



United Nations  
Economic Commission for Africa

# MACROECONOMIC & SOCIAL DEVELOPMENTS IN EASTERN AFRICA 2018

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# **Macroeconomic & Social Developments in Eastern Africa 2018**



United Nations  
Economic Commission for Africa

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This report is a collective effort of colleagues of the Sub-Regional Office for Eastern Africa of UNECA. The report was prepared under the general guidance of Andrew Mold, Officer-in-Charge of the Sub-Regional Office for Eastern Africa. The lead author was Wai Kit Si Tou, with inputs being provided by Andrew Mold, Priscilla Lecomte, Rodgers Mukwaya, Pedro Martins, Emelang Leteane, Yohannes Hailu, and Geoffrey Manyara of the Sub-Regional Office for Eastern Africa.







## EXECUTIVE SUMMARY



## EXECUTIVE SUMMARY

The economic performance of Eastern Africa has been impressive in recent years, with an average annual growth rate of 6.5 per cent between 2012 and 2016 – much higher than the African average and even outpacing East Asia. The people of the region live longer and healthier, receive better education, and enjoy an improved quality of life compared with just a generation ago. These positive results are largely attributable to increased state capacity, as governments in the region have rebuilt their institutions after the 'lost decades' of the 1980s and 1990s. Where state action has been effective, improvements have been largest.

Despite the positive developments, there are a number of challenges looming on the horizon. Amid the severe drought conditions which afflicted parts of the region, Eastern Africa recorded a marked moderation in its economic growth in 2016, down to 5.5 per cent from 7.1 per cent in 2015. According to UNECA estimates, regional economic growth was little changed in 2017 (at 5.5 per cent), with a modest acceleration

*Regional economic growth was little changed in 2017 (at 5.5 per cent), with a modest acceleration to 5.9 per cent being forecast for 2018.*

to 5.9 per cent being forecast for 2018. However, as this report stresses, this performance is still well below the ambitious developmental goals that many member States have set themselves, and the region is not on track to meet targets of achieving middle-income status. Meanwhile, job creation and poverty reduction have not kept pace with a rapidly growing population and workforce. Policymakers have to contend with a

large informal sector and some of the fastest rates of urbanization in the world.

One of the key questions this report asks is whether the region is about to enter into a new dynamic, with slower growth rates and growing developmental challenges. To avoid such a scenario, some key constraints to growth would need to be addressed.

- Firstly, a weak manufacturing sector has made the regional economy less resilient. Compared to the rapid expansion of the services sector, the development of the manufacturing sector has been lagging behind, as evidenced by the stagnant or even declining share of manufacturing value added over the last decade. Although some service sub-sectors (e.g. tourism) have shown considerable dynamism and job creation potential, an excessive dependence on the services sector may not generate sufficient employment opportunities to sustain inclusive growth. Other than in Ethiopia, which has implemented an ambitious programme of export-oriented industrial parks, industrial policies have not thus far managed to promote robust growth in the manufacturing sector. This also partly explains why the economic performance has fallen short of national growth targets.

*A weak manufacturing sector has made the regional economy less resilient.*
- Secondly, this report stresses the need to continue improving the business environment. Across the region, private sector development has been relatively lackluster. In some countries, the bulk of productive investments are accounted for the public sector and the private sector has generally lagged behind. Growth would be stronger and more resilient if policies were made to bolster private sector activity. One key constraint to achieving this, as reflected in repeated business surveys, is the lack of access to credit. Although central banks generally maintained an accommodative monetary policy in 2017, credit growth remained sluggish and the cost of borrowing often prohibitive. The interest rate cap introduced in 2016 by the Central Bank of Kenya was an interesting initiative intended to address these problems, and did succeed in bringing down lending rate and loans-deposit spread. Yet the impact of the interest rate cap in terms of improving long-term access to credit is unclear.

*Although central banks generally maintained an accommodative monetary policy in 2017, credit growth remained sluggish and the cost of borrowing often prohibitive.*
- Thirdly, the prospects for economic diversification and industrial growth are greatly improved by the necessary investments in infrastructure. In recent years, the region has been doing well in terms of providing a much-needed boost to infrastructural investment. A promising development came in 2013, with the announcement of *China's Belt and Road Initiative*, which has directly implicated a number

of economies in the region (e.g. Djibouti, Ethiopia and Kenya). In 2016-17, two large-scale projects were completed with the financial support from China – Kenya’s Nairobi-Mombasa railway and the Addis Ababa-Djibouti railway. Economic activity has undoubtedly been boosted by this infrastructure investment boom. However, the increased public expenditure has also started to stretch budgets and a number of countries have experienced rising debt levels. For instance, Kenya’s public debt is projected to rise to around 55 per cent of GDP in 2017, compared with 44 per cent in 2013. Djibouti was rated by the IMF as a country at a high risk of debt distress and the risk has increased significantly in recent years, something that could constrain future growth and increase vulnerability. These trends clearly need monitoring.

- Fourthly, in the context of structural current account deficits, regional economies have to better manage exchange rate fluctuation. Most countries in the region have now adopted either floating exchange rate or ‘managed’ float. Many currencies recorded notable depreciations against the US dollar between 2014 and 2016, although there was some stabilisation in 2017. Currency depreciations together with the spike in food prices due to severe drought conditions exerted upward pressure on inflation. Following a subsequent fall in the value of US dollar and an easing effect of a prolonged dry season, both exchange rate and inflation pressures subsided mid-2017.
- Fifthly, the region is still underperforming in terms of exports, as evidenced by the large trade deficits sustained by most countries. The structure of trade also remains little changed compared to the situation a decade ago. Specifically, exports are still excessively concentrated on primary commodities, leaving the region in the lower rungs of global value chains and highly vulnerable to commodity price shocks. The report highlights the role not only of goods exports, but also of services – and in particular tourism, which is a major foreign exchange earner in a number of countries across the region (e.g. Comoros, Ethiopia, Rwanda and Seychelles).

This leads us to a more general discussion about the regional trade performance and its determinants. Trading relations have been complicated by a number of new developments in recent years, with both positive and negative implications. Firstly, countries have been diversifying their trade away from traditional

*The rise of China and India as a source of imports may be good news for consumers, but it also implies greater competition in domestic markets, especially for local manufacturers.*

markets (e.g. Europe) towards new trading partners (e.g. China and India). The rise of China and India as a source of imports has been particularly notable, accounting more than a third of all imports into the East African Community (EAC) in 2016. This may be good news for both consumers and purchasers of capital goods, as it has reduced the relative price of some consumer and machinery imports, but it also implies greater competition in domestic markets, especially for local manufacturers.

At the same time, relations with major traditional trading partners have been complicated by a series of disputes. The proposed Economic Partnership Agreements (EPA) between the European Union (EU) and the EAC potentially offers a more permanent and stable basis for access to the European market, but it has raised concerns about how the agreements could constrain the policy space in the design and implementation of industrial policy. This issue resulted in major disagreements among EAC member States in 2017. Controversies have similarly surrounded the African Growth and Opportunity Act (AGOA) with the United States. As this report makes clear, the benefits from AGOA have hitherto been modest and poorly distributed among member States, with just two countries in the region (Kenya and Madagascar) managing to export significant quantities of goods under the provisions of the agreement. With a view to reinvigorating the regional textile and clothing industry, the EAC proposed a ban on the import of second-hand clothing in 2016. As a result, however, the eligibility of Rwanda, Tanzania and Uganda to receive benefits under AGOA was reviewed – a measure hardly likely to be conducive to improving the effectiveness of AGOA, as it highlights the impermanence of the market access offered under the agreement.

*The benefits from AGOA have hitherto been modest and poorly distributed among member States, with just two countries in the region (Kenya and Madagascar) managing to export significant quantities of goods under the provisions of the agreement.*

Finally, the region has had to confront numerous humanitarian crises in 2016 and 2017. Around 31 million people suffered from severe food insecurity as of May 2017. The region is also one of the largest recipients of refugees in the world hosting around 3.5 million refugees at the end of 2016, with Uganda and Ethiopia accommodating around half of them. In addition, there were 5.8 million internally displaced persons (IDPs), mainly in D.R. Congo, South Sudan and Somalia due to political instability and/or civil conflict. The recent outbreaks of communicable diseases, combined with the increasing number of vulnerable populations, could have significant implications on public health. Several emerging social problems usually associated with middle- or high-income countries, such as the prevalence of cancer, drinking and smoking, and road traffic deaths, are being overlooked and could impose a further burden on the region.

*Several emerging social problems usually associated with middle- or high-income countries, such as the prevalence of cancer, drinking and smoking, and road traffic deaths, are being overlooked.*

To sum up, the region has clearly performed well over the last decade, but is beginning to confront a new set of challenges. To sustain the impressive development, this report recommends member States to focus more attention on (i) actively implementing reforms to create a more conducive business environment, especially with regard to providing adequate financing of the private sector; (ii) better leveraging inflows of FDI into the manufacturing sector to facilitate a more rapid technological upgrading and faster job creation; (iii) continuing to invest in infrastructure but in financially sustainable ways; (iv) strengthening domestic resource mobilization and managing external borrowing prudently; and (v) strategically reviewing existing trade agreements.





MACROECONOMIC PERFORMANCES



# 1. MACROECONOMIC PERFORMANCES

## 1.1. Moderated Growth Momentum in Eastern Africa

The world economy was sluggish in 2016, with an expansion of just 2.4 per cent. Supported by the strengthening of global economic activity since the end of 2016 (e.g. trade and industrial production), the world economy is expected to grow by 3.0 per cent in 2017 and 2018 (UNDESA, 2017a).

The slowdown in economic growth was more notable in Africa, down from 3.1 per cent in 2015 to 1.7 per cent in 2016. The low growth rate was due to adverse weather conditions, subdued global economic recovery, low commodity prices and political instability. In particular, the growth rate of oil exporters like Nigeria fell sharply to -1.6 per cent in 2016. Meanwhile, South Africa registered a negligible growth of 0.3 per cent in 2016 amid a slump in mining and quarrying. Following the easing of the prolonged dry season and improving external demand, growth is expected to rebound to 3.0 per cent and 3.5 per cent in 2017 and 2018 respectively (UNDESA, 2017a). Having said that, the continent remains vulnerable to global headwinds, weather-related shocks, as well as political conflicts.

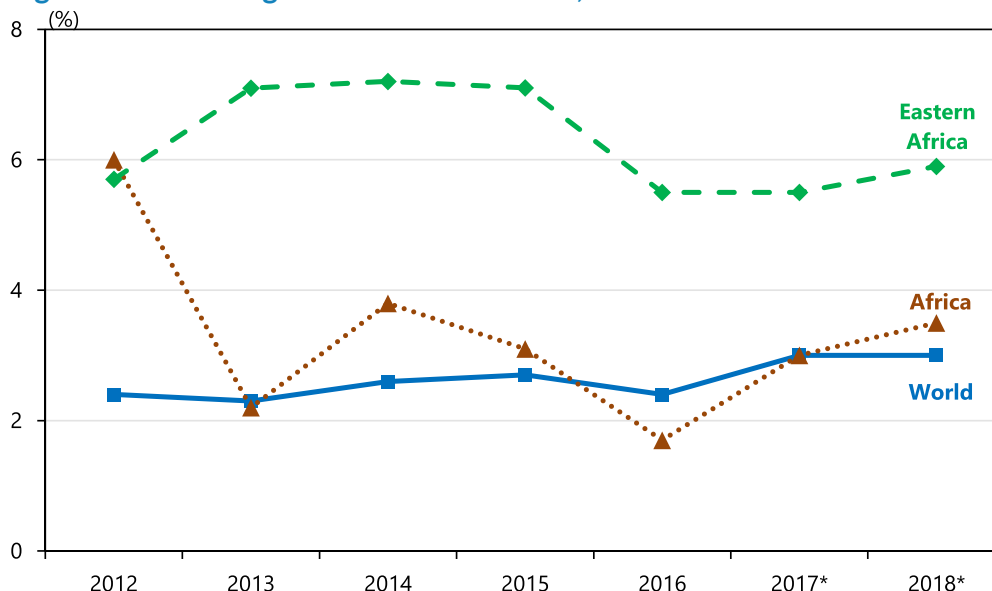
Regarding Eastern Africa<sup>1</sup>, the growth performance remains impressive. The average growth rate between 2012 and 2016 was 6.5 per cent, much higher than the African average (3.4 per cent) and the world average (2.5 per cent) and even outpacing East Asia (6.1 per cent) over the same period. Nonetheless, growth in the region moderated to 5.5 per cent in 2016. One particularly important reason for the slowdown was the fact that several countries in the region (e.g. Kenya, Uganda and Rwanda) experienced a sharp decline in agricultural performance, due to severe drought conditions. The evidence suggests that Eastern Africa is especially vulnerable to the dynamics of climate change (Abidoye and Odusola, 2015).<sup>2</sup>

*The economic performance of Eastern Africa has been impressive, with the average growth rate between 2012 and 2016 outpacing East Asia.*

<sup>1</sup> For the United Nations Economic Commission for Africa (UNECA), Eastern Africa is a region comprising of 14 countries: Burundi, Comoros, D.R. Congo, Djibouti, Ethiopia, Eritrea, Kenya, Madagascar, Rwanda, Seychelles, Somalia, South Sudan, Tanzania and Uganda.

<sup>2</sup> Analysis by Abidoye and Odusola (2015), based on annual data for 34 African countries from 1961 to 2009, suggests that a 1°C increase in temperature reduces annual GDP growth by 0.67 percentage points. In some countries in Eastern Africa, the impact of climate change on GDP growth is even more significant, at -1.11 and -0.94 percentage points in D.R. Congo and Madagascar, respectively. For other countries in the region, the impact on GDP growth ranges from -0.50 percentage point in Rwanda to -0.81 percentage point in Burundi. This represents a significant drag on the regional growth performance. It should also be noted that the climate data used by Abidoye and Odusola ends in 2009. In the years since then, global temperatures have continued to rise, suggesting that the negative impacts on GDP growth attributable to climate change are likely to be larger.

**Figure 1: Real GDP growth in Eastern Africa, Africa and the World**



Notes: (\*) Forecast.

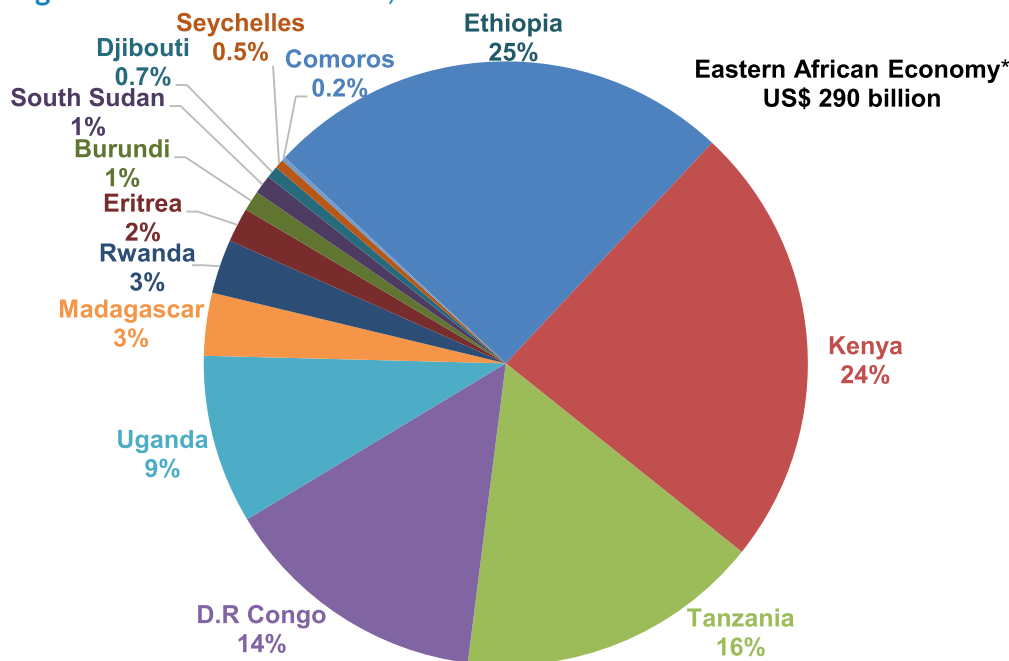
Data for Eastern Africa is the weighted average (based on current prices gross domestic product (GDP) figures) of the 12 countries (excluding Somalia and South Sudan).

Sources: National sources, UNDESA (2017a), IMF (2017a) and UNECA calculations.

Economic growth was little changed in 2017, at 5.5 per cent, with a modest acceleration to 5.9 per cent being forecast for 2018 (Figure 1). In 2016, the Eastern African economy amounted to around US\$ 290 billion, representing approximately 13 per cent of Africa GDP.<sup>3</sup> Ethiopia overtook Kenya as the largest economy after years of robust economic growth, despite its relatively low income per capita. The five largest economies, namely, Ethiopia, Kenya, Tanzania, D.R. Congo and Uganda, account for around 88 per cent of the regional economy. While the GDP share of most countries remains largely stable, the share of South Sudan shrank drastically from around 9 per cent in 2011 to just 1 per cent in 2016, amid a severe recession caused by political strife and a sharp fall in oil production (Figure 2).

<sup>3</sup> Given that Eastern Africa is home to around one-third of Africa population, the region is under-represented in terms of GDP.

**Figure 2: Nominal GDP share, 2016**

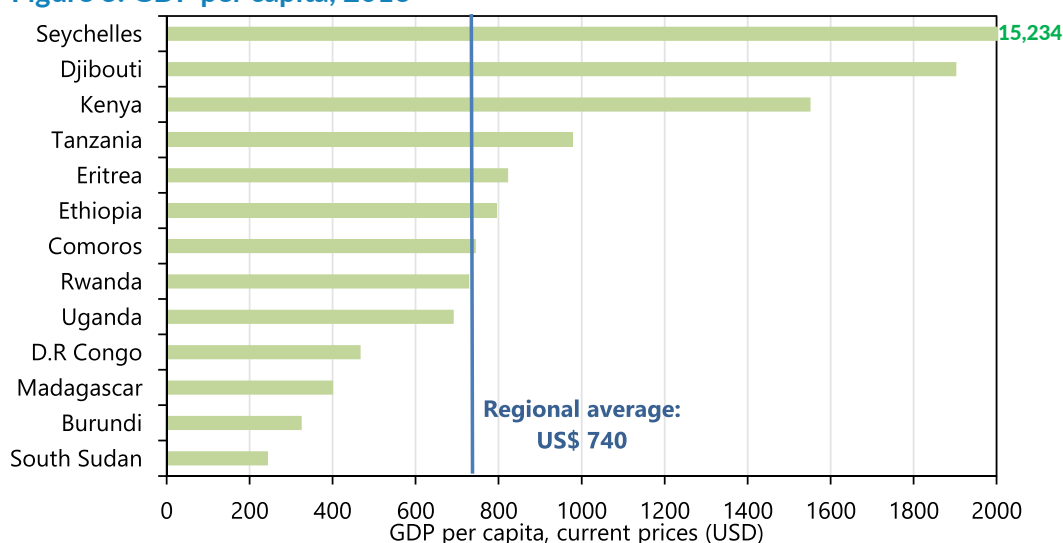


Note: (\*) Somalia is not included.

Source: IMF (2017a).

Reflecting the sustained nature of economic growth, the average GDP per capita of the region doubled over the last decade to around US\$ 740 by 2016. Seychelles continues to be the country with the highest average income in the region, enjoying a per capita income of around US\$ 15,000 in 2016. Djibouti and Kenya are the second and third highest, respectively. Notwithstanding the ambitious national development plans, which aim at achieving middle-income status within a fairly short time horizon, all other countries in the region are currently classified by the World Bank as low-income (Figure 3).

**Figure 3: GDP per capita, 2016**



Source: IMF (2017a).



Regarding the economic performance of individual countries in the region, Ethiopia, Rwanda and D.R. Congo experienced the fastest growth rates between 2012 and 2016. Nevertheless, even in these cases growth moderated in 2016 due to lower agricultural production amid the El Niño induced drought and declines in commodity prices. As for the other major economies in the region, Tanzania and Kenya sustained solid growth in 2016, while the Ugandan economy lost momentum due to poor agricultural and manufacturing performances (Table 1). In terms of the economic performance in 2017, the most recent statistics suggest moderated growth compared to 2016. For example, Kenya's economy expanded by 4.4 per cent in the third quarter of 2017, compared to 5.6 per cent in the third quarter of 2016.<sup>4</sup> In Tanzania, economic growth also moderated to 7.8 per cent in the second quarter of 2017 from 8.5 per cent observed in 2016.

*Between 2012 and 2016, Ethiopia, Rwanda and D.R. Congo experienced the fastest growth rates in the region.*

**Table 1: Real GDP Growth (% annual change)**

	2012	2013	2014	2015	2016	2017*	2018*	Average Growth Rate (2012-2016)
Ethiopia	8.6	10.6	10.3	10.4	7.6	6.5	7.3	9.5
Rwanda	8.8	4.7	7.6	8.9	5.9	6.2	6.8	7.2
D.R. Congo	7.1	8.5	9.5	6.9	2.5	3.0	3.0	6.9
Tanzania	5.1	7.3	7.0	7.0	7.0	7.0	6.8	6.7
Djibouti	4.8	5.0	6.0	6.5	6.7	6.8	6.8	5.8
Kenya	4.5	5.9	5.4	5.7	5.8	5.2	5.9	5.5
Seychelles	3.7	5.0	6.2	4.3	5.9	4.1	3.4	5.0
Eritrea	7.0	3.1	5.0	4.8	3.5	3.2	3.4	4.7
Uganda	3.2	4.7	4.6	5.7	2.3	5.2	5.7	4.1
Madagascar	3.0	2.3	3.3	3.1	4.2	4.3	4.5	3.2
Comoros	3.0	3.5	2.1	1.0	2.2	3.0	3.4	2.4
Burundi	4.4	4.9	4.5	-3.9	-0.5	0.0	0.0	1.9

Notes: (\*) Forecast.

Data for Ethiopia refer to fiscal years (July/June) and data for 2012 represent fiscal year 2011/12.

Sources: National sources, UNDESA (2017a), IMF (2017b) and UNECA calculations.

<sup>4</sup> Apart from the drought which has led to crop failure, the political unrest caused by the annulment of the general election result in August 2017 and a subsequent rerun of the election in October 2017 affected business confidence, thereby weighing on the economic performance in 2017.

### Box 1: Did Economic Growth Meet National Targets?

Countries in the region have been setting ambitious targets on economic and social developments. Some of the examples are cited below, with comparison between the actual economic performance and the growth targets:

**Ethiopia:** Since the early 2000s, Ethiopia has been setting development plans with the aim of achieving broad-based, accelerated and sustained economic growth so as to eradicate poverty. The development plans include the Sustainable Development and Poverty Reduction Program (SDPRDP, covering 2002/03-2004/05), the Plan for Accelerated and Sustained Development to End Poverty (PASDEP, covering 2005/06-2009/10), the Growth and Transformation Plan (GTP I, covering 2010/11-2014/15) and the current second round of the Growth and Transformation Plan (GTP II, covering 2015/16-2019/20) (MOFEC). While the Ethiopian economy has shifted to a higher growth trajectory since 2003/04, the average growth rate was around 11 per cent between 2005/06 and 2009/10, outpacing the growth target of 7 per cent (base case) and 10 per cent (high case). However, as economic growth moderated in the past few years, the average growth rate was slightly lower than the target of 11 per cent during 2010/11-2014/15 and is expected to be below the target by 3 percentage points during 2015/16-2019/20.

