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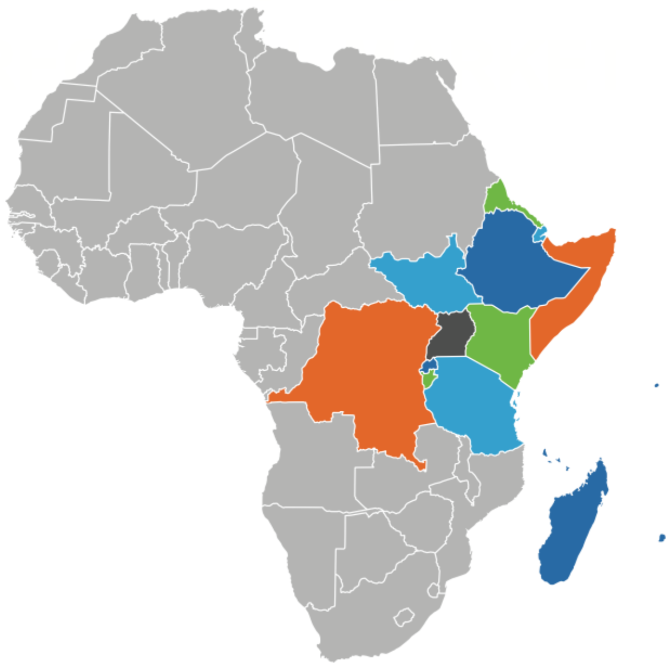

The Economic and Social Impacts of the Covid-19 Crisis on Eastern Africa: Strategies for Building-Back-Better

The African Continental Free Trade Area:

A Catalyst for Accelerating Services Trade in Eastern Africa

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Abstract

This document reviews the evidence regarding the state of preparedness of Eastern Africa with regard to the implementation of the African Continental Free Trade Area (AfCFTA) in the area of services trade. The report highlights the opportunities, strengths and weaknesses of the regional economy in different services sectors, and discusses the areas for the attention of policymakers.

Contents

1. Overview of the Issues at Stake

As a part of its goal to bolster intra-African trade, the AfCFTA committed itself to liberalizing services trade across the continent. In stark contrast to merchandise trade, where large deficits are recorded across the region of Eastern Africa, services have become a key contributor to export earnings, with six countries posting positive service trade balances in 2019 (Seychelles, Djibouti, Tanzania, Kenya, Madagascar and Ethiopia) and two countries (Rwanda and Uganda) not far from doing so. Against this backdrop, this report makes the case for **the AfCFTA as a timely catalyst for the expansion of services trade in Eastern Africa.**

Under the free trade area, trade in services will be governed by the Protocol on Trade in Services whose aim is to create "open, rules-based, transparent, inclusive and integrated single services market." The first phase of negotiations focuses on five priority sectors: business, communication, financial, transport and tourism services. Negotiations of the remaining seven sectors will follow thereafter (African Union, 2018).[1] In parallel, countries are negotiating frameworks to foster regulatory cooperation in the services sector.

This document modestly sets forth some of the issues to be considered during the said negotiations, and points to areas of both strengths and weaknesses. For policymakers wishing to see an overview of the issues, we believe the current document should help gain a better understanding of what is at stake.

2. Some Initial Theoretical and Practical Considerations

It is easy to confuse arguments for wholesale liberalisation of services sectors with the arguments for the creation of an intra-regional market for services. The conventional view has been in support of wholesale liberalisation, as opposed to selective liberalisation with regional partners.[2] The AfCFTA is about the latter. It therefore will demand a *selective* opening in favour of service sectors providers based in other member states, not a global opening up of services sub-sectors.

A lot of developing countries – including countries in Eastern Africa - were initially quite hostile to the services sector being included in the multilateral agenda in the 1990s and 2000s based on legitimate concerns - it does of course matter who you open up to, particularly in view of the large competitive gap that exists between certain high-income countries with highly advanced and sophisticated services sectors, and poorer developing countries with lower prevailing levels of human capital and productivity.

