devaluation.

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[172] Krugman (n 171 above) 39.
[173] As above.
[174] Krugman (n 171 above) 42.
[175] Krugman (n 171 above) 39.
[176] These are peso-denominated bonds issued by the Mexican government and whose coupons and principal are indexed to the USD at the spot rate in effect at the time of issuance. Investors are insulated from exchange rate risks and should the value of the peso fall, the loss is borne by the Mexican government.
[177] H Cole & K Kehoe 'A self-fulfilling model of Mexico's 1994-1995 debt crisis' (1996) 41 Journal of international economics 309-330.
[178] Krugman (n 171 above) 47.
[179] Currency boards were usually used in European colonies where the colony was allowed to issue its own currency but the value of the currency would be rigidly tied to the value of the currency in the colonial master. The domestic currency issue would also have to be backed by hard-currency reserves.
[180] Krugman (n 171 above) 48.
[181] Krugman (n 171 above) 50.
[182] As above.

The December, 1994 decision by Mexico to devalue the *peso* resulted in a terrible crisis, not because the decision was unsound, rather because the process was simply botched. First, the devaluation was not big enough to stem speculation of the possibility of more to come and second, Mexico failed to immediately assure the market of the soundness of the economy resulting in a panic and massive capital flight.[183] The value of the *peso* fell drastically, businesses went bankrupt and there was massive unemployment. [184] The government was unable to roll-over its short term liabilities due to panic by investors and thus had trouble servicing its debts that had been indexed to the dollar.[185]

The crisis spread to other Latin American countries, especially Argentina whose currency was pegged to the dollar under the currency board system. The nature of the crisis in Argentina was the direct result of mass speculation. Doubting the value of the *peso*, there was a sudden demand for *dollars* and everyone sought to convert their *pesos* into *dollars*. The banks ran out of their cash reserves as they could no longer replenish the *pesos* and the central bank could not print new *pesos* due to a prohibitive legislation and could thus not act as a lender of last resort to the banks.[186] As credit conditions tightened, the banks experienced serious runs and "moved quickly to the edge of collapse and threatened to bring the rest of the economy down with them".[187]

The Mexican and Argentine economies were rescued by the infusions of huge amounts of dollars by the American Treasury and the World Bank respectively, effectively stabilising the *peso*.[188]

The experience of the Latin American crisis was a classic example of how markets can be deceptive: "today's good press does not insulate you from tomorrow's crisis of confidence".[189] It was also a lesson that "minor policy mistakes can actually transform into major economic disasters".[190]

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[183] Krugman (n 171 above) 52.
[184] Krugman (n 171 above) 53.
[185] G Corsetti, et al 'What caused the Asian currency and financial crisis? (1999) 11 Japan and the World Economy 305-373 available at: http://www.sciencedirect.com/science/article/pii/S0922142599000195 accessed on 25/09/2017.
[186] Krugman (n 171 above) 55.
[187] Krugman (n 171 above) 54.
[188] J Sachs, et al 'Financial crises in emerging markets: the lessons of 1995' (1996) 147-217 Brookings Papers on Economic Activity.
[189] Krugman (n 171 above) 39.
[190] Krugman (n 171 above) 58.

Perhaps the biggest question today is why there was a repeat of a similar crisis in Asia only four years later, even before the ink had dried.

3.2.4 The Asian flu (1997-1998)

The Asian crisis was, like the Latin American crisis, triggered by a devaluation of currency; Thailand's *baht*. Thailand was traditionally an agricultural economy with its export market characterised by agricultural products.[191] Its transformation into an industrial economy only began in the 1980s with Japanese investors setting up plants in the country.[192] Other investors followed suit but a greater influx of investors from the western economies was to be seen in the mid-1990s following the resolution of the Latin American crisis which renewed investor confidence in developing economies.[193]

Thailand experienced a boom in investments receiving numerous foreign loans and equally experiencing a significant rise in the demand for the *baht*.[194] Most of these loans were however short term liabilities which exceeded the foreign currency reserves, effectively rendering the financial sector very fragile and susceptible to shocks.[195] Ordinarily, an increase in the demand for the *baht* would increase its value against other currencies. However, Thailand's central bank maintained a fixed exchange rate between the *baht* and the US dollar and responded to the increased demand for the *baht* by increasing its supply in the market. The result was an expansion of credit, an increase in speculative investments, and an increase in imports.[196] The export market was not as vibrant as other sectors primarily because China, Thailand's major competitor, had devalued its currency and was thus more competitive in the export market. Eventually, the economy could not sustain this kind of expansion.

Towards the end of 1996, some speculative investments went bust resulting in a decline in foreign loans. This had a serious effect on the central bank as the demand for *baht* on the foreign exchange market declined effectively decreasing its foreign currency reserves.[197] The situation was exacerbated by government's inaction to stem the instability of the currency. Instead, the central bank tried to keep the currency from falling by buying more of the *baht* but in the process depleted its foreign exchange reserves much faster.[198] At this point, the

[191] Krugman (n 171 above) 84.
[192] As above.
[193] As above.
[194] As above.
[195] G Corsetti, et al (n 185 above) 308.
[196] Krugman (n 171 above) 87.
[197] Krugman (n 171 above) 90.
[198] Krugman (n 171 above) 91.

likelihood of the *baht* falling in value became more apparent and speculators took advantage of the situation and sold or exchanged their holdings of the *baht* for other currencies. Eventually, the government succumbed and on July 2, 1997 the *baht* was devalued.[199]

However, instead of restoring the economy with a reasonable margin of devaluation, the currency went into a free fall and the government had to sharply increase the interest rates to prevent further loss.[200] The cause of the plunge in the currency, according to Krugman, was panic[201] characterised by a "decline in confidence in Thailand's currency and economy".[202] Panic by Thailand's external creditors also made it impossible for the country to roll-over its short-term liabilities thus exacerbating its liquidity problems.[203] Both the loss of value of the baht and the increase in interest rates were two sides of the same coin with deleterious effects on the economy. On the one side, dollar debts became burdensome with the low value of the baht and on the other side, repayments on the baht debts were hard to make due to the high interest rates.[204] The sharp increase in interest rates was a move too little too late and instead of restoring market confidence, it induced a contraction of credit increasing the amount of loans and reducing spending. [205] Eventually the economy went into a meltdown.[206]

The effects of the crisis rapidly spread to Malaysia, Indonesia and Korea not necessarily because of their trade linkages, but rather because of their association as beneficiaries of the "*emerging markets fund*".[207] A crisis in one country would trigger a withdrawal of funds from the common fund leaving all other countries in the region susceptible to a crisis of their own.[208] The other major reason for the contagion was that "the market's loss of confidence started a vicious circle of financial and economic collapse".[209] All the economies "were linked in the minds of investors, who regarded the troubles of one Asian economy as bad news about the others; and when the economy is vulnerable to self-validating panic, believing makes it so".[210]

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[199] Krugman (n 171 above) 92.
[200] Krugman (n 171 above) 93.
[201] As above.
[202] Krugman (n 171 above) 94.
[203] G Corsetti, et al (n 185 above) 334.
[204] Krugman (n 171 above) 94.
[205] G Corsetti, et al (n 185 above) 352.
[206] Krugman (n 171 above) 95.
[207] Krugman (n 171 above) 97.
[208] As above.
[209] Krugman (n 171 above) 98.
[210] As above.

3.2.5 The global financial crisis (2007-2008)

The global financial crisis that culminated in the collapse of the American interbank lending markets on 11 August 2007[211] can largely be attributed to disorderly financial markets; a general lack of regulation of the industry; and failure of government supervision of and intervention in the market. The story of the crisis actually began in the 1980s with a large-scale deregulation of the financial markets.[212] These changes in the legal environment marked the beginning of the subprime mortgage industry that singlehandedly brought down the financial markets. What were previously murky waters and forbidden ground suddenly became very attractive.[213]

A subprime mortgage is a mortgage "considered to be more risky than average" as it is extended to borrowers with poor credit ratings.[214] Mainstream banking institutions that were previously averse to subprime lending were lured into the subprime mortgage market by the innovations in the financial sector in the form of securitisation.[215] Mortgage securitisation was highly linked to the relaxation of lending standards[216] as borrowers were no longer being screened and everyone qualified for a home loan.[217] Rating agencies and the government regulators were the only checks on the growth of subprime lending and were supposed to prevent market failures.[218] They however performed dismally as the rating agencies gave good ratings to bad loans and the regulators were simply blinded by the benefits of home ownership to low income families.