**Rwanda:** After the national consultative process between 1998 and 1999, Vision 2020 was adopted by the government. One of the major objectives was to transform Rwanda into a middle-income country by 2020 (MINECOFIN, 2012). Despite the solid economic performance over the past 16 years (around 8 per cent per annum), the average growth rate is still 3.5 percentage points below the ambitious target of 11.5 per cent.

**Tanzania:** Vision 2025 was adopted in 1999, with the aim of achieving high quality living standards for its people, good governance through the rule of law, and a strong and competitive economy. It was envisioned that Tanzania will transform into a middle-income country by 2025 and achieve a growth rate of 8 per cent per annum (MOF, 1999). The average growth rate was around 6.4 per cent between 2000 and 2016, 1.6 percentage points lower than the target. Based on the latest National Five Year Development Plan (2016/17-2020/2021), Tanzania aims to raise annual real GDP growth to 10 per cent by 2021 from 7 per cent in 2015 (MOF, 2016).

**Kenya:** Vision 2030 was officially launched by the Grand Coalition Government in July 2008 which aims to transform Kenya into a newly industrializing, middle-income country providing a high quality of life to all its citizens in a clean and secure environment by 2030. The Vision comprises of three key pillars, namely, economic, social and political (Kenya Vision 2030). Compared to the growth target of 10 per cent per annum, the average real GDP growth was around 6 per cent between 2010 and 2016.

**Comoros:** The country's Strategy for Accelerated Growth and Sustainable Development (SCA2D) aims at reaching an average of 6.1 per cent GDP growth between 2015 and 2019 in order to achieve the long-term objective of becoming an emerging economy by 2030. While the GDP growth reached 2.8 per cent on average between 2010 and 2013, the country experienced a slowdown in 2015-2016 amid serious energy supply constraints. The government's subsequent efforts to improve infrastructure and the business environment have triggered a modest recovery. Following the 2.2 per cent growth in 2016, the economy is expected to expand at 3.0 per cent and 3.4 per cent in 2017 and 2018 respectively.

## 1.2. Benchmarking Regional Economic Performance

While Eastern Africa is among the fastest growing regions in the world over the past decade, growth has been uneven and most countries are still not reaching their ambitious developmental targets. To achieve middle-income status within the proposed timeframes, countries would need to grow significantly faster and, crucially, sustain that higher growth rate. Although the factors that determine growth vary from country to country, there is an emerging consensus that countries that have sustained strong growth tend to have higher investment and savings rates, prudent fiscal policy with low deficits, as well as diversified exports with a healthy current account balance (McAuliff, Saxena, and Yabara, 2012 and World Bank, 2008a). Berg, Ostry, and Zettelmeyer (2008) also point out that external shocks and macroeconomic volatility are negatively associated with the length of growth spells, while good political institutions help prolong growth spells. Moreover, openness to trade and foreign direct investment, an export structure that favours manufacturing and relatively sophisticated products, as well as more equal income distribution are conducive to longer growth spells. This section reviews some of the evidence with regard to these factors for Eastern Africa.

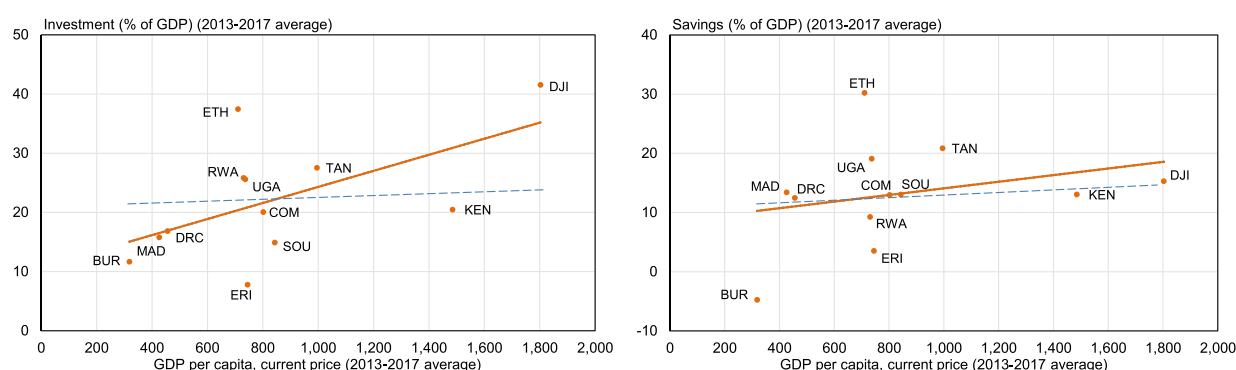
*To achieve middle-income status within the proposed timeframes, countries would need to grow significantly faster and, crucially, sustain that higher growth rate.*

Figure 4 plots the investment and savings shares of GDP against GDP per capita, with the orange solid line and blue dotted line representing the fitted values for Eastern African countries and all African countries, respectively.

*Djibouti, Ethiopia, Tanzania, Rwanda and Uganda are all spending more than 25 per cent of GDP on investment.*

As illustrated by the steeper line of best fit, the investment and savings shares increase more in Eastern Africa when income levels rise. While the investment shares of many Eastern African countries are lower than countries of similar income levels in Africa, Djibouti, Ethiopia, Tanzania, Rwanda and Uganda are all outliers, spending more than 25 per cent of GDP on investment – the minimum investment rate for sustained high growth suggested by the Commission on Growth and Development (World Bank, 2008a). It is important to note that continued high investment needs to be backed by high domestic savings, as there is a limit to external finance and the reliance on foreign borrowing could endanger macroeconomic stability. In this regard, the large gaps between investment and savings in Djibouti, Rwanda and Burundi warrant attention. Apart from these two headline indicators, it is clear that a deep and efficient financial system is vital for allocating resources productively and mobilizing domestic savings (Griffith-Jones and Gottschalk, 2016).

**Figure 4: Investment and savings versus GDP per capita**

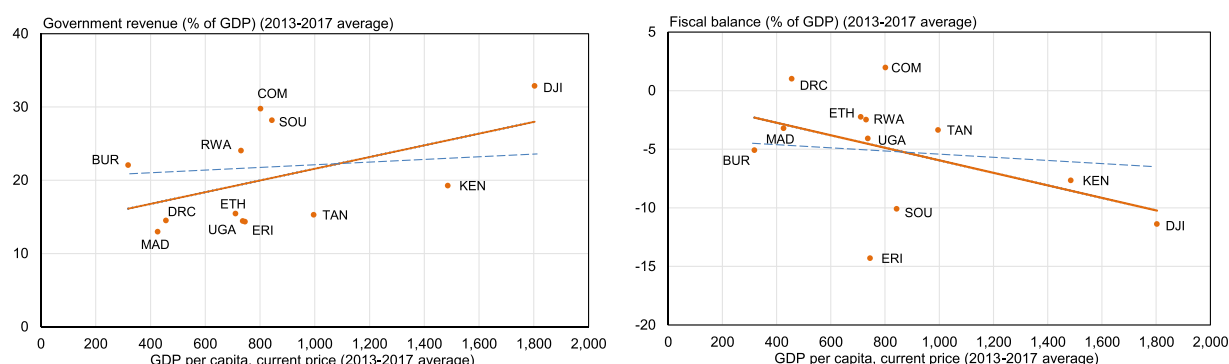


Source: UNECA calculations based on IMF (2017a).

An adequate level of government revenue is also essential for sustained growth, in order to support public expenditures on service delivery and investment. While most countries in Eastern Africa have been strengthening domestic resource mobilization, the levels of government revenue remain low. A mismatch between government revenue and expenditure results in fiscal imbalance, and large fiscal deficits can be destabilizing to the macroeconomy as well as constraining investment. In Eastern Africa, the size of fiscal deficits in Eritrea, Djibouti and South Sudan is particularly large (Figure 5).

*While most countries in Eastern Africa have been strengthening domestic resource mobilization, the levels of government revenue remain low.*

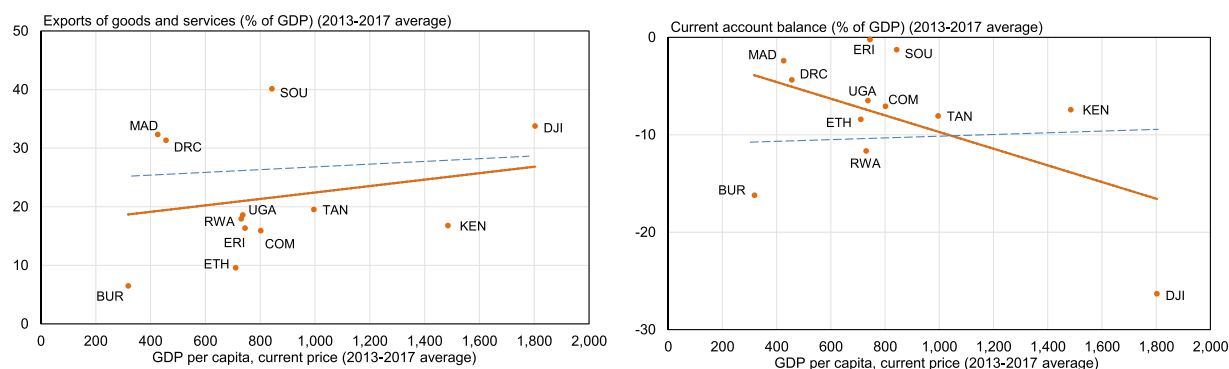
**Figure 5: Government revenue and fiscal balance versus GDP per capita**



Source: UNECA calculations based on from IMF (2017a).

From an external perspective, exports have played a limited role in contributing to growth in most countries of Eastern Africa. In fact, export shares are generally lower than for other African countries of similar income levels. Given high import bills, countries have to sustain structural current account deficits. Most of the deficits are still below 10 percentage of GDP – a high but arguably manageable level for low-income economies, with the exception of Djibouti which faces large deficits fueled by a surge of investment-related imports (Figure 6).

**Figure 6: Exports of goods and services and current account balance versus GDP per capita**



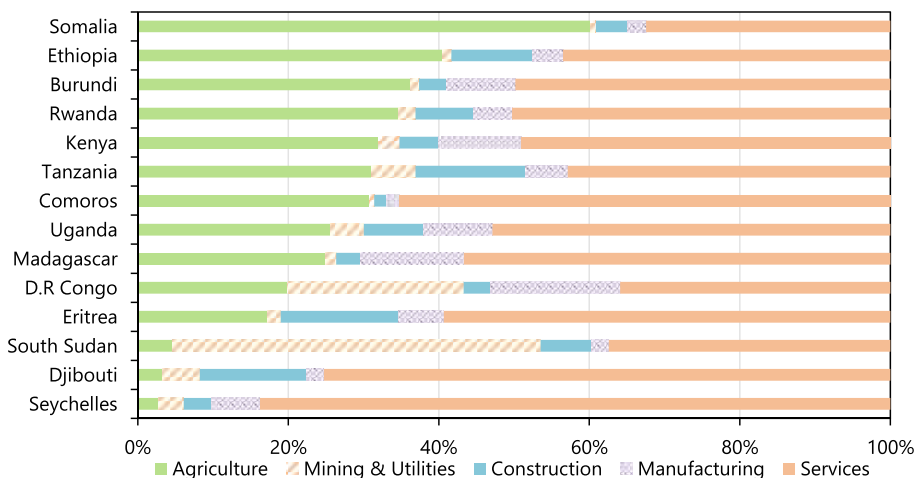
Source: UNECA calculations based on IMF (2017a and 2017b).

### 1.3. Key Drivers of Economic Growth

Sectoral analysis provides a clearer picture of economic structure, as well as the highlighting key drivers of growth. Figure 7 shows that agriculture retains its prominent role, on average accounting for around 30 per cent of total value added in the region, with a modest annual growth rate of around 4 per cent in recent years. Given the fact that most of the labour force still works in the agriculture sector, its performance remains crucial to people's livelihoods.<sup>5</sup> As the sector is highly vulnerable to weather-related shocks, it is not only one of the main constraints in terms of maintaining a strong economic performance, but its underperformance is also one of the major causes of humanitarian crisis in the region.<sup>6</sup> The successive episodes of drought in 2016 and 2017 stood out in scale and severity, resulting in significant drops in agricultural production and contributing to food insecurity in some countries (see section 2.3 for a more detailed discussion). Moreover, the spread of the fall armyworm to Eastern Africa in early 2017 affected about 200,000 hectares of crops in Kenya and more than half of the country in Uganda (FAO, 2017).

*The successive episodes of drought in 2016 and 2017 stood out in scale and severity, resulting in significant drops in agricultural production and contributing to food insecurity.*

Figure 7: Sector shares, 2015



Source: UNdata.

Mining and utilities represent a significant share of the economy in resource-rich countries such as D.R. Congo and South Sudan. On the back of the rapid infrastructure development in the region, the construction sector recorded double-digit growth over the past decade, and accounted for a growing share of GDP in countries such as Djibouti, Ethiopia and Tanzania. The construction boom is associated with the trend of rapid urbanization, with Eastern Africa experiencing the fastest rate of urban population growth in the world, at around 5 per cent annually over the past decade (UN-Habitat, 2016). Analysis shows that an increasing volume of capital is targeted at real estate investment, with the retail property sector continuing to be a major focus and the logistics property sector emerging as a new development area. The shopping mall concept is taking root in an increasingly wide range of cities. For instance, Nairobi has been a retail development hotspot over the last two years. In Eastern Africa, the retail prime rents in the capital cities range from US\$15/sq m/month in Antananarivo to US\$48/sq m/month in Nairobi (Knight Frank, 2017). Nonetheless,

*The construction boom is associated with the trend of rapid urbanization, with Eastern Africa experiencing the fastest rate of urban population growth in the world, at around 5 per cent annually.*

<sup>5</sup> For example, more than 80 per cent of the working population is employed in the agriculture sector in Burundi, and the sector is affected by the poor productivity linked to soil erosion, low use of agricultural inputs, etc.

<sup>6</sup> Proactive measures, including investing in climate resilient agriculture, protecting natural resources, shifting towards renewable energy sources, as well as putting in place early warning system, are crucial to mitigate the impact of climate change. Indeed, the costs of adaptation in developing countries are increasing, strengthening the case for urgent mitigating actions (UNEP, 2017).

as discussed in ECA's *Economic Report on Africa 2017*, urban and industrial development in Africa are disconnected and rapid urbanization puts a strain on urban infrastructures as well as city planning and management (UNECA, 2017b).

*The manufacturing sector's share of value-added is below 10 per cent for most countries and has been on a stagnant or declining trend.*

As for the manufacturing sector, its share of value added is below 10 per cent for most countries and has been on a stagnant or declining trend over the last decade. Manufacturing is a crucial sector for enhancing productivity and job creation. It contributes not only to the trade balance, but a minimum level of manufacturing is required for countries to attain a sustainable rate of economic growth (Fosu, 1990 and 1996). Despite various industrial policies and ambitious targets set by governments, the levels of implementation have been generally low. In fact, other than in Ethiopia, which has witnessed a rapid growth in manufacturing production (albeit from a very low base – see Box 2), the sector has played a very limited role in boosting the economies of the region.

By contrast, the services sector, which accounts for more than 40 per cent of total value added of most countries in the region, has sustained robust growth over the past decade, making the largest single contribution to overall economic expansion. A major concern has been the extent to which the sector is characterized by low rather than high value-added services, and also the high degree of informality prevalent in the sector. Among the various services subsectors, tourism is a key focus and many countries are actively tapping their tourism potential. For example, Rwanda introduced a meetings, incentives, conferences and events (MICE) strategy in 2014 that targets business tourists while complementing existing gorilla tourism and eco-tourism (RDB, 2014). The efforts are paying off, with the ranking of capacity to host international meetings in Africa up from 13<sup>th</sup> in 2014 to 3<sup>rd</sup> in 2016 (ICCA, 2017), along with a strong growth in tourism revenue (UNCTAD, 2017a).

### Box 2: Lessons on Implementing Industrialization Policy from Ethiopia

Ethiopia's industrial development vision was set out in the mid-1990s in the Agricultural Development-Led Industrialisation (ADLI) strategy, which emphasised the central role of agriculture in the industrialization process. Based on the ADLI strategy, the 2003 Industrial Development Strategy (IDS) can be viewed as a state-driven industrial policy focusing on creating robust linkages between its dominant agriculture sector and industry, with an emphasis on export-oriented and labour-intensive sectors. Although the Ethiopian state has been active in developing the industrial sector and direct public involvement has been intensified under the GTP I, the government has continuously stressed the role of the private sector as an engine in the industrialization process.

In countries with poor infrastructure and challenging business environments, special economic zones or industrial parks can be used to overcome barriers to firm entry, attract FDI and encourage industrial clusters. The development of industrial parks aims to transform Ethiopia into a major manufacturing hub in Africa and has three intertwined objectives, namely, employment creation, foreign exchange generation, and technology and skill transfer. In implementing its vision of industrial development, Ethiopia has committed to attracting FDI whereby foreign firms play a major role in terms of job creation and, crucially, providing technological upgrading and managerial capacity, particularly with regard to export industries. Such an initiative has been used in other 'late industrialisers' – countries such as China and Vietnam which have used foreign investment not so much for the financial contribution the investment makes, but rather to facilitate a more rapid assimilation of foreign technologies and modern managerial practices. However, the advantages of FDI are far from automatic and depend on mediating characteristics of the domestic economy (Jacob and Sasso, 2015). In addition, in the face of

low domestic productive capacities the extent to which the broader economy will benefit from the strategy remains to be seen.<sup>7</sup> It needs stressing that FDI has to be paid for, too, in terms of the repatriation of profits and fully taking into account the fiscal concessions and the cost of infrastructure provision. The long term balance of costs and benefits is thus complex.

There have been a number of tangible and impressive achievements from the implementation of industrialization policies. Over the last decade, Ethiopia has developed thriving leather, floriculture and cement industries, with plans in the pipeline to increase the number of industrial hubs. In 2016 alone, the country opened no less than three industrial parks. The flagship Hawassa Industrial Park which was officially inaugurated in July 2016, for instance, is a 300-hectare industrial park focused on textile and garment production. Once operational at its full potential, the park is expected to create about 60,000 jobs and generate US\$ 1 billion annually.

Ethiopia's experience also holds lessons about harnessing linkages to boost industrial growth. Part of the recipe for success is to know which linkages are most important for a specific industry. Ethiopia's floricultural sector benefited tremendously from state supported upstream linkages that strengthened cold storage facilities and air service logistics using the Ethiopian airline, a publicly owned company. The late President, Meles Zenawi, recognised the new activity as an important contributor to export-led growth and engaged personally to remove any hurdles to the sector's development, by, for example, setting land aside for new farm projects, providing fiscal incentives and ensuring that Ethiopian Airlines offered lower freight tariffs. With these conditions in place, the industry evolved favourably. By 2014, about 120 farms accounted for the country's US\$ 245 million exports. Most firms are foreign investors, but about one third are Ethiopian companies that succeeded in emulating the pioneering investor's business model (Altenburg and Lutkenhorst, 2015).

Source: UNECA (2017a).

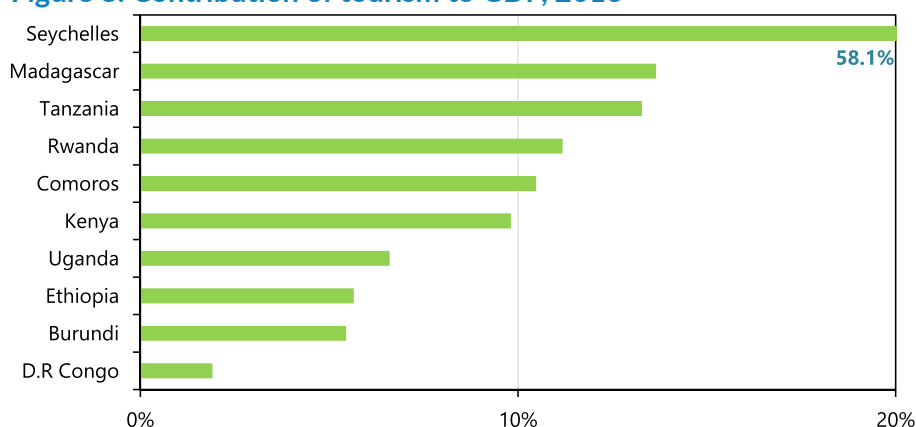
<sup>7</sup> A recent analysis by Abebe et. al. (2017) suggests that total factor productivity in domestically-owned plants in Ethiopia is 16 per cent higher in districts that have attracted a large greenfield plant.



### Box 3: Contribution of Tourism to Eastern African Economy

Despite a turbulent year, the tourism industry continues to play an important role to the economy of the region<sup>8</sup>. The industry accounted for over US\$ 22 billion to the region's GDP in 2016, or around 8 per cent of GDP. Tourism's contribution has been sustained with Seychelles, the usual outlier, at 58.1 per cent, while D.R. Congo was at the lower end at 1.9 per cent (Figure 8). Nonetheless, 2016 saw a decline in tourism growth for a number of countries, with Ethiopia registering the largest decline of 8.1 per cent compared to the previous year.

**Figure 8: Contribution of tourism to GDP, 2016**



Source: WTTC (2017).

The tourism industry is one of the leading foreign exchange earners<sup>9</sup>, contributing an estimated US\$ 10.3 billion of export revenues for the region in 2016. While several countries registered growth in tourism income in 2016, a sharp deceleration of 25.4 per cent was recorded in Ethiopia, which could be partially attributed to a perception of political instability. Another emerging trend has been the gradual increase in outbound tourism which spending valued at more than US\$ 2 billion in 2016.

The region is also an attractive destination for capital investment in the sector, accounting for around US\$ 6.6 billion in 2016. In fact, Kenya was ranked as Africa's hottest investment spot, where 24 multi-billion five-star hotel projects are currently underway (Business Daily, 2017). In addition, the industry remains an important source of employment, generating more than 6 million jobs in 2016, accounting for about 6 per cent of total employment across the region.

In spite of the positive outlook of the industry, the region has continued to endure challenges that hinder its growth potential. According to the Travel and Tourism Competitiveness Index, the region has not been ranked favourably, with the exception of Seychelles (Table 2). The major areas of concern have been relating to the lack of tourism and physical infrastructure (including air and ground), and issues related to human resources as well as safety and security. For instance, in terms of the quality of the prevailing tourism infrastructure, Burundi, D.R. Congo and Ethiopia were ranked at 136<sup>th</sup>, 134<sup>th</sup> and 129<sup>th</sup> in 2017 respectively, while Tanzania and

<sup>8</sup> Due to data limitations, Eastern Africa refers to Burundi, Comoros, D.R. Congo, Ethiopia, Kenya, Madagascar, Rwanda, Seychelles, Tanzania and Uganda in this box.

<sup>9</sup> The tourism industry is the major foreign exchange rate earner in a number of countries across the region (e.g. Comoros, Ethiopia, Rwanda and Seychelles) and is a significant earner in several others (e.g. Kenya, Madagascar, Tanzania and Uganda). Yet it should be noted that the linkages between tourism and other sectors are relatively weak and there are notable leakages of revenue across the region.