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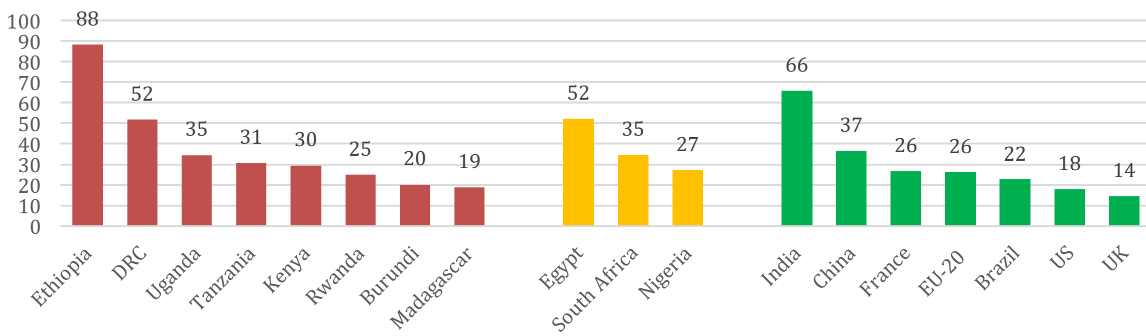
[1] In future phases, the intra-African liberalisation of the sectors of construction, distribution, education, energy, environmental, health and social services will be addressed.

[2] Annex A provides the results of a number of studies assessing the impact of wholesale liberalization. It is notable that often the gains are not as large as proponents of liberalization claim.

So far, there has been a marked degree of heterogeneity in the policy stance towards the services sector across the region. We can approximately gauge this by looking at the World Bank's Services Trade Restrictiveness Index (STRI) which, although outdated[3] and with its own limitations (see Borchert, Gootiiz and Mattoo, 2012), allows a comparison of the existing degree of 'openness' within the service sector.

Figure 1: World Bank's Services Trade Restrictiveness Index, Selected Economies



Source: World Bank Services Restrictions database.
Note: Scores range from 0 (fully liberalized) to 100 (highest restrictions and closed for foreign investment)

3. How Important is Services Trade in Eastern Africa?

In developing economies, services' exports grew at an average of 7.6 per cent annually between 2005 and 2018, increasing services' direct contribution to total exports from 14 to 17 per cent. In Eastern Africa, the contribution of service exports to GDP is generally on the rise, with several countries registering more than a three-fold increase since 2005. For a group of countries in the region (e.g. Comoros, Djibouti, Ethiopia, Rwanda Uganda and Seychelles), service exports are now the single largest source of foreign exchange.

Also, there is a consensus among trade experts that the true value of services trade is systematically underestimated by such measures, for various reasons (Eacaith, 2008, Lanz & Maurer, 2015, UNCTAD, 2020):

- **The role of services as an input into manufacturing production** – often termed "*servicification*" of manufacturing – is substantial in both developed and developing economies. While services' *direct exports* are estimated to accounted for 14 per cent of total

[3] The STRI refers to data collected between 2008-2010 for the countries in Eastern Africa. The database covers a total of 103 countries (of which 79 are non-OECD countries and 24 are OECD countries) and five sub-sectors (telecommunications, finance, transportation, retail and professional services).

exports in developing economies, services represented a much higher share of the value-added in total exports: 32 per cent; [4]

- When also considering **services activities conducted *within* manufacturing firms**, a study by UNCTAD (2020) estimated that the contribution of services to overall exports was closer to two-thirds;[5]
- The economic importance of **services trade goes beyond the usual cross-border statistics**. The economics profession has traditionally viewed services as primarily non-tradeable. However, more recently a clear, internationally accepted definition of how services are traded has evolved (WTO, 2019). The General Agreement on Trade in Services (GATS) identifies four basic modalities of services supply:
    a. Mode 1: **Cross border trade** – services supplied from one territory to another territory (e.g., software services sent by email);
    b. Mode 2: **Consumption abroad** – services supplied in one territory to consumers from another territory (e.g., cross-border tourism);
    c. Mode 3: **Commercial presence** – services supplied through a business established in one territory that is operating in another territory (e.g., financial institutions with branches in other countries); and
    d. Mode 4: **Presence of natural persons** – services supplied by nationals of a territory in another territory (e.g., travelling entertainers) (WTO, 2019).

