

# Macroeconomic and Social Developments in Eastern Africa 2019

## *Towards the Implementation of the African Continental Free Trade Area in Eastern Africa*

### Executive Summary

#### Overview of Regional Performance

As the fastest growing region on the continent, Eastern Africa recorded an annual average growth rate of 6.7 per cent between 2013 and 2017, more than double the African average. According to UNECA estimates, the region is set to grow at 6.0 per cent in 2018, rising to 6.2 per cent in 2019. The strong performance is underpinned by notable improvements in agricultural production and sustained infrastructure investment. Prospects for regional growth have also been bolstered by the resolution of the long-standing political conflict between Eritrea and Ethiopia, a remarkable development that promises to provide a substantial boost to growth in the Horn of Africa. Socially, too, there have been major gains in the region. Life expectancy – a broad measure of welfare and living standards – in Eastern Africa has increased by 5.3 years over the past decade, with Kenya and Rwanda registering historically unprecedented gains.

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Finally, a major regional consensus was achieved at the African Union (AU) Summit held in Kigali in March 2018, with thirteen of the fourteen countries of Eastern Africa signing up to the establishment of an African Continental Free Trade Area (AfCFTA). If implemented, the agreement could boost intra-African trade and accelerate the pace of structural transformation in the region.

This last point is especially important because studies coincide in highlighting the slow pace of structural change in Eastern Africa. Job creation has been much slower than the rate of economic expansion over the past decade, raising the specter of jobless and exclusionary growth. With an estimated annual growth in the labour force of around 3 per cent for the coming two decades, countries in Eastern Africa will have to sustain GDP growth of at least 6 per cent per year in order to absorb the rapidly-growing labour force. Moreover, this report stresses the fact that the so-called –demographic dividend– – the potential boost to economic growth as dependency ratios fall and a large share of the population moves in the workforce – is far from guaranteed under current demographic trends. The rapid population growth could become a barrier to growth, if the appropriate policies are not in place, especially in terms of investments in education and health.

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The report also flags a number of additional risks to regional growth:

- The first is structural. Accentuated by climate change, Eastern Africa still suffers from sharp fluctuations in agricultural production which accounts for around one-third of regional GDP. This vulnerability reflects both an increase in the intensity of weather-related shocks, as well as a long-term lack of investment in the sector. In 2016, for instance, severe weather conditions (both drought and flooding) negatively impacted economic growth in several countries in the region (e.g. Ethiopia, Kenya, Uganda, Rwanda and Somalia).
- Secondly, ongoing conflicts in parts of the D.R. Congo, South Sudan and Somalia continue to act as a brake on growth and development, with a very clear human cost. FAO (2018) estimates that there are currently 132 million undernourished people in Eastern Africa, around 31 per cent of the regional population. This represents a significant increase of an additional 19 million undernourished people since 2012.
- Thirdly, there are signs of rising trading tensions between Partner States of the East African Community (EAC), which has been resulting in declining levels of intra-regional trade. As the report stresses, such disputes are not uncommon within regional blocks ó in the past, conflicts of a similar kind have occurred both within North American Free Trade Agreement (NAFTA) and the European Union, for example. Nevertheless, to maintain the momentum of the EAC project, it is important that such disputes are resolved expeditiously. *Econometric analysis carried out for this report suggests that intra-EAC trade would almost double (a 95 per cent increase) if it were to attain its maximum potential, unencumbered by these barriers.* *Econometric analysis suggests that the East African Community is currently trading at just half of its potential level.*
- Finally, downside risks to global and regional growth have increased since the second half of 2018, mainly due to the escalating trade tensions between the United States and its trading partners, worries about peace and stability in the Middle East, and volatility in the financial markets of several emerging markets. Brexit has also created a lot of additional concerns. So far, Eastern Africa has weathered this uncertainty well. Although the depreciation pressure of most local currencies in Eastern Africa remained moderate and inflation has stayed modest in 2018, the heightened external risks, coupled with tighter global financial conditions, raises the risk of capital outflows and even exchange rate crises, especially for those countries with low foreign reserves and high debt levels. Apprehension about capital reversals and debt shocks are heightened by the fact that in a number of countries (among them, Ethiopia, Eritrea, Burundi, D.R. Congo and South Sudan) foreign reserves now stand at less than two months of imports in 2018.

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This last point on the more challenging external environment brings us back to the importance of consolidating regional integration within Eastern Africa. During a time of increased trade protectionism and moderating global demand, it is crucial for African countries to focus on the regional ties which are more resilient and dynamic. This report stresses the fact Africa's trading relations with the rest of the world over recent decades ó under the guise of multiple preferential

market access schemes ó have had disappointing results. They have neither led to a notably stronger export performance nor to more diversified economies. In addition, the temporary nature of preferential market access schemes has made it difficult for firms and investors to take a longer-term view and invest in the strategically important export-oriented sectors of the economy. Against this backdrop, the importance of leveraging the unique opportunity presented by the AfCFTA cannot be overstressed.