Also, the long chain of intermediaries all pursuing their private interests not only contributed to the boom through transfer of risk, but also created systemic instability.[219] As Cassidy puts

[211] JK Galbraith 'From Milton Friedman to Jane D'Arista: The financial crisis and the dilemma facing the central banks' in GA Epstain, et al (eds) *Banking, monetary policy and the political economy of financial regulation* (2014) 31.
[212] J Cassidy *How markets fail* (2009) 252.
[213] As above.
[214] JC Hull 'The credit crunch of 2007: What went wrong? Why? What lessons can be learned?' in AM Berd (ed) *Lessons from the Financial Crisis* (2010) 3.
[215] JC Hull 'The credit crunch of 2007: What went wrong? Why? What lessons can be learned?' in Berd (n 202 above) 7.
[216] BJ Keys, et al 'Did Securitisation Lead to Lax Screening? Evidence from subprime loans' (2010) 125 The Quarterly Journal of Economics 307–362 available at: https://doi.org/10.1162/qjec.2010.125.1.307 accessed on 25/09/2017.
[217] Cassidy (n 212 above) 257.
[218] Cassidy (n 212 above) 262.
[219] Cassidy (n 212 above) 256.

it, "the notion that the self-interested machinations of all players in the subprime business would work out for the best turned out to be an illusion - the illusion of harmony."[220]

Eventually, when investors discovered that the underlying securities were actually not as good as the rating agencies had made them out to be, they sought to withdraw their investments. Stock market speculators who had placed their bets on the booming housing markets also sought to cash in resulting in an unprecedented run in the banking system. Consequently, the ensuing foreclosures rendered most of the new homeowners homeless and the American economy simply contracted with adverse effects to SSA.

3.3 Strengthening global financial markets

Ben Bernanke, the then chairman of the Fed, on 6 March 2007 stated of financial crises thus:

> Financial crises are extremely difficult to anticipate, and each episode of financial instability seems to have unique aspects, but two conditions are common to most such events. First, major crises usually involve financial institutions or markets that are either very large or play some critical role in the financial system. Second, the origins of most financial crises…..can be traced to failures of due diligence or 'market discipline' by an important group of market participants.[221]

Therefore, in strengthening the financial markets, the rapid growth of financial institutions and market discipline should be the primary focus. In his report on reforming the international monetary and financial systems in the wake of the global crisis, Stiglitz noted that "in many countries, the financial system had grown too large; it had ceased to be a means to an end and had become an end in itself".[222]

With the increasing rate of innovation in financial products in the world today, financial markets ought to be the drivers of more productive real economies. They should facilitate the mobilisation of savings, allocation of capital and management of risk.[223] Instead, the operations of financial markets have turned into Keynes' colossal muddle [224]and have become

[220] As above.
[221] PP Drake & FJ Fabozzi *The basics of finance* (2010) 37.
[222] JE Stiglitz 'The Stiglitz report: Reforming the international monetary and financial systems in the wake of the global crisis' (2010) 52.
[223] JE Stiglitz, 'Principles for a New Financial Architecture' (24–26 June 2009)1 Paper presented at the Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System.
[224] Keynes (n 70 above).

a primary cause of economic regression. The instability of global financial markets throughout history is evidence of the volatile nature of financial markets.

The model of financial regulation adopted following the Great Depression and WW2, largely a Keynesian model, appears to have been the most successful in the history of post crisis policy reform.[225] It "kept competition within prescribed limits while allocating credit and capital away from private, speculative activity and into longer-term public investment in physical and social infrastructure".[226] While this approach was more forward looking, subsequent post crisis policy actions have focused more on preventing a repeat of the crisis rather than pre-empting the possibility of a more complex form of the crisis; in essence, "preparing to fight the last war".[227]

Even more alarming, is the move, from the 1970s, away from the Keynesian regulatory model towards privatisation and deregulation.[228]The dangers of deregulation manifested in the post 1970s financial crises whose causes could be traced to the resulting bubble economies.[229]Following the 2007-2008 crisis, Cassidy observed of bubbles that:

> Every bubble is different, but almost all of them share three common features: policymakers beholden to the illusion of stability; financial innovations that make speculating easier; and New Era thinking typified by overconfidence and disaster myopia.[230]

There is an obvious need to rethink how the operations of the financial markets are managed. Reflecting on the 1940s Keynesian model of financial regulation, perhaps "today, we are in need of the same simple tools of regulation - speed bumps and traffic lights - to restore order to our markets and provide the resources needed to rebuild our economy".[231]

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[225] TA Canova 'Financial market failure as a crisis in the rule of law: From market fundamentalism to a new Keynesian regulatory model' (2009) 3 Harvey Law & Policy Review 369, available at: http://nsuworks.nova.edu/law_facarticles accessed on 16/09/2017.
[226] As above.
[227] RP Buckley 'Reconceptualizing the regulation of global finance' (2016) 36 Oxford Journal of Legal Studies 242–271 available at: https://academic.oup.com/ojls/article-abstract/36/2/242/2472457/Reconceptualizing-the-Regulation-of-Global-by accessed on 14/09/2017 p 244.
[228] Canova (n 225 above) 370.
[229] As above.
[230] Cassidy (n 212 above) 239.
[231] Canova (n 225 above) 396.

3.3.1 To regulate or not to regulate

'Excessive leverage', 'excessive risk' and 'proprietary trading' tend to be the most common phrases in any discourse addressing the causes of the 2007-2008 global financial crisis. Naturally, therefore, it would be expected that the post crisis policy and regulatory reform would primarily seek to address these key areas at the centre of the financial collapse.[232] Indeed the US government attempted to address this through the Volcker Rule introduced under the Dodd-Frank financial reform legislation principally prohibiting proprietary trading.

This piece of legislation was however met with such great resistance by the large investment banks and banking institutions that its implementation was effectively postponed on several occasions. The two main criticisms against the Volcker Rule were that, first, by limiting proprietary trading, the banks' role in providing liquidity to the securities market would be greatly hampered; and second, that it would "interfere with the crucial role of *'price discovery'* played by investment banks, hedge funds and other aggressive traders".[233]

These criticisms present what Keynes referred to as a genuine dilemma and require an assessment on whether the need for market liquidity outweighs the need for market stability. Keynes argued that on the one hand, liquidity may be a necessary evil to facilitate capital accumulation.[234] On the other hand, however, "a market in which investors believe they can buy and sell cheaply and unload their risky securities instantaneously at the first hint of trouble will encourage excessive speculation and market volatility".[235] Keynes suggested that the only way to tame the excesses of liquidity was through effective legislation.[236]

Another compelling case for regulation was made by the IMF in 2010 while considering the effects of financial instability on the taxpayers. It noted that "expecting taxpayers to support the financial sector during bad times while allowing owners, managers, and/or creditors of

[232] J Crotty and GA Epstein 'The last refuge of scoundrels: Keynes-Minsky perspectives on the uses and abuses of the "liquidity defense"' in Epstain, et al (eds) (n 76 above) 319.
[233] J Crotty and GA Epstein 'The last refuge of scoundrels: Keynes-Minsky perspectives on the uses and abuses of the "liquidity defense"' in Epstain, et al (eds) (n 76 above) 320.
[234] J Crotty and GA Epstein 'The last refuge of scoundrels: Keynes-Minsky perspectives on the uses and abuses of the "liquidity defense"' in Epstain, et al (eds) (n 76 above) 323.
[235] J Crotty and GA Epstein 'The last refuge of scoundrels: Keynes-Minsky perspectives on the uses and abuses of the "liquidity defense"' in Epstain, et al (eds) (n 76 above) 321.
[236] B Cho 'Investment finance and financial sector development' in Wray & Forstater (eds) (n 92 above) 212.

financial institutions to enjoy the gains of good times misallocates resources and undermines long term growth".[237]

James Tobin also reiterated the need for regulatory control over the financial sector in order to encourage the development of other sectors of the economy. He observed that "we are throwing more and more of our resources, including the cream of our youth, into financial activities remote from the production of goods and services, into activities that generate high private rewards disproportionate to their social productivity".[238] His sentiments were echoed by Turner[239] and Krugman[240] who both felt that the "oversized financial industry [was] hurting the broader economy".[241]

Ultimately, regulation of the financial markets should be pursued "to protect consumers and investors; ensure solvency and financial soundness of the country's financial institutions; promote fairness, efficiency and transparency in the securities markets; and to promote a stable financial system".[242] Following the 2007-2008 crisis, and noting the potential risks to the financial system posed by the secondary market, the EU successfully implemented the first ever regulation on the repo market in the form of the SFT Regulations discussed later on.