Uganda were at 131<sup>st</sup> and 115<sup>th</sup> in terms of human resources quality. Being ranked at 129<sup>th</sup>, safety and security related issues continue to hinder tourism growth and development in Kenya. On a positive note, some countries have made progress on a number of areas including visa openness, for example, Uganda was ranked at 8<sup>th</sup> globally, price competitiveness in the case of Tanzania and Madagascar at 34<sup>th</sup> and 55<sup>th</sup>, and availability of skilled employees in the case of Kenya at 26<sup>th</sup>. The region also did quite well in terms of the quality of prevailing natural resources, with countries like Tanzania, Kenya and Uganda being ranked at 8<sup>th</sup>, 15<sup>th</sup> and 44<sup>th</sup>.

**Table 2: Tourism and Travel Competitiveness Index**

	2007 (out of 124)	2009 (out of 133)	2011 (out of 139)	2013 (out of 140)	2015 (out of 141)	2017 (out of 136)
Burundi	123	131	137	138	135	134
D.R. Congo	-	-	-	-	-	133
Ethiopia	117	123	122	120	118	116
Kenya	98	97	103	96	78	80
Madagascar	112	116	127	131	121	121
Rwanda	-	-	102	105	98	97
Seychelles	-	-	-	38	54	-
Tanzania	80	98	110	109	93	91
Uganda	101	111	115	116	114	106

Source: WEF (2017a).

On the expenditure side, private consumption has been the main driver of economic growth in the region, given its significant weight in aggregate demand (a regional average of around 70 per cent) and an annual growth rate of around 6 per cent over the last decade. Another important impetus for economic growth has been rising levels of investment.<sup>10</sup> Economic activities were particularly boosted by investment booms in Djibouti and Ethiopia in recent years, driven by the large-scale infrastructure projects, such as the Grand Ethiopian Renaissance Dam and the Addis Ababa–Djibouti railway (Figure 9).<sup>11</sup>

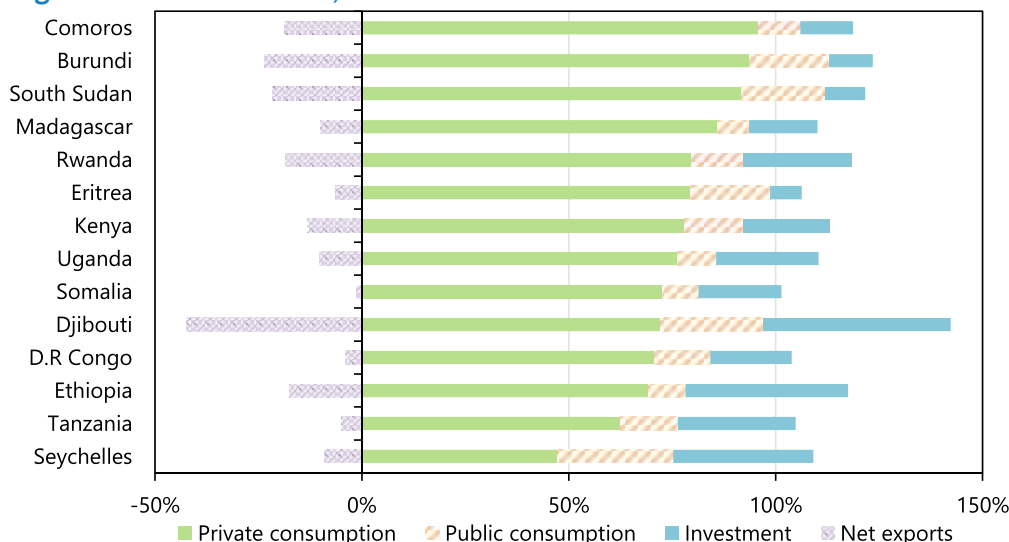
According to the Global Infrastructure Hub, the total infrastructure investment forecast for Africa to 2040 is projected to be US\$ 174 billion per year under current trends, and an additional US\$ 66 billion per year is required to raise the performance to match the best performing peers (i.e. the 75<sup>th</sup> percentile amongst countries with similar income levels). Specifically, transport investment requires much larger inputs as it only accounted for 27 per cent of total infrastructure spending between 2007 and 2015 in Africa compared to the world average of 45 per cent. While infrastructure investment, especially with the support from China's *Belt and Road Initiative*, is expected to boost economic growth, it has also raised concerns about debt sustainability as the projects were financed primarily by external borrowing (see section 1.7 for a more detailed discussion). Meanwhile, whether the projects are value for money (i.e. provide higher economic payoffs than the costs) is something to be monitored.

*While infrastructure investment is expected to boost economic growth, it has also raised concerns about debt sustainability.*

<sup>10</sup> The average share of investment as of GDP in the region increased gradually from around 22 per cent in 2005 to 26 per cent in 2015.

<sup>11</sup> Investment projects in oil, energy and infrastructure are also set to boost Uganda economy. Key projects include the Uganda-Tanzania Crude Oil Pipeline, the Karuma and Isimba dams, as well as the new Standard Gauge Railway that will link Kampala with Mombasa.

**Figure 9: Demand shares, 2015**



Source: UNdata.

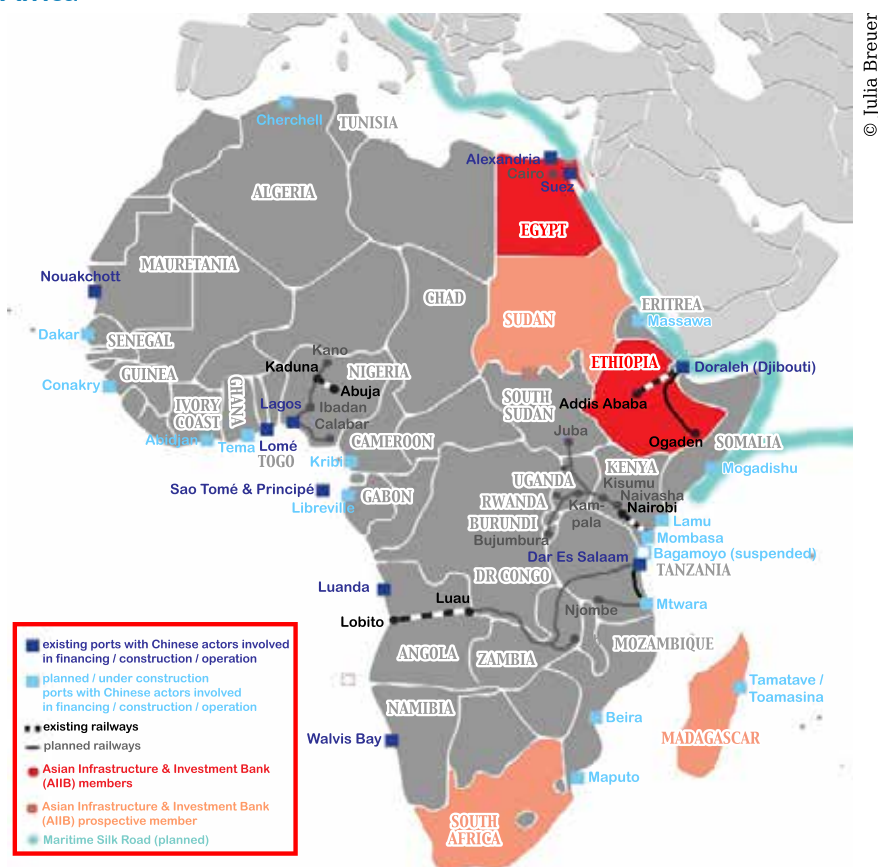
#### Box 4: Opportunity from China's Belt and Road Initiative

In 2013, Chinese President Xi Jinping announced a proposal for a "Silk Road Economic Belt" and a "21<sup>st</sup> Century Maritime Silk Road", together formally named as *Belt and Road Initiative*. The initiative covers, but is not limited to, the area of the ancient Silk Road, and emphasises five areas of cooperation: (i) policy coordination, (ii) facilities connectivity, (iii) trade and investment, (iv) financial integration, and (v) cultural exchanges (NDRC, 2015). The routes run through the continents of Asia, Europe and Africa, covering more than 60 countries which account for around one-third of global GDP and over 60 per cent of the world's population. A US\$ 40 billion Silk Road Fund and the Asian Infrastructure Investment Bank have been established to finance the Belt and Road Initiative. During the first Belt and Road forum in May 2017, President Xi announced an additional RMB 100 billion (around US\$ 14.5 billion) for the Silk Road Fund (Xinhua News Agency).

Building upon two decades of intensifying China and Africa economic ties, the *Belt and Road Initiative* is expected to strengthen China and Africa cooperation and take a win-win approach to economic complementarity. Africa, especially Eastern Africa, could benefit from the new trade and investment opportunities in infrastructure and industrialization programmes.

The hotspots of China's engagement in Africa under the *Belt and Road Initiative* are countries along the Maritime Silk Road such as Kenya, Ethiopia and Djibouti. The figure below highlights the existing and planned ports and railways projects with Chinese actors. For example, the Standard Gauge Railway that connects Mombasa's port with Kenya's capital Nairobi was opened at the end of May 2017. The project was largely financed by the Export-Import Bank of China and is expected to connect a number of proximate land-linked countries.

**Figure 10: Key existing and planned ports and railways projects with Chinese actors in Africa**



Source: Stiftung Asienhaus (2017).

Apart from the infrastructure investment, industrial cooperation is a priority of current China-Africa cooperation. At the Forum on China-Africa Cooperation in December 2015, it was agreed that several African countries will be selected to set up pilot programmes and industrial parks. In April 2016, Ethiopia, Kenya, Tanzania and D.R. Congo were identified as pilot countries for such cooperation. In Ethiopia, for example, China will support the construction of an economic corridor along the Addis Ababa-Djibouti railway link and set up several industrial parks along the route.

## 1.4. An Unconventional Path of Structural Transformation

The impressive growth performance in Eastern Africa has been accompanied by a declining share of manufacturing value added. This is worrisome in the context of rapid population growth and urbanization, as the services sector driven growth model may not be able to generate sufficient employment opportunities to absorb the additional labour supply, and thus workers may end up in informal activities.

By decomposing gross valued added (GVA) per capita growth into labour productivity growth, changes in employment rates, and demographic change<sup>12</sup>, the pace and depth of structural transformation in the region can be better accessed. In particular, labour productivity growth can be decomposed into (i) the within-sector component, which relates to labour productivity improvements achieved through enhanced skills, better resource relocations, and/or adoption of technological progress within a specific sector, as well as (ii) the between-sector component, which relates to labour productivity gains accrued by the shift of labour from lower-productivity to higher-productivity sectors and usually serves as a proxy for structural transformation.

Table 3 presents the breakdown of GVA per capita growth. In the case of Ethiopia, Tanzania and Uganda, there were notable between-sector gains and the three countries were ranked as the top five structural transformation performers in Africa. As for D.R. Congo, Kenya, Rwanda and Burundi, within-sector gains provided the major boost to GVA per capita growth, while the contribution from labour reallocation was less remarkable.

**Table 3: Decomposition of gross valued added per capita growth – Country, 2002-2013**

Country	GVA per capita growth (%)	Contribution from (percentage points):			
		GVA per worker		Changes in employment	Changes in demography
		Within-sector	Between-sector		
Ethiopia	6.9	3.5	2.5	0.3	0.7
Tanzania	3.6	1.2	2.4	0.1	-0.1
Uganda	2.4	1.4	1.4	-0.6	0.2
D.R. Congo	3.3	2.3	0.8	-0.1	0.3
Kenya	1.9	1.2	0.4	0.1	0.2
Rwanda	4.4	3.4	0.4	-0.1	0.7
Burundi	3.7	3.2	0.1	-0.1	0.6
Eritrea	-1.6	-2.1	-0.1	0.3	0.3
Comoros	0	-0.2	-0.2	0.4	-0.1
Madagascar	0.5	1.2	-1.5	0.2	0.6

Sources: Martins (2015) and UNECA calculations.

In Eastern Africa<sup>13</sup>, the solid growth during 2002 to 2013 was mainly due to labour productivity improvements, both within- and between-sectors. Compared to other regions in Africa, its contribution to structural change was more significant (Table 4). However, it should be noted that Eastern Africa has the lowest labour productivity across major sectors and the highest share of employment in the least productive sector (i.e. agriculture), thereby providing a large potential for a boost to growth through within-sector improvements and the reallocation of labour.

<sup>12</sup> GVA per capita can be expressed as  $Y/N = (Y/E) \times (E/A) \times (A/N)$  where Y is the total value added, N is total population, E is total employment, and A is the working-age population. GVA per worker (i.e.  $Y/E$ ) can then be decomposed by sectors into within-sector and between-sector effects.

<sup>13</sup> In the following two tables, Eastern Africa comprises Burundi, Comoros, Eritrea, Ethiopia, Kenya, Madagascar, Malawi, Mauritius, Mozambique, Rwanda, Tanzania, Uganda, Zambia and Zimbabwe as defined in Martins (2015). The coverage is somewhat different from that of UNECA.

**Table 4: Decomposition of gross valued added per capita growth – Africa, 2002-2013**

Region	GVA per capita growth (%)	Contribution from (percentage points):			
		GVA per worker		Changes in employment	Changes in demography
		Within-sector	Between-sector		
Eastern Africa	3.28	1.65	1.25	0.10	0.29
Middle Africa	3.27	2.25	0.78	0.00	0.24
Northern Africa	1.93	0.72	0.25	0.54	0.42
Southern Africa	2.11	2.04	0.01	-0.13	0.19
Western Africa	4.24	2.64	1.38	0.22	0.01

Source: Martins (2015).

The current sectoral breakdown, however, does not seem promising from the perspective of industrialization. The share of manufacturing employment was little changed between 2002 and 2013. By contrast, other services provided the largest contribution to GVA per capita growth, mainly through structural change and also by an increase in employment. Construction, commerce and transport were also important contributors, recording the highest GVA growth from 2002 to 2013 (Table 5). In short, structural transformation has provided a boost to economic growth in Eastern Africa, but mainly through the services rather than the manufacturing sector.

*Structural transformation has provided a boost to economic growth in Eastern Africa, but mainly through the services rather than the manufacturing sector.*

**Table 5: Decomposition of gross valued added per capita growth – Sector, 2002-2013**

	Contribution from (%):				Total contri- bution (%)
	GVA per worker		Changes in employment	Changes in demography	
	Within-sector	Between-sector			
Eastern Africa	50.1	38.0	3.0	8.9	100.0
Agriculture	11.0	-4.5	-10.7		-4.2
Mining & Utilities	0.3	5.4	0.7		6.4
Manufacturing	6.3	-0.5	-0.1		5.7
Construction	5.8	7.1	2.1		14.9
Commerce	14.6	-0.4	0.0		14.2
Transport	8.3	6.5	1.2		15.9
Other services	3.9	24.6	9.8		38.3

Source: Martins (2015).

## 1.5. Accelerating Industrialization via Infrastructure Development

UNECA's recent publications have advocated for a resurgence of industrialization as a development strategy for Africa, stressing its role in accelerating structural transformation. The 2013 Economic Report on Africa (ERA) (UNECA, 2013a) argued that economic growth alone had not generated enough economic diversification and job growth, and advocated for the design and implementation of better industrial strategies to tap Africa's natural resources for industrialization. The recommended strategy included a boost to infrastructure investment. The 2014 ERA on Dynamic Industrial Policy in Africa also emphasized the pursuit of industrial policy by addressing 'missing inputs' such as infrastructure (UNECA, 2014). The 2015 ERA looked at industrialization through trade, with a recommendation to invest in infrastructure for better integration of Africa into global value chains (UNECA, 2015). The report in 2016 advocated greening Africa's industrialization, and recommended building 'system-wide infrastructure to ensure secure supplies of water, food and energy' (UNECA, 2016b). In further exploring the links between urbanization and industrialization, UNECA's latest report recommended infrastructure investment to leverage urban development and industrialization links and called for coordination especially with the energy sector (UNECA, 2017b). It is, therefore, imperative that infrastructure development in Eastern Africa is tied to the nature and pace of industrialization.

Infrastructure assets have both direct and indirect effects on industrialization. Firstly, infrastructure development increases economy-wide cost efficiency, and improves domestic and regional markets integration. Secondly, infrastructure assets improve the attractiveness of countries as recipients of FDI. Thirdly, infrastructure development enhances social outcomes, such as health and education, which in turn improve industrial productivity (UNECA, 2017d). These observations are supported by numerous studies, such as Hulten et al. (2006) and Fedderke and Bogetic (2009). These studies suggest that industrial output is increased by the provision of better infrastructure services, and produce gains in productivity and efficiency through economies of scale and better access to technology. A study on the relationship between energy capacity and industrialization further demonstrated a positive association, indicating the relevance of energy development to industrial growth (Isaksson, 2010).

However, the prevailing infrastructure gap hinders industrialization. For example, under the Programme for Infrastructure Development in Africa (PIDA) framework, a continental infrastructure investment need of US\$ 360 billion between 2011 and 2040 was identified, with an investment of US\$ 68 billion in PIDA Priority Action Plan (PAP) to be realised by 2020. Current levels of investment in infrastructure are not adequate to meet these goals and the biggest demand for investment of the PIDA PAP programme is energy. The prevailing levels of infrastructure are minimal, as reflected in aggregate and industrial energy consumption. In fact, Eastern Africa has one of the lowest rates of industrial energy consumption in Africa.

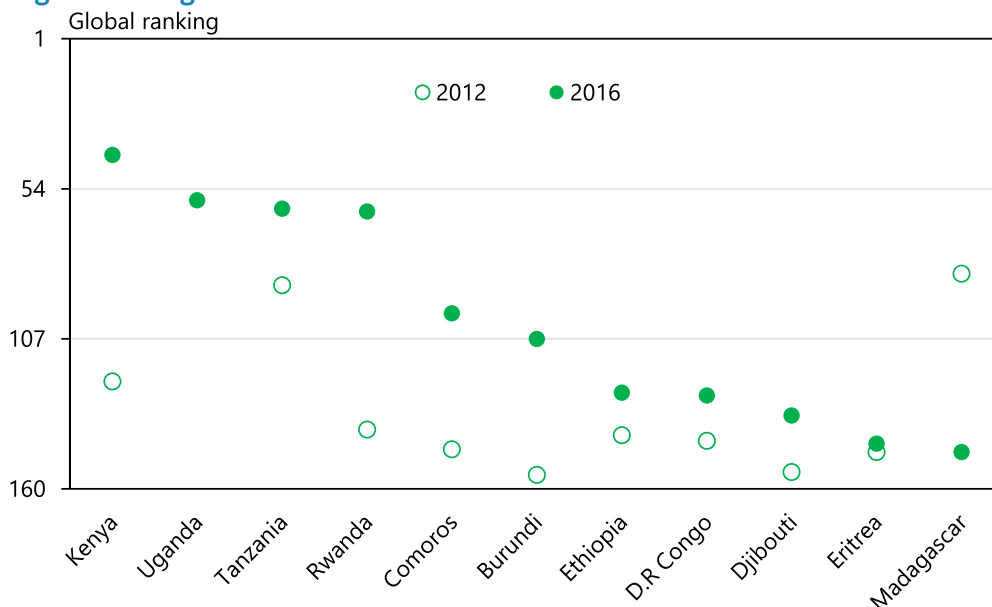
The Africa Peer-Review Mechanism (APRM) report entitled *Major Bottlenecks Facing Africa* calls for an infrastructure investment level of 10 per cent of GDP by 2020. The development and financing of infrastructure in Eastern Africa will, therefore, continue to be crucial for strengthening industrialization. According to UNECA estimates, energy demand in Africa will rise from 125 GW in 2010 to 700 GW by 2040, with increases in Eastern Africa at above 10 per cent per year (UNECA, 2017b). Addressing these growing infrastructure deficits in a policy environment geared to rapid industrialization remains a key policy challenge.

*According to UNECA estimates, energy demand in Africa will rise from 125 GW in 2010 to 700 GW by 2040, with increases in Eastern Africa at above 10 per cent per year.*

Industrial competitiveness is affected by the overall state of infrastructure development. Analysis by the World Bank (2017a) indicates that while there are major improvements in logistical performance since 2012 (especially in Kenya and Rwanda), the overall ranking for many Eastern African countries is above 100, demonstrating the need to speed up infrastructure development (Figure 11).<sup>14</sup>

<sup>14</sup> The Logistical Performance Index consists of qualitative and quantitative measures and assesses performance along the logistics supply chain within a country from both international and domestic perspectives.

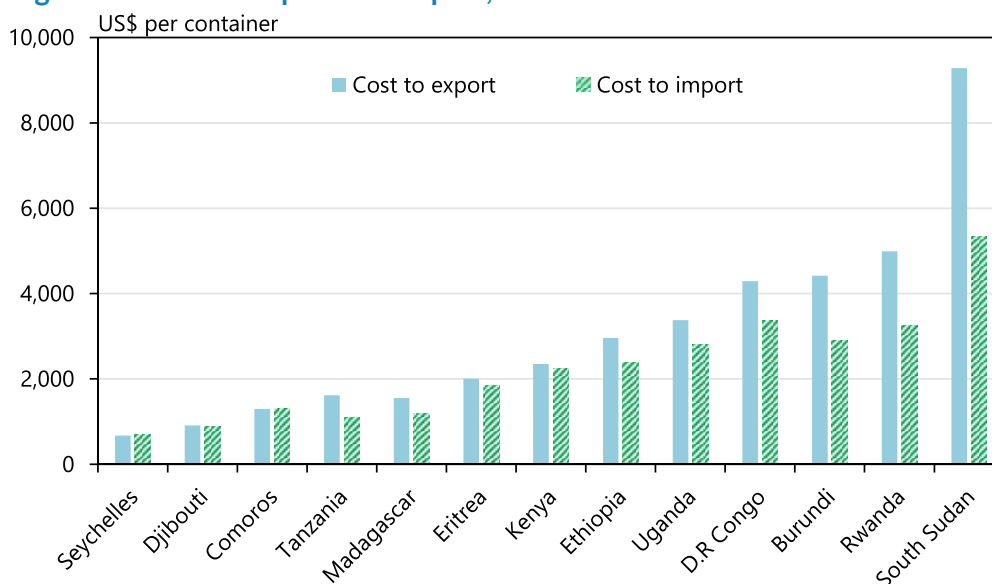
**Figure 11: Logistics Performance Index**



Source: World Bank (2017a).

Industrial development is also directly affected by import and export costs, driven by logistical (including infrastructure) development and efficiency. Coastal countries in the region are expected to have lower import and export costs, as indeed is the case. However, the cost of trade increases rapidly in landlocked countries, such as Burundi and Rwanda (Figure 12). Regional infrastructure development is, therefore, inherently linked to industrial performance and development.

**Figure 12: Cost to export and import, 2014**



Source: World Bank (2017b).

In order to meet the infrastructure gap for industrialization, it is important to invest in infrastructure in financially sustainable ways. The region has already made major public investments in infrastructure, about 40 per cent of which have been targeted on the energy sector (Deloitte, 2015). Sustaining such investment in infrastructure is crucial to make major gains in closing the gap and create a more conducive environment for industrialization.

Yet financing will constitute a major challenge for the region. Under the International Energy Agency's (IEA) energy development scenario for East Africa<sup>15</sup> (2014-2040), average annual total investment in the energy sector is expected to grow from US\$ 4.2 billion in the 2014-20 period to US\$ 12.2 billion in 2036-40. During the same period, grid infrastructure investment is also expected to increase from US\$ 2.4 billion to US\$ 6.3 billion per year (IEA, 2014). Moreover, their financial analysis comprises of only selected countries in Eastern Africa, and hence the financial requirement for power sector investment for the whole region will be much higher.