In terms of prevalence of each of these modalities of service trade delivery, we do not currently have estimates of the breakdown specifically for Eastern Africa. However, at the global level it is well established that the most frequent mode of delivery is through a commercial presence in another country (i.e. through FDI, licensing or franchising), accounting for nearly 60 percent of services trade in 2017 (WTO, 2019). By coincidence, global investment statistics show that service FDI has increased from a quarter of the global FDI stock in the 1970s to half in the 1990s and to approximately two-thirds by the 2000s (UNCTAD 2010).

4. Arguments in Favour of Creating an Intra-Regional Market in Services

The argument for a higher degree of liberalisation of services trade, under the aegis of the AfCFTA, may be particularly strong for Eastern Africa because while only one country in Eastern Africa has a positive merchandise trade balance, five countries currently enjoy surpluses in services. Depending of course on the ultimate outcome of the negotiations, the AfCFTA

[4] Estimates are for 2011.

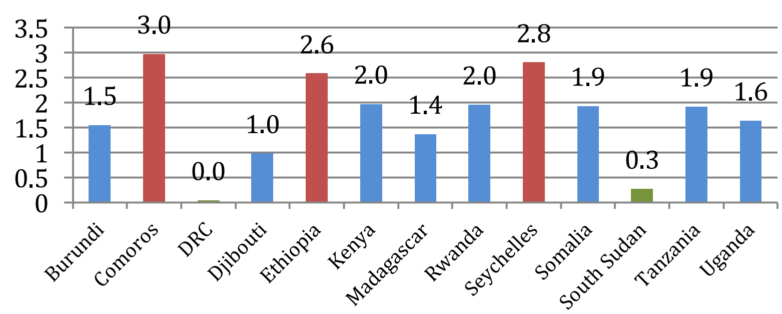
[5] If the sales of services by foreign affiliates of multinational firms are added, then the value of trade in services rises further. While we have no equivalent statistics for Eastern Africa, data in 2007 for fifteen OECD countries put the value of such sales at some $1.5 trillion in (WTO 2009).

certainly opens up a lot of new opportunities in trading in services. Encouraging, preliminary analysis by SRO-EA shows that, in line with previously cited studies done many decades ago for other developing countries (e.g. Sapir and Lutz, 1981; Bhagwati, 1987), Eastern Africa has a clear *Revealed Comparative Advantage (RCA)*[6] in a range of service sub-sectors. In aggregate, **11 of the 14 countries in the region currently have an RCA in services**. Of these **3 countries** have an RCA of above 2 (**Figure 1**). Moreover, it is noteworthy that, beside North Africa, Eastern Africa is the only sub-region of Africa to possess such a strong comparative advantage in services trade going into the AfCFTA negotiations (**Table 1**).

Table 1: Revealed Comparative Advantage in Services in Africa, 2005-2019

	2005-7	2008-10	2011-13	2014-16	2017-19
Africa	0.758	0.730	0.701	0.817	0.843
By Sub-Region:					
Northern Africa	0.991	1.009	0.983	1.178	1.166
Eastern Africa	1.645	1.570	1.589	1.429	1.466
Middle Africa	0.169	0.180	0.180	0.241	0.227
Southern Africa	0.786	0.688	0.695	0.652	0.606
Western Africa	0.396	0.380	0.352	0.531	0.626