3.4 Developing financial markets in Sub Saharan Africa

Instability in the global financial markets not only affects the stronger, more developed economies, but also has dire consequences in the developing economies. Developing countries' vulnerability to the changes in the world economy is compounded by the fact that most of them are highly indebted poor countries.

In SSA, for example, the 1980s debt crisis, which was more directly linked to SSA countries than any of the other crises discussed above, had serious socio-economic effects on the poor. Excessive borrowing by governments and the rich invariably burdened the poor through heavy taxes; and where the governments' expenditures were dominated by loan repayments, their ability to provide basic healthcare, education and other necessities to the poor was

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[237] International Monetary Fund 'A fair and substantial contribution by the financial sector' (June 2010) 9, 15 Final report for the G20 available at: https://www.imf.org/external/np/g20/pdf/062710b.pdf accessed on 25/09/2017.

[238] J Tobin 'On the efficiency of the financial system' (1984) 153 Lloyds Bank Review 14 available at: https://economicsociologydotorg.files.wordpress.com/2014/12/tobin-on-the-efficiency-of-the-financial-system.pdf accessed on 25/09/2017.

[239] A Turner 'How to tame global finance' Prospect Magazine 27 August 2009 available at: www.prospectmagazine.co.uk/magazine/how-to-tame-global-finance accessed on 18/09/2017.

[240] P Krugman, 'Don't Cry for Wall Street' New York Times 23 April 2010 A27.

[241] As above.

[242] KV Wyk 'Regulation of the financial markets' in Zyl, et al (eds) (n 34 above) 122.

severely limited.[243] The situation was made worse with the massive defaults and subsequent withdrawal of credit lines from the west. Saddled with heavy foreign debt and no source of finance, SSA countries had to find alternative financing sources.

Structured trade finance in SSA countries emerged at this time to fill the financing gap through the use of collateral. It was primarily meant to mitigate the risk factor inherent in lending transactions through the transfer of risk from those less able to bear them to those more able to bear them.[244] The financial markets subsequently developed through innovations in available financial products.

The rate at which financial markets are developing in SSA is, however, not at par with the west and even some of the emerging economies of the east. They are "constrained by perceptions of high counterparty risk and often a limited supply of high quality collateral, contributing to high spreads".[245] They are therefore unable to perform certain vital functions in an economy. In his 'Principles for a new financial architecture',[246] Stiglitz noted that a well-preforming modern economy results from a good financial system. He further stated of financial markets as follows:

> Financial markets are not an end in themselves, but a means: they are supposed to perform certain vital functions which enable the real economy to be more productive:
>
> (a) Mobilizing savings;
>
> (b) Allocating capital;
>
> (c) Managing risk, transferring it from those less able to bear it to those more able.

The benefits of well-developed financial systems will continue to be elusive in SSA unless we take advantage of the present day financial innovations and ensure that there are sufficient speed bumps and traffic lights in the form of regulatory control to prevent possible adverse effects on the system.

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[243] RP Buckley 'The rich borrow and the poor repay: the fatal flaw in international finance' (2002/2003) 19 World Policy Journal 62.

[244] UNCTAD, 'Potential applications of structured commodity financing techniques for banks in developing countries' UNCTAD/ITCD/COM/31, (2001) 4 available at: http://unctad.org/en/Docs/poitcdcomd31.en.pdf accessed on 15/06/2017.

[245] Financial Stability Board, IMF & World Bank 'Financial stability issues in emerging markets'(2012) Report to G20 available at: http://www.imf.org/external/np/g20/pdf/110211.pdf accessed on 23/07/2017.

[246] Stiglitz (n 223 above) 1.

3.4.1 Exploring the repurchase (repo) market

As earlier stated, developing countries' vulnerability to the changes in the world economy is compounded by their indebtedness. The nature of public debt in most developing countries has traditionally been foreign or external. However, with the increasing volatility in the global financial markets, most developing countries are increasingly looking towards domestic debt as a less volatile and safer source of finance.[247] The shift towards domestic debt poses certain challenges; among which include the possibility of banks or other institutional investors absorbing "too much government debt" resulting in adverse effects on financial stability and private investments.[248] It is in such cases that the repo market provides the much needed financing lifeline. Indeed, the repo market has been termed "the lifeblood of modern finance".[249]

The repo market is a secondary market where idle debt instruments are utilised to obtain short term funds from entities with surplus funds.[250] Government bonds held by banks can be applied in repo transactions as underlying instruments or collateral assets in exchange for funds from investors or other entities with surplus funds. Repo market transactions in government bonds are particularly attractive to investors or lenders as they provide a double security. Firstly, the lender takes ownership of the security or collateral (bond) for the duration of the loan; and secondly, in the event of default by the borrower, the lender has a second recourse against the bond issuer (government).[251]

Repo markets, therefore, present an attractive opportunity for developing countries seeking to wean themselves off of their dependence on foreign debt. They could provide the necessary support to domestic debt by ensuring the liquidity balance within the banking sector is maintained hence avoiding the crowding out effect on private investments.

3.5 Conclusion

The importance of a well-functioning financial system to the economic development of any country cannot be gainsaid. The history of the global financial markets characterised by one financial crisis after the other resulting from poor policy making and selfish interests of investors are testament that the markets are indeed not perfect and the players not rational. SSA countries are particularly vulnerable to instability in the global financial markets as a

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[247] U Panizza 'Is domestic debt the answer to debt crises?' in Herman, et al (eds) (n 22 above) 92.
[248] U Panizza 'Is domestic debt the answer to debt crises?' in Herman, et al (eds) (n 22 above) 91.
[249] Z Botha 'The money market' in Zyl, et al (eds) (n 25 above) 251.
[250] Z Botha 'The money market' in Zyl, et al (eds) (n 25 above) 209.
[251] Z Botha 'The money market' in Zyl, et al (eds) (n 25 above) 258.

large portion of their public debt is external. Therefore, such instability impedes their ability to provide necessary healthcare, education and other essential services to their already heavily taxed, poor populations.

In a bid to cushion themselves from the adverse effects of global financial instability, most SSA countries are moving towards a greater reliance on domestic debt sources. However, with domestic debt posing a potential strain on financial stability and private investments, the need to develop the SSA financial markets becomes rather urgent and the repo market presents an attractive opportunity.

It is evident from the experience of past financial crises that financial markets are inherently unstable. Therefore, while developing the SSA financial markets, it is imperative that certain checks are put in place in the form of regulation to tame selfish interests and achieve a more balanced resource allocation in the various sectors of the broader economies.

CHAPTER FOUR

PUBLIC DEBT AND THE REPO MARKET: KENYA'S OPPORTUNITY FOR FINANCIAL DEVELOPMENT

4.1 Introduction

"In many ways, repos are the building blocks of financial markets.
To mess with repo is to mess with the DNA of the markets."[252]
Andrew Hill[253]

The vital role played by financial markets in ensuring economic stability and its contribution to the development of the real economy provides a good impetus for financial development in the Kenyan financial markets. Although recent studies show that Kenya has made significant strides in fostering financial inclusion and achieving some measure of financial development, such achievement is dwarfed by comparable achievements in developed countries.[254] The scope for further financial development in Kenya is, therefore, quite broad and any opportunities for such development should be embraced while carefully avoiding the pitfalls that resulted in the financial crises of yester years.[255]

Financial development comprises three main elements: depth, accessibility and efficiency of the markets. Depth entails the size and liquidity of the markets; accessibility refers to the ability of individuals to access financial services; and efficiency refers to the "ability of institutions to provide financial services at low cost and with sustainable revenues, and the level of activity of capital markets".[256] A well-functioning system should therefore portray all three elements.