Industrial and infrastructure development should be pursued in tandem. Economic development planners need to consider infrastructure assets in industrial design, while energy and infrastructure planners need to anticipate and respond to emerging industrial development aspirations. Integrated planning capacity, and support for it, is crucial to meet these aspirations.

## 1.6. Improved Governance and Business Environment

Good governance and a conducive business environment play a prominent part in economic growth. According to the 2017 *Ibrahim Index of African Governance* which covers 54 countries, the overall governance performance at the continental level improved slightly from an average score of 49.4 in 2007 to 50.8 in 2016. Within Eastern Africa, the performance of different countries varies hugely, ranging from the top ranked countries (e.g. Seychelles and Rwanda) to the bottom ranked countries (e.g. Eritrea, South Sudan and Somalia). Regarding the more notable changes, Rwanda and Kenya registered impressive progress between 2007 and 2016, mainly thanks to improvement in human development including education, health and welfare.<sup>16</sup> In contrast, Madagascar recorded sharp deterioration due to a protracted political crisis from 2009 to 2014 (Figure 13).<sup>17</sup> Moreover, presidential elections are an important factor that can cause political uncertainty and affect business confidence. For example, Kenya's business conditions deteriorated sharply in August 2017 when its general election was held, with some trading activities shifted to ports nearby over Mombasa and shops closed in major towns amid uncertainty and fears of violence over the election.

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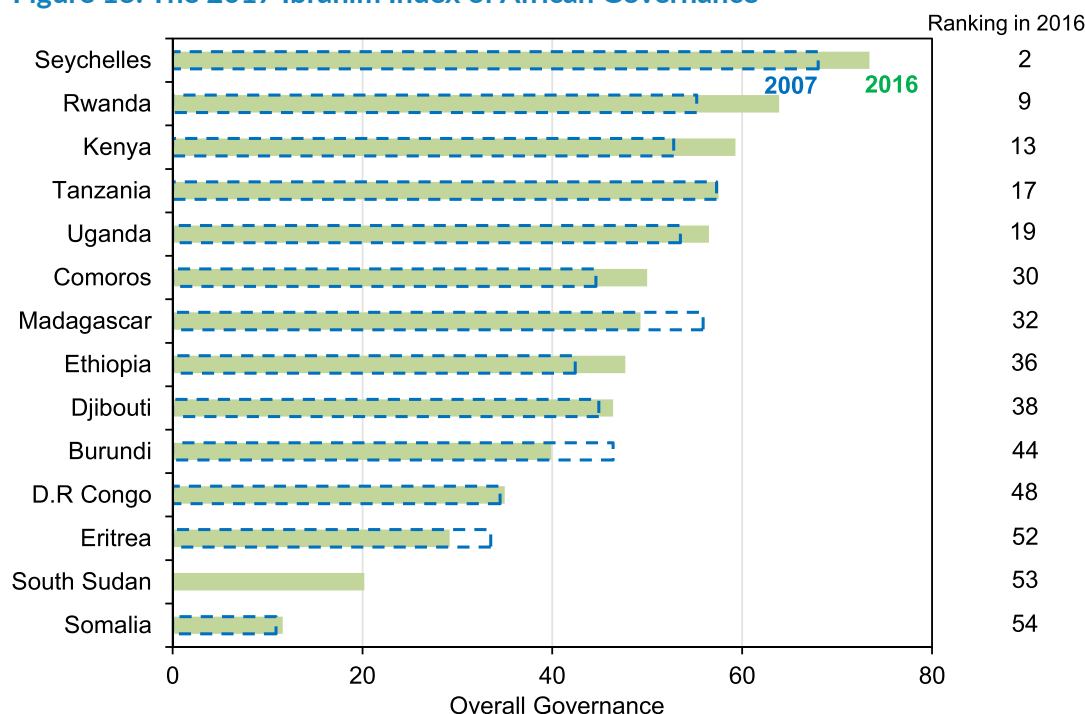
<sup>15</sup> Under the IEA regional classification for this analysis, East Africa is constituted by Eritrea, Djibouti, Somalia, Kenya, Uganda, Rwanda, Burundi, South Sudan and Sudan.

<sup>16</sup> Seychelles, Comoros and Ethiopia also recorded visible improvement between 2007 and 2016, especially in human development.

<sup>17</sup> The Worldwide Governance Indicators also showed that more than half of the countries in Eastern Africa recorded improvement in government effectiveness over the past two decades, especially for Rwanda and Ethiopia (World Bank, 2017c).



**Figure 13: The 2017 Ibrahim Index of African Governance**



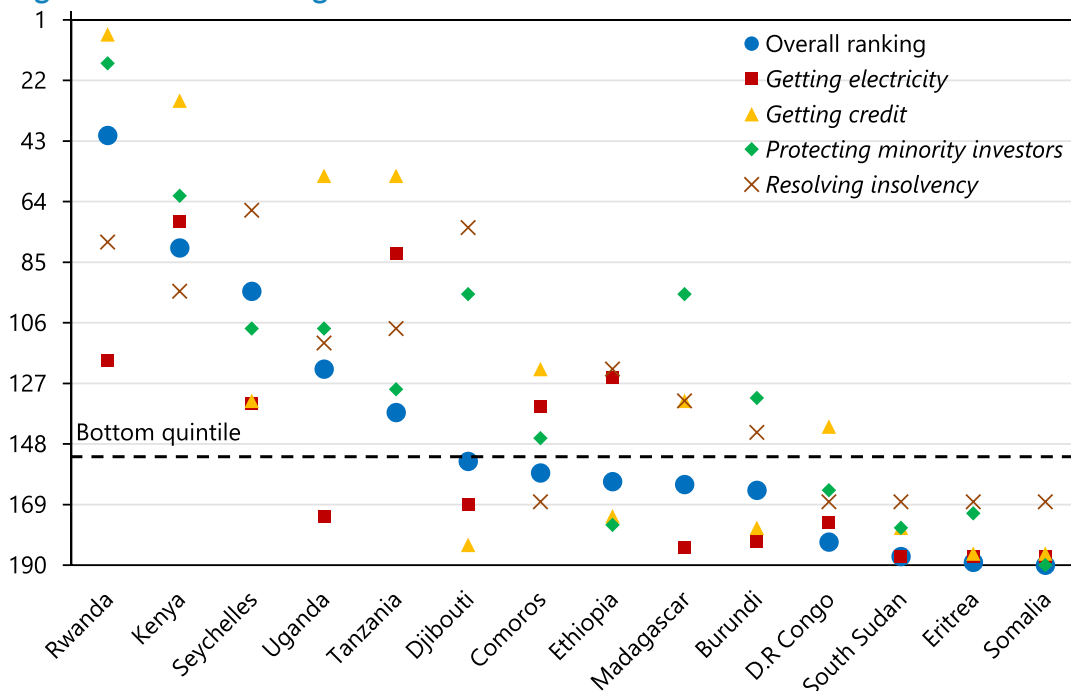
Source: Mo Ibrahim Foundation (2017).

*Most countries recorded an improvement in the Ease of Doing Business Index 2018 – the highest-ranked country being Rwanda, in 41<sup>st</sup> place out of 190 countries.*

Eastern Africa countries have been actively implementing reforms to create a more conducive business environment. In the 2018 edition of the *Doing Business* report, most countries recorded an improvement – the highest-ranked country being Rwanda, in 41<sup>st</sup> place out of 190 countries. Djibouti had the largest increase in score in the region and was among the top ten most improved countries in the

world. Specifically, Djibouti made the most significant improvements to minority investor protections as well as notably reduced the cost of starting a business. Having said that, most of the countries in the region still have relatively low scores, with more than half of them ranking in the bottom quintile. In particular, the performances in getting electricity, getting credit, protecting minority investors and resolving insolvency are significantly behind international standards, thereby constraining the development of private sector (Figure 14).

Figure 14: Ease of Doing Business Index 2018



Source: World Bank (2017d).

## 1.7. Widening Budget Deficits Under Elevated Infrastructure Expenditure

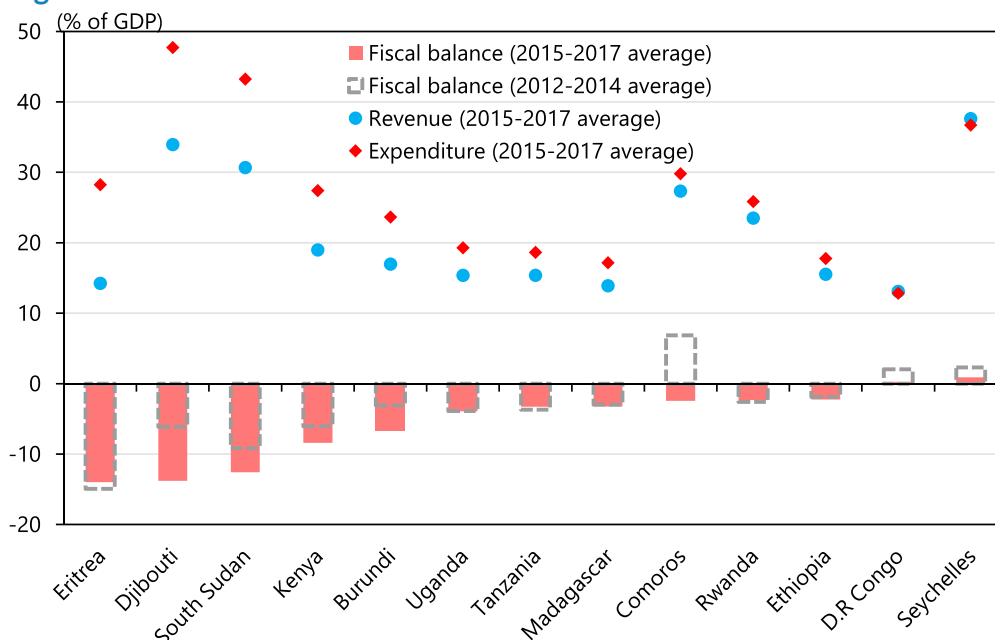
Budget deficits have widened in a number of countries in recent years amid elevated infrastructure development spending (Figure 15). The increase in infrastructure expenditure was particularly notable in Djibouti (construction of several new ports, a railroad and a water pipeline from Ethiopia) and Kenya (a new railway and increased transfers for infrastructure investment to the counties).<sup>18</sup> While countries have been trying to achieve fiscal sustainability by curbing recurrent expenditures and raising revenues, the generally low tax base and high share of informal activities have limited the scope for revenue collection.<sup>19</sup> Against this backdrop, countries have been strengthening domestic resource mobilization via enhancing tax administration and collection, as well as introducing new taxes and cancelling tax exemptions. For instance, Tanzania has developed the Government e-Payment Gateway System and a new Electronic Revenue Collection System to facilitate revenue collection, and started collecting property tax in the 2016/17 financial year (MOF, 2017).

*While countries have been trying to achieve fiscal sustainability by curbing recurrent expenditures and raising revenues, the generally low tax base and high share of informal activities have limited the scope for revenue collection.*

<sup>18</sup> The budget-making process has also raised concerns, especially when budget deficits are underestimated (The East African, 2017).

<sup>19</sup> New trade agreements that imply lower customs duties would also weaken the revenue mobilization capacity.

**Figure 15: Fiscal balance**



Source: IMF (2017a).

Widening fiscal deficits, coupled with weak exchange rate, have resulted in rising external debt levels in the region. Based on the latest IMF debt sustainability assessment, the risk of debt distress in Kenya<sup>20</sup>, Rwanda, Tanzania and Uganda remained low, whereas Comoros, D.R. Congo, Ethiopia and Madagascar carried a moderate risk. Burundi and Djibouti were rated as high risk, due to the high external debt-to-exports ratio of the former<sup>21</sup> and the rapid accumulation of debt from 2014 to 2016 of the latter. Despite moderate levels of public external debt, South Sudan fell into debt distress amid the economic crisis and continued political instability (Table 6).

**Table 6: Debt sustainability assessment**

Country	Risk of debt distress	Latest publication
Burundi	High	March 2015
Comoros	Moderate	November 2016
D.R. Congo	Moderate	August 2015
Djibouti	High	February 2017
Ethiopia	Moderate	August 2016
Kenya	Low	December 2016
Madagascar	Moderate	June 2017
Rwanda	Low	June 2017
South Sudan	In debt distress	March 2017
Tanzania	Low	June 2016
Uganda	Low	December 2016

Source: IMF (2017c).

<sup>20</sup> Yet Kenya's public debt is projected to rise to around 55 per cent of GDP in 2017, compared with 44 per cent in 2013 (IMF, 2017c).

<sup>21</sup> Burundi has relied more heavily on domestic borrowing after the withdrawal of financial support from international donors.

*There has been a shift from concessional to non-concessional debt financing sources and from advanced economies to China.*

In terms of the source of financing, there has been a shift from concessional to non-concessional debt financing sources (including bilateral and commercial credits, as well as international bond market) and from advanced economies to China in some countries (e.g. Djibouti, Kenya, Tanzania and Rwanda).<sup>22</sup> The international capital market, which does not enforce the same kind of conditionalities on bilateral and multilateral loans, seems

to be an appealing source of finance amid the extremely low global interest rates. Yet the associated risks (e.g. currency mismatch) and greater market volatility warrant prudent debt management.

## 1.8. Accommodative Monetary Policy Amid Easing Inflation and Exchange Rate Pressure

Inflation rates showed signs of picking up in Eastern Africa in 2016. Despite the low fuel price, the spike in food prices after the long spell of the drought and pass-through of currency depreciations exerted upward pressures on inflation. The latest statistics show that inflation continued to rise in early 2017, but gradually decelerated since mid-2017 as the effect of a prolonged dry season on food prices eased. For instance, Tanzania's headline inflation rate moderated from 6.4 per cent in March 2017 to 4.0 per cent in December 2017. For most of the countries in the region, it is expected that the annual inflation rate in 2017 would be higher than that in 2016 (Table 7).

**Table 7: Inflation (% annual change)**

	2012	2013	2014	2015	2016	2017*	Average (2012-2016)
Eritrea	20.7	7.3	15.2	9.0	11.5	7.5	12.7
Ethiopia	22.8	8.1	7.4	10.1	7.3	9.0	11.1
Burundi	18.0	8.0	4.4	5.6	5.5	17.0	8.3
Tanzania	16.0	7.9	6.1	5.6	5.2	5.3	8.2
Kenya	9.4	5.7	6.9	6.6	6.3	9.0	7.0
Madagascar	5.7	5.8	6.1	7.4	6.7	7.0	6.3
Uganda	12.7	4.9	3.1	5.4	5.5	6.4	6.3
Rwanda	6.3	4.2	1.8	2.5	5.7	7.0	4.1
D.R. Congo	9.7	1.6	1.0	1.0	4.9	5.0	3.6
Seychelles	7.1	4.3	1.4	4.0	-1.0	2.8	3.2
Djibouti	3.7	2.4	1.3	-0.8	2.7	3.5	1.9
Comoros	1.8	2.3	0.6	2.0	2.0	2.2	1.7

Note: (\*) Estimate.

Sources: UNDESA (2017a) and IMF (2017a).

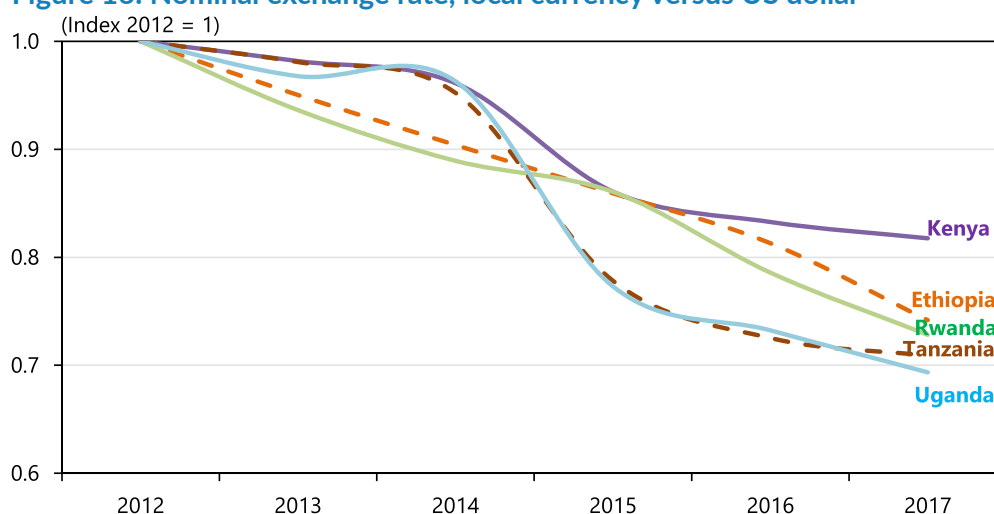
<sup>22</sup> For example, the recent major infrastructure investment projects in Djibouti, including the multipurpose Port Doraleh, the Addis Ababa-Djibouti railway, and a water pipeline with Ethiopia, were largely financed by the Export-Import Bank of China. At the end of 2016, 68 per cent of the external debt was government-guaranteed debt, of which 77 per cent was owned to the Export-Import Bank of China (IMF, 2017d). As for Kenya, the share of bilateral credits from China accounted for 17.4 per cent of external debt in 2016 compared to 4.8 per cent in 2012, partly due to the construction of the Standard Gauge Railway. During the same period, the share of international sovereign bond went up from zero per cent to 15.5 per cent (KNBS, 2017a and IMF, 2017c).

On the other hand, many of the local currencies depreciated notably against the US dollar in recent years, especially from 2014 to 2016 given the significant strengthening of the US dollar. Specifically, the local currency of Tanzania and Uganda depreciated by around 30 per cent against the US dollar between 2012 and 2016.<sup>23</sup> In 2017, exchange rate pressures subsided due to a weakening US dollar (Figure 16).

*Inflation continued to rise in early 2017, but gradually decelerated thereafter. Exchange rate pressures also subsided due to a weakening US dollar.*

The worst inflationary and exchange rate pressures were experienced by South Sudan which faced significant economic challenges due to internal conflict. Inflation averaged at around 160 per cent in the fiscal year 2015/2016 and is expected to reach over 300 per cent in 2016/17. Meanwhile, the official exchange rate became increasingly hard to maintain as oil revenues and foreign exchange receipts fell sharply in recent years and the gap between the official and parallel market rates widened markedly. Following the switch to a de jure floating exchange rate in December 2015, the South Sudanese pound depreciated against the US dollar by more than 90 per cent in 2016 (IMF, 2017e).

**Figure 16: Nominal exchange rate, local currency versus US dollar**



Source: IMF (2017f).

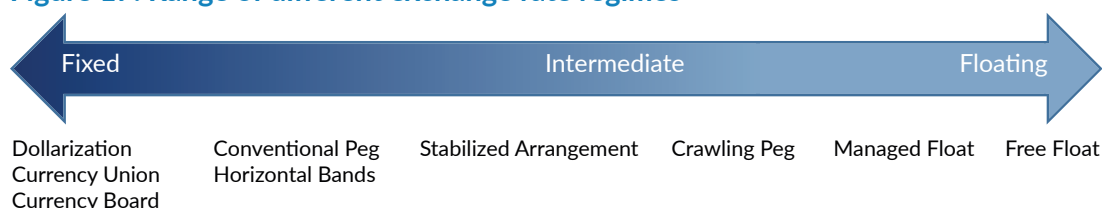
### Box 5: Overview of The Exchange Rate Regimes in Eastern Africa

Exchange rate regimes range from fixed to freely floating (Figure 17). For a fixed exchange rate regime, a country uses a foreign currency as legal tender (Dollarization<sup>24</sup>) or multiple countries issue the same currency (Currency Union), whereas a currency board arrangement guarantees unlimited currency conversion at a fixed rate which is backed by foreign-exchange reserves. On the other hand, the currency's value under a freely floating exchange rate is purely determined by market forces. Intermediate regimes are hybrids between the two extremes. A conventional peg does not commit to full parity, but admits a tight band around the central rate, while a crawling peg tolerates small adjustments to account for inflation differentials. In a managed float, the authorities smooth the path of the otherwise market determined exchange rate in order to prevent excessive fluctuations.

<sup>23</sup> In October 2017, the National Bank of Ethiopia announced a devaluation of the country's currency by 15 per cent to boost export earnings.

<sup>24</sup> Although it is called 'Dollarization', the adopted means of payment may be any foreign currency.

**Figure 17: Range of different exchange rate regimes**



While there is no one-size-fits-all exchange rate policy, theoretical and empirical evidence suggests that the choice of exchange rate regime can significantly affect macroeconomic performance, especially inflation and economic growth. In the 1990s, a growing number of countries in Eastern Africa experiencing declining terms-of-trade adopted floating regimes to allow for real depreciations. However, there are some signs of ‘fear of floating’ in the region, while ‘de jure’ and ‘de facto’ regimes often mismatch (Slavov, 2013).

**Table 8: Exchange rate regime classification in Eastern Africa**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	
Burundi	Currency Board								Managed float								
Comoros	Conventional peg																
D.R. Congo	Currency Board								Managed float								
Djibouti	Currency Board																
Eritrea	Conventional peg																
Ethiopia	Managed float						Conventional peg		Stabilized / Crawl								
Kenya	Managed float																
Madagascar	Freely floating					Managed float											
Rwanda	Managed float						Conventional peg			Stabilized / Crawl							
Seychelles	Conventional peg								Managed float								
Somalia	Freely floating																
South Sudan	Managed float												Conventional peg				Stabilized / Crawl
Tanzania	Freely floating						Managed float										
Uganda	Freely floating						Managed float										

Currency Board

Conventional peg

Stabilized / Crawl

Managed float

Freely floating

Source: IMF (2017i).

The table above depicts ‘de facto’ regimes according to IMF’s Annual Report on Exchange Arrangements and Exchange Restrictions. Comoros and Djibouti are the two economies in Eastern Africa with long lasting fixed exchange rate regimes. Since the Monetary Cooperation Agreement in 1979, the Comorian Franc has been pegged to the French Franc (and Euro since 1999). This arrangement is guaranteed by the French Central Bank and has remained stable.<sup>25</sup> As for Djibouti, limited experience at the central bank reasoned in favour of a peg of the Djibouti franc to the US dollar in 1949. It is now one of the world’s oldest currency board arrangements.

Consistent with the theory, inflation in both countries has been significantly lower than the rest of Eastern Africa, after accounting for other factors.<sup>26</sup> Although Eritrea also preserves a conventional peg to the US dollar since 2000, repetitive devaluations did not generate the credibility needed to ensure price stability. Instead, scarce foreign exchange reserves and large current account deficits spur inflation, while the real overvaluation of the Nakfa constrains private sector activity in Eritrea.

<sup>25</sup> The parity agreement between the Comorian Franc and the Euro imposes the Comorian Central Bank to have 65 per cent of its reserves deposited in the French Central Bank. Convergence criteria are also set up to maintain inflation below 3 per cent as well as limit budget deficits and debt stocks.

<sup>26</sup> The IMF (2016) suggests that, in sub-Sahara Africa, inflation rates in a pegged regime are on average 4 to 7 percentage points lower than in other regimes.

Pegs to the Euro have recently received heightened criticism (e.g. Nubukpo et al., 2016). The main argument is that the strengthening of Euro over the past years has led to a steady appreciation of the pegged currencies in real effective terms, thus undermining the exports' competitiveness of the affected countries. Moreover, for countries like Comoros whose imports represent a significant share of GDP, a devaluation could mean substantial pass-through to inflation.