Figure: 1 Revealed Comparative Advantage 2017-2019



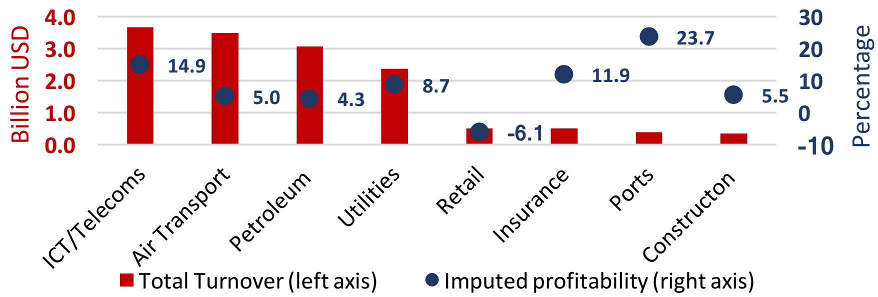
Source: ECA calculations, from UNCTADStat data

A second reason for believing that the regional economy has much to gain from the AfCFTA-related liberalisation of services is the high profitability of many service sector activities. Using the *Jeune Afrique*'s annual dataset of 500 Top African Firms, ECA has calculated that the level of profitability for service sector firms based in Eastern Africa is extremely high in a number of

[6] A country is said to have an RCA in services when its ratio of services exports to its total exports exceeds the same ratio for the world as a whole. A value greater than one expresses na RCA in services.

sub-sectors, such as ports, utilities, ICT/telecoms and insurance – well above the average for the African continent.

Figure 2: Profitability[7] and Turnover of East Africa's Largest Service Sector Companies, by sector, 2017



Source: ECA calculations, from Jeune Afrique data

To sum up, there are thus a series of compelling reasons why East Africa is well placed to benefit from the selective liberalisation of services under the AfCFTA. The experience of the East African Community, in terms of its estimated impact on services trade (Box 1), in providing a further impetus to services trade is encouraging – using a new form of the gravity equation, we econometrically estimate that the formation of the EAC led to a 65 percent increase in bilateral services trade among member states.

Box 1: Effect of the EAC Integration on Services Exports: A Structural Gravity Model Approach

We can gain some insights into the potential for the AfCFTA to impulse further intra-African trade by looking at the impact of the establishment of the East African Community (EAC) on services exports using bilateral trade data from 1995 to 2012. The data on services exports were obtained from the OECD-WTO Balanced Trade in Services Database (BaTIS) while the data on the other covariates were obtained from the CEPII website. Following Anderson and Yotov (2011) and Silva and Tenreyro (2006), the following structural gravity model is estimated using the Poisson pseudo-maximum likelihood estimator (PPML) that controls for heteroscedasticity and allows for bilateral zero trade values between trading partners.

$$X_{ijt} = exp\left(\beta_1 GDP_{O_{it}} + \beta_2 GDP_{D_{ijt}} + \beta_3 lnDIST_{ijt} + \beta_4 BRDR_{ijt} + \beta_5 LANG_{ijt} + \beta_6 CLNY_{ijt} + \beta_7 EAC_{ijt} + EX_i + M_i\right) + e_{ijt} \dots\dots(1);$$

where, X_{ijt} are services exports from East African countries to the rest of the, $GDP_{O_{it}}$ and $GDP_{D_{ijt}}$ are exporter and importer GDP, $lnDIST_{ij}$ stands for the logarithm of bilateral distance. $BRDR_{ij}$, $LANG_{ij}$ and $CLNY_{ij}$ capture the presence of contiguous borders, common language and colonial ties,

[7] Profitability is calculated as reported profits/turnover. For the complete dataset, see Jeune Afrique (2019).

respectively. EACijt is a dummy variable for the EAC trade agreement between African countries i and j at time t. EX_i and M_i are exporter and importer fixed effects.