This study, however, focuses on financial deepening; the volume and liquidity of the markets and Kenya's potential for converting idle debt instruments into useful sources of investment finance through the all-important yet underutilised repo market. This chapter shall, therefore, analyse the extent of Kenya's public debt and its effect on private investments; and explore

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[252] Repo Watch quote by Andrew Hill, September 2015 available at: https://repowatch.org/2010/03/11/the-valukas-report-2200-pages-about-lehman-and-repos/ accessed on 23/09/2017.
[253] Andrew Hill is a senior director, market practice and regulatory policy at ICMA and the secretary to the ICMA secondary market practices committee.
[254] Central Bank of Kenya, Kenya National Bureau of Statistics & FSD Kenya *The 2016 FinAccess Household Survey on financial inclusion* (2016) 1.
[255] R Sahay, et al 'Rethinking financial deepening: Stability and growth in emerging markets'(May 2015) 5 IMF staff discussion note SDN 15/08 available at: https://www.imf.org/en/Publications/Staff-Discussion-Notes/Issues/2016/12/31/Rethinking-Financial-Deepening-Stability-and-Growth-in-Emerging-Markets-42868 accessed on 19/09/2017.
[256] As above.

the opportunity for financial deepening within the Kenyan repo market through the adoption of an appropriate and effective regulatory framework.

4.2 Government fiscal policy

Kenya's fiscal policy is best analysed through three main components: planned expenditure, fiscal deficits and revenue generation.[257] With regard to the planned expenditure, Kenya's annual fiscal budget has increasingly been on an upward trend with figures ranging from Kes 1,459.9 billion in the fiscal year 2012/2013[258] to a whooping Kes 2.627 trillion in the fiscal year 2017/2018.[259] With the most recent massive fiscal budget is an overly ambitious revenue target of about Kes 1,704.5 billion for the fiscal year 2017/2018.[260] The projected fiscal deficit of about Kes 524.6 billion is expected to be met through borrowing.[261]

Kenya's trend of ballooning government budgets in successive years has not been supported by an equivalent increase in revenue generation. Even where, perchance, a sufficient amount of revenue is generated from the various sectors of the economy, the KRA has never met its revenue collections targets. It is, therefore, unlikely that the revenue generated and collected in the year 2017/2018 will be sufficient to meet the estimated government expenditure for the period. The fiscal deficit is thus likely to be greater than projected.

Kenya, like many other developing countries, relies heavily on both external and domestic borrowing to meet her development objectives and annual budgetary obligations.[262] The Government of Kenya (GoK) derives its authority to incur public debt from the Public Finance Management Act (PFM Act)[263] and the Public Finance Management (National Governments) Regulations, 2015 (PFM Regulations)[264] made pursuant to the PFM Act. It may, therefore, borrow funds;

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[257] A Were 'Kenya's fiscal policy: Challenges and recommendations' Emerging Equity 9 November 2015 available at: https://emergingequity.org/2015/11/09/kenyas-fiscal-policy-challenges-and-recommendations/ accessed on 19/09/2017.

[258] As above.

[259] KPMG '2017/2018 Kenya Budget Analysis' 31 March 2017 available at: https://home.kpmg.com/ke/en/home/insights/2017/03/kpmg-2017-2018-kenya-budget-analysis.html accessed on 20/09/2017.

[260] The National Treasury Republic of Kenya 'Budget Statement for the Fiscal year 2017/2018' 30 March 2017 35 available at: http://www.treasury.go.ke/component/jdownloads/send/175-budget-statement/518-budget-statement-2017-18.html accessed on 20/09/2017.

[261] As above.

[262] Central Bank of Kenya (n 11 above) 22.

[263] Public Finance Management Act 18 of 2012 also available at: http://www.kenyalaw.org/lex//actview.xql?actid=No.%2018%20of%202012 accessed on 20/09/2017.

[264] Subsidiary legislation under the Public Finance Management Act available at: http://www.kenyalaw.org/lex//sublegview.xql?subleg=No.%2018%20of%202012#KE/LEG/EN/AR/P/NO. 18 OF 2012/SUBLEG/HC_342015/sec_187

a) by issuing external government securities; or
b) by issuing Treasury Bills or Treasury Bonds or stock; or
c) by advances from Central Bank of Kenya under the Central Bank of Kenya Act (Chapter 491); or
d) by bank overdraft on Exchequer Account or any other public account; or

by any other loan or credit evidenced by instruments in writing. [265]

Kenya's capacity to borrow and repay its debts is considered sustainable as the bulk of the external debt carries concessional terms.[266]However, with the recent increase in commercial borrowing primarily from China and the floating of the Eurobond[267], there has been significant pressure in servicing the loans subsumed within the annual budgets.[268]This, coupled with the unpredictable nature of external financing has resulted in a shift from over-reliance on external debt towards a greater reliance on domestic debt.

Indeed, by the end of June 2015, the ratio of external debt to internal debt stood at 50:50.[269] More recently, the Cabinet Secretary for the National Treasury, in his budget statement, reiterated GoK's intention to focus more on domestic borrowing and only limit external borrowing to those on concessional terms.[270] He further stated that should non-concessional borrowing be necessary, this shall only be pursued in relation to projects with viable expected returns.[271]

Although this move by the GoK is intended to ease the burden of foreign debt, it may also have the unintended effect of pushing Kenyans out of the domestic borrowing markets and increasing "pressure to raise foreign currency to service the fiscal deficit portion sourced externally".[272]

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[265] PFM Regulations 187(2) (b).
[266] Ryan & Maana (n 12 above) 3.
[267] Sovereign debt instruments (government bonds) issued by GoK in Europe in 2014 to raise USD 500 million and USD 1.5 billion in the international markets payable in 5 years and 10 years respectively. The first re-payment is due in 2019 and the second in 2024.
[268] International Monetary Fund & International Development Association 'Debt Sustainability Analysis – Kenya' (2016) available at: https://www.imf.org/external/pubs/ft/dsa/pdf/2017/dsacr1725.pdf accessed on 20/09/2017.
[269] The National Treasury (n 13 above) 3.
[270] The National Treasury (n 260 above) 36.
[271] As above.
[272] Were (n 257 above).

4.2.1 Role of banks in public finance

In Kenya, commercial banks are the major source of domestic debt for GoK as they are the largest holders of government securities in the form of treasury bills and treasury bonds.[273] As at June 2015, the volume of domestic debt held by the banking sector was 55.9% with commercial banks holding the largest volume among all investor categories at 51.4%.[274] The other investor categories include NBFIs, insurance companies, and pension funds including NSSF.

The large holding of government securities by commercial banks is due to the fact that they are largely considered low risk. However, this, coupled with other exogenous factors such as the introduction of interest rate caps on lending and deposits in 2016[275]; a segmented interbank market with great disparities in liquidity levels; low levels of deposits affecting the banks' capacity to lend; and underutilisation of overdraft facilities by corporate borrowers has resulted in the crowding out of domestic bank credit to the private sector.[276] Private borrowers now have to compete with the government for credit within the domestic borrowing markets; a situation that creates a financing gap for private sector driven development activities. There is, therefore, need to bridge this financing gap through alternative sources of funding liquidity for commercial banks.

4.2.2 Role of banks in private sector finance

Commercial banks primarily engage in deposit taking and lending activities and are regulated under the Kenyan Banking Act.[277]They provide banking services to the general public; predominantly the private sector. GoK is banked by the CBK, which is regulated under the Central Bank of Kenya Act.[278] Among the permissible banking or financial business under the Banking Act is the investment of deposits held.[279] Government securities, being the safest form of investment are usually the most preferred by commercial banks as opposed to lending to the private sector which poses a greater risk of default.

Therefore, where both the government and the private sector are competing for the same financing, commercial banks naturally prioritise the government lending with very little funding left for the private sector. This greatly fetters the opportunities for economic growth

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[273] The National Treasury (n 13 above) 8.
[274] The National Treasury (n 13 above) 10.
[275] See n 17 above.
[276] Central Bank of Kenya (n 16 above) 13.
[277] Chapter 488 of the Laws of Kenya.
[278] Chapter 491 of the Laws of Kenya.
[279] Banking Act (n 277 above) sec 2.

and development through the private sector. In order to resolve the conflicting interests arising from the need to minimise external public debt without necessarily crowding out private sector credit, this study proposes that financial deepening in the already existing Kenyan repo market should be pursued.