On the other hand, the de jure floating exchange rate regimes, such as those of Burundi, D.R. Congo, Ethiopia and Rwanda, have seen a higher degree of exchange rate management since the mid-2000s. This trend may lean against nominal currency appreciations as foreign capital inflows increased due to excessive liquidity searching for yield when the advanced economies introduced unconventional monetary policies after the global financial crisis.

According to studies by the IMF (2016) and AfDB (2016), the Ethiopian birr is overvalued by 20 to 40 per cent and an improvement of the misalignments could improve Ethiopia's external competitiveness and support export diversification. In October 2017, the National Bank of Ethiopia announced a devaluation of the country's currency by 15 per cent to boost export earnings. However, it should be noted that a strong devaluation could undermine the infrastructure-led growth strategy and the exchange rate pass through into inflation could be substantial.

*Central banks generally maintained an accommodative monetary policy in 2017, with the aim of supporting the financing of the economy, but credit growth remained sluggish.*

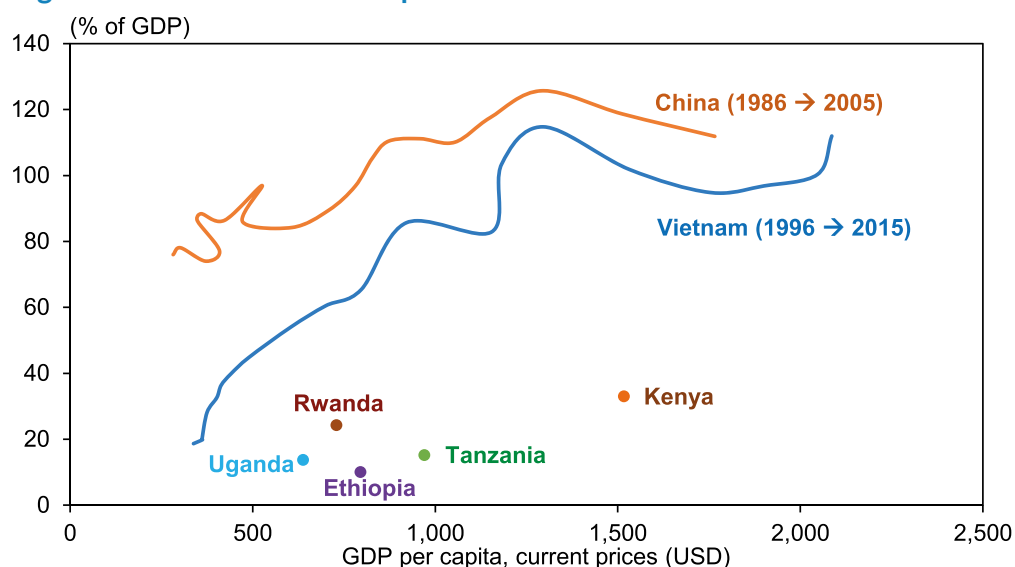
Regarding monetary policy, central banks generally maintained an accommodative monetary policy in 2017, with the aim of supporting the financing of the economy. However, the cost of credit remains high and access to credit often difficult. For example, the National Bank of Rwanda reduced its policy rate twice by 0.25 percentage point in December 2016 and June 2017 to 6.0 per cent. Yet new authorized loans by the banking sector contracted modestly in the first half of 2017, and more worryingly, higher loan delinquencies were observed across major economic sectors (BNR, 2017).<sup>27</sup> The

Central Bank of Kenya also lowered the Central Bank Rate (CBR) from 11.5 per cent to 10.5 per cent in May 2016, and then to 10 per cent in September 2016. It is worth noting that the Banking Act was amended in August 2016 to put a cap on lending rate at no more than 4 percentage points above the CBR and a floor on the deposit rate at 70 per cent of the CBR. As a result, both the lending rate and loans-deposit spread declined sharply. While the latest statistics show that credit growth remains sluggish, the impact of the interest rate cap in terms of improving long-term access to credit is to be monitored.<sup>28</sup> Worryingly, compared to the development trajectory of China and Vietnam, countries in the region have a much lower credit to GDP ratio at similar levels of income per capita (Figure 18).

<sup>27</sup> Credit growth resumed in the second half of 2017 and the Monetary Policy Committee decided to reduce the policy rate from 6 per cent to 5.5 per cent in 2018Q1 to encourage banks to boost lending to the private sector.

<sup>28</sup> Small and medium enterprises (SMEs) and borrowers with low credit quality may be excluded from accessing loans as banks cannot increase the lending rate to reflect the risks involved. While banks have increased their lending to the government and other public sector, the contraction of credit in agriculture, manufacturing and business services in recent months has raised concerns as these sectors consist a large number of SMEs and are key drivers of job creation (CBK, 2017). It is noted that the Bank of Tanzania also considers introducing interest rate cap on loans.

**Figure 18: Domestic credit to private sector**



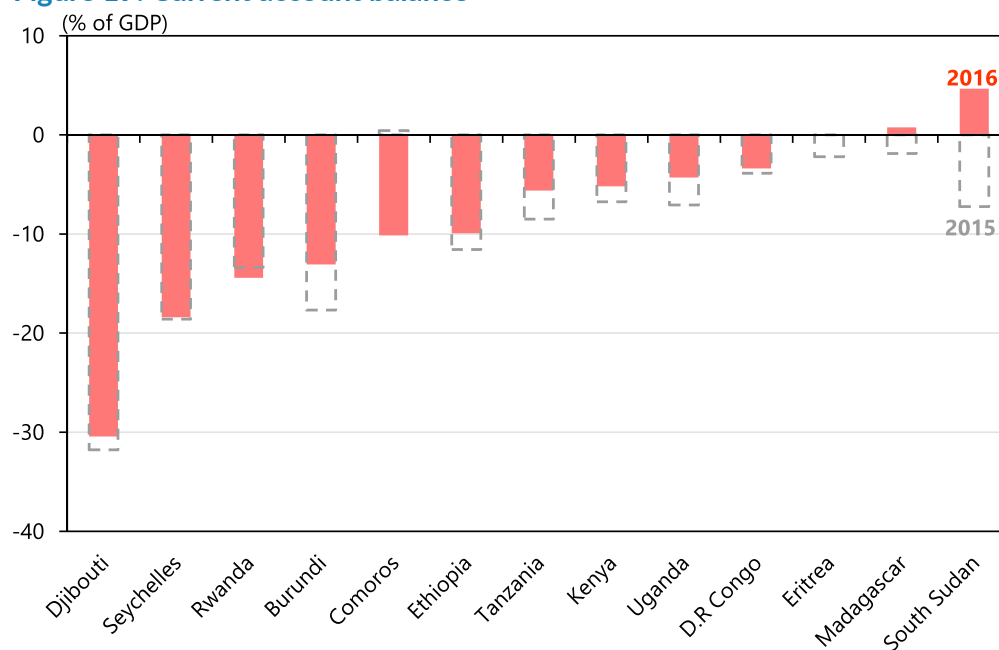
Source: World Bank (2017b).

## 1.9. Structural Current Account Deficits and Imbalanced Trade Structure

The current account balance of most countries in the region improved slightly in 2016, partly owing to a decline in imports. The most marked changes in the current account balance were Comoros, largely owing to one-off support from Saudi Arabia to resolve the crisis of wage arrears in 2015, and South Sudan, estimated to have regained its current account surplus in 2016 due to the decline in imports and the modest recovery in oil prices. Despite the latest development, a number of countries still register large current account deficits, mainly due to sizeable trade deficits (Figure 19). That, coupled with fiscal deficits (i.e. twin deficits), could constrain growth and increase vulnerability in the long run.

*A number of countries still register large current account deficits, mainly due to sizeable trade deficits.*

**Figure 19: Current account balance**

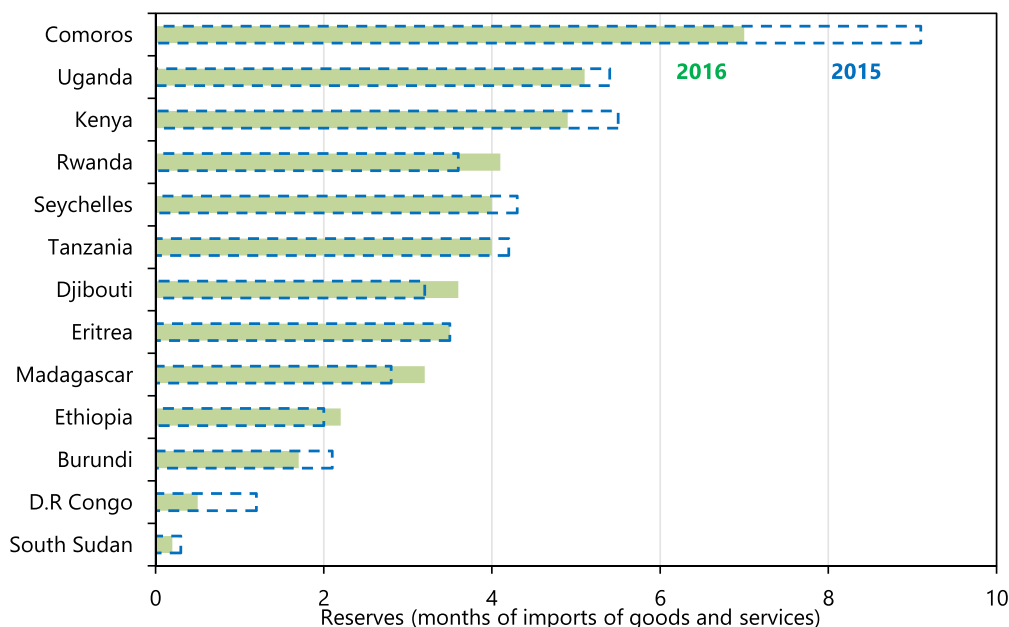


Source: IMF (2017a).



Because of large current account deficits, countries have to rely on external borrowing and investment as well as drawing on their international reserves. Comoros recorded notable decline in reserves in 2016 equivalent to around two months of imports of goods and services. Yet the situation in Comoros remains stable, with reserves still accounting for more than six months of imports. Countries with relatively low official foreign exchange reserves (e.g. Ethiopia, Burundi, D.R. Congo and South Sudan) could be more vulnerable to current account shocks (Figure 20).

**Figure 20: Official foreign exchange reserves**



Source: IMF (2017b).

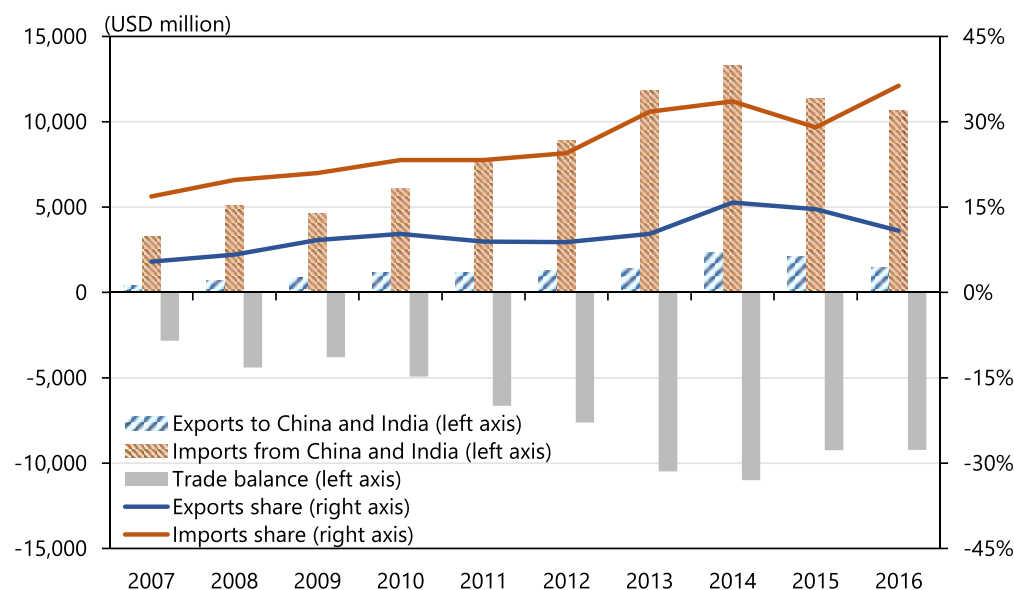
Regarding goods trade, there has been a substantial expansion in trade and diversification of partners. The value of Eastern African exports and imports doubled over the past decade to around US\$ 27 billion and US\$ 61 billion in 2016 respectively, yet this was slower than the growth of Eastern African economy which almost tripled during the same period, resulting in narrowing trade deficits as a share of GDP. On the other hand, countries in the region have been diversifying their exports away from traditional markets (e.g. Europe) towards new trading partners (especially developing countries in Asia, such as China, India and Vietnam), thereby increasing their resilience to economic shocks. While the share of exports to the two largest consumption markets in Asia (i.e. China and India) is still low, the significant increase in importance

*Exports to China and India accounted for around 11 per cent of EAC total exports in 2016, in contrast to the import share of around 36 per cent.*

as imports sources is striking. Figure 21 shows that exports to China and India accounted for around 11 per cent of EAC total exports in 2016, in contrast to the import share of around 36 per cent. The unbalanced growth of trade over the past decade resulted in large trade deficits between the EAC and China and India. In 2016, the trade imbalance was around US\$ 9.2 billion, representing around 57 per cent of EAC overall trade deficits. The rise of China and India as a source of imports may be a good news for consumers, but it also implies greater competition in domestic markets, especially for local manufacturers. Giovannetti and Sanfilippo (2009) found econometric support for the proposition that, with the intensification of economic

relations, China has not only started flooding African markets with its low cost manufactures, but has also begun to crowd-out cheap African manufactures in the region's traditional foreign markets. A more recent study by Jeanneney and Hua (2015) also suggested that manufactured goods imports from both China and other countries had an adverse effect on African industrialization.

**Figure 21: Trade balance between the East African Community and China and India**



Note: Figures do not include South Sudan.

Source: IMF (2017g).

Despite the shift in trade geography, the EU and the United States remain major trading partners of Eastern African countries. The proposed EPA between the EU and African countries could have significant implications on trade and industrial development (Box 6). Another recent dispute comes from the review of the eligibility of Rwanda, Tanzania and Uganda to receive benefits under the AGOA which has provided trade preferences for quota and duty-free entry into the United States for certain goods since 2000 (Box 7).

#### Box 6: Potential Impacts of The EAC-EU Economic Partnership Agreement

The EU has been pursuing EPAs with African countries to replace its existing preferential agreements for more than a decade. The EU claims that the existing preferential access arrangements will no longer be tolerated within the World Trade Organization and could be legally challenged. The EPAs were premised on the grounds that they would be negotiated only on a regional level and would help consolidate regional integration processes in Africa. While the proposed agreements potentially offer a more permanent and stable basis for access to the European market, the discussions have been controversial and views about the agreements are highly diverse across countries.

To assess the implications of the EAC-EU EPA for EAC, UNECA simulated the potential impact using the Globe Trade Analysis Project (GTAP) 9.0 data base and model. The model describes global bilateral trade patterns, production, consumption and intermediate use of commodities and services. The simulation helps model the static effect of the EU EPA on four of the EAC member States (i.e. Kenya, Rwanda, Uganda and Tanzania).

The simulations suggest that EAC imports from the EU would increase significantly by 12.7 per cent. In contrast, exports from EAC to the EU would only increase marginally.<sup>29</sup> There is also a slight deterioration of the terms of trade for all countries in the EAC. With regard to GDP, the simulation suggests that the EPA reduces GDP by 0.2 to 0.5 per cent across the four EAC countries considered in the exercise (Table 9). It is worth noting that imports from all

<sup>29</sup> This is a consequence of the fact that the EPAs will not result in any substantially improved market access to the EU market, as EAC countries already benefit from the Everything But Arms (EBA) agreement, which provides for non-reciprocal market access for all products except armaments and a few select agricultural products (e.g. sugar and rice).

other regions would decline (i.e. the trade diversion effect). Perhaps more importantly, intra-EAC imports would decline by US\$ 42 million (mainly in manufacturing), while tariff revenues accruing from imports would decline by US\$ 169 million in EAC (Table 10).

**Table 9: Impact of EPA in 2042 (change from baseline, %)**

	GDP	Imports (Total)	Exports (Total)	Terms of Trade	Imports (EU)	Exports (EU)
Kenya	-0.5	-0.3	0.8	-0.3	12.5	1.1
Rwanda	-0.3	-0.1	0.4	-0.1	10.4	0.5
Tanzania	-0.3	-0.2	0.4	-0.1	14.3	0.4
Uganda	-0.2	-0.3	0.2	-0.1	10.9	0.4
EAC	-	-0.3	0.5	-	12.7	0.7
EU	0.0	0.0	0.0	0.0	0.0	0.0

Source: UNECA (2017c).

**Table 10: Impact of EPA in 2042 (change from baseline, USD million)**

	Welfare	Imports (Total)	Exports (Total)	Imports (EU)	Exports (EU)	Tariff Revenue
EAC	-49	-99	97	815	42	-169
EU	212	441	303	-100	-96	-

Source: UNECA (2017c).

These simulation results contrast with the results presented by the European Commission which suggests net gains for EAC member (EC, 2017), despite the fact that both studies use the same underlying database (i.e. GTAP 9.0).<sup>30</sup> It is notable, however, that in macroeconomic terms, both studies show relatively small effects. For instance, UNECA estimates suggest that the GDP impacts would be negligible. This is generally the case with this kind of modelling, particularly when one party (the EAC) is not gaining any significant enhanced access compared with existing arrangements. The modelling exercise does, however, alert us to the possibility that any potential gains with regards to trading relations with Europe may be at the expense of trading relations with other EAC partners and the rest of the world.

Beyond the direct impacts, questions have also been raised about the way the EPA could potentially constrain the development of EAC industrial policy. The agreements contain various articles relevant to EAC industrial policy objectives. Some are trade related; others impinge on the way domestic support measures may be provided. Regarding the former, these mechanisms do enable temporary emergency restrictions on imports of specific products in the case of a surge in imports or a sharp decline in import prices. However, the trade-related safeguard provisions are limited in scope and their implementation is, arguably, cumbersome (SEATINI, 2017 and CUTS International, 2011).

Source: UNECA (2017a).

<sup>30</sup> The reasons for the differences are probably tied up in a number of factors, including the fact that the EC study uses a baseline scenario which presupposes a return to standard Generalized System of Preference tariffs for Kenya and uses a dynamic rather than static modelling approach. The precise reasons for the differences could not be ascertained as the EC study does not contain details such as the model closure, the elasticities utilized, etc.

### Box 7: An Opportunity Missed? – The African Growth and Opportunity Act

For some EAC countries in the region, difficulties have arisen recently with regards to the trading relations with another major trading partner, the United States. A particular bone of contention has been over EAC plans to ban the imports of second-hand clothing. In an effort to incentivise the local production of textiles, the EAC unanimously decided to move forward with a phased ban on the importation of used clothes in February 2016, including a gradual increase in import duties followed by an outright ban by 2019. After its announcement, the Secondary Materials and Recycled Textiles Association, a US industry association representing used clothing businesses, filed a complaint against the EAC claiming that the ban was in direct violation of AGOA. The region now risks losing its eligibility to AGOA.

Rwanda, Tanzania and Uganda have maintained strong support for the EAC's position to restrict the import of second-hand clothing to promote its textile and apparel industry. In spite of pending review of eligibility, the three EAC countries have doubled down on their position and increased the environmental levy imposed on used clothes. In 2016, the EAC imported used clothes worth US\$ 239 million, which was 15 per cent of clothing imports into the EAC (UN Comtrade). The EAC hopes that the used clothing ban would provide local garment manufacturers with an opportunity to increase their market share and continue to develop their production capacities.

Despite the big hopes initially pinned on AGOA, the reality is that most countries in Eastern Africa, in practical terms, benefited very little from the provisions of AGOA.<sup>31</sup> In 2016, total Eastern Africa (seven eligible countries) AGOA exports to the United States, excluding exports under Generalized System of Preferences (GSP), valued at just US\$ 584 million, which was only about 6.2 per cent of total African AGOA exports. The biggest beneficiary in Eastern Africa was Kenya which exported US\$ 391 million, representing around 7 per cent of its merchandise exports (United States Department of Commerce, 2017).<sup>32</sup> The low levels of Eastern Africa exports under AGOA may reflect a more general problem related not only to the limited supply-side capacities on the part of beneficiary countries, but also perhaps more fundamental problems in the form of the agreement itself – including phytosanitary standards, the time-bound nature of the concessions and rules of origin (UNECA, 2014).

If these EAC countries stick to their second-hand clothing ban, they could potentially stand to take over market share of all used-clothes importers. Even with the possibility of losing AGOA eligibility<sup>33</sup>, the clothing ban could on balance benefit the textile and apparel industry. However, it should be noted that this cost benefit analysis does not account for the loss of tariffs due to the ban nor the potential welfare losses to the people who strongly rely on used clothing for a decent quality of life. Ultimately, the outcome of the used clothing ban depends on whether EAC textile and apparel manufacturers can effectively meet demand. Their success, in turn, is at least partially dependent on the support of the governments to provide the optimal conditions for manufacturers to fill the supply gap.

Source: UNECA (2017a).

<sup>31</sup> The situation was quite different in Madagascar. The agreement was concomitant with a boom in the textile industry supported by incentive policies towards exports processing zones. Exports under AGOA accounted for around one-fifth of merchandise exports before the agreement was suspended in 2010 in the wake of political crisis. Madagascar's eligibility was reinstated in 2014 after the return of political stability.

<sup>32</sup> AGOA exports to the United States accounted a small fraction of the country exports. In 2016, the share was 4.3 per cent in Madagascar, 1.3 per cent in Ethiopia, 0.8 per cent in Tanzania, 0.1 per cent in Rwanda and 0.01 per cent in Uganda (United States Department of Commerce, 2017).

<sup>33</sup> In 2013, in anticipation of a possible revision of AGOA, UNECA prepared a report to measure the potential impact on

As for regional trade, the share of intra-EAC exports stayed largely stable at around 20 per cent over the past decade, whereas the share of intra-EAC imports hovered at around 6 per cent. Although the level of intra-regional trade is far below that of other regional blocks like the Asia-Pacific Economic Cooperation (APEC) and the EU (with shares of intra-regional trade above 60 per cent), the EAC has the highest share of intra-regional trade among the eleven major regional economic communities in Africa<sup>34</sup> and is close to the level seen among Association of Southeast Asian Nations (ASEAN) countries (UNCTADstat). Regional trade integration is a cornerstone of EAC policy and partner states are expected to benefit from enhanced trade flows and improved production efficiency in the community. In this regard, the protracted trade dispute between the two major traders (i.e. Kenya and Tanzania) as well as an increase in the number of non-tariff barriers, have raised concerns on regional trade integration.<sup>35</sup>

Despite the rapid growth in trade and diversification of trading partners over the past decade, Eastern Africa's exports to the world remains dominated by primary commodities and that leaves the region highly vulnerable to commodity price shocks.<sup>36</sup> In fact, the export revenues of Burundi, Ethiopia, Kenya, Rwanda and Uganda were seriously affected by the decline in coffee and tea prices in recent years, whereas Eritrea, D.R. Congo and Tanzania were hit hard by lower prices of gold and metals (Figure 22). Meanwhile, the export of raw materials rather than processed goods places countries in the lower rungs of global value chains and is not conducive for structural transformation.