Table 1 reports the panel regression results. As a baseline estimation, Column 1 was estimated using the OLS estimator. In Column 1 the coefficients of the standard gravity variables including logarithm of exporter and importer GDP, bilateral distance, and the dummy variables for common borders, colonial ties, and a dummy variable EAC were significant with the expected signs. However, the OLS model is biased due to heteroscedasticity and endogeneity. Column 2 and 3 presents results from the gravity model estimated using the PPML estimator. The equation in column (3) was estimated with the PPML estimator, importer, exporter fixed effects and pair fixed effects to control for endogeneity. Results in column (3) showed that the EAC had a positive significant on services exports, **the formation of the EAC led to an average increase of 65 percent in EAC services exports among member countries.**

Table 1: Estimating the Effects of the EAC regional trade agreement on service trade

	(1)	(2)	(3)
	OLS	PPML(FE)	PPML(Endogeneity)
Log exporter GDP	0.529**		
	(0.045)		
Log importer GDP	0.571**		
	(0.045)		
Logdistance	-0.709**	-1.633**	-0.543**
	(0.126)	(0.284)	(0.043)
Common border	1.118**	-0.199	-0.091
	(0.257)	(0.295)	(0.166)
Common language	0.213**	0.411**	0.712**
	(0.076)	(0.103)	(0.140)
Colony	1.484**	1.345**	3.307**
	(0.385)	(0.108)	(0.185)
EAC	1.205**	1.288**	0.495*
	(0.186)	(0.305)	(0.255)
Constant	-13.651**	16.907**	8.081**
	(1.289)	(2.180)	(0.556)
Number of Observations	31730	32560	32560
Pair FE	No	No	Yes
Exporter FE	Yes	Yes	Yes
Importer FE	Yes	Yes	Yes
R-squared	0.789	0.908	0.934

* p<0.10	** p<.05	***p<.01

Source: Authors' calculations.

*Notes: All estimates are obtained using exporter and importer fixed effects. The estimates of the fixed effects are omitted for brevity.Column (1) applies the OLS estimator and column (2) uses the PPML estimator but does not control for endogeneity. Column (3) uses the PPML estimator and adds pair fixed effects to control for endogeneity. The estimates of the pair fixed effects are omitted for brevity. Standard errors are clustered by country pair and are reported in parentheses. The p-values read as follows: *p < 0.10; ** p < 0.05; and ***p < 0.01.*

5. Two Steps Forward, One Step Back? - Covid-19's Impact on Services Trade

Undoubtedly, the positive narrative espoused here about the role of services and services trade in regional growth and development has been dealt a blow by the Covid-19 crisis. Subsequent data confirmed this picture, with a global decline in services trade of -30 percent in the second quarter of 2020. Tourism was hit particularly hard, with international travellers' expenditure down 81 percent and transport down 31 percent. How the crisis will impact services trade over the long run is yet to be determined. These global impacts were of course reflected in services trade in Eastern Africa. The tourism sector has been worst affected of all sectors in East Africa. High frequency data on tourism-related sectors paint a grim picture, with dramatic reductions in tourism arrivals. For a region in which many countries are heavily dependent on tourism revenues, this is clearly a significant blow.

Conversely, some services are clearly benefiting from the crisis. This is particularly true of information technology services, demand for which has boomed as companies try to enable employees to work from home and people socialise remotely. For instance, the ICT sector in Rwanda expanded in the second quarter by 33%. To curb the spread of COVID-19, some Eastern African governments and mobile money providers moved to promote the use of digital payments. The National Bank of Rwanda removed charges and raised the cap for mobile money payments and transfers for three months from mid-March 2020.[8] The immediate result was a 400% increase on the weekly number and value of person-to-person transfers (Carboni & Bester, 2020).[9]Other countries also recorded an increase in the value of mobile money transactions, such as Tanzania, where 1Q 2020 transactions valued 19% more than 1Q 2019.