4.3 The repurchase (repo) market

The repo market has been described as "an elemental building block of modern financial markets. Whether used as a money market instrument, a source of funding, a means of mobilising collateral, or the transmission mechanism for monetary policy, it is difficult to think of any financial instrument or derivative that is not impacted in one way or another by repo rates."[280]

However, the repo market in Kenya is still very rudimentary. It is characterised by horizontal repos among commercial banks for overnight lending activities and the central bank monetary policy function. It is based on pledges of securities and not outright transfer of securities hence does not offer the same comfort with regard to mitigating credit risk as would a real repo market transaction.[281] Where real repo transactions involving actual transfer of securities are concluded, they are concluded within the context of a vertical relationship between the CBK on behalf of the government and a commercial bank. The Kenyan repo environment does not anticipate repo transactions among peer commercial banks or with other investors involving transfer of securities.

The Kenyan repo market, therefore, presents a great opportunity for further deepening. It can be a great source of the much needed liquidity for private sector credit. Public debt instruments such as treasury bills and bonds, which comprise a large portion of commercial banks' asset portfolio, can be used as collateral in the repo market for short term borrowing by the banks to facilitate further lending activities. It is also a flexible and relatively safe investment opportunity for short term investors.[282] Both the borrower and the lender in a repo market transaction stand to benefit from the low transaction costs and the attractive yield on a short term secured transaction respectively.

However, the existing legal and regulatory framework in Kenya does not support a proper functioning repo. Repo transactions are merely referred to under the CBK Prudential

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[280] Repo Watch (n 252 above).
[281] Nicol (n 20 above).
[282] FJ Fabozzi *The handbook of financial instruments* (2002) 173.

Guidelines[283] (Guidelines) as an explanatory note to liquidity reporting requirements.[284] Like any other lending arrangements, however, repo transactions are also susceptible to credit risks even where the underlying collateral is considered high quality.[285] This risk would be compounded in Kenya by the fact that the 'high quality' collateral, being government securities, are issued by a very highly indebted government. Therefore for repo transactions to be attractive to investors, both local and foreign, they must operate within a robust legal and regulatory environment.

In developing the Kenyan repo market, it is important to first gain an understanding of what a real repo transaction is and how it should be effectively conducted to ensure that the parties enjoy its benefits while at the same time insulate themselves from any attendant risks.

4.3.1 Defining a repo transaction

Repo transactions are conducted through repurchase agreements (repo) and are normally used to meet short term liquidity needs.[286] A repo is simply defined as "the sale of security with a commitment by the seller to buy the same security back from the purchaser at a specified price on a designated future date".[287] In most cases it involves the sale and repurchase of government securities although other forms of security can also be used such as money market instruments, corporate bonds or even shares.[288] In a repo therefore, the seller is the borrower seeking a cash loan from the buyer with the security as collateral; and the buyer is the lender accepting the security as collateral for the loan.[289]

In addition to cash loans, repos can be used to obtain securities. In such cases the transaction is referred to as a 'reverse repo' as the buyer now becomes the borrower seeking a securities loan with the cash as collateral; and the seller becomes the lender accepting the cash as collateral for the securities loan.[290]

Other terms associated with repo transactions include:

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[283] Central Bank of Kenya 'Prudential Guidelines for Institutions Licensed under the Banking Act' 2013 (herein referred to as CBK Prudential Guidelines) CBK/PG/05 176.
[284] Under the Guidelines, treasury bills held under a repo agreement do not form part of the commercial bank's liquid assets and can therefore not be negotiated or discounted during the tenure of the agreement.
[285] Fabozzi (n 19 above) 176.
[286] G Gorton & A Metrick 'Securitised banking and the run on the repo' (2012) 104 Journal of Financial Economics 425–451 available at: https://doi.org/10.1016/j.jfineco.2011.03.016 accessed on 12/06/2017.
[287] FJ Fabozzi, et al 'Money markets instruments' in Fabozzi (ed) (n 29 above) 173.
[288] Z Botha 'The money market' in Zyl, et al (eds) (n 25 above) 252.
[289] FJ Fabozzi, et al 'Money markets instruments' in Fabozzi (ed) (n 29 above) 173.
[290] Bank for International Settlements (n 33 above) 3.

Purchase price: this is the amount for which the security is initially sold by the seller/borrower in the repo transaction. This is the loan amount.[291]

Haircut/repo margin: this is the difference between the value of the security and the amount actually lent by the purchaser/lender at the beginning of the repo transaction.[292] Usually, the amount lent is less than the market value of the security to provide the lender "some cushion should the collateral's market value decline".[293]

Repo interest rate: this is the interest rate chargeable on the cash loan and is determined by such factors as the quality of the collateral and the duration of the repo among other factors.[294]

Variation margin: during the term of the repo, the value of the collateral is usually marked to the market. In essence any change in the market value of the collateral is noted and if it falls below the amount borrowed, then a margin call is made and the borrower has to top up the security. Where the market price appreciates, then the lender has to return some of the excess security to the borrower. This shifting of the margin during the term of the repo is what is called the variation margin.[295]

Repurchase price: this is the amount returned by the seller/borrower in order to buy back the security and includes the interest charged on the use of the cash.[296]

4.3.2 Mechanics of a repo transaction

The structure of a repo is usually defined and agreed upon within the repo agreement itself and the transaction involves two main parts.[297] Within the context of commercial banks, the first part involves the sale or transfer of the security by the bank/borrower to the investor/lender in return for the cash loan.[298] The second part involves a contemporaneous agreement by the bank/borrower to repurchase the security upon maturity of the term of the

[291] Z Botha 'The money market' in Zyl et al (eds) (n 25 above) 252.
[292] As above.
[293] FJ Fabozzi, et al 'Money markets instruments' in Fabozzi (ed) (n 29 above) 177.
[294] FJ Fabozzi, et al 'Money markets instruments' in Fabozzi (ed) (n 29 above) 180.
[295] Z Botha 'The money market' in Zyl, et al (eds) (n 25 above) 254.
[296] As above.
[297] Gorton & Metrick (n 286 above) 432.
[298] As above.

loan and at the original price of the security, that is, the amount of the cash loan plus interest earned.[299]

Upon the transfer of the collateral to the lender, ownership rights over the collateral pass to the lender for the term of the repo. This means that the lender has full control of the collateral and can even use it in a subsequent repo subject to the initial repo.[300]

The amount loaned at the beginning of the transaction is usually lower than the value of the security by a predetermined haircut or margin. This margin/haircut reflects "the perceived underlying risk of the collateral and protects the lender against a change in its value".[301] Also, in order to limit the credit risk, the value of the collateral is usually marked to the market thus when the market value of the collateral changes, the repo position is adjusted accordingly through variation margins.[302] For example, a fall in the market value of the collateral will create a margin deficit which must be remedied by the borrower through the provision of additional securities. Conversely, a rise in the market value will create a surplus in the margin and the excess security is returned to the borrower.[303]

The other credit risks attendant to repos relates to counterparty defaults. Repos provide double security where the underlying collaterals are government securities. Thus where the bank/borrower defaults in repurchasing the security upon maturity of the repo, the investor retains control over the collateral and any income owed to the borrower. The value of the collateral at the time of default, however, may present a credit risk to either party. If the market value of the collateral falls below the unpaid repurchase price, then the investor loses any potential gains from the investment. In the same vein, if the market value of the collateral rises during the term of the repo, then the bank loses a valuable asset.[304] In both cases, the effects of default are mitigated by the fact that either party retains ownership and use of either the cash or collateral.

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[299] As above.
[300] As above.
[301] As above.
[302] FJ Fabozzi, et al 'Money markets instruments' in Fabozzi (n 29 above) 178.
[303] Deutsche Bundesbank 'The financial system in transition: the new importance of repo markets' (2013) 59 Monthly report available at: https://www.bundesbank.de/Redaktion/EN/Downloads/Publications/Monthly_Report_Articles/2013/2013_12_repo_markets.pdf?__blob=publicationFile accessed on 25/09/2017.
[304] FJ Fabozzi, et al 'Money markets instruments' in Fabozzi (n 29 above) 177.