This, combined with a reliance on capital and consumer goods imports, reveals the weakness of the manufacturing sector in the region. For instance, Tanzania trades raw cotton for imported cotton fabrics, and D.R. Congo exports crude petroleum and imports refined petroleum.

*Export revenues of Burundi, Ethiopia, Kenya, Rwanda and Uganda were seriously affected by the decline in coffee and tea prices in recent years, whereas Eritrea, D.R. Congo and Tanzania were hit hard by lower prices of gold and metals.*

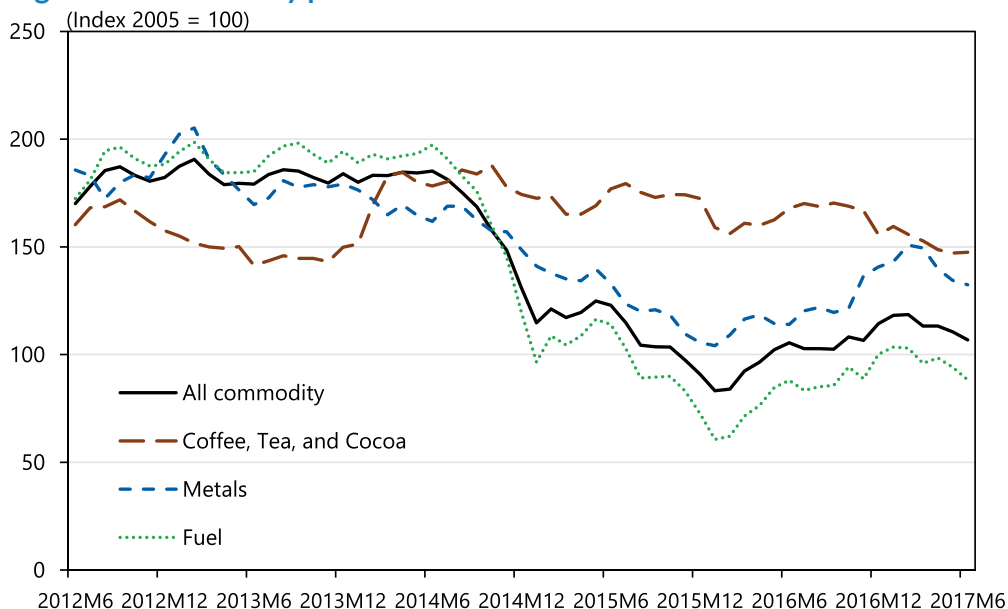
AGOA eligible countries if AGOA was discontinued (UNECA, 2013b). It provides a useful insight into what Rwanda, Tanzania and Uganda could lose if its eligibility is revoked. Interestingly, the report's simulations showed that the three countries could expect marginal losses to exports and real wages: less than 0.2 per cent decrease in total exports, assuming a return to GSP trade provisions, and a negligible decrease in real wages.

<sup>34</sup> The eleven major regional economic communities in Africa include Arab Maghreb Union (UMA), Common Market for Eastern and Southern Africa (COMESA), Community of Sahel-Saharan States (CENSAD), Economic Community of Central African States (ECCAS), Economic Community of West African States (ECOWAS), Inter- Governmental Authority on Development (IGAD), Southern African Development Community (SADC), Economic and Monetary Community of Central Africa (CEMAC), East African Community (EAC), Southern African Customs Union (SACU) and West African Economic and Monetary Union (UEMOA).

<sup>35</sup> Reciprocal barriers against each other's goods continue to recur. For example, Tanzania imposed tariffs on Kenya's milk products and Kenya imposed a ban on importation of liquefied petroleum gas from Tanzania. Meanwhile, according to the East African Community Common Market Scorecard 2016, Kenya's doubled the use of non-tariff barriers from 10 in 2014 to 23 in 2016, whereas Tanzania's more than tripled from 7 to 24.

<sup>36</sup> Several countries in the region also rely heavily on commodity imports (e.g. Comoros, D.R. Congo, Djibouti, Eritrea, Kenya, Seychelles and Somalia). Analysis suggests that commodity dependence is negatively associated with human development, and thus should be understood as a fundamental development challenge to be addressed as part of the broader development strategies (FAO and UNCTAD, 2017).

**Figure 22: Commodity prices**



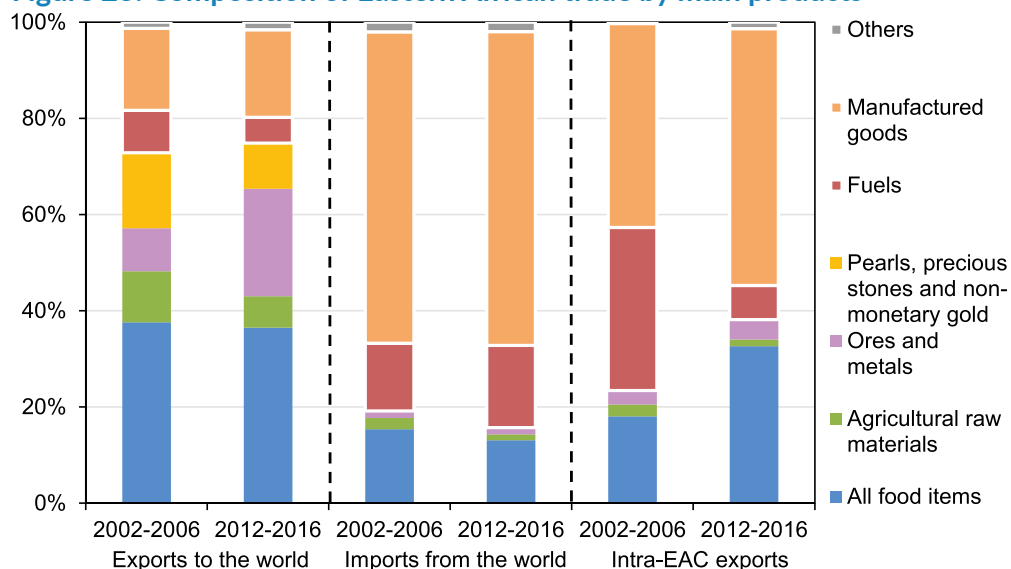
Note: The recent decline in price index of coffee, tea and cocoa was mainly due to the plentiful cocoa production in West Africa. In fact, the price of coffee and tea increased in the first half of 2017.  
Source: IMF (2017h).

A detailed breakdown of traded products shows that half of the exports were food items and agricultural raw materials during 2002 to 2006, whereas ores and metals as well as pearls, precious stones and gold accounted for one-fourth, and fuels represented another one-tenth. In contrast, less than one-fifth of the exports were manufactured goods. Surprisingly perhaps, the overall export composition has little changed over the past decade, other than the notable increase in the export shares of ores and metals and the decline in the share of pearls, precious stones and gold. Compared to the concentration of exports in primary commodities<sup>37</sup>, countries rely heavily on manufactured goods imports (Figure 23). Meanwhile, the level of technological sophistication in manufacturing exports for most countries in the region is much lower than the major import sources (e.g. China, India and Vietnam) (Figure 24). Against this backdrop, manufactured goods account for over 50 per cent of intra-EAC exports, reinforcing the importance of intra-regional trade for industrial development. Intra-regional trade in intermediate goods offers scope for the development of regional value chains. Countries with more advanced manufacturing sectors are expected to benefit significantly from the resultant trade.

*Manufactured goods account for over 50 per cent of intra-EAC exports, reinforcing the importance of intra-regional trade for industrial development.*

<sup>37</sup> For more than half of the countries in the region, the top ten products constituted 75 per cent or more of their total exports (UN Comtrade).

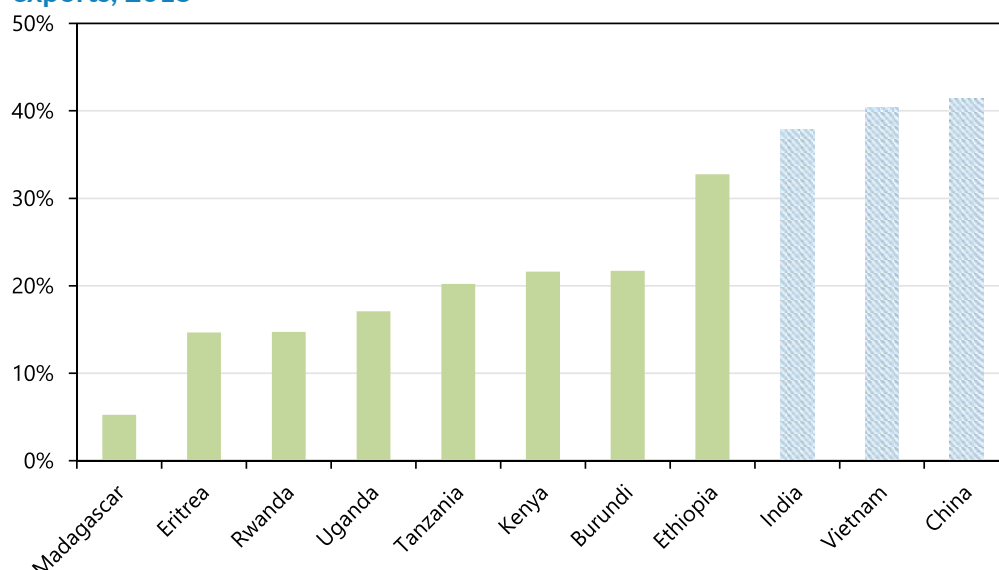
**Figure 23: Composition of Eastern African trade by main products**



Note: Figures do not include Somalia.

Source: UNCTADstat.

**Figure 24: Medium and high technology manufactured exports share in total manufactured exports, 2015**



Source: UNIDO (2017).

Further analysis on export composition provides insights into a country's economic structure and growth potential. According to Hausmann and Hidalgo et al. (2011), the amount of embedded knowledge that a country possesses is expressed in the diversity and ubiquity of the products that it makes, and it can be quantified by the *Economic Complexity Index (ECI)*. Countries with higher ECI have more diversified and sophisticated exports, and are more likely to enjoy faster economic growth given the same income level. On a positive note, the five Eastern African countries discussed in their analysis (i.e. Ethiopia, Kenya, Madagascar, Tanzania and Uganda) all recorded improvement in the ECI over the past decade, albeit from low levels and rankings (the average ranking was around 100 out of 124 countries in the world in 2015). Considering the current income level, the ECI indicates that Uganda's exports have a relatively high level of complexity. On the basis of this, Hausmann and Hidalgo et al. argued that Uganda is expected to be among the top ten fastest growing countries to 2025 (CID, 2017).

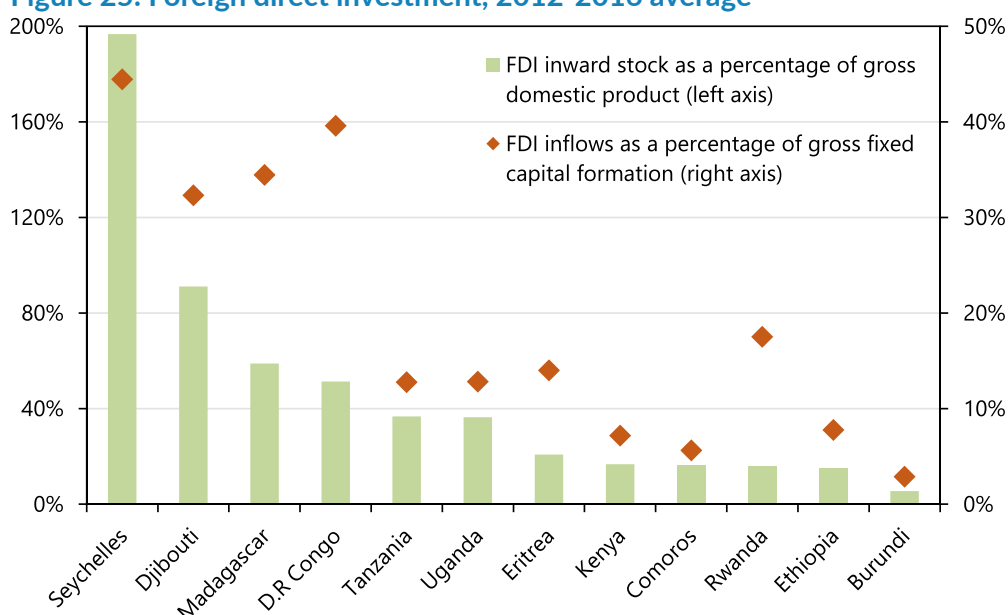


In view of the unbalanced trade structure, some countries have been actively taking measures to increase the export-orientation of foreign investments and reduce reliance on imported inputs. For example, the development of local production capacity in Rwanda is paying off, as illustrated by the notable decline in the imports of construction materials since 2016, thanks to the increase in domestic cement production (BNR, 2017). These measures not only help narrow trade deficits and relieve exchange rate pressure, but also promote industrial development and structural transformation in the long run.

## 1.10. Leveraging Foreign Direct Investment

FDI has become an important source of external finance in a number of the countries. The share of FDI inward stock as a percentage of GDP rose rapidly over the past decade, with Seychelles and Djibouti standing out at a level of around 200 per cent and 100 per cent respectively. Meanwhile, FDI inflows contributed significantly to gross fixed capital formation, especially for countries such as Seychelles, Djibouti, Madagascar and D.R. Congo (Figure 25).

**Figure 25: Foreign direct investment, 2012-2016 average**



Source: UNCATD (2017b).

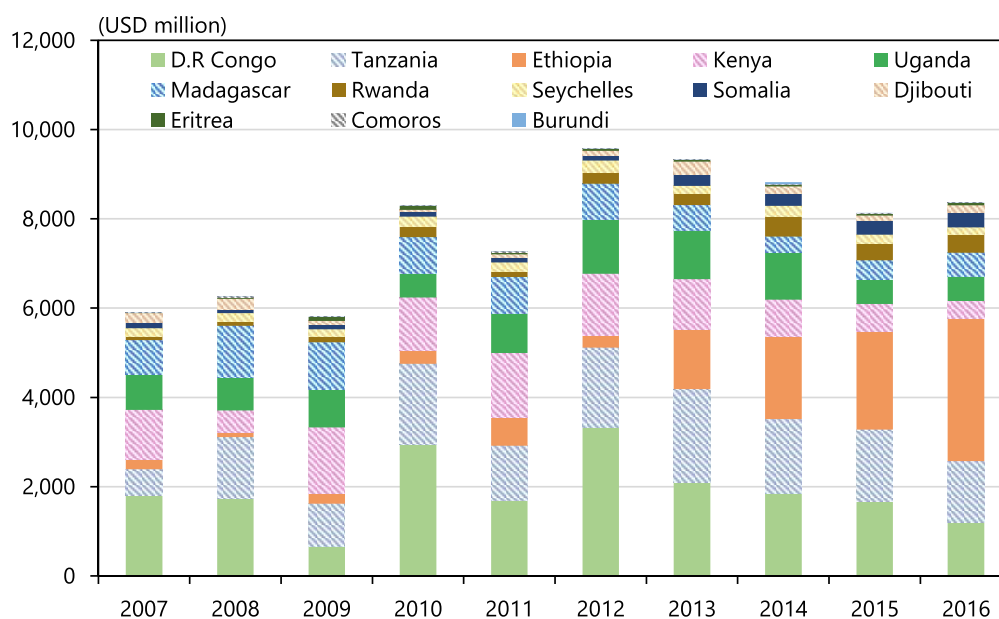
Over the past decade, FDI inflows to Eastern Africa experienced a notable degree of volatility. FDI inflows to the region stagnated during the global financial crisis and increased markedly afterwards given the promising macroeconomic prospects. FDI inflows then peaked in 2012 and declined steadily till 2015, partly due to the decrease in commodity prices during the same period that weighed on resource-seeking investments. While FDI inflows to Africa continued to slide in 2016, inflows to Eastern Africa recorded a slight rebound, to US\$ 8.3 billion, up from US\$ 8.1 billion in 2015, largely driven by the prominent increase in

*Ethiopia alone received an impressive US\$ 3.2 billion of FDI in 2016, attributable to the government's efforts in improving the legal framework and institutional capacities, as well as the development of industrial parks.*

FDI inflows to Ethiopia. Detailed breakdowns by country show that the four major FDI recipients (i.e. D.R. Congo, Tanzania, Kenya and Uganda) registered visible declines in FDI inflows in recent years, in contrast to the sharp increase in Ethiopia and Rwanda (Figure 26). Ethiopia alone received an impressive US\$ 3.2 billion of FDI in 2016. The rapid growth of FDI inflows to Ethiopia can be attributed to the government's efforts in improving the legal framework and institutional capacities (e.g. setting up of the Ethiopian Investment Commission), as well as the development of industrial parks (see Box 2).



**Figure 26: Foreign direct investment inflows to Eastern Africa, 2007-2016**



Source: UNCTAD (2017b).

Regarding the source of FDI inflows, there has been a shift from advanced economies to developing economies, mirroring the change in trading partners. The share of FDI inward stock in Africa from the EU and the United States decreased gradually, while that from China increased notably over the years. In fact, China and India were ranked as the top 4<sup>th</sup> and 7<sup>th</sup> investor economies in Africa in 2015 (UNCTAD, 2017b).

Within Eastern Africa, the boom of FDI inflows from China has been remarkable. Chinese investment used to focus on resource-rich countries such as Algeria, Nigeria and South Africa, but subsequent to the global financial crisis, the region has become a priority for Chinese investors. According to the Ministry of Commerce of the People's Republic of China, China's FDI flows to Eastern Africa surged from less than US\$ 100 million in 2007 to around US\$ 1.2 billion in 2015, representing more than 40 per cent of China's total FDI to Africa in 2015 compared to that of around 6 per cent in 2007. As for the major recipients, D.R. Congo and Kenya were the destinations of around half of the China's FDI outflows to Eastern Africa during 2007 to 2015, while Tanzania and Ethiopia accounted for another 30 per cent. For the region as a whole, China was the source of around 16 per cent of FDI inflows to Eastern Africa in 2015.

*The region has become a priority for Chinese investors. China's FDI flows to Eastern Africa surged from less than US\$ 100 million in 2007 to around US\$ 1.2 billion in 2015, representing more than 40 per cent of China's total FDI to Africa in 2015.*

On a positive note, Chinese FDI in Africa is rather diversified, with increasing investment in the manufacturing sector. A research report by McKinsey & Company (2017) suggests that Chinese firms operate across many sectors of the African economy, with around one-third involving in manufacturing, a quarter in services, and around a fifth in trade, construction and real estate. In contrast, statistics show that foreign investment from the United States has been heavily skewed towards the mining sector. In 2014, around 80 per cent of the value added and 90 per cent of profit of the affiliates in Africa came from the mining sector (United States Bureau of Economic Analysis, 2017).

Attracting more foreign investment into the manufacturing sector could help introduce new technology, promote knowledge and skills transfers, as well as improve production capacity, thereby accelerating structural transformation and boosting productivity. In this regards, countries in the region have been actively launching different strategies. As discussed in Box 2, Ethiopia has committed to attracting FDI in implementing its vision of industrial development. Special economic zones have also been established

in various countries with the aim of attracting FDI and promoting exports. These initiatives usually offer generous incentives such as tax exemption, import duty exemptions and favourable land leases to encourage foreign investment. In order to ensure that the government subsidies pay off rather than undermining tax revenues or falling into a regional 'race-to-the-bottom' amid heightened competition for FDI, the related costs and benefits should be well balanced. To this end, governments could grant subsidies with clear conditions and sunset clauses to reduce the risk of poor selection of beneficiaries and the promotion of assistance-dependent firms with low productivity. Also, regular policy monitoring and outcomes evaluation are essential to improve policy design and implementation in light of developmental objectives. From the perspective of national policy, FDI is more than just a capital and technology transfer, but rather needs to be seen in the context of a wider development strategy.



**SOCIAL DEVELOPMENTS**

## 2. SOCIAL DEVELOPMENTS

The previous sections of this report provide evidence of the general improvement in economic conditions in Eastern Africa. However, there is a resounding consensus that the end objective of all economic progress is greater human and social development (see, for instance, Sen, 1999). This section charts some of the achievements, existing and emerging challenges for the region in this terrain, beginning with the trajectory of UNDP's Human Development Index (HDI).

### 2.1. Overview of Human Development

The HDI integrates three basic dimensions of human development (i.e. health, education and standard of living) and provides an overview of regional performance over an extended period. Although the Eastern Africa region remains at a low level of human development, with all of the countries in the region being classified in the bottom quintile (except Seychelles), there has been impressive progress over the past decade (Table 11). People of the region live longer, receive better education, and enjoy an improved quality of life. Specifically, Burundi recorded the largest increase in HDI value over the last decade, albeit from a very low base. During the same period, the HDI growth in Ethiopia and Rwanda was also remarkable, mainly thanks to the rapid economic growth and notable improvement in education.

*Although the Eastern Africa region remains at a low level of human development, there has been impressive progress over the past decade.*

**Table 11: Human Development Index and its components**

HDI Rank	Country	HDI Value		Life expectancy at birth (years)		Mean years of schooling (years)		Expected years of schooling (years)		Gross national income per capita (2011 PPP\$)	
		2005	2015	2005	2015	2005	2015	2005	2015	2005	2015
63	Seychelles	0.728	0.782	72.3	73.3	7.7	9.4	13.1	14.1	16,568	23,886
146	Kenya	0.483	0.555	53.6	62.2	5.8	6.3	9.7	11.1	2,267	2,881
151	Tanzania	0.446	0.531	55.6	65.5	4.8	5.8	7.6	8.9	1,798	2,467
158	Madagascar	0.478	0.512	61.2	65.5	5.6	6.1	9.0	10.3	1,372	1,320
159	Rwanda	0.404	0.498	54.9	64.7	2.8	3.8	9.3	10.8	1,008	1,617
160	Comoros	0.451	0.498	60.1	63.6	3.1	4.8	9.9	11.1	1,368	1,335
163	Uganda	0.434	0.493	51.8	59.2	4.4	5.7	10.6	10.0	1,211	1,670
172	Djibouti	0.405	0.473	58.0	62.3	3.7	4.1	4.3	6.3	2,169	3,216
174	Ethiopia	0.346	0.448	56.3	64.6	1.9	2.6	6.6	8.4	734	1,523
176	D.R. Congo	0.364	0.435	53.7	59.1	4.3	6.1	7.5	9.8	577	680
179	Eritrea	0.405	0.420	58.6	64.2	3.7	3.9	5.3	5.0	1,528	1,490
181	South Sudan		0.418	51.2	56.1		4.8		4.9		1,882
184	Burundi	0.290	0.404	52.7	57.1	2.3	3.0	5.9	10.6	381	691

Source: UNDP (2016).

There are two additional aspects to human development captured by the Inequality-adjusted HDI (IHDI) and the Gender Development Index (GDI). Compared to the average difference of around 11 per cent between the IHDI and HDI in countries with very high human development (i.e. HDI  $\geq$  0.8), the loss to human development due to inequality is significant (around 30 per cent) for most of the countries in the region, primarily owing to the notably high inequality in health and education. As for the gender gap, the GDI measures female HDI as a percentage of the male HDI. While Rwanda stands out with nearly gender equality, women are seriously lagging behind their male counterparts in Comoros, D.R. Congo and Ethiopia,

especially regarding education and income. Building on the same framework as the IHDI, the Gender Inequality Index (GII) further measures the human development costs of gender inequality based on three different dimensions, namely, reproductive health, empowerment and labour market participation. Similar to the results of GDI, countries in the region (except Rwanda) suffer from high gender inequality (Table 12).