## The Case for the AfCFTA for Eastern Africa

With a combined GDP of \$6.4 trillion (measured in Purchasing Power Parities) and a population of 1.2 billion, the elimination of tariffs and non-tariff barriers called for by the AfCFTA will improve developmental prospects for Eastern Africa, allowing regional firms to tap into the rapidly growing markets in other parts of Africa. Currently, private consumption has been the main driver of economic growth in Eastern Africa, but a large proportion of domestic demand has been met by imports rather than domestic production.

Analyzing consumption patterns by income-group, this report shows that poor households constitute the dominant consumer market in the region, with food and beverages accounting for around two-thirds of their household expenditure. A number of countries in the region register periodic trade deficits in food items, deficits which could be met by greater intra-regional trade. This was the case, for instance, in 2016/17 when food shortages due to an extended in Kenya were largely met by higher imports from neighbouring Uganda and Tanzania. Increased intra-regional trade in agricultural products would lead to greater food security and would accelerate the growth of the sector.

Beyond the opportunities for much greater trade in agricultural and food products, this report stresses the importance of tackling the major source of deficits in Eastern Africa – manufactured goods. A breakdown of trade imbalances by sector shows that trade deficits in the region are driven almost exclusively by manufactured goods imports. Highlighting the need to address this serious constraint on growth, econometric evidence presented in this report finds that a 10 per cent increase in the resultant current account deficits reduces the annual per capita growth rate of the region by 0.9-1.4 per cent.

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The region's heavy reliance on intermediate goods and manufactured products imported from the rest of the world also hampers the full utilization of productive capacities. Currently manufacturing firms in Eastern Africa report capacity utilization that is on average 30 per cent under its potential. With so many unmet consumer demands in the region, this is inadmissible. The heavy reliance on manufactured imports also results in many missed

opportunities for the region to develop deeper regional value chains (RVCs), both within Eastern African and with the rest of the African continent.

Our assessment of the AfCFTA estimates that, if fully implemented, the value of exports of the Eastern Africa to the rest of the continent would increase by almost a third (31 per cent), with the processed food and manufacturing products being the main beneficiary sectors. In fact, in Eastern Africa only a quarter of agricultural trade is currently processed, whereas for intra-African exports, two thirds are. Greater exports to the rest of Africa from the region could thus help provide an incentive to agro-industries – put simply, it could create a more vibrant demand for processed foods. We estimate that the lower cost for goods and services from the implementation of the AfCFTA would result in welfare gains amounting to US\$ 1.4 billion for the region. All this will be achieved at a very small fiscal cost to the region, with a reduction in tariff revenue of just 4 per cent on average, equivalent to less than 1 per cent of total government revenues.

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*The service sector is an important foreign exchange earner in Eastern Africa. In contrast to the negative trade balances in merchandise goods, five of the fourteen countries actually enjoy positive balances in services – Djibouti, Kenya, Madagascar Tanzania, and Seychelles.*

The AfCFTA is not only about trade but creating access, free movement of people, goods and services. Most countries in Eastern Africa have a better trade balance in services than merchandise trade. Five of the fourteen countries actually enjoy positive balances in services (Djibouti, Kenya, Madagascar Tanzania, and Seychelles), compared with only one (D.R. Congo) with a positive balance in merchandise trade. Kenya and Tanzania, for instance, had a net service trade balance of over US\$ 1.6 billion and US\$ 2.1 billion in 2017.

Intra-African liberalization of services trade could harbour great benefits for Eastern Africa. Intra-regional tourism, an example of growing intra-regional trade in services, has been gaining prominence. With intra-African migration on the rise, the Agreement on Free Movement of Persons, which was signed by only half of African Member States, is particularly important. A more open continental labour market would go a long way towards addressing skill-shortages that constrain the growth of important strategic sectors of our economies. Our report also stresses the importance of improving inter-connectiveness of the region through improvements in port facilities and greater investments in inland waterways in the Great Lakes region. These constitute vital arteries in the transport corridors of the region. Burundi, for instance, depends heavily on Lake Tanzanyika, with approximately a quarter to a third of its trade transported on the lake. Yet the port facilities are dilapidated and require further investment.

*This report argues forcefully for the Regional Economic Communities to take a protagonistic role in the implementation of the AfCFTA.*

Looking forward, further to the signing and ratification of the AfCFTA, a crucial next step is to develop national and regional AfCFTA implementation strategy which is complementary to their broader trade and industrialization policies, along with the identification of key opportunities and current constraints, so as to take

full advantage of the continental market. This report argues forcefully that the Regional Economic Communities in the region ó particularly the East African Community, the Intergovernmental Authority on Development, and the Indian Ocean Commission ó need to take a protagonistic role in reaching this objective.