During the Covid-19 crisis, the transition to remote work and home-based entertainment for many Eastern Africans was often curtailed by the very nature of their work, and more

[8] The impact was monitored by the telecommunications regulator, Rwanda Utilities Regulatory Authority and researchers insight2impact.

[9] Interestingly, there appears to be some gender impacts of the policy - the proportion of female senders increased from 31% prior to the lockdown to 36%.

importantly, by the limited access to reliable and affordable internet connections. Internet penetration rates are relatively low in the region, and frequent internet users often depend on work-based connections for much of their internet consumption. Nonetheless, preliminary evidence does indeed suggest that internet use rose. In Kenya, the most internet-penetrated country in Eastern Africa, data usage on the Safaricom network surged by 70% in the month after the first reported COVID-19 case (Reuters, 2020). Liquid Telecom's fortunate timing in being the first to connect fibre internet in South Sudan in early 2020 led to a 10% month-on-month growth in internet traffic during the pandemic.

To sum up, the Covid-19 crisis comes at a time when, because of the ongoing AfCFTA negotiations, countries were already re-evaluating service sector strategies. It is clear that assuming a 'business as usual' approach is not going to be viable. For instance, in light of the collapse of foreign and conference tourism, there is a certain need to reconsider the long-term implications of an excessive dependence on international visitors. In line with the spirit of the AfCFTA, an increased reliance on national and regional tourism may provide an appropriate response. Similarly, it is evident that the Covid-19 crisis is going to accelerate the digital transformation of the region (World Bank, 2020). Eastern Africa was already a leader in some technologies, such as digital money (M-Pesa). But to maintain that momentum, there will need to make the necessary investments in human capital: the highly skilled and specialised nature of work in many service sectors poses challenges to generate an appropriate labour force for 'modern' services (such as finance, ICTs, tourism and real estate). (Berhuria and Goodfellow, 2019).

6. The AfCFTA Protocol on Services – A Step-Change in the Regional Integration Agenda

Since the late 1990s, more trade liberalization in services has been manifested through regional trade agreements than through the WTO's General Agreement on Trade in Services (GATS) (Mattoo et al, 2019). It is worth noting that many Eastern African countries have inscribed the GATS through their membership of WTO (Burundi, DRC, Djibouti, Kenya, Madagascar, Rwanda, Seychelles, Tanzania and Uganda). However, there are significant differences in their schemes of commitments within GATS which in effect exposes each country to a different degree of multilateral openness. Furthermore, a number of countries in Eastern Africa do not endorse the GATS because of being non-members or observers of WTO (Comoros, Ethiopia, Eritrea, Somalia and South Sudan).

Member states of the East African Community (EAC) are probably the countries in the region that have taken service trade liberalisation furthest, though adopting a positive list approach to GATS, i.e., identifying selected service subsectors for liberalization across all supply modes in varying degrees. However, different countries in the block have committed to different number of sectors among which, Rwanda is the most liberalized, having committed to opening 101 service subsectors, primarily in the Business, ICT, and Transport spaces.

Because of their inherent nature, services require sector-based regulatory frameworks. For the negotiation of new regulatory frameworks for continental integration, the existence of EAC, COMESA and SADC is an advantage because their current regulatory frameworks can be used as a basis for further strengthening, harmonization and expansion to Eastern Africa and beyond to the rest of the continent. This can be termed as a 'low hanging fruit approach' whereby instead of starting from scratch, the RECs build on their current institutions (Hartzenberg, 2020).

It is also important to remember that the AfCFTA's scope is not limited to free trade in goods and services, but also covers free movement of professionals and investment which has close significance to Mode 3 (commercial presence, particularly FDI) and Mode 4 (movement of natural persons) of trade in services. Thus greater harmonisation is needed for *Mutual Recognition Agreements* (MRAs), competition laws, intellectual property rights etc.