**Table 12: Inequality and gender aspects of human development**

HDI Rank	Country	HDI Value	Inequality-adjusted HDI		Gender Development Index	Gender Development Index, 2015	
2015		2015	2015	Loss (%)	2015	Value	Rank
63	Seychelles	0.782					
146	Kenya	0.555	0.391	29.5	0.919	0.565	135
151	Tanzania	0.531	0.396	25.4	0.937	0.544	129
158	Madagascar	0.512	0.374	27.0	0.948		
159	Rwanda	0.498	0.339	31.9	0.992	0.383	84
160	Comoros	0.498	0.270	45.8	0.817		
163	Uganda	0.493	0.341	30.9	0.878	0.522	121
172	Djibouti	0.473	0.310	34.6			
174	Ethiopia	0.448	0.330	26.3	0.842	0.499	116
176	D.R. Congo	0.435	0.297	31.9	0.832	0.663	153
179	Eritrea	0.420					
181	South Sudan	0.418					
184	Burundi	0.404	0.276	31.5	0.919	0.474	108

Source: UNDP (2016).

Peoples' perceptions also provide an interesting reflection on social developments.<sup>38</sup> Surveys by Afrobarometer (2017) show that people in Eastern Africa are generally satisfied with government efforts on addressing educational needs, while perceptions about government performance on creating jobs and improving living standards of the poor are rather negative (Figure 27).<sup>39</sup>

*People in Eastern Africa are generally satisfied with government efforts on addressing educational needs, while perceptions about government performance on creating jobs and improving living standards of the poor are rather negative.*

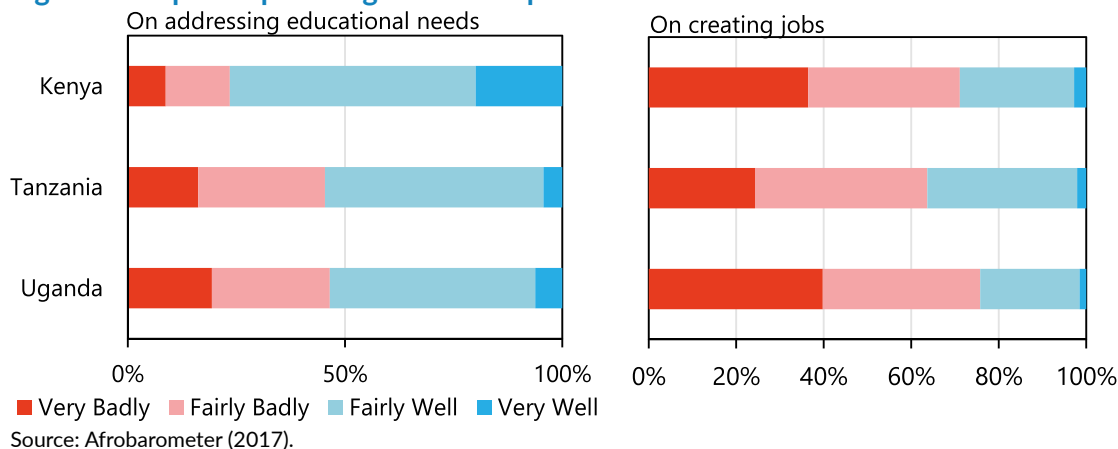
The negative views on job creation echo the concern that an excessive dependence on the services sector may not generate sufficient employment opportunities to sustain inclusive growth. In view of the rapidly growing population and relatively young workforce in Eastern Africa<sup>40</sup>, the role of the manufacturing sector in promoting job creation is particularly crucial.

<sup>38</sup> As discussed in the report "Social Cohesion in Eastern Africa", qualitative data, including opinion surveys and questionnaires, provides a deeper appreciation of the perspectives of citizens in the region and is essential for understanding the state of social cohesion (UNECA, 2016d).

<sup>39</sup> People's perception about government performance on improving living standards of the poor is similar to that on creating jobs. Kenya and Uganda were surveyed in 2016/18, whereas Tanzania was surveyed in 2014/15.

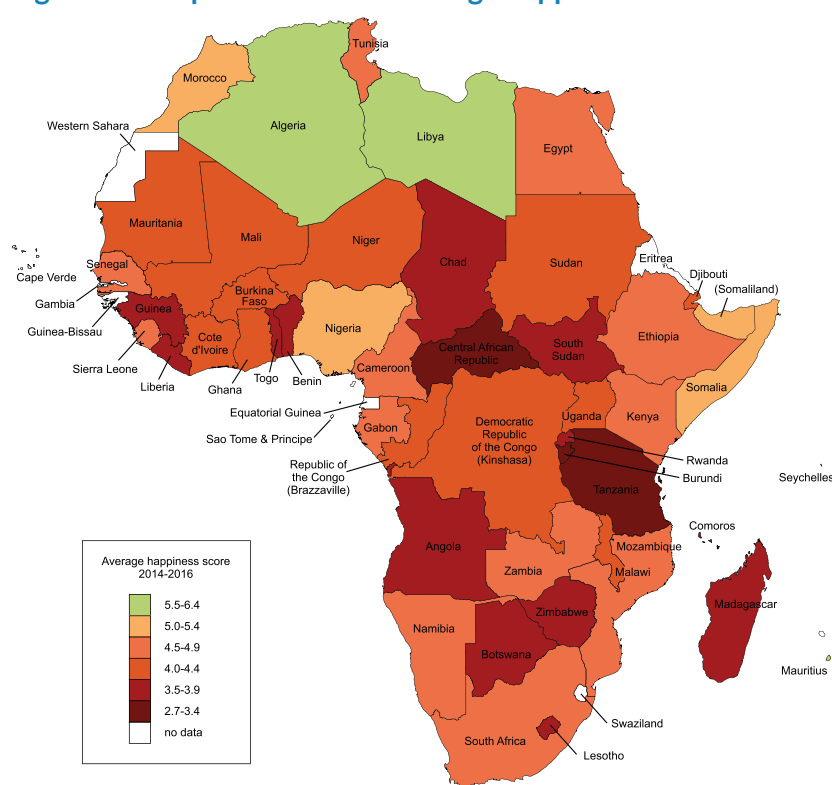
<sup>40</sup> The average annual population growth rate was around 3.0 per cent between 2005 and 2015 in Eastern Africa, much higher than the world average of 1.2 per cent. Meanwhile, median age of the population is below 20 years for most of the countries in the region, compared to the world average of around 30 years (UNDESA, 2017b).

**Figure 27: Opinion polls of government performance**



Another interesting, albeit subjective, measure of development and social progress is peoples' professed levels of 'happiness' ('furaha' in Kiswahili). Figure 28 presents the average happiness scores in Africa, as revealed in the Gallup World Poll. Respondents are asked to evaluate the quality of their current lives on a scale of 0 to 10 (with 10 indicating the greatest feelings of 'happiness'). Over 86 per cent of the surveyed countries in Africa fall below the mid-point of the scale, mirroring the low ranking in HDI.<sup>41</sup> Having said that, the scores differ significantly among countries within Eastern Africa, ranging from a low 2.9 in Burundi to a surprisingly high 5.2 in Somalia.

**Figure 28: Map of Africa with average happiness scores**



Source: World Happiness Report 2017.

<sup>41</sup> Countries in the region recorded lower happiness levels compared to ten years ago with the only exception of Kenya. Despite the low life evaluations, Africa's optimism is exceptional, especially among the youth, as evidenced by the notably higher future evaluations of 7.2 against the present rating of 4.7 among people ages 15 to 24.

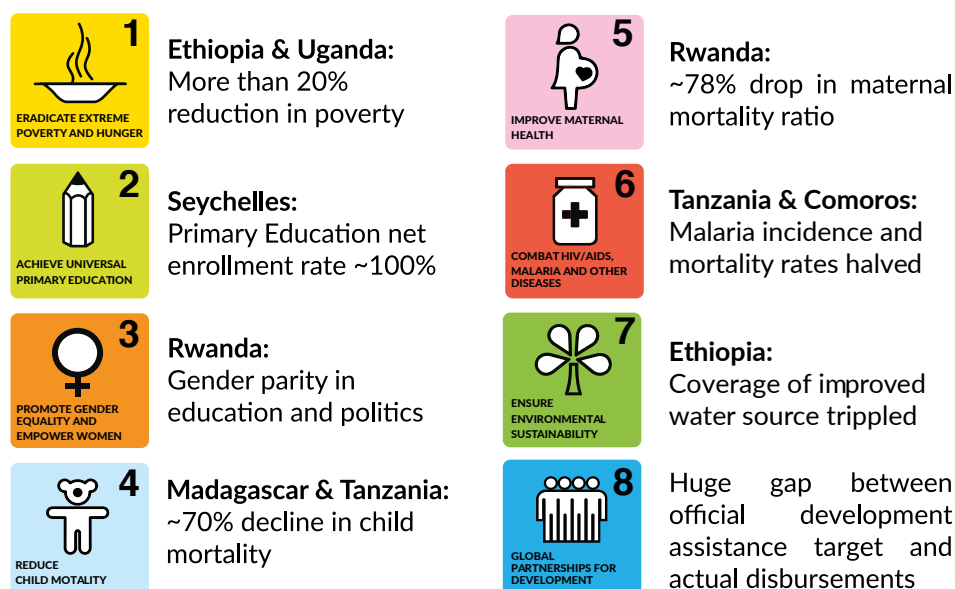


## 2.2. Leaving No One Behind

For a more comprehensive assessment of development progress, the Sustainable Development Goals (SDGs) Dashboard highlights achievements in meeting the 17 SDGs, thereby helping countries identify priorities for early action. Building upon the successes of the Millennium Development Goals (Figure 29), the 17 SDGs were adopted by all member States of the United Nations in 2015, which serve as a universal agenda of sustainable development combining economic development, social inclusion and environmental sustainability. Figure 30 summarises the performance of the region and highlights the areas that require focused actions in order to achieve the bolder and broader set of SDGs by 2030. Specifically, most countries need more determined progress towards ending extreme poverty (SDG 1) and hunger (SDG 2), as well as improving health (SDG 3), access to basic infrastructure (SDGs 6-9) and peace, security, and institutions (SDG 16). To facilitate the implementation of the SDG agenda, UN agencies have been working closely with member States to mainstream SDGs into sub-regional and national development policies, strategies and programmes.<sup>42</sup> For example, Uganda was one of the first countries to develop a national development plan in line with the SDGs.

*Uganda was one of the first countries to develop a national development plan in line with the SDGs.*

**Figure 29: Major observations of the Millennium Development Goals**

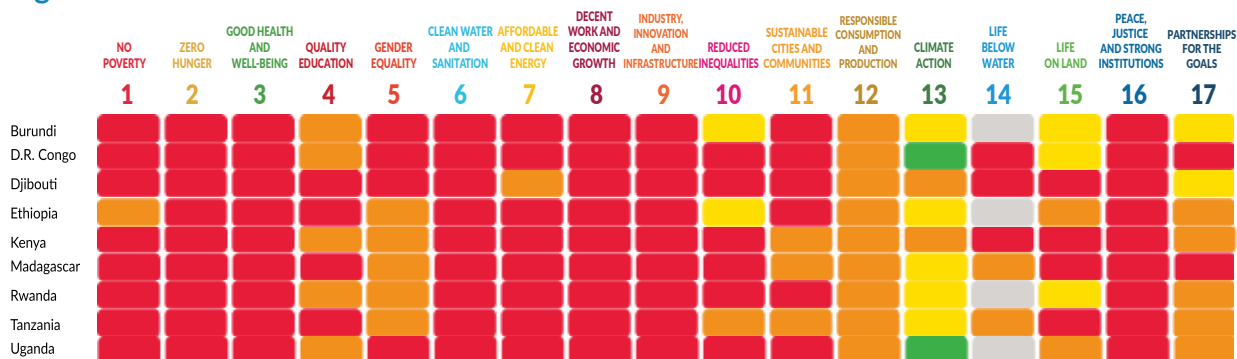


Note: Time periods for the progresses are: MDG 1 (1990-2012), MDG 4 (1991-2016), MDGs 5 and 7 (1990- 2015) and MDG 6 (2010-2015). Further to the above observations, the coverage of antiretroviral therapy for HIV/ADS increased by around 50 per cent between 2009 and 2011 in Burundi, Djibouti, Ethiopia, Kenya, Madagascar and Somalia (MDG6).

Source: UNECA (2016c).

<sup>42</sup> African leaders also established the Sustainable Development Goals Center for Africa which provides technical support and expertise to governments, civil society, businesses and academic institutions in order to accelerate progress towards the SDGs across Africa.

Figure 30: SDG Dashboard for Eastern Africa



Note: Green denotes SDG achievement, red highlights major challenges, while yellow and orange indicate that significant challenges remain.

Source: Bertelsmann Stiftung and Sustainable Development Solutions Network (2017).

Apart from the overall picture that HDI and SDG Dashboard present, the following sections focus on several social developments (i.e. drought and food insecurity, increased displacement, communicable disease outbreaks and emerging social problems) for more in-depth discussion.

## 2.3. Drought and Food Insecurity

The region has been experiencing serious food insecurity challenges, exacerbated by the successive episodes of drought in 2016 and 2017 resulting in extensive growing season failures and livestock deaths.<sup>43</sup> As of May 2017, the number of people in Integrated Phase Classification Crisis (IPC) phase 3 (crisis), 4 (emergency) and 5 (famine) increased significantly to over 31 million (Figure 31).<sup>44</sup> As a share of population, the ratios of affected populations were highest in South Sudan<sup>45</sup> and Somalia, at around 46 per cent and 23 per cent respectively. Of major concern are Somalia, Ethiopia and Kenya, which accounted for around half of food insecure people in the region, amongst fears that they may face another season of below average rainfall. In particular, some parts of Somalia face an elevated risk of famine.

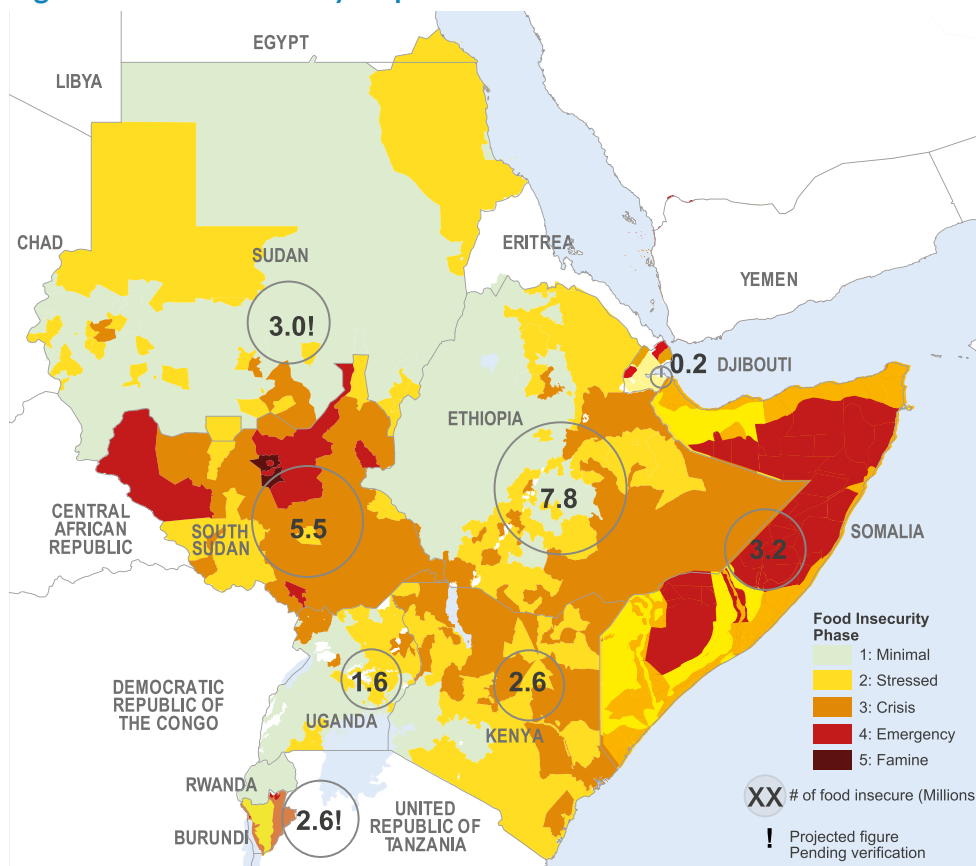
*The region has been experiencing serious food insecurity challenges, with more than 31 million people requiring humanitarian assistance.*

<sup>43</sup> Food self-sufficiency is a key focus of Africa. The President of the African Development Bank indicated that Africa's annual food import bill is estimated to rise to US\$ 110 billion by 2025, thereby weakening African economies, and decimating its agriculture and exports jobs from the continent (AfDB, 2017). Meanwhile, subsistence and cash crop farming coupled with rearing of animals characterizes most rural agricultural activities in Eastern Africa and agricultural performance is highly vulnerable to weather-related shocks.

<sup>44</sup> While the food insecurity situation in D.R. Congo is not presented in the map, around 11 per cent of the total rural population (i.e. 7.7 million) are classified in IPC Phases 3 and 4 in June 2017, mainly due to inter-communal conflicts (IPC, 2017a). Several districts of Madagascar are classified as in IPC "Serious" Malnutrition for the period March to May 2017 (IPC, 2017b).

<sup>45</sup> Food insecurity in South Sudan was mainly due to continued conflict and insecurity. In February 2017, a famine affecting 90,000 people in Leer and Mayendit counties was declared. Famine is no longer occurring in Leer and Mayendit counties as a result of immediate and sustained multi-sector humanitarian assistance delivered to the affected population since March 2017. Yet 1.7 million people in South Sudan are still facing emergency levels of hunger (IPC, 2017c).

Figure 31: Food insecurity map



Source: UNOCHA (2017a).

*The prevalence of undernourishment in Eastern Africa increased to around 34 per cent in 2016 compared with the African average of 20 per cent.*

Food insecurity is not only life-threatening, but also has long-term consequences on physical health and cognitive functions, especially for children. These disadvantages in human capital could lead to poor prospects in the labour market, including lower wages and higher poverty. The prevalence of undernourishment

in Eastern Africa increased to around 34 per cent in 2016 compared with the African average of 20 per cent (FAO, IFAD, UNICEF, WFP and WHO 2017).<sup>46</sup> In parts of northern Kenya, South Sudan and Somalia, as of June 2017 the level of acute malnutrition was still worryingly high and above emergency thresholds.

Apart from the humanitarian needs, the impact of the drought compounds the challenges to maintain robust economic growth and stable price levels.<sup>47</sup> For example, the production of most food crops recorded notable decline in Kenya, resulting in a sharp slowdown of growth in agriculture, forestry and fishing to 1.4 per cent in the second quarter of 2017 from 7.1 per cent in the corresponding quarter in 2016 as well as a surge in food prices (KNBS, 2017b). Also, drought could lower hydroelectric power generation, exacerbate health challenges and slow poverty eradication efforts.

<sup>46</sup> The coverage of Eastern Africa as defined by FAO et. al. differs from UNECA's, comprising of Burundi, Comoros, Djibouti, Eritrea, Ethiopia, Kenya, Madagascar, Malawi, Mauritius, Mozambique, Rwanda, Seychelles, Somalia, South Sudan, Tanzania, Uganda, Zambia and Zimbabwe.

<sup>47</sup> For example, maize supplies are generally below-average, resulting in above-average prices across most of the Eastern Africa (FEWS NET, 2017b).

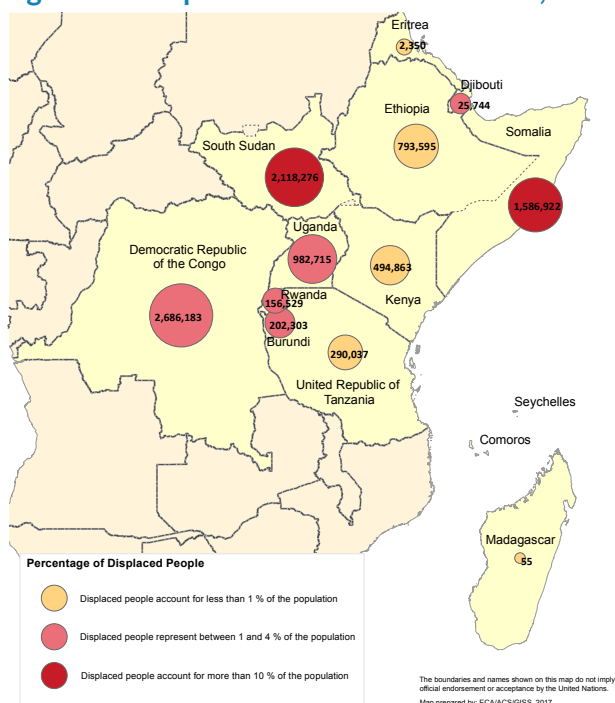
## 2.4. Displacement On the Rise

Eastern Africa is one of the regions in the world that currently accommodates the highest number of refugees, asylum seekers and IDPs. The humanitarian crisis in the region has been largely driven by conflict, climate and natural disasters (e.g. drought), and economic shocks. At the end of 2016, there were approximately 9.3 million displaced people in the region, of which 3.5 million were refugees and asylum seekers, and 5.8 million were IDPs (UNHCR, 2017).

*There were around 9.3 million displaced people in the region at the end of 2016.*

Uganda and Ethiopia hosted the highest number of refugees and asylum seekers, accounting for around half of the regional total, while D.R. Congo, South Sudan and Somalia had most of the IDPs in the region (around 98 per cent). As a share of population, the percentage of displaced people in South Sudan and Somalia were the highest, at over 10 per cent (Figure 32).

**Figure 32: Displacement in Eastern Africa, end of 2016**



Note: Displaced people includes refugees, asylum seekers and IDPs.

Sources: UNDESA (2017b) and UNHCR (2017).

The refugee crisis in South Sudan is one of the most worrying in Africa, with more than 1.8 million people having fled to Uganda, D.R. Congo, Ethiopia, Sudan and Kenya. Since the beginning of the conflict in 2013<sup>48</sup>, more than two million people have been internally displaced. The government has been making efforts to foster reconciliation through an ongoing national dialogue<sup>49</sup>. However, neither the ceasefire which has been unilaterally declared by the government nor the 2015 peace agreement have been broadly respected and implemented (UNSC, 2017a). The conflict is fueled by a dire humanitarian situation linked to recurrent droughts and a severe economic crisis. Meanwhile, the situation is becoming difficult in Uganda, which is hosting the highest share of South Sudanese refugees. For the past year, 1,800 refugees fled to

<sup>48</sup> The crisis erupted in December 2013, after political disagreements between the President Salva Kiir and the then First Vice-President Riek Machar. Political unrest led to ethnic conflict and clashes between armed groups. The UN compounds in South Sudan have been opened to protect fleeing civilians and are now protecting more than 200,000 IDPs at the United Nations Mission in the Republic of South Sudan (UNMISS) protection of civilians' sites.

<sup>49</sup> The Intergovernmental Authority on Development is trying to hold peace negotiations while Ugandan President Museveni is also facilitating peace talks. Meanwhile, the UN Security Council decided to create a 4,000-strong regional protection force in charge of securing the capital city, main roads and UNMISS premises.

Uganda daily, given its open-door policy toward refugees.<sup>50</sup> In the northern regions bordering South Sudan, pressure has increased on natural resources, land and social services amid rising insecurity (IRIN News, 2017).