Another important aspect in a repo transaction is the settlement and custodial arrangement as this affects the kind of credit exposure the parties will be subjected to.[305] Among the common custodial arrangements are firstly, *hold-in-custody* arrangements where the borrower receives the cash loan but continues to hold the collateral on behalf of the lender. In this case, the lender is at risk of a potential default by the borrower or fraudulent use of the collateral in another repo.[306] Secondly, *delivery-out* arrangements where payment is made against delivery of the collateral and this should ideally occur simultaneously. Thirdly, *tri-party* arrangements where a third party custodian is engaged to take possession of the collateral on behalf of the lender. The custodian "ensures that the collateral meets the lender's requirements, and provides valuation and margining services".[307] The custodian is usually the lender's custodial account in the borrower's clearing bank.[308]

4.3.3 Adapting a repo for Kenya

As already stated above, in Kenya, commercial banks hold the largest volume of government securities. These are idle debt instruments in the banks' books waiting to be cashed in upon maturity. The Banking Act prescribes a minimum liquidity requirement where the total liquid assets of a bank at any given time should meet a certain minimum threshold.[309] These assets could however be held in the form of cash, bank balances in other banks or treasury bills and bonds of not more that ninety one days maturity.[310] Therefore banks may opt to hold more of their liquid assets in the form of treasury bills and bonds provided that the total assets held meet the prescribed minimum threshold.[311]

Where the banks hold an excessive amount of government securities and do not have sufficient cash liquidity to lend to the private sector, they can apply these securities in the repo market as collateral for cash loans which can then be lent out to the private sector. The lenders could be other commercial banks or even local or foreign investors.

To mitigate the counterparty risk, the appropriate settlement and custodial mode to be adopted would be the tri-party arrangement where the investor/lender of the funds opens a custodial account at CBK which is the clearing house for all banks in Kenya. The

[305] Bank for International Settlements (n 33 above) 38.
[306] As above.
[307] As above.
[308] FJ Fabozzi, et al 'Money markets instruments' in Fabozzi (ed) (n 29 above) 180.
[309] Banking Act (n 277 above) sec 19.
[310] As above.
[311] CBK Prudential Guidelines (n 283 above) 158 Currently, an institution is required to maintain a statutory minimum of twenty per cent (20%) of all its deposit liabilities, matured and short term liabilities in liquid assets.

bank/borrower would then deliver the collateral to CBK which now acts as an agent for both parties. Here the costs attendant to delivery of the collateral is significantly reduced as it merely involves a transfer within the borrower's clearing bank.

As the custodian, CBK would hold the collateral on behalf of the lender and manage any changes in the margin by ensuring that it is always adjusted in relation to any changes in the market price of the securities held. It would also ensure that any class of securities comprising the collateral that mature during the term of the repo are replaced by the bank with other securities in order to maintain the margin.

In the event of default by the bank/borrower in repurchasing the securities, then the investor will have a right to any payments due on the securities by the government upon maturity. This payment can be made directly by CBK into the investor's custodial account. Also, with the custodial account, the investor/lender's ability to reuse the securities in another repo transaction is limited hence the possibility of default in delivery back of the collateral upon maturity of the term is mitigated.

4.3.4 Benefits of repos in financial deepening

The main advantage of repos is that with the double security afforded, the investors/lenders would only really lose out if both the borrower and the bond issuer (government) fail.[312] Repos are generally very flexible sources of short term funding as their maturities range from one day to twelve months. Apart from the CBK, other possible investors could be other commercial banks, both local and foreign, "pension funds, unit trusts and even non-financial corporates".[313]

Other notable benefits are that first, banks with a large portfolio of government bills and bonds can obtain cheaper short term funding through the sale of these securities in a repo to finance term loans to bank customers.[314] Second, where any of the categories of investors have surplus cash, they can invest the cash in a repo by buying securities and thus earn a return on the surplus cash.[315] Third, repos can be used to facilitate the implementation of the GoK monetary policy through obtaining cash to maintain an appropriate level of cash

[312] As above.
[313] Z Botha 'The money market' in Zyl, et al (eds) (n 25 above) 258.
[314] Z Botha 'The money market' in Zyl, et al (eds) (n 25 above) 259.
[315] As above.

reserves;[316] and fourth, by buying securities in a repo, banks are also able to satisfy the minimum liquid assets requirements under the Guidelines.[317]

These, among other benefits, warrant a deepening of the repo market beyond merely the vertical repo between CBK and commercial banks; and the horizontal repos among commercial banks based on pledges and not actual transfers. It is, however, commendable that Kenya has begun to embrace the idea of further deepening in the financial markets. Recently, the Kenyan repo market saw the completion of a true repo transaction characterised by a transfer of legal ownership of the collateral instrument. The transaction, touted as *'a first of its kind'*, was completed in 2016 between a Kenyan commercial bank and a South African bank for a one year facility of USD 25 million on the security of GoK bonds.[318]

4.4 Legal and regulatory framework

In Kenya, there is no legal framework governing repo transactions. This is pretty much the case in most countries the world over where attempts at regulating the secondary markets operations have been met with great resistance. The Volcker Rule, for example, that was introduced following the global financial crisis of 2007-2008 in USA as an attempt to stem excessive risk taking by banking institutions, was aggressively resisted resulting in a suspension of its implementation. Thus "the potential for repo markets to act as a channel for financial instability in the event of, or perception of, financial distress at a large dealer remains".[319]

With the lack of a legal framework in Kenya, the pioneer horizontal 'real' repo transaction in 2016 was concluded under the standard ISDA Agreement.[320] This is an "internationally agreed document published by ISDA which is used to provide certain legal and credit protection for parties who enter into over-the-counter (OTC)[321] derivatives".[322] Although the transaction was successful, it was largely market driven and depended on the goodwill of the parties.

[316] As above.
[317] CBK Prudential Guidelines (n 283 above) 158.
[318] D Rozo 'Paving the way in Kenyan repo markets' (2016) available at: www.frontclear.com/paving-the-way-in-kenyan-repo-markets accessed on 03/07/2017.
[319] Repo Watch (n 252 above) quote by Standard and Poor's 13 May 2014.
[320] Rozo (n 318 above).
[321] OTC derivatives are simply financial instruments that are not traded on a formal stock exchange such as debt securities.
[322] Derivatives Documentation Limited 'What is an ISDA Master Agreement?' available at: https://www.derivsdocu.com/services/consultancy/What-is-an-ISDA-Master-Agreement/ accessed on 22/09/2017.

In order to encourage further investment in this market and ensure investor confidence, Kenya should develop an adequate and efficient legal framework to ensure legal certainty for new entrants in the market. From the experience of the 1980s debt crisis, government securities are not always as guaranteed as they are touted to be, more so where the government itself is reeling under a huge debt burden. Therefore, there should be clear channels of mitigating risk and seeking remedy for default by either of the parties including the bond issuer, GoK.

4.4.1 Legislative objectives

In such untapped markets as the Kenyan repo market, certainty and predictability of the business environment are the primary magnets for investors. The lack of an adequate legal framework governing repo market operations therefore presents a major shortcoming.[323]

The objectives of regulation are primarily to "protect consumers and investors; ensure solvency and financial soundness of the country's financial institutions; promote fairness, efficiency and transparency in the securities markets; and to promote a stable financial system."[324] Regulation also ensures competition, prevents financial crime;[325] and ultimately facilitates the creation of new businesses and the expansion of existing businesses through availability of capital.[326]

Recent attempts at regulating the repo markets have been focused primarily on transparency. This is because the repo markets, despite being vital to financial systems, remain largely unknown to both the participants and the regulators. There is really no official data anywhere on the size of this market hence it has operated in most countries without any supervision. It is this opaqueness of the market that resulted in the introduction of the Volcker Rule in the USA and the EU SFT Regulations in Europe. Repos are, however, generally governed by bilateral agreements known as repurchase agreements described below.

4.4.2 Repurchase agreements

The main legal framework governing repos the world over is the GMRA developed by SIFMA[327] and ICMA[328] as adapted by the various countries.[329] The GMRA is a model legal

[323] Bank for International Settlements (n 33 above) 28.
[324] KV Wyk 'Regulation of the financial markets' in CV Zyl, et al (eds) (n 34 above) 122.
[325] J Armour, et al *Principles of Financial Regulation* (2016) 52.
[326] As above.
[327] This is a USA based financial industry trade association created in 2006 from the merger of SIA and BMA.
[328] This is a self-regulatory organisation and trade association that represents the bond and repo markets in Europe. It was created in 2005 from the merger of ISMA and IPMA.

agreement designed to be used in repo transactions.[330] It contains boilerplate clauses that are generic to the market and also allows for adaptation by the parties to reflect the special terms and conditions of their business relationship.[331]

The latest version of the GMRA was published in 2011 having been updated to reflect changes in market practice and general legal developments since 2000[332]; and harmonised with other master agreements, including the GMSLA and the ISDA Master Agreement.[333] The multiplicity of the model agreements that may be adopted in these transactions creates legal uncertainty and the decision to adopt one model over the other is subject to the agreement of the parties. Nevertheless, the only regulatory framework governing the repo market is contained in these agreements which are essentially market driven. Attempts have however be made to regulate repo market activities through the Volcker Rule and the EU SFT Regulations.