Developing strong MRAs is imperative for culminating AfCFTA into a common market through enabling the flow of professional services and investment across the continent. Looking back, members of the East African Community (EAC) were the earliest in the region to negotiate MRAs, starting with accounting services in 2011. Subsequently, the concept of MRAs spilled over to SADC and COMESA since all EAC countries overlap with either one of these blocs. EAC has signed additional MRAs (architectural services in 2011, engineering services in 2012; and veterinary services in 2016) and have ongoing negotiations for legal and health services.

Another important aspect for negotiation of regional integration in services is *competition law* which predominantly affects mode 3 of services trade. For this aspect also the region has previous experience to draw from. Nineteen years ago, while liberalizing their air transport sector, EAC-COMESA-SADC realized the need for harmonized competition law. Multiple joint stake-holders meetings ensued, reviewing the competition regulations and finally in September 2002 the Ministers for Transport at a meeting in Pretoria adopted common regulation for competition of air transport services in EAC-COMESA-SADC. This shows that the region already has some grounding on unification of competition regulation to enhance productivity, competitiveness and consumer protection in the service sector.

Finally, *intellectual property rights* are yet to be separately acknowledged for services in any of the current regional blocks. Hence it is important that the AfCFTA prioritizes this as a separate topic. In line with the *low hanging fruit* approach, they may also draw from the already established intellectual property frameworks in different countries (Hartzenberg, 2020).

7. Conclusions and Policy Highlights

Beyond the spur to greater intra-regional FDI in services, this report has highlighted the potential of greater service sector trade under the AfCFTA. In stark contrast with its merchandise trade performance, a number of regional economies already enjoy positive trade balances in services. And that service sector trade is highly dynamic: our own econometric estimates show that the formation of EAC membership on intra-regional trade in services will be 65% over a short time frame, hinting at the enormous possibilities that are to arise from greater continental integration under the AfCFTA.

This relatively strong performance in services reflects a number of unique characteristics of the sub-region, including the possession of some high-performing centres of higher education, a well-qualified returnee diaspora and the region's ability to innovate in search for solutions to constraints on the ground. Thus, for example, Eastern Africa has taken a lead in mobile banking simply because of the manifest deficiencies of the traditional banking system.

Despite these relative strengths, by global standards the service sector in Eastern Africa is still relatively undeveloped and in need of injections of more capital, technology transfer and managerial expertise. In this report, we argue strongly that deficiencies can at least in part be addressed by attracting more intra-African investment. Greater FDI in services is contingent on the free movement of professionals across the continent, and this will be contingent on reaching *Mutual Recognition Agreements*. More will need to be done in the educational sphere too - the highly skilled and specialized nature of much work in the service sectors poses challenges in creating the requisite forms and quality of labour. This will require a greater investment in both TVET and in tertiary education.

The effectiveness of more open service sector policies is heavily contingent on the right national regulatory frameworks being in place. Without this, the opening up of the service sector to greater intra-African investment is unlikely to yield the desired results. But there will also be a continued role of state-owned enterprises (SOEs) in the provision of some services. One example is Ethiopian Airlines, which in 2019 ranked as the top airline in Africa – and is likely to be the only airline which posts a profit in 2020, despite the disruption caused by the Covid-19 crisis. It thus finally boils down to appropriate regulatory measures needed to ensure competitiveness (or 'contestability') in the provision of services, regardless of ownership.

Finally, as the date of the coming into force of the AfCFTA approaches rapidly, a new issue to take into account is the Covid-19 pandemic. Covid-19 has negatively impacted the services sector in the Eastern African region, as reflected in the slump in service sector GDP in the second quarter of 2020. The future direction is yet to be seen as the pandemic unfolds, but its impact on services trade is likely to be profound. If social distancing persists, because of the necessity of physical proximity between consumers and suppliers, it will be particularly disadvantageous for services transacted via- Mode 2, 3 and 4 (Shingal, 2020). Investments which seemed at one point lucrative (e.g. in tourism sectors targeting international visitors) may no longer be viable. Going into the negotiations, member states should pay heed to this and alter their existing strategies accordingly.