Somalia is moving towards political stability and economic recovery after more than 25 years of civil war.<sup>51</sup> The new National Development Plan adopted in December 2016 focuses on recovery, democracy and prosperity. However, the security and humanitarian situation remains fragile because of recurrent Al-Shabaab attacks, clan clashes and a severe drought which hit the country in the beginning of 2017 (UNSC, 2017b). As a result, more than 10 per cent of the population is still internally displaced in the country. Insecurity concerns and drought have also slowed down the voluntary return programme of Somali refugees from Kenya.<sup>52</sup>

Regarding D.R. Congo, which has the highest number of displaced people in the region, the multifaceted crisis is related to more than two decades of successive shocks. The country is confronted with the consequences of armed conflict and inter-communal violence mainly in the regions of North and South Kivu, and Central Kasai, as well as epidemics, malnutrition and food insecurity. The humanitarian context is aggravated by pre-election tensions and economic slowdown, while access to some vulnerable areas has proven very challenging in terms of security and infrastructure (UNOCHA, 2017b). Besides the 2.2 million IDPs, the country also hosts more than 450,000 refugees, mainly from Central African Republic, South Sudan and Burundi.

*The increased displacement seriously affects the well-being of people and puts a strain on host countries' resources.*

The increased displacement seriously affects the well-being of people in the region and puts a strain on host countries' resources. Worryingly, humanitarian needs continue to be underfunded, with large funding gaps in Ethiopia, Somalia, South Sudan and D.R. Congo amounting more than US\$ 2.3 billion in 2017 (FTS, 2017).

## 2.5. Communicable Disease Outbreaks

Due to the enhanced provision of basic health services, people of the region on average now live longer and healthier. Statistics from the World Health Organization (WHO, 2017a) show that both life expectancy and healthy life expectancy at birth has increased substantially over the last decade.<sup>53</sup> In particular, Eritrea, Rwanda and Uganda recorded the largest increase, with the two figures up by around one year per annum from 2000 to 2015.<sup>54</sup> Moreover, both the incidence rate and mortality rate of communicable disease

*The recent outbreaks of communicable diseases send a warning signal to healthcare systems.*

dropped notably. For instance, malaria incidence rate fell by 21 per cent in Africa between 2010 and 2015, whereas malaria mortality rate declined by 31 per cent (WHO, 2016).<sup>55</sup> Despite the remarkable improvement, the recent outbreaks of communicable diseases in the region send a warning signal to healthcare systems.

<sup>50</sup> Refugees in Uganda are given a small plot within the local host community, construction materials and tools to work. They have access to the same services as Ugandan nationals, have the right to work and freedom of movement. This approach is supposed to reduce dependency on aid and favour social cohesion with the local communities (UNHCR, 2015).

<sup>51</sup> Parliamentary elections were held in 2016 under a unique system of power sharing between clans, the new President Faramajo was elected in 2017 and an inclusive government was formed.

<sup>52</sup> In 2013, a Tripartite Agreement was signed between the UNHCR, the Kenyan and Somali governments to initiate a voluntary repatriation process. 73,400 refugees have returned to Somalia since the process started.

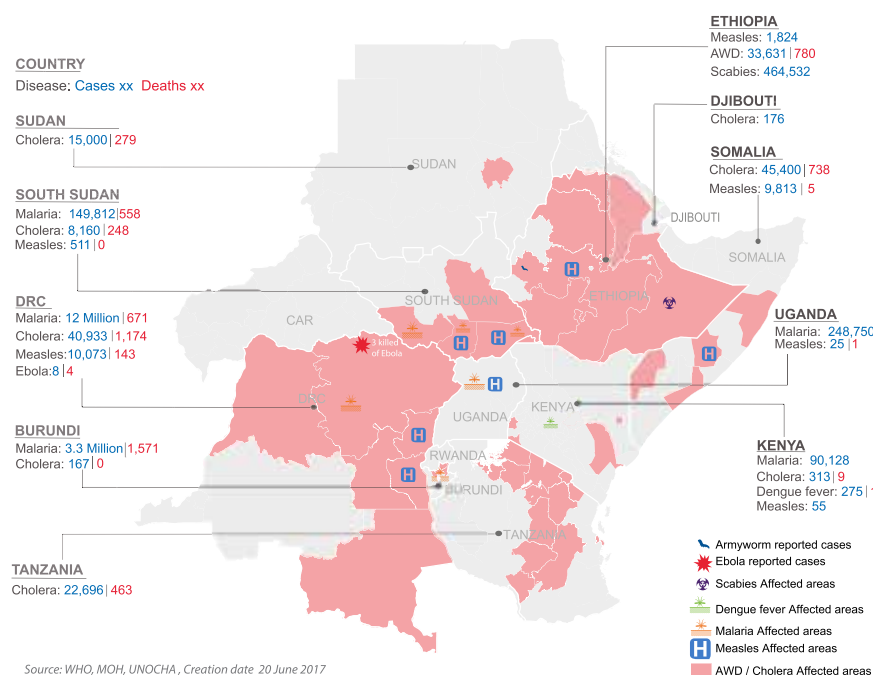
<sup>53</sup> Nevertheless, the disease burden has also increased, as reflected by the widening gap between life expectancy and healthy life expectancy.

<sup>54</sup> As a higher proportion of birth was delivered by a skilled provider in a health facility, maternal mortality reduced markedly during the same period, especially for Rwanda, Ethiopia and Tanzania whose ratio was down by more than 50 per cent (WHO, 2017a).

<sup>55</sup> Yet malaria incidence and mortality rates in Burundi, D.R. Congo and Madagascar actually increased during the same period, whereas malaria incidence rates in Kenya and Rwanda also went up.

Burundi has faced an outbreak of malaria since 2015 and a malaria epidemic was declared in March 2017. Meanwhile, cholera outbreaks have occurred in D.R. Congo, Ethiopia, South Sudan, Kenya and Somalia. Water shortages further exacerbated the cholera outbreaks in Ethiopia and Somalia. Moreover, several cases of Ebola were confirmed in D.R. Congo in June 2017 (Figure 33). Since August 2017, Madagascar has been experiencing a large outbreak of plague, with more than 2,000 confirmed, probable and suspected cases including around 200 deaths (WHO, 2017b). The recent communicable disease outbreaks, combined with the increasing number of vulnerable displaced populations, could have significant implications on public health.

**Figure 33: Communicable disease outbreaks, Jan-Jun 2017**



Source: UNOCHA (2017a).

## 2.6. Emerging Social Problems

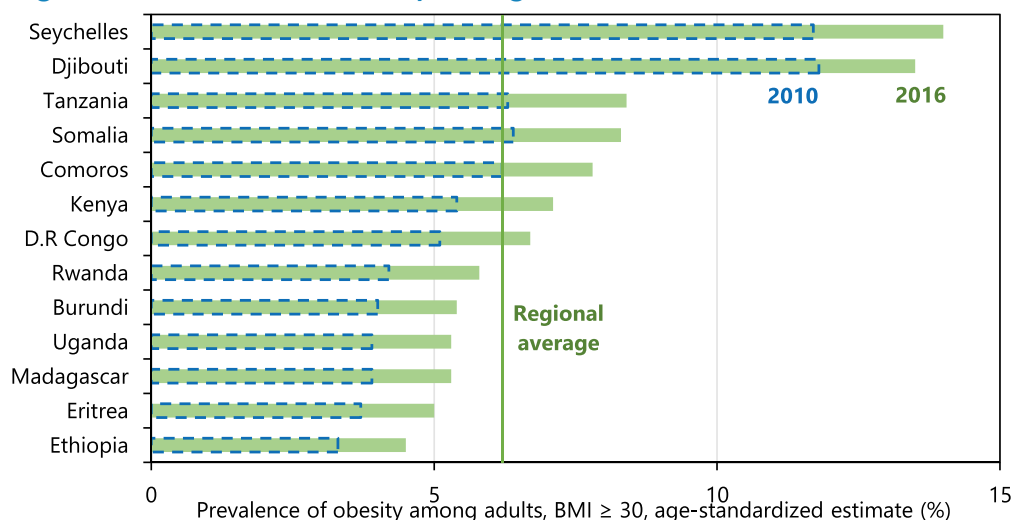
*Eastern Africa is beginning to experience social problems usually overlooked in low-income countries, such as the prevalence of cancer, obesity, excessive alcohol consumption, smoking and road traffic deaths.*

Partly as a consequence of the rapid growth and development of the region, Eastern Africa is also beginning to experience social problems usually overlooked in low-income countries, such as the prevalence of cancer, obesity, excessive alcohol consumption, smoking and road traffic deaths. The scale of these 'ills of modernity' need to be fully recognized by policy makers if the right preventative measures are to be put in place.

With the rise in incomes, particularly in urban areas, obesity, one of the diseases of affluence, is becoming more prevalent in the region. Figure 34 shows that the prevalence of obesity among adults increased notably in recent years. It is also noted that the differences in the proportion of obese adults among Eastern African countries is not as distinct as the differences in GDP per capita, suggesting that obesity is a common emerging problem in the region. Although the issue of obesity in Eastern Africa is much less severe than the developed countries such as the United States (36.2 per cent) and the United Kingdom (27.8 per cent), the regional average is comparable to China (6.2 per cent) and is significantly higher than some middle-income countries like India (3.9 per cent) and Vietnam (2.1 per cent).



**Figure 34: Prevalence of obesity among adults**



Source: WHO (2017a).

*The region still faces high levels of undernutrition and communicable diseases, but the increasing prevalence of obesity could impose a further burden on public health systems.*

The prevalence of obesity among children and adolescents recorded a similar rising trend. Surprisingly, the proportion of obese children in the Seychelles (10.8 per cent in 2016) is even higher than the United Kingdom (10.2 per cent), Germany (8.9 per cent) and France (8.1 per cent). Other than the two outliers (i.e. Seychelles and Djibouti), the proportion of child obesity is around 2 per cent in the region. Of course, the region still

faces high levels of undernutrition and communicable diseases, but the increasing prevalence of obesity in some segments of the population and the associated risk for non-communicable diseases, including cardiovascular disease, diabetes and some cancers, could impose a further burden on public health systems.<sup>56</sup>

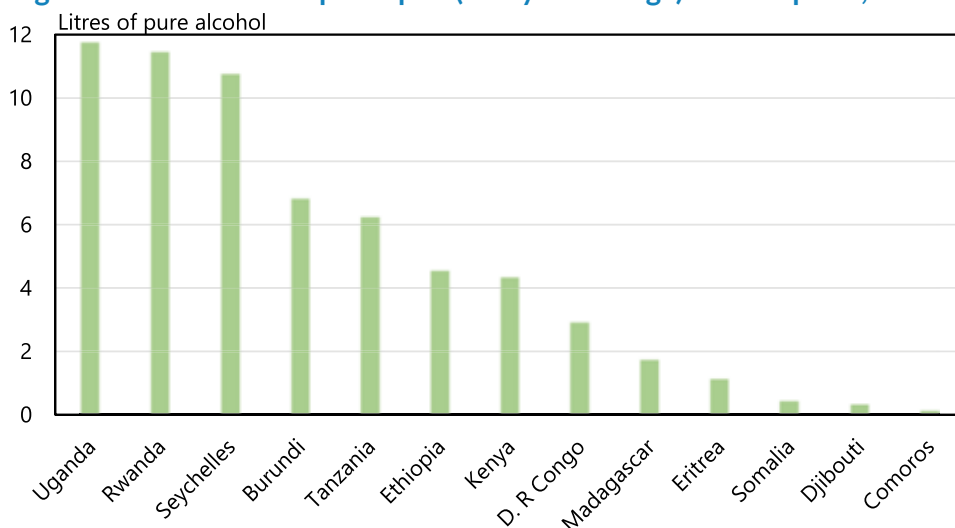
Related to the SDG target 3.5 (i.e. strengthen the prevention and treatment of substance abuse), the high and rising level of alcohol consumption in a number of countries warrant attention too. Specifically, Uganda, Rwanda and Seychelles consumed the equivalent of approximately 11 litres of pure alcohol per capita in 2016, more than in Europe (10.3 litres) and the United States (9.3 litres), and far above the global and African averages of 6.4 and 6.0 litres respectively (Figure 35). Moreover, the implementation of the WHO Framework Convention on Tobacco Control is emphasized under SDG 3 and Addis Ababa Action Agenda amid the huge induced healthcare burden. Although the prevalence of tobacco smoking is expected to decline gradually due to various tobacco control measures (WHO, 2015a), further work is needed to improve the existing tobacco control laws and regulations coverage of countries with high smoking prevalence (Figure 36).<sup>57</sup>

*Uganda, Rwanda and Seychelles consumed the equivalent of approximately 11 litres of pure alcohol per capita in 2016, more than in Europe and the United States, and far above the global and African averages.*

<sup>56</sup> In 2015, high body mass index (BMI) contributed to 4 million deaths (or 7 per cent of the deaths from any cause). Cardiovascular disease and diabetes were the leading causes of death related to high BMI, accounting for 2.7 million and 0.6 million deaths respectively. Overall, an estimated 40 million deaths occurred due to non-communicable diseases (or 70 per cent of the total deaths). The majority of such deaths were caused by cardiovascular disease (17.7 million), cancer (8.8 million), chronic respiratory disease (3.9 million) and diabetes (1.6 million) (The GBD 2015 Obesity Collaborators, 2017).

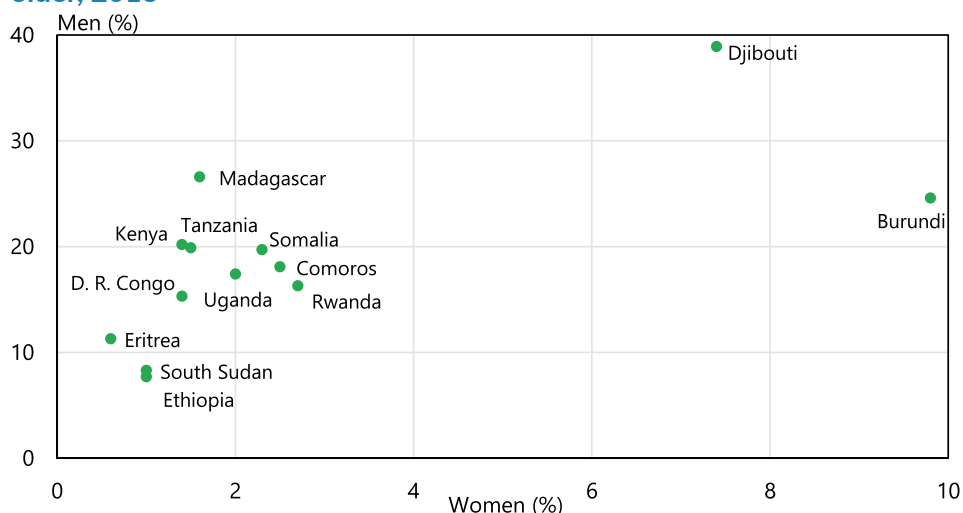
<sup>57</sup> While smoking in public places is banned in a number of countries, Rwanda and Kenya have recently banned the use and importation of water-pipe tobacco (popularly known as shisha).

**Figure 35: Total alcohol per capita ( $\geq 15$  years of age) consumption, 2016 estimates**



Source: WHO (2017c).

**Figure 36: Age-standardized prevalence of tobacco smoking among persons 15 years and older, 2013**



Source: The American Cancer Society (2018).

In view of the prevalence of obesity, drinking and smoking, the probability of dying from cardiovascular disease, cancer, diabetes or chronic respiratory disease between age 30 and 70 ranged from 17.8 per cent in

*Despite low reported incidence rates of cancer, the chances of surviving a cancer once diagnosed is extremely low, at around a tenth of the survival rates reported in high-income countries.*

Kenya and Tanzania to 25.4 per cent in Eritrea in 2015, comparable to China (18.1 per cent) and India (23.3 per cent) yet far above that in the developed countries such as Australia (8.9 per cent), Canada (9.8 per cent) and the United Kingdom (11.0 per cent) (WHO, 2017a). Despite low reported incidence rates of cancer, the chances of surviving a cancer once diagnosed is extremely low in the region, at around a tenth of the survival rates reported in high-income countries (The American Cancer Society, 2018).<sup>58</sup> The cost of treatment, according to the cancer type and stage of progression, can be prohibitive and well beyond the capacity of local health facilities, leaving patients with little

<sup>58</sup> The number of survivors diagnosed with cancer within the past five years per 100,000 adults (15 years and older) in 2012 was around 200 to 300 in the region, compared to over 2,000 in some high income countries (The American Cancer Society, 2018).

option but to travel abroad to receive treatment. The rise of modern chronic illnesses like cancer raises important questions about the allocation of resources to the health sector. As such diseases become more prevalent, the decision to focus resources on primary health care in the region becomes more difficult to sustain.<sup>59</sup>

Regarding road traffic deaths, the risk is highest in Africa (26.6 deaths per 100,000 population relative to the global rate of 17.4 in 2013) despite having the lowest number of registered vehicles per capita.<sup>60</sup> Meanwhile, Africa has the highest proportion of pedestrians deaths at 39 per cent of all road traffic deaths compared to the world average of 22 per cent, partly reflecting the level of safety measures to protect different road users and the forms of daily commute (WHO, 2015b). In fact, the average road traffic mortality rate is even higher in Eastern Africa, with several countries recording over 30 road traffic deaths per 100,000 population. This could be attributed to the inadequate post-crash care, as well as the lack of good drink-driving, seat-belt and mobile phone use laws with enforcement (Table 13). While most traffic crashes are preventable and various effective interventions are available (e.g. setting and enforcing laws relating to key behavioural risk factors), more focused actions are required if the SDG target 3.6 (i.e. halve the number of global deaths and injuries from road traffic accidents by 2020) is to be met in the face of rapidly increasing motorization.<sup>61</sup>

**Table 13: Road traffic statistics**

Country	Road traffic mortality rate (per 100,000 population)	Estimated % seriously injured patients transported by ambulance	Good drink-driving law	Good seat-belt laws	Legislation on mobile phone use while driving
D.R. Congo	33.2	< 11	No	No	No
Tanzania	32.9	< 11	No	No	No
Rwanda	32.1	-	No	No	No
Burundi	31.3	-	-	-	-
Kenya	29.1	< 11	No	Yes	No
Madagascar	28.4	< 11	No	No	Yes
Comoros	28.0	-	-	-	-
South Sudan	27.9	-	-	-	-
Uganda	27.4	< 11	No	Yes	Yes
Somalia	25.4	< 11	No	No	No
Ethiopia	25.3	< 11	No	Yes	Yes
Djibouti	24.7	≥ 75	No	Yes	No
Eritrea	24.1	11 – 49	No	Yes	Yes
Seychelles	8.6	≥ 75	No	Yes	Yes

Note: Countries which meet both criteria (i.e. drink-driving law is based on a blood alcohol concentration (BAC) limit of ≤0.05g/dl for the general population and a BAC limit of ≤0.02 g/dl for young or novice drivers) are considered to have a good drink-driving law. Meanwhile, countries with law applies to drivers, front-seat and rear-seat passengers are considered to have a good seat-belt wearing law.

Source: WHO (2017c and 2015b).

<sup>59</sup> The SDG target 3.4 aims at reducing premature mortality from non-communicable diseases by one third through prevention and treatment and promote mental health and well-being by 2030.

<sup>60</sup> Estimates suggest that road traffic deaths and injuries in low- and middle-income countries cause economic losses of up 5 per cent of GDP (World Bank, 2008b).

<sup>61</sup> For instance, motorcycles accounts for around half of the registered vehicles in Rwanda and are also a major source of road injuries and deaths. The recent initiative of installing GPS devices on taxi motos to reduce road traffic accidents provides a good example of focused action (The New Times, 2017).





CONCLUSIONS



### 3. CONCLUSIONS

This report has provided an overview of the key macroeconomic and social developments in Eastern Africa in recent years. With the aim of setting the scene for more in-depth policy discussion, it has also reviewed the major structural changes in the regional economies over the past 10 to 15 years. Countries have been benchmarked against the average regional performance, highlighting their main achievements, challenges and opportunities for future growth and development. Where relevant, examples of different policy initiatives have been discussed to promote peer-learning.

Eastern Africa is still growing at a healthy pace compared with the rest of Africa, principally due to the robust growth of the construction sector and parts of the services sector (particularly transport and finance). However, the economic performance of Eastern Africa has weakened during the last two years, principally due to drought, a decline in commodity prices, and (in some cases) growing political instability and/or civil conflict. In addition, the region has had to confront numerous humanitarian crises. We have also stressed the importance of policymakers addressing several emerging social problems to mitigate their negative impacts, such as high levels of alcohol abuse, road traffic deaths and low survival rates from chronic diseases like cancer.

Several structural issues are to be addressed in order to unlock the full growth potential of the region. Firstly, a weak manufacturing sector has made the regional economy less resilient. A dependence of regional growth on the expansion of the services sector has not generated sufficient employment opportunities to sustain inclusive growth, amid demographic pressures and rapid urbanization.

*In order to achieve ambitious national developmental and growth targets, a more rapid expansion of the manufacturing sector is crucial.*

In order to achieve ambitious national developmental and growth targets without engendering constant foreign exchange shortages and balance of payments problems, a more rapid expansion of the manufacturing sector is crucial.<sup>62</sup> The sector facilitates faster productivity growth, job creation, and helps tackle the tradeable goods deficits that characterize the regional economies. Our argument is not categorical, however, and this report stresses that there are sub-sectors of the service sector which show great

potential for value-addition and job creation (e.g. tourism). In fact, some countries in the region have adopted explicit 'service sector-based' strategies (e.g. Djibouti as a logistics hub and Rwanda as a service sector hub) with an important measure of success. Similarly, it would be wrong to neglect the role that the primary sector has in generating higher incomes and employment growth through, for instance, exploiting better and sustainably the region's 'blue economy' assets. Hence not all countries in the region should attempt to specialise in manufacturing – but our argument is that there is a critical minimum level of manufacturing below which no country should fall.

Secondly, by general consensus the private sector in the region is relatively weak. The reasons for this are complex, but in this report we single out a leading constraint – the lack of access to credit as a result of the poor performance of the banking sector in terms of providing long term affordable finance to businesses. Some policy action is required to address this perennial problem, in terms of creating a financial system that is fit-for-purpose. Useful lessons can be gleaned from case studies of Ethiopia and Kenya (Griffith-Jones and Gottschalk, 2016).

Thirdly, widening fiscal imbalances coupled with structural current account deficits have been constraining growth and increased economic vulnerability in the region. A related problem is that the region is still underperforming in terms of exports. In particular, exports are excessively concentrated on primary commodities, leaving the region in the lower rungs of global value chains and highly vulnerable to commodity price shocks. This again brings us back to the importance of boosting the performance of the tradeable goods sector and in particular manufacturing.

<sup>62</sup> See the arguments put forward in Newman et. al. (2016).



*A major constraint on regional development is the poor performance of the banking sector in providing long-term affordable finance to businesses. Some policy action is required to address this perennial problem, in terms of creating a financial system that is fit-for-purpose.*

In view of these challenges, this report recommends member States to focus more attention on (i) actively implementing reforms to create a more conducive business environment, especially with regard to providing adequate financing of the private sector; (ii) better leveraging inflows of FDI into the manufacturing sector to facilitate a more rapid technological upgrading and faster job creation; (iii) continuing to invest in infrastructure but in financially sustainable ways; (iv) strengthening domestic resource mobilization and managing external borrowing prudently; and (v) strategically reviewing existing trade agreements.

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