4.4.3 The Volcker Rule

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was enacted on July 21, 2010 to effect regulatory changes in the financial services industry in response to the global financial crisis of 2007-2008.[334] Section 619 of the Dodd-Frank Act, commonly known as the Volcker Rule[335]contained provisions primarily prohibiting proprietary trading by banking institutions and their affiliates.[336] It however contained certain exemptions to this general prohibition including the exemption from the application of the rule to such trading activities in connection with market making.[337]

Proprietary trading is the sale and purchase of securities or financial instruments with the intention of making a profit; while market making is a form of proprietary trading designed to provide ‘immediacy’ or liquidity for the investor.[338]

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[329] Z Botha ‘The money market’ in Zyl, et al (eds) (n 25 above) 251.

[330] International Capital Markets Association ‘What is the GMRA?’ available at: https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/repo-and-collateral-markets/frequently-asked-questions-on-repo/19-what-is-the-gmra/ accessed on 22/09/2017.

[331] As above.

[332] The year of the last version of the GMRA.

[333] International Capital Markets Association (n 330 above).

[334] AV Thakor *Economic consequences of the Volcker Rule* (2012) 2.

[335] The Volcker Rule is named after a former Federal Reserve Chairman, Paul Volcker, who is credited as its chief architect.

[336] Thakor (n 334 above) 3.

[337] D Duffie ‘Market making under the proposed Volcker Rule’ (2012) available at: www.stanford.edu/~duffie/ accessed on 16/09/2017.

[338] As above.

The Volcker Rule was introduced to prevent a recurrence of the global financial crisis by stemming excessive risk taking. This was to be achieved through separating commercial banking activities from investment banking, which comprises both proprietary trading and principle investments.[339] It was therefore meant to create a regulatory divide similar to the traditional banking model adopted by the repealed[340] Glass-Steagall Act of 1933.[341]

Also, by removing proprietary trading from the banking business, banks would no longer be distracted "from their fiduciary obligations to clients, as well as from their core function of safely and soundly providing long-term credit to families and business enterprises".[342] Despite the criticisms against the Volcker Rule in relation to liquidity and price discovery, which have been discussed above, another criticism that requires careful consideration is the approach adopted by the Volcker Rule in regulating the financial system.

"To be effective, new financial regulation must reflect new relationships in the marketplace".[343] The Volcker Rule has been said to be simply reviving certain provisions of the repealed Glass-Steagall Act and does not take into account the developments in financial markets particularly with regard to innovations in financial products and securitisation.[344] It has been likened to a financial *Maginot Line*[345] that may be ineffective in applying old principles to present day challenges.[346] In fact, the Rule's approach to banking regulation has been said to have the unintended effect of moving proprietary trading from banks to less regulated entities that affect banks and banking activities.[347] As Whitehead notes, "by causing proprietary trading to move to the hedge fund industry, banks continue to be exposed to the

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[339] D Skeel *The new financial deal* (2011) 86–87.
[340] The Glass-Steagall Act of 1933 was repealed in 1999 by the Gramm-Leach-Bliley Act, also called the Financial Services Modernization Act, which effectively eliminated the separation between loan origination and securities underwriting that was at the heart of Glass-Steagall Act.
[341] CK Whitehead 'The Volcker Rule and evolving financial markets' (2011) Cornell Law Faculty Publications Paper 184 available at: http://scholarship.law.cornell.edu/facpub/184 accessed on 16/09/2017.
[342] Whitehead (n 341 above) 43.
[343] Whitehead (n 341 above) 44.
[344] DH Carpenter & MM Murphy 'The 'Volcker Rule': Proposals to limit 'speculative' proprietary trading by banks' 22 June 2010 7–5700 Congressional research service report for Congress.
[345] The Maginot Line was a line of fortifications and other defences that France constructed along its borders with Germany during the period before World War II. The fortification was based on the success of static, defensive combat in World War I and was intended to provide time for the French army to mobilize in the event of attack. It ultimately proved to be ineffective in World War II, as motorized elements of the German army were able to flank the Maginot Line and proceed directly into France.
[346] IM Gibson 'The Maginot Line' (1945) 17 Journal of Modern History 130, 141–46.
[347] F Guerrera & G Tett 'Goldman President Warns on Bank Rules' Financial Times 26 January 2011 available at: http://www.ft.com/cms/s/0/f9753506-2990-11e0-bb9b-00144feab49a,s01=1.html#axzz1F56PbpaL accessed on 25/09/2017.

same risks – perhaps less directly than before, but now in an industry also subject to less regulation".[348]

There is hardly any doubt that the Volcker Rule's objective in addressing systemic risk and banking fragility is laudable and necessary.[349] Its approach in embracing historical successes can also not be entirely faulted. For decades, the Glass Steagall Act ensured stability of the financial markets and the changing landscape in financial markets should have informed the development of the law and not its absolute abandonment. The Volcker Rule could be further refined to take into account the changing financial markets landscape or a possible alternative introduced through capital and liquidity regulations[350] similar to those prescribed by the Basel III Capital Regulations.[351] It is, however, a step in the right direction.

4.4.4 EU SFT regulations

The most successful attempt at regulating the repo market was made by the EU with the passing of Regulation (EU) 2015/2365 on Transparency of Securities Financing Transactions and Reuse (SFT Regulations).[352] The Regulations "lay down rules on the transparency of securities financing transactions (SFTs) and of reuse"[353] and applies to repurchase transactions, securities or commodities lending, buy sell-back transactions, and margin lending transactions.[354]

These Regulations impose reporting requirements on all market participants, whether financial or non-financial participants, of details regarding the SFTs concluded, the composition of the collaterals, and the haircuts applied.[355] The financial participants referred to include investment firms, credit institutions, insurance undertakings, and central securities depositories.[356]

The Regulations also require information on the risks inherent in the securities financing markets to be centrally stored and accessible by the regulators[357] and that such information is

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[348] Whitehead (n 341 above) 73.
[349] Thakor (n 334 above) 33.
[350] V Acharya, et al 'Robust Capital Regulation' (2012) Working paper, Federal Reserve Bank of New York.
[351] Basel III is a global regulatory standard on bank capital adequacy, stress testing and market liquidity risk agreed upon by the members of the Basel Committee on Banking Supervision.
[352] The SFT Regulations were passed on 25 November 2015 by the European Parliament and the European council.
[353] See Article 1 of the SFT Regulations.
[354] See Article 3 (11) (a)-(d) of the SFT Regulations.
[355] Preamble (n 352 above) Par 10.
[356] See Article 3 (3) of the SFT Regulations.
[357] Preamble (n 352 above) Par 13.

exchanged among the competent authorities within the financial markets.[358] On reuse of collateral, the Regulations impose minimum information requirements on the right holder. “Reuse should only take place with the express knowledge and consent of the providing counterparty. The exercise of a right to reuse should therefore be reflected in the securities account of the providing counterparty”.[359]

The Regulations also provide for administrative sanctions for non-compliance by the parties.[360]

While passing the above Regulations, the EU Parliament and Council noted that despite the efforts at strengthening the banking system, the global financial crisis of 2007-2008 had revealed certain shortcomings and “highlighted the need to improve transparency and monitoring not only in the traditional banking sector but also in areas where bank-like credit intermediation known as ‘shadow banking’, takes place”. [361]

4.5 Conclusion

While Kenya has made significant strides in the development of its financial markets particularly with regard to accessibility and efficiency of the markets, the depth of the markets remains largely unexplored. With the ballooning annual fiscal budgets and the recent inclination by GoK towards domestic debt sources, there is a pressing need for financial innovation to provide alternative sources of finance that can support both public and private sector credit.

The Kenyan financial markets present an attractive opportunity for financial deepening, particularly within the repo market. Kenya’s repo market is characterised by horizontal repos among commercial banks based on pledges of securities and not outright transfer of securities. Outright transfers are only made within the context of a vertical relationship between the CBK on behalf of the government and a commercial bank. The Kenyan repo market does not anticipate repo transactions involving transfer of securities among peer commercial banks or with other investors.

This chapter has therefore sought to lay out the potential benefits of expanding the repo market particularly in providing an alternative source of financing; and how a repo structure

[358] Preamble (n 352 above) Par 14.
[359] Preamble (n 352 above) Par 22.
[360] Preamble (n 352 above) Par 26.
[361] Preamble (n 352 above) Par 1.

can be adapted within the Kenyan financial system. Being a secondary market operation and with "the potential of the repo markets to act as a channel for financial instability",[362] this chapter has also highlighted the recent efforts at regulating the repo market particularly through the introduction of the Volcker Rule in the USA and the EU SFT Regulations in Europe. Kenya can borrow from these efforts in establishing its own regulatory framework to support a more robust repo market.

[362] Repo Watch (n 252 above) quote by Standard and Poor's 13 May 2014.

CHAPTER FIVE

CONCLUSION AND RECOMMENDATIONS

5.1 Summary of findings

The inadequacy of finance has over the years been a major barrier to trade the world over. In order to bridge financing gaps, several attempts have been made in developing financial markets to provide alternative sources of finance and thus facilitate trade.

Financial markets today are characterised by complex innovations in financial products. Such innovations have had significant impact in the economic wellbeing of many countries while at the same time have been the source of great instability within the global financial markets. Attempts at stemming such instability through regulation have largely been unsuccessful with market players preferring unfettered market liquidity. The aim of regulation, however, is not to unnecessarily fetter market liquidity but rather to allow "financial institutions to provide investment finance in a more stable manner and firms to make sound investment decisions through stabilising the liquidity preference and controlling the liquidity pursuit appropriately."[363]

SSA countries are particularly vulnerable to instability in the global financial markets as they rely heavily on external debt. Thus the unpredictable global financial environment greatly affects their ability to provide necessary healthcare, education and other essential services to their poor populations. This study posits that though greatly outpaced by the west in financial innovation, SSA countries have a great potential to develop their own financial markets and minimise their overreliance on external debt. Such financial markets can be developed with adequate checks to ensure that these countries reap the benefits of robust financial systems while at the same time avoiding the pitfalls that the global markets have contended with in the recent past.

With a greater focus on Kenya, this study suggests that Kenya's opportunity for financial deepening, to create alternative sources of financing for development, lies in the repo market. A well-developed repo market will not only support domestic debt thus easing the burden of external debt, but will also ensure sufficient funding liquidity for private sector credit. In developing the repo market, an adequate legal framework is also necessary to check any possible excesses within the market that may result in instability.

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[363] B Cho 'Investment finance and financial sector development' in Wray & Forstater (eds) (n 92 above) 212.

5.2 Conclusion

Throughout history, a consensus has never been reached on the most effective way through which markets should operate. The discourse from free markets to controlled markets and back to free markets only serves to create uncertainty in the policy making space particularly with regard to financial markets. Despite the varied theories on the operations of the markets, it is worth noting that a common idea transcends these theories; government intervention.

A well-functioning financial system is vital for the economic development of any country. The history of the global financial markets, characterised by one financial crisis after the other resulting from poor policy making and selfish interests of investors, are testament to the volatile nature of financial markets. For SSA countries, the adverse effects of such financial crises on their economies are overwhelming hence the recent move towards a greater reliance on domestic debt sources which are cheaper and relatively predictable.

However, with domestic debt posing a potential strain on financial stability and private investments, the need to develop the SSA financial markets becomes rather urgent. It is evident from the experience of past financial crises that financial markets are inherently unstable. Therefore, while developing the SSA financial markets, it is imperative that certain checks are put in place in the form of regulation to tame selfish interests and achieve a more balanced resource allocation in the various sectors of the broader economies.

In Kenya, the ballooning annual fiscal budgets and the increasing need to meet the fiscal deficits through public debt necessitates innovation in the financial markets to provide alternative sources of finance. Although Kenya has made significant strides in the development of its financial markets particularly with regard to accessibility and efficiency of the markets, the depth of the markets remains largely unexplored. The repo market, therefore, presents an attractive opportunity for financial deepening.

Repo transactions mostly involve the sale and repurchase of government securities to meet short term liquidity needs.[364] Other forms of security that may be transacted in a repo include money market instruments, corporate bonds or shares.[365] While commercial banks in Kenya hold the largest volume of government securities, they are also the primary source of private sector credit in the form of term loans. Therefore, an increase in domestic debt by GoK carries with it the unintended effect of crowding out private sector credit. A healthy balance

[364] Gorton & Metrick (n 286 above) 431.
[365] Z Botha 'The money market' in Zyl, et al (eds) (n 25 above) 252.

between domestic debt and private sector credit can be achieved in the repo market through the conversion of idle debt instruments into available cash for further lending to the private sector.

Kenya's current repo environment, however, does not support a robust repo market. It does not anticipate repo transactions involving transfer of securities among peer commercial banks or with other investors. Such transactions only happen within the context of a vertical relationship between the CBK on behalf of the government and a commercial bank. This study has therefore sought to highlight the potential benefits of expanding the repo market to allow for market making activities among commercial banks and interested investors.

The main benefits of the repo market are that it is a source of cheaper short term funding for banks through the sale of securities to finance term loans[366]; and an avenue for investment of surplus cash by investors to earn a return on investment.[367] Other benefits include the double security afforded to investors with recourse against both the borrower and the bond issuer; the flexibility of the market; facilitating the implementation of GoK monetary policy in terms of cash reserves[368]; and the satisfaction of minimum liquid assets requirements by banks.[369]

While pursuing financial deepening in the repo market, it should always be borne in mind that the "repo has a flaw: it is vulnerable to panic, that is, 'depositors' may 'withdraw' their money at any time, forcing the system into massive deleveraging".[370] Also, as observed by the USA Senate, "the repo market is as complex as it is crucial. It is built upon transactions that are highly interrelated. A collapse of one institution involved in repo transactions could start a chain reaction, putting at risk hundreds of billions of dollars and threatening the solvency of many additional institutions".[371] Therefore to deal with the potential instability within this market, this study proposes legislative speed bumps to ensure that the market remains within the reasonable control of the regulators.

5.3 Recommendations

In order to ensure a robust and efficient repo environment certain regulatory measures should be introduced. There is, however, no need for the introduction of new legislation as the

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[366] Z Botha 'The money market' in Zyl, et al (eds) (n 25 above) 259.
[367] As above.
[368] As above.
[369] CBK Prudential Guidelines (n 283 above) 158.
[370] Repo Watch (n 252 above) quote by Gary B. Gorton, professor of management and finance, Yale School of Management, August 14, 2010.
[371] Repo Watch (n 252 above) quote from the USA Senate report, 1983.

measures can be adopted within the existing legislation to avoid duplication or a multiplicity of laws.

First, the legislation should allow all banking and NBFIs that hold government securities to participate in repo market transactions. This should be endorsed by the CBK, being the primary regulator of financial services.

Secondly, where banking institutions are involved, structural regulation should be introduced to define and restrict the activities that they may be involved in.[372]With regard to repo markets, banking activities as defined within the Banking Act[373]should also include proprietary trading but only for market making purposes, that is, to provide funding liquidity for the bank cheaply and quickly as and when necessary. Proprietary trading should however be limited to only government securities; thus, the other assets of the bank such as mortgages should not be included among the tradable assets.

Thirdly, all market participants must be subject to reporting requirements regarding the repo transactions. Information to be submitted should include the details of the parties to the transaction, the composition of the collaterals used, the term of the agreement and the haircuts applied. The market participants include the investors and the other NBFIs holding government securities such as insurance companies and pension funds, among others.

Fourthly, a central platform for information sharing should be established where details of the inherent risks of the transactions are recorded and are accessible by the various financial services regulators such as the CBK, the capital markets authority, the insurance regulatory authority and the SACCO societies regulatory authority. Such information should also be easily exchanged when reference is required.

Fifthly, minimum information requirements should also be imposed on the investors regarding the reuse of collateral. Thus the original holder of the security must be notified and their express consent in writing sought before such securities are reused by the investor.

Sixthly, administrative sanctions must also be imposed for non-compliance with any of these requirements.

(24,332/26,430 words)

[372] J Armour, et al *Principles of Financial Regulation* (2016) 505.
[373] See (n 277 above